RESEARCH CORNER

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<u>OBSERVATIONS</u>: *US economy working on all cylinders; Chinese economy sputtering.*

- Markets continued to trade down amid a three-week slide—with the S&P down -2.1% and small caps (Russell 2000 index) down -3.4%. The yield on the 10-year US Treasury increased to 4.26% and briefly closed above 4.27% last Thursday—this is the highest closing yield on a US 10-year Treasury since Dec-2007.[1]
- Retail sales surprised strongly to the upside, gaining +0.7% month-over-month (MoM) in July—against consensus expectations of +0.4%—and retail sales excluding autos and gas (volatile components) was +1.0% MoM, more than double consensus expectations, and June's retail sales figures were revised up as well.[1]
- Industrial production also exceeded expectations reversing two months of MoM declines and gained 1.0% MoM in July. Industrial production was up across all three major components—manufacturing +0.5% MoM, mining +0.5% MoM, and utilities +5.4% MoM—and capacity utilization moved higher in July as well to 79.3%.[1]
- New housing starts increased in July moving up to 1.452 million (annualized rate), which is up +3.9% over June's figure. New housing building permits were flat (+0.1% MoM) in July.[1]
- In contrast to the strong numbers emanating from the US economy, China missed in July on a slew of economic data points. China's retail sales fell to +2.5% year-over-year (YoY) in July from June's +3.1% YoY figure, while fixed asset investment fell to +1.2% YoY from June's +3.4% figure—both of these figures were weaker than expectations. Industrial production also softened and came in below expectations at +3.7% YoY on the back of weaker export growth, which fell -14.5% YoY in July.[2]
- In response to weak economic data, the Chinese central bank announced surprise cuts lowering the 1-year interest rate by -15 basis-points (bps) to 2.50% and the 7-day reverse repo-rate by -10bps to 1.8%.[2]

<u>EXPECTATIONS:</u> *Fed minutes reinforce data dependency, Russia forced to hike rates.*

- The minutes from the last Fed meeting showed that most Fed Governors were uncertain as to the cumulative impact that higher rates and tighter lending conditions would have on future economic activity, hiring, and inflation, and felt that further Fed action should be dependent on forthcoming economic data.[1]
- Russia's central bank announced a surprise rate hike last week of +350bps raising its main policy rate to 12.0% in effort to stabilize the Russian Ruble, which has fallen about -30% against the US dollar this year and breached the 100 Ruble to $1.00 threshold—the Ruble has not been this weak against the dollar since just after the invasion of Ukraine.[1] The Kremlin is also considering further currency controls on exporters making sales in foreign currencies that they hold overseas to convert the funds to Rubles within 90-days.[3]

<u>ONE MORE THOUGHT</u>: *China property sector woes deepen, the consequences far reaching.*[2]

The Chinese economy is experiencing a soft patch—see Observations above. At the root of much of China's problems is the deleveraging that is going on in the real estate sector. For the better part of the past decade, China has navigated the global business cycle by stimulating its economy during times of sluggish global growth by goosing its property sector. By lowering rates and urging state-owned banks to lend freely, China's property developers levered up, bought land from regional governments—most of China's undeveloped land belonged to the provincial governments—and built new housing. Chinese citizens, unable to invest their money outside of China, put their extra cash into real estate. The scheme worked for most of the past fifteen years; real estate prices rose, and real estate investments became about two-thirds of the average Chinese household net wealth (see Chart of the Week). However, in the post-Covid world, Beijing determined that the leverage in the real estate sector had

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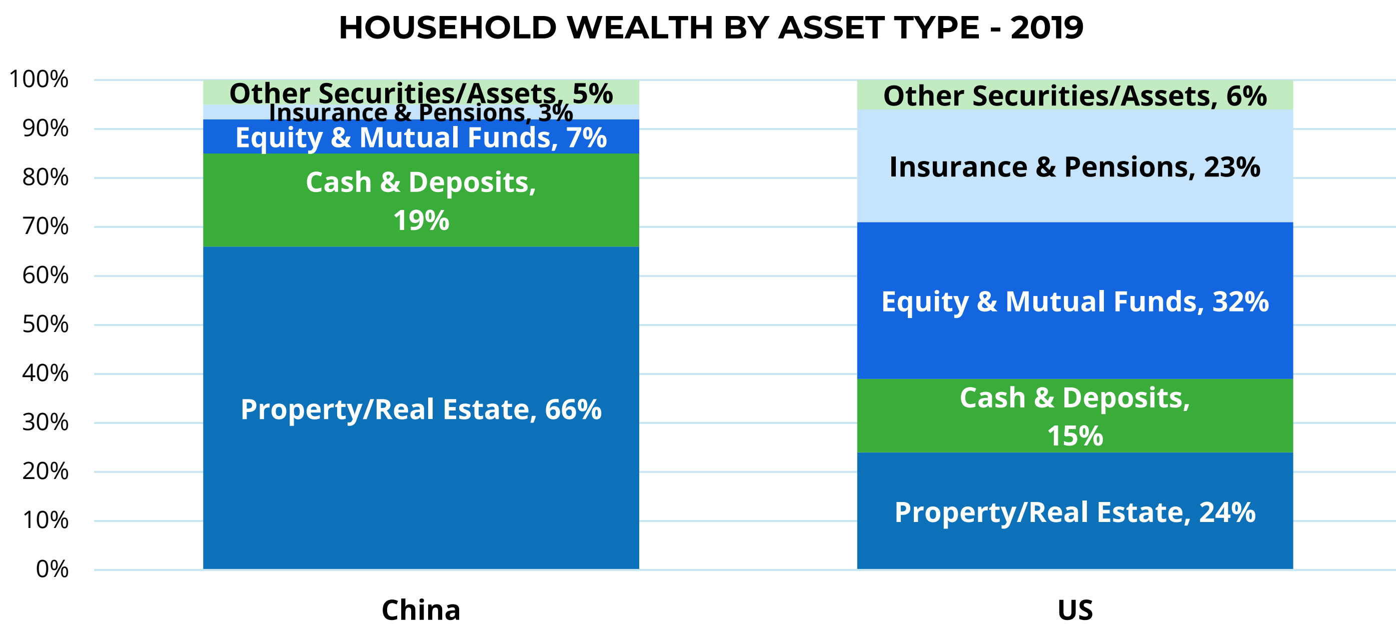
[1] *Bloomberg LP*
[2] *Goldman Sachs "China: July activity data broadly missed (low) expectations; PBOC cut rates" 8/15/2023*
[3] *FT "Vladimir Putin to hold meeting on Russian currency controls after rouble slide" 8/16/2023*

become too great. In an effort to reign in lending for the largest property developers, they have popped a real estate bubble that is now dragging down consumer consumption and forcing Beijing to spread bad-loans across a wide swath of its financial system. Last week, Country Garden, China's third largest property developer, missed payments on two bonds triggering a 30-day grace period before a formal default. Last year, China's second-largest property developer, Evergrande, became insolvent, restructured over $350 billion in debt, and recently filed for bankruptcy. As property developers curtailed activity, real estate prices declined across China, which has created a corresponding negative wealth effect prompting everyday Chinese to save more and spend less as their primary asset diminishes in value. On top of this, Beijing's draconian Covid lockdowns, attempts to regulate the tech sector, and compel its largest firms to allocate a more significant share of their profits to "common prosperity" (higher wages and taxes) has put a damper on entrepreneurial activity and business investment. The net result is a "balance-sheet" type recession where both households and businesses are reluctant to borrow and spend (invest) regardless of the level of interest rates. Beijing recently responded by announcing a 31-point plan to reinvigorate the economy, but unfortunately restoring consumer and business confidence and right-sizing the property market is likely to need years not months or quarters.

CHART OF THE WEEK



Source: Clearstead, JPMorgan, Goldman Sachs Aug-2023

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