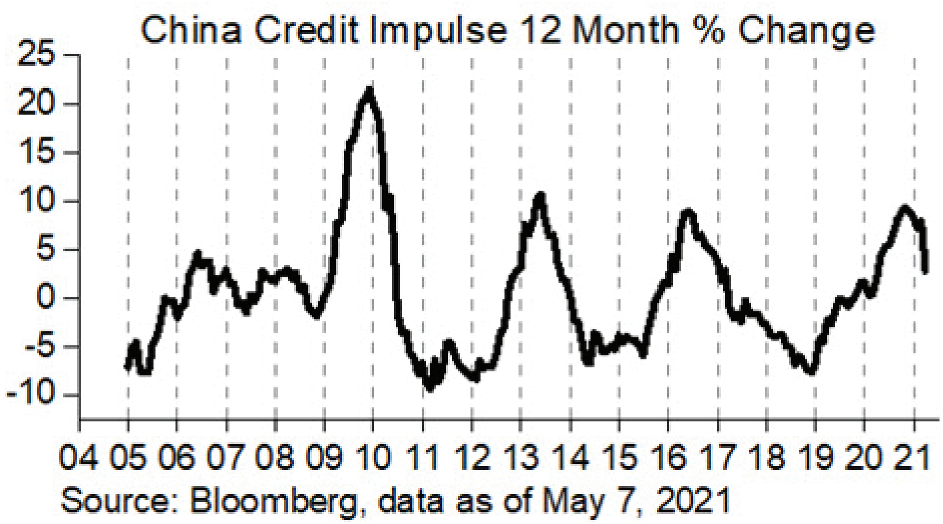
Thackray Report

China Credit Impulse Indicating Economic Slowdown?

May 17, 2021 Written by Brooke Thackray

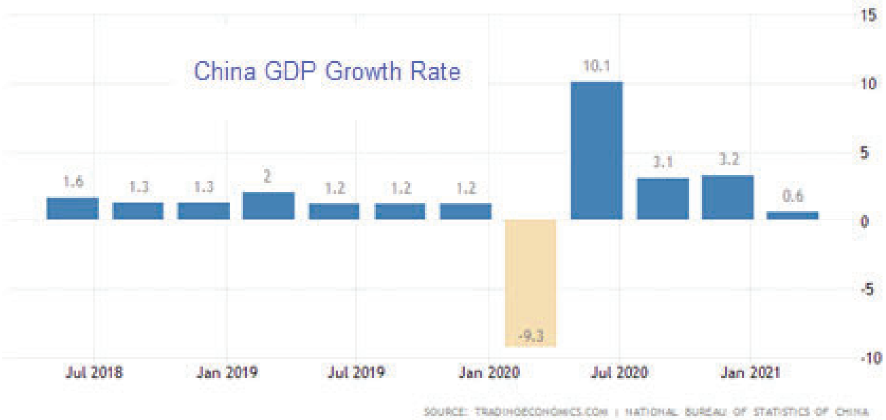
The global economy is re-opening and economic growth has been accelerating, but according to the China Credit Impulse, this could all be on borrowed time.

In my May newsletter, I outlined how China has been deliberately withdrawing support from its economy since late 2020. Yes, you heard that right. China has taken opposite approach of the western governments, who have continued to pump more money and credit into the economy. In late 2020, China "told" its banks to reduce the amount of credit in the system, reducing China's Credit Impulse, which is defined as the growth rate of credit, as a percentage of GDP. The Chinese government is playing the long-term game and acting in a fiduciary responsible manner, wanting to control the amount of debt that it takes on. A novel idea (sarcasm), but it has been working.

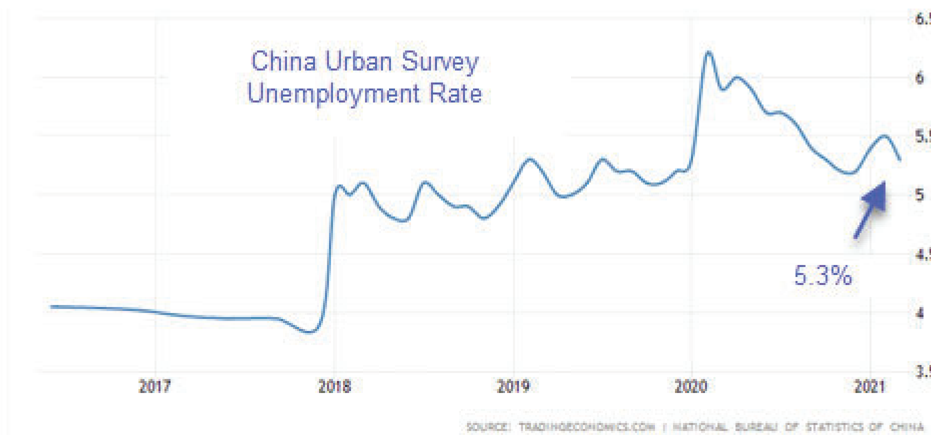


The above graph shows that during the Great Financial Crisis (GFC), China waited until late in the crisis before dramatically increasing credit in the system. China continued its credit expansion program for most of 2009 and dramatically reduced it when the economy was performing well. Fast forward to 2019, on an absolute level China's Credit Impulse started to rise off a low level and when the COVID-19 pandemic unfolded credit expansion continued to increase by approximately the same rate as it had been since the beginning of 2019. There was not a "hockey stick" graph or "moon shot" of China dramatically accelerating its credit during the COVID-19 pandemic, China just carried on with its normal credit expansion for most of 2020. In late 2020, China decided to start reducing credit in the system and has continued to reduce credit in 2021 as the economy has stabilized.

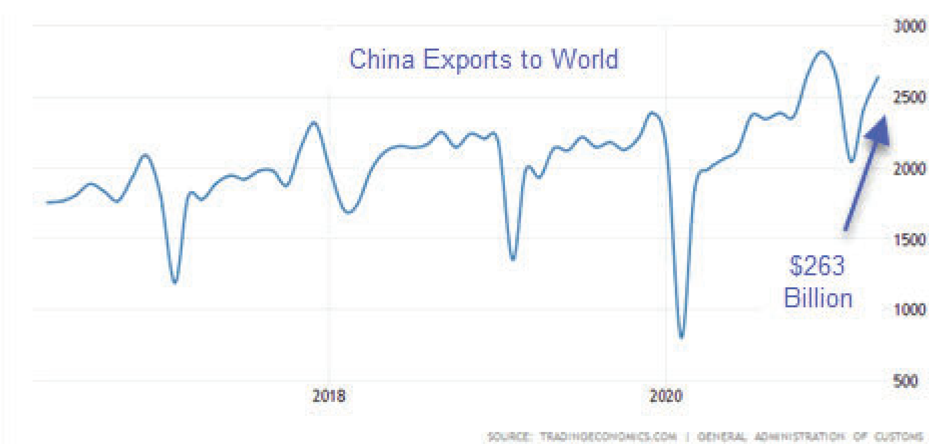
China's economy has largely recovered from the COVID-19 pandemic. After dropping sharply at the beginning of the COVID-19 pandemic, China's GDP quickly jumped higher and has since stabilized. I know that some readers are going to point to the fact that China is an authoritarian state and has more flexibility in getting people back to work. I am not going to enter into a political discussion in this report, but rather focus on the facts. The graph below shows a sharp GDP decline in Q1 2020 and a fast recovery in Q2, followed by fairly high growth for the rest of 2020.



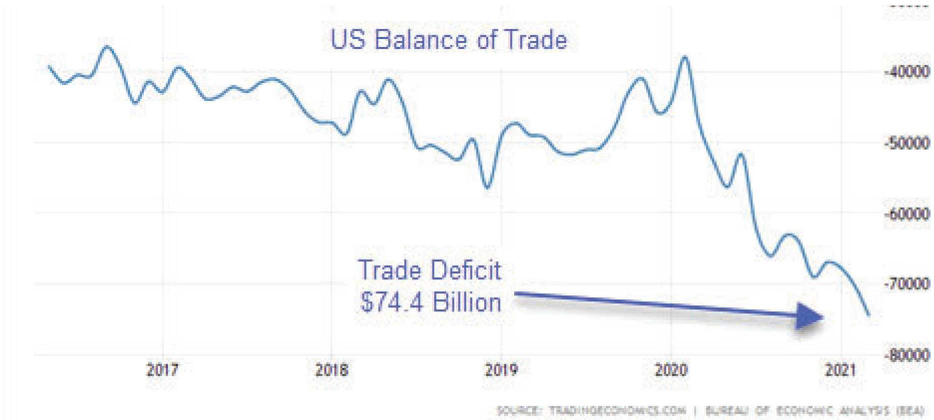
It is not just the GDP growth rate that has normalized, but China's unemployment rate has moved back to levels slightly above the pre-COVID-19 pandemic, 5.3%.



The US has "rammed" excess money into their economy, creating a unique situation where unemployment has increased at the same time the total income in the system has increased. Retail sales have skyrocketed in recent months as people have spent their "stimmi" checks. A lot of the money spent has flowed out of the country and into China. The graph below shows China's exports to the world. After falling sharply in early 2020, exports have increased and quickly surpassed pre COVID-19 levels.

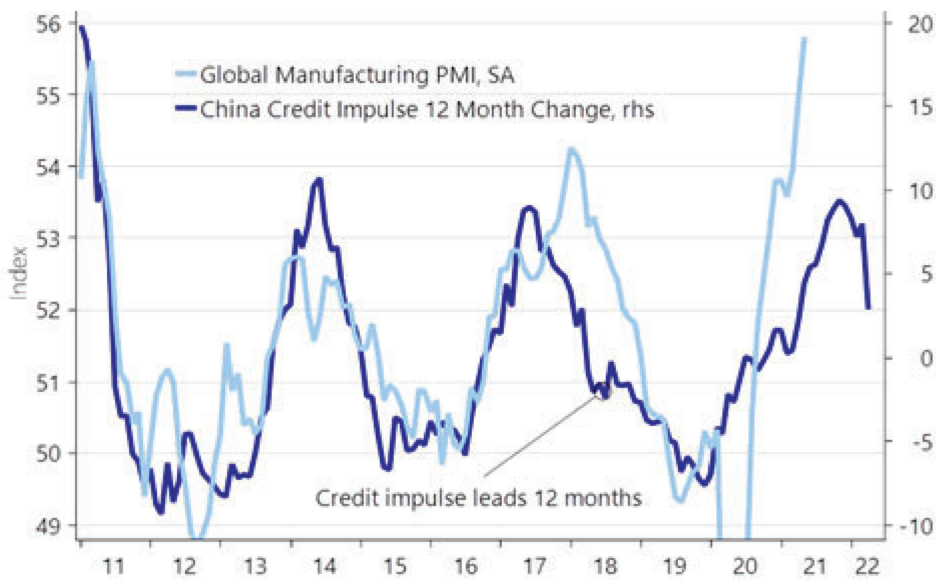


The graph below shows the US trade deficit and it is easy to see where a lot of the "stimmi" checks are going, out of the country and mainly to China.



So, what does all this add up to? The US and other western countries have been overstimulating their economies, which has increased the demand for Chinese goods, which has meant that China has not needed to provide excess stimulation to their economy.

China has not joined the "helicopter money" parade during the COVID-19 pandemic, the economic expansion that is taking place in the West may not last long. China is a major growth engine of the world and when it moderates its growth levels, the rest of the world feels the effects. The graph below from Nordea shows the relationship between China's Credit Impulse and Global PMI. The graph illustrates that there is a twelve month lag between the reduction of China's credit impulse and turn down of the global PMI. In other words, there is a time delay. China's credit impulse has already turned lower. If it continues,, it is probably only a matter of time before global manufacturing slows.



In the past when China was expanding rapidly and the government was taking aggressive action to try control the economic cycle, the world counted on China to help them out. A fast growing Chinese economy demanded huge amounts of raw materials, which helped provide a ballast for slowing global growth. Times are different. China has stated publicly many times that it is not after the high growth rates that it achieved in the early 2000's but is looking for slower growth that is more sustainable. The US and other countries can continue to "print money" in order to try and stimulate their economies, but it is clear that they should not rely on China's help to grow their economies

The US government seems to be announcing a new $2 trillion dollar stimulus package every month or so, but the positive effects on the economy and markets keeps diminishing. The law of diminishing returns is defined roughly as the more you do something, each time produces less of an output. The law of diminishing returns applies to government stimulus packages. It is going to be very difficult for governments and central banks to "print" their way to sustained growth.

On a seasonal basis, on average, the stock market tends to fade in the summer months. Of course there are exceptions, but if China's reduction in credit coincides with the stock market turning lower on its own accord, the reduction in credit could act as a catalyst for even lower markets. Although the graph showing the relationship between the Global PMI and China's Credit Impulse is offset by twelve months, indicating a possibility of a turn down in global PMI later this year, there is nothing from stopping the effect from starting early. The direction of the China Credit Impulse heading lower, indicates that the stock market could be on borrowed time.