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MACROCOSM

# It Can Happen There (China)

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**Donald Luskin**

**China's M2 contracted a year ago, and now there's deflation. Is that why US stocks are falling?**

From the highs on July 27, as of this writing the S&P 500 has corrected more than 5% – but judging from client conversations, it feels worse. That's not unusual considering the atmosphere of triumphalism that has developed over the last couple months.

- Inflation continues to evaporate (see "Data Insights: CPI/PPI" August 10, 2023).
- Yet no landing in sight. According to the minutes of the July FOMC, surveys showed that "the probability of avoiding a recession through 2024 grew noticeably," and the Fed "staff no longer judged that the economy would enter a mild recession toward the end of the year" (see "Data Insights: FOMC Minutes" August 16, 2023).
- Most important, the July high-water mark for equities was a 19-year low for the S&P 500 risk premium,  (making the US the least attractively valued equity market in the world – please see the chart below, and "Data Insights: Global Equity Risk Premium" August 7, 2023).

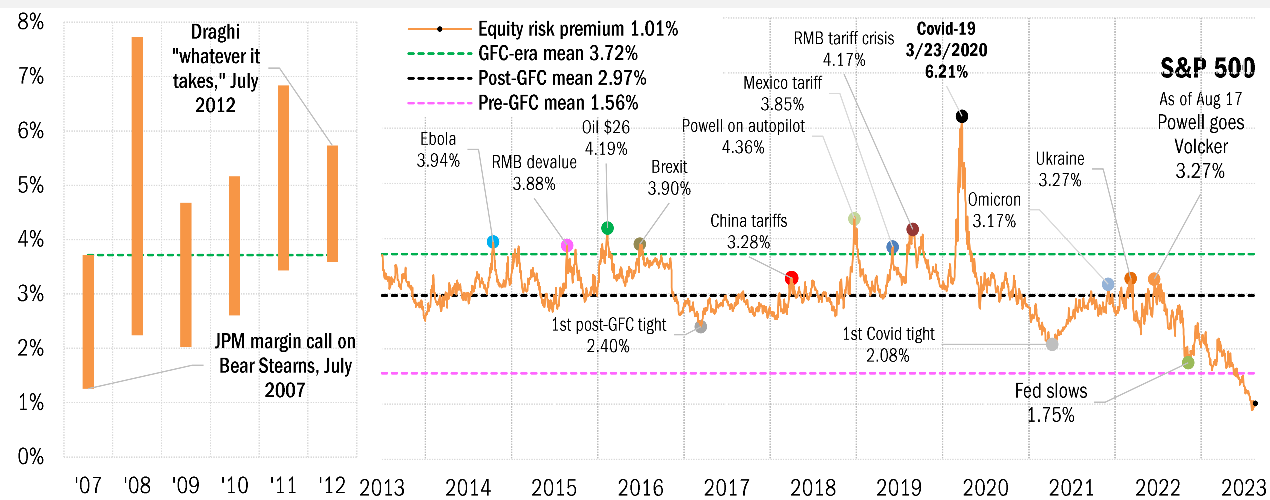
*Is this the "intense correction" we forecasted would follow a blow-off top* (see "Mid-Year Outlook: Our Unloved Bull Market in Equities" July 5,

**Update to strategic view**

**US STOCKS, US MACRO, ASIA MACRO:** US stocks are in an alarming correction from a low equity risk premium not seen since 2004, as mortgage rates make new highs and China's housing woes compound. But forward earnings upgrades are accelerating and estimates of Q3 GDP are almost 6%. This could be just a pre-Jackson Hole tantrum to keep Powell from taking out an insurance policy against inflation with one more hike. Or this might be the "intense correction" we…

*[Continued on next page]*

S&P 500 equity risk premium: forward earnings-yield minus 30-yr Treasury




Source: Bloomberg, TrendMacro calculations

2023)? Maybe. Indeed, it seems like everything is going wrong at once.

- China's housing ecosystem continues to degrade.
- US mortgage yields have moved to a new cycle high.
- The US banking system continues to grow loans and leases at a pace seemingly insufficient to fuel expansion, or for that matter to rebalance its asset portfolio and heal wide-spread net interest margin issues (see "Data Insights: High-Frequency Post-Virus Recovery Monitor" August 17, 2023).
- And *please* permit us a political observation – it's not confidence-inspiring to see the party in power subvert the 2024 election by prosecuting the opposition party as racketeers for inquiring as to whether the 2020 election had been subverted, indeed by making the same claims the party in power had made when it claimed the

*[Continued from first page]*

…have been expecting as markets recognize the arrival of outright CPI deflation. The catalyst could be China's July CPI print at negative 0.20% year on year, following its money supply contraction last year. With US M2 in contraction, if it can happen there it can happen here.

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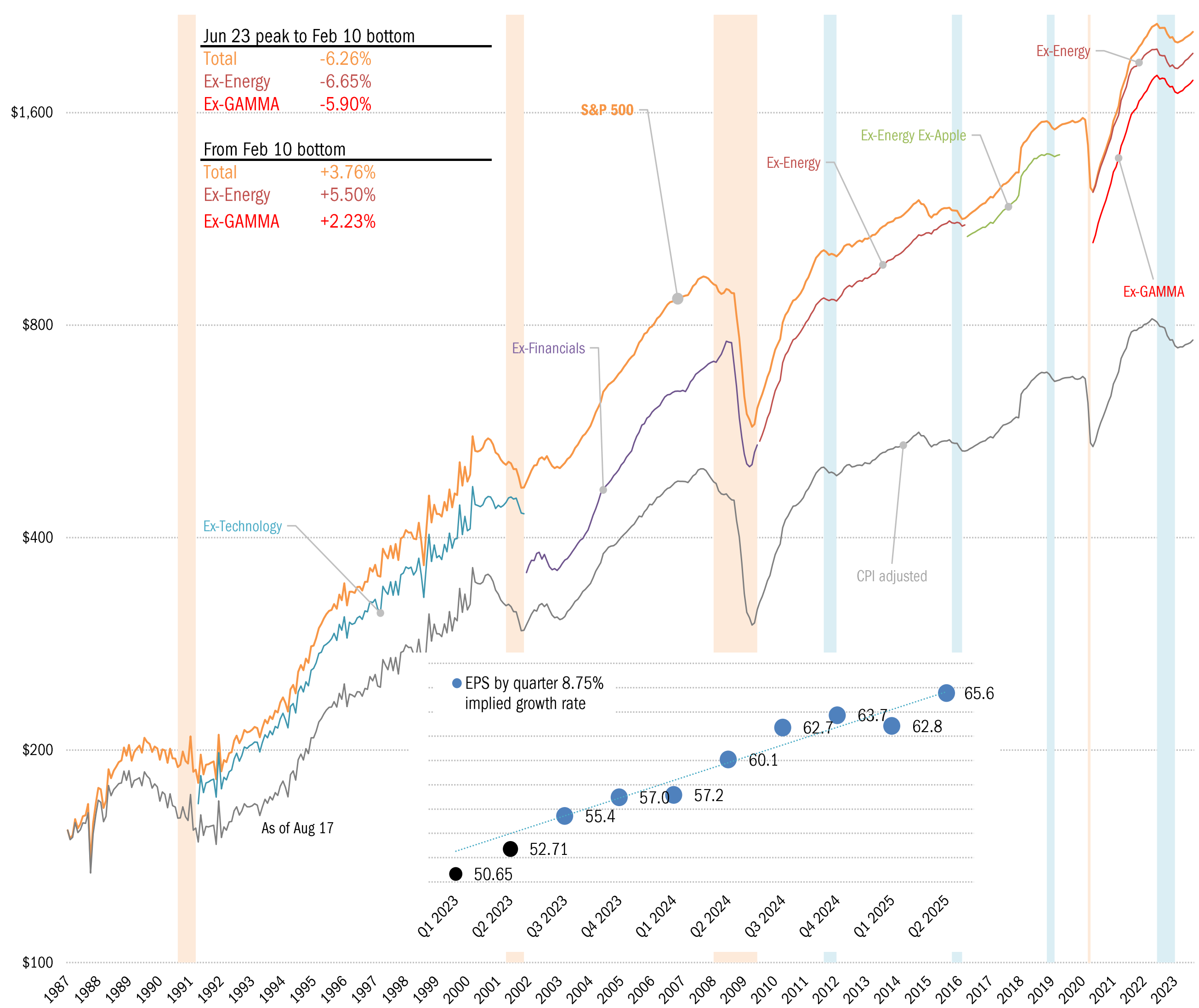
**S&P 500 forward earnings (USD billions, log scale)  Recession: Official  Undocumented**




Source: Various, TrendMacro calculations

2000 and 2016 elections were subverted. [Even the left-leaning celebrated appellate attorney Allan Dershowitz is appalled] (he is now moving America up to an alarming 4 bananas on his Banana Republic Meter).

- But one tends to look at such headlines with a certain degree of pessimistic confirmation bias when one is three weeks into an uninterrupted slide lower in equities. More data-grounded telemetry is actually quite promising, such as the [Atlanta Fed's GDPNow] which projects that Q3-2023 real GDP is coming in at a rather astonishing 5.8%, at an annual rate.
- And our favorite indicator of growth expectations, bottom-up consensus 365-day forward earnings for the S&P 500, has been consistently rising since its February 10 bottom, and is now accelerating. Overall estimates are up 3.76% in just over six months. Take out the tiny energy sector and it's 5.50%. And you can take out the "GAMMA" stocks (Google, Amazon, Meta, Microsoft and Apple) and it's still 2.23% (please see the chart on the previous page).

***Probably the simplest explanation for this correction is that it's just the usual tantrum ahead of Fed Chair Jerome Powell's tone-setting Jackson Hole speech next Friday. Mr. Market wants to be sure that the relaxation of fears of imminent recession doesn't give Powell the license to take out an insurance policy against an inflation resurgence by hiking rates one more time – when the Fed now openly admits that they are "restrictive" already***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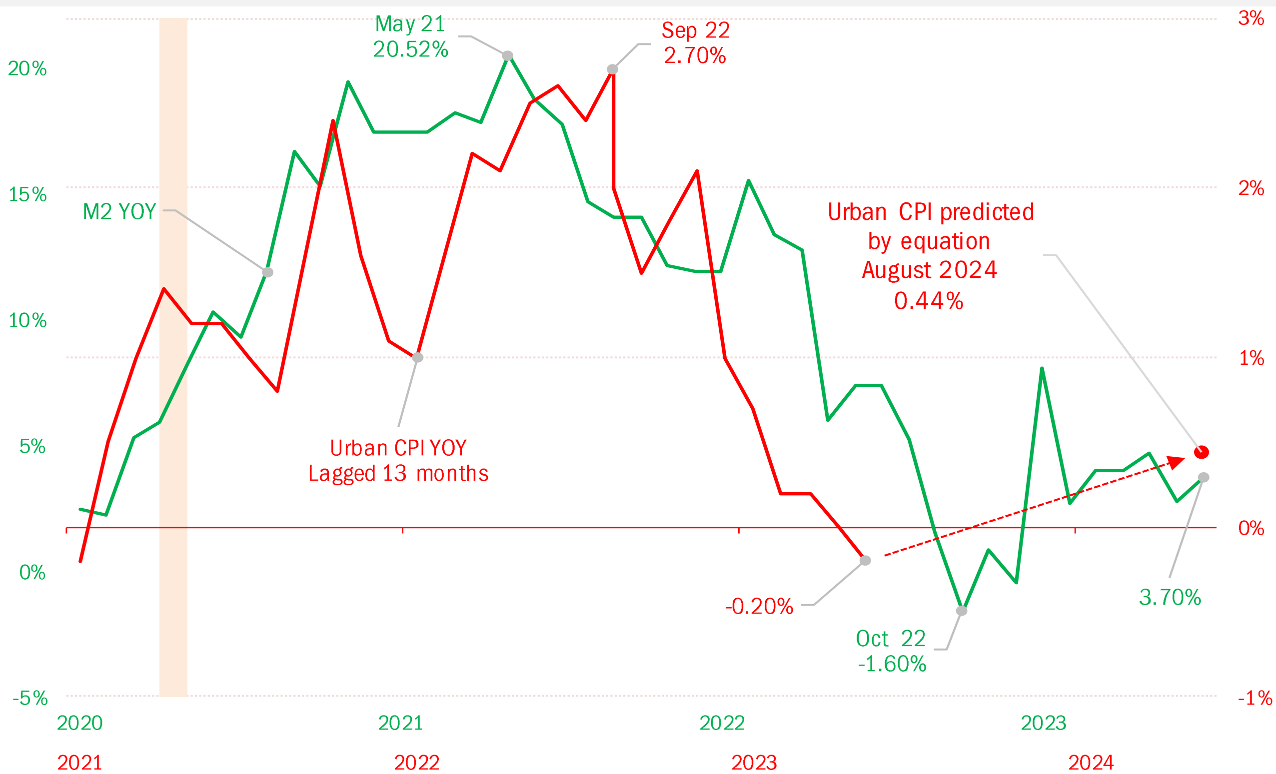
China Urban Consumer Price Index and M2 money supply (year-over-year) Recession




Source: Bloomberg, TrendMacro calculations (again, see “Data Insights: FOMC Minutes”) – or even to signal that with no more hikes these “restrictive” levels will persist across a long plateau (see “On July CPI: So What will Powell Find to Hate About It?” August 10, 2023). Indeed, over the last several days, the money-market curve has moved out its expectations for the first rate cut from next year’s March FOMC all the way to June as of yesterday, and May as of this writing.

*But what haunts us about this correction* – and maybe this is just our own confirmation bias at play – *is news out of China. It is the data release last week showing that China is experiencing outright deflation in its consumer price index – negative 0.20% year-on-year for July* (please see the chart on the previous page).

- No, it’s not China’s real-estate problems that have created this outright deflation. Nor is it China’s record-high youth unemployment rate (well, we think it’s record high – it was last month, but suddenly they don’t publish it anymore).
- They do still publish a consumer price index and an M2 money supply. And just as in the US, just as “everywhere and always” according to Milton Friedman, it is the latter that explains the former (again please see the chart on the previous page, and among many, “Why Inflation Is on the Way Down” July 25, 2022).
- Like everywhere else, China’s money supply growth accelerated dramatically in the aftermath of the 2020 Covid lockdowns. As everywhere, inflation followed (although China and Japan experienced less of an inflation surge than western nations did). China’s money supply went into outright contraction a year ago – at worst, at a 1.6% rate year-on-year – and now with the usual lag, China’s CPI is in year-on-year deflation. Everywhere and always.
- China’s money supply is now back in expansion, so its deflation will be shallow and brief. The US money supply fell further, as much as 4.45% year-on-year two months ago. So the US deflation will likely be deeper and longer lasting.
- We had forecasted that the trigger for the “intense correction” would be a sudden awareness that the US is falling into deflation, and a panic that the Fed had done its inflation-fighting job too well and that the deflation will only deepen because of the lagged effects of what the Fed has already done (see, among others, “Video: What you’re not hearing about the coming deflation” June 23, 2023). We’d thought the specific trigger might be the public capitulation of some sticky-inflationista like Larry Summers. That would be sweet karma.
- *But maybe it’s China*. More than two decades ago then-Fed governor Ben Bernanke gave a landmark speech at the New York Economics Club about the special and pernicious risks of deflation, called “Making Sure ‘It’ Doesn't Happen Here.”
- With the sudden shock of a large inflation incident last year – after four decades in which nobody had to really worry about it very much – deflation is the last thing anyone thinks can “happen here.”
- Which means if it does “happen here” it will be quite a shock.

- But it can “happen there,” in China. And all the causal conditions are the same as here. Our money supply is in contraction. So it can “happen here,” too.
- Is that what this correction is about? If so, then it’s the beginning of the “intense correction” we were expecting a little later. We don’t think it is… but… We can’t rule that out.

**Bottom line**

US stocks are in an alarming correction from a low equity risk premium not seen since 2004, as mortgage rates make new highs and China’s housing woes compound. But forward earnings upgrades are accelerating and estimates of Q3 GDP are almost 6%. This could be just a pre-Jackson Hole tantrum to keep Powell from taking out an insurance policy against inflation with one more hike. Or this might be the “intense correction” we have been expecting as markets recognize the arrival of outright CPI deflation. The catalyst could be China’s July CPI print at negative 0.20% year on year, following its money supply contraction last year. With US M2 in contraction, if it can happen there it can happen here.