THOUGHTS FROM THE FRONTLINE

Slow Change Speeds Up

By John Mauldin | January 21, 2023

Chinese Bounce
Maximum Xi
Settlement Fight
Other China Thoughts
Russia: The Black Queen is Loose
Dallas and Home Alone

The world's leading CEOs, politicians, and various do-gooders were in Davos, Switzerland, this week, discussing ways to solve our collective problems and create opportunities for their own companies. The most important conversations were off the record and many of the public speeches were simply performance art. (Sadly, I wasn't invited even though I have a few thoughts they should hear.)

While that particular gathering could use more balance, such discussions are still important. We can't fully understand the economic outlook, whether for large corporations or individual investors, without considering the global forces that affect it.

Those forces aren't simply economic, either. Political, social, demographic, and other factors influence how nations trade and interact. Technology—and access to it—is incredibly important. The world runs on energy. We call this mixture "geopolitics," and it is hard to separate from economics.

We had a sharp reminder of this in 2022 when Russia's attack on Ukraine produced economic warfare alongside the kinetic one. The global economic outlook shifted almost overnight as governments responded in unexpected ways.

More often, though, the problem with geopolitics is that trends develop so *slowly*. They're plainly visible but easily missed against flashier, more immediate events. So, as we enter 2023, we need to review a few big-picture things that may prove important, maybe sooner than we think. Hint: They mostly involve China.

But first, I want to enlist your help in setting the agenda for the Strategic Investment Conference, which will again be virtual during the first two weeks of May this year. I've often found that my readers are some of the best sources. I am always amazed at their connections. The team at Mauldin Economics and I want to hear who you would like at the conference. Further, I would like your assistance in getting an introduction to them. In addition to your own ideas, I would love to have an introduction to Marc Andreessen, Matt Taibbi, and Sam Zell. We have a very quick, simple survey. Simply hit that link and let me know your thoughts. Thank you ever so much in advance.

Chinese Bounce

Most 2023 economic and market forecasts revolve around the Federal Reserve's efforts to fight inflation. Their policy choices are indeed important. However, inflation is a moving target. It responds to other forces. Events in China may be critically important this year.

China's aggressive "Zero COVID" strategy has been a major influence on the world economy since 2020. Looking back, it's a bit staggering how quickly Beijing responded. The outside world first learned about the mysterious flu-like illness hitting Wuhan in late December 2019. By mid-January 2020, China had shut down internal movement, confined millions to their homes, and was hastily constructing hospitals and quarantine camps. Their lockdowns were truly draconian, literally shutting down much of the economy.

This created a "path-dependent" situation. Leaders can't impose such harsh, sudden change and then say, "Oops, never mind." The policy risked social stability, but backing down from it was a risk, too.

So, Zero COVID continued with effects far outside China. It had a lot to do with the supply-chain slowdowns and interruptions that produced inflation elsewhere. China was the world's growth engine for well over a decade. Then it wasn't.

Then, in late 2022, Xi Jinping seems to have decided Zero COVID had outlived its usefulness. The reasons aren't entirely clear. Some think it was a response to anti-lockdown protests. I suppose that's possible, but I suspect the protests were a convenient cover for something Xi wanted to do anyway. Maybe he decided it was better to get the pain over with and move on.

Now the pain is happening; the virus is spreading unimpeded through a population with little immunity. It's difficult to know from the outside how bad conditions are, but some of the stories are horrific (36,000 deaths a day from some sources, with others being more or somewhat less. Every private estimate I've seen is significantly higher than official reports). But eventually, it will end. Then what?

Economically, the key is when and how much Chinese consumption will rebound. This matters globally because restored consumer spending will likely boost China's energy and commodity imports—maybe enough to drive prices considerably higher.

The Gavekal Dragonomics team watches all this closely, and they think the recovery is near. This is from their January 17th report.

> "The overarching question now is how quickly the economy will rebound as the current wave of infections passes.
>
> "High-frequency indicators suggest the recovery has already started: travel and mobility are bouncing back as the Chinese New Year approaches, driven by pent-up demand from people unable to visit families over the past two years due to Covid controls. Still, things have not yet fully returned to normal.
>
> "Passenger numbers by air and rail rebounded to 70% and 84% of 2019 levels, respectively, as of January 16. Private road transportation is even stronger: traffic congestion indexes in 100 major cities are now back at 2019 levels, and passenger car flows on highways are 16% higher, probably because some travelers are avoiding public transportation to minimize the risk of infection.
>
> "Other consumer activities may take longer to experience a robust rebound; our surveys suggest many consumers are still worried about new Covid strains such as XBB.1.5, and households may take time to shift back to normal spending patterns, especially after low-income growth last year. Box-office receipts, for instance, are climbing but still have reached only around 30% of pre-pandemic levels.
>
> "Property sales will also take a bit longer to rebound. Transactions are typically low during the Chinese New Year holiday and homebuyer concerns about financially troubled developers remain, though policymakers continue to ramp up support for the sector, which should boost the market in time.
>
> "The base case is for consumption to rebound meaningfully in January and February, though it may not return to pre-pandemic levels until late Q1 or early Q2—that will depend in part on the spread of XBB.1.5. Still, the high-frequency data provide a bit more optimism about the rebound to come."

If Gavekal is right, then by mid-year, we should start to see more Chinese resource demand. How much? Well, compare it to the US in 2021. Pent-up demand and stimulus money produced a giant economic bounce. China could have something similar and possibly stronger, given how normal activity was even more suppressed there.

You could also compare it to the post-2008 period when Beijing sought to sustain growth with massive infrastructure projects, ghost cities, and so on. This time, it may happen more naturally rather than by central orders.

In either case, this could help sustain inflation around the globe as restored Chinese demand raises energy and raw materials prices. But it might not be entirely inflationary. The US housing boom may slow further if Chinese construction activity makes building materials more expensive.

How all that evolves will be a key factor in Fed policy this year. I suspect it will support the "higher for longer" forecasts, but we'll see.

Maximum Xi

Ian Bremmer's Eurasia Group issues a "Top Risks" report each January. China is high on his list, too, and COVID is only part of it. Ian says Xi Jinping's successful concentration of power in his own hands is overriding more pragmatic voices in the bureaucracy and creating policy rigidity.

From the Eurasia report…

> "Now that all Chinese policy flows directly from a single all-powerful leader, there's even less transparency on the decision-making process, less information flowing to the top, and less room to admit error, course correct, or compromise…
>
> "Xi's drive for state control will produce arbitrary decisions and policy volatility. China's economy is in a fragile state after two years of harsh Covid-19 controls. Forced deleveraging efforts and plummeting homebuyer and market sentiment have ground growth in the critical real estate sector to a halt, depleting local government revenue. Debt defaults threaten to spread to the broader financial sector. It has long been the case that more global GDP growth was coming from a politically riskier market as China's economic footprint expanded. But in 2023, China's outlook is even more important, given the rising risks of recession elsewhere.
>
> "This backdrop—of weakening global growth and deepening domestic challenges—demands competent economic management from Beijing. But the Chinese leadership is delivering opacity and unpredictability. China's sudden decision to delay the release of long-scheduled economic data during the 20th Party Congress was an ominous sign of things to come for global markets. At a minimum, heightened market and company sensitivity to the singular voice of Xi will invite volatility in response to any signals he conveys, resulting in a repricing of credit risks that in turn drives debt defaults and bankruptcies. Beijing will struggle to manage these pressures in an environment of centralized power and stifled debate."

Watching from the West, Chinese decisions have long been mysterious, but we assumed there was some kind of plan. We also expected Beijing to move slowly as leaders sought to build consensus at the top. It's not clear if we can expect this from Xi. The speed with which he swung away from Zero COVID shocked many China watchers, who simply couldn't believe what they were seeing. Yet it was real, raising the question of what *else* could change with equally little warning. We don't know, and that's a problem.

This new opacity, combined with increased Chinese saber-rattling, might raise concerns about a Taiwan crisis. Ian Bremmer thinks this is unlikely in 2023. Both the US and China have too many other challenges a military conflict would only make worse. The two governments want to reduce their interdependence and will keep working to do so, but for now, their economies are too entangled to risk confrontation. He thinks Xi will remain focused on "peaceful reunification" with China at some unspecified future date.

Settlement Fight

World trade isn't just about goods and services. Capital flows are equally—and sometimes more—important. The US has long had the privilege of paying for everything in our own currency. Our persistent trade deficits mean we import goods and export dollars.

China has long wanted to change this situation. It also has new reasons, having seen the US weaponize its financial dominance against Russia this year. That kind of vulnerability is intolerable if you want to call your country a world power.

It is probably not a coincidence Xi Jinping used one of his rare overseas trips to visit Saudi Arabia last month. And he went there representing not just China but also a number of other countries with similar goals.

Simon Hunt described events in his letter.

> "What emerged from this meeting was a fully-fledged strategic partnership covering, trade investment, energy and security.
>
> "As Xi reportedly said, 'Under the current situation, to convene the first Arab China-Arab States Summit and the first China-Gulf Cooperation Council (GCC) Summit is of special significance and will play a strategic role in spearheading China-Arab relations and China GCC relations in the next stage. China looks forward to working with Saudi Arabia and Arab States to turn the two summits into milestone events in the history of China-Arab relations and China-GCC relations and bring these relations to new heights.'
>
> "Later Xi in his speech to GCC, he said, 'First setting up a new paradigm of all dimensional cooperation. China will continue to import large quantities of crude oil on a long-term basis from GCC countries and purchase more LNG. We will strengthen our cooperation in the upstream sector, engineering services as well as storage, transportation and refinery of oil and gas. The Shanghai Petroleum and Natural Gas Exchange Platform will be fully utilized for RMB settlement in oil and gas trade.'
>
> "MBS noted that Saudi Arabia and China have very close and friendly relations and Saudi Arabia is China's comprehensive strategic partner in the Middle East. Saudi Arabia looks forward to working with China to enhance mutual support and jointly elevate their comprehensive strategic partnership to a higher level."

The key phrase there is "RMB settlement" of China's oil and gas purchases. China wants to pay for its imports with renminbi, and the Saudis seem willing to take it.

Simon thinks Xi and the Arabs are forging a new strategic alliance against the US. They want to end the "petrodollar" arrangement and associated American dominance. That would affect more than just energy; it would inevitably lead to other kinds of trade settling in non-dollar currencies, too.

I can believe that's the goal. Whether it's a *feasible* goal is a different question.

Suppose the Saudis start taking RMB in exchange for oil. Now they have Chinese money in the bank. What can they do with it? They can use the RMB to buy Chinese goods and services, but that has limits if the Saudis run a trade surplus with China, as they will if the relationship grows.

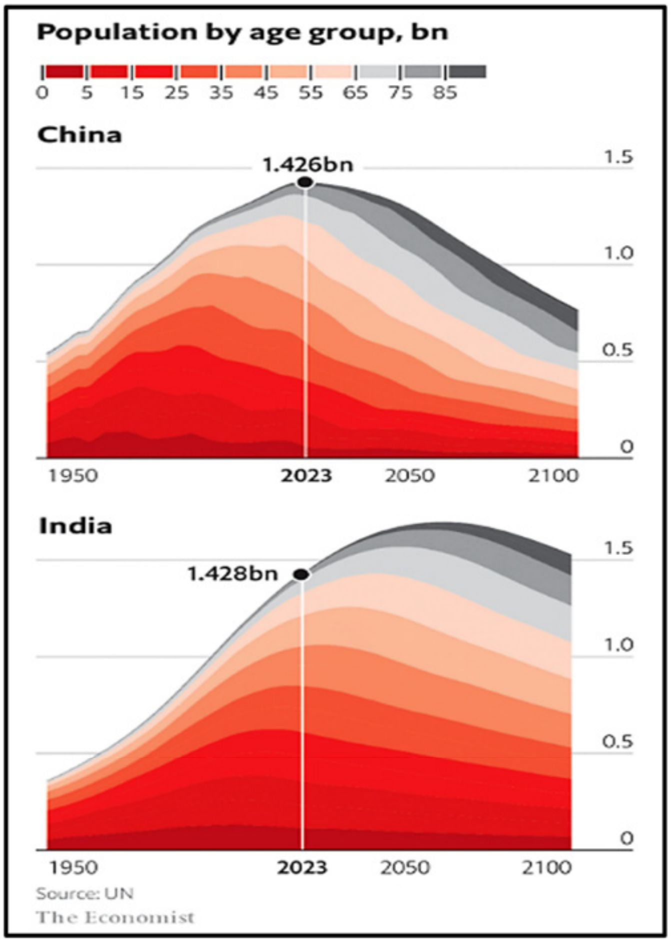
The Saudis could also use their Chinese-currency oil revenue to purchase Chinese assets: real estate, stocks, entire companies. But, as many US businesses have discovered, Beijing puts a lot of strings on foreign investment.

Meanwhile, China would still be earning a lot of dollars for its exports to the US. What does it do with them if it's not buying oil? The amounts are gargantuan. Right now, they're able to invest in US Treasury securities at relatively attractive yields, using the most liquid markets in the world.

As noted above, both the US and China would like to be less co-dependent. But change will be a very slow process.

Other China Thoughts

India will become the country with the world's largest population this year. Chinese population will continue to contract even as India's population increases. In the middle of this century, when India's population begins to contract, it will do so at a much lower rate than China will.



Source: [Clips That Matter]

This is important, not just for bragging rights. GDP is calculated by the number of workers times the level of their productivity. China is losing workers in the optimal age range. India's will climb until 2062, at least.

But all is not lost. There are ways to make more with fewer people, which humanity has done since the advent of the steam engine. China is countering with robots (which are increasingly important all over the world and becoming ever more adaptable). This from Simon Hunt.

China's population has peaked with a mainland population of 1.412 billion last year but this was no surprise. China has been preparing for a slowdown in the working population for many years by a strong focus on technology. For instance, the annual installation of industrial robots has risen from 69,000 in 2015 to 300,000 last year as follows:

Annual Installation of Industrial Robots
000's Units

2015	2016	2017	2018	2019	2020	2021	2022
69	97	156	154	140	168	243	300

Rather than total population it's those in the working age (18-60) and the increasing number of retirees which are more important.

Millions

	2010	2020	2022	2025	2030	2040
Working Age	689.9	745.6	742.2	722.9	673.6	624.5
Retirees	207.4	275.0	290.5	321.5	382.3	448.5

Source: Dr Clint Laurent, Global Demographics

Source: Simon Hunt

Japan grew rich before it grew old. China will grow old before it gets rich. That being said, China has made remarkable progress in pulling its population out of poverty over the last 40 years. No other country has come close. Still, there are roughly 80 million Chinese living on roughly $2/day and another few 100 million living not far above that. Maximum Xi appears focused on that, as traditionally, it is the source of unrest.

Officially, China grew at 3% last year. Simply using nominal GDP and inflation, that growth falls into the 1% range, which is more realistic. And while they may not bounce back to 6% growth, even 4%–5% growth from their current level of GDP is relatively monstrous. It will create enormous demands on the rest of the world for all sorts of products and services.

Thought experiment: China's economy is roughly in line with US economy. How bullish would it be for the world if the US grew at 5%?

Russia: The Black Queen is Loose

In chess, an unfettered Queen can cause chaos. I think Russia can be thought of as the Black Queen, loose on the board, with multiple options and no one really knowing the next move.

The Russian economy is clearly shrinking, though not as much as many expected, and Russians still seem to overwhelmingly support Putin. A large push this spring into Ukraine seems likely.

What is not clear is how Ukraine will defend itself. The Germans are actually asking the US and Britain for permission to supply Ukraine with its very advanced Leopard tanks. Supposedly the US is seriously considering giving Bradley armored vehicles to the Ukrainians. The Russians are installing their best anti-air missile systems in Moscow in preparation for what?

This is a wild card for global growth. The World Bank recently downgraded its 2023 global growth estimate to under 3%, down from 6% in 2019. An end to what I believe will be a global recession coupled with a resolution to the Ukraine/Russia conflict could be a massive boost to global growth and markets. It will certainly increase demand in commodities and energy.

In closing, western central banks (including Japan's) are in a tightening mode, which will slow growth globally. China and much of Asia don't have that policy backdrop. A return to Asia's pre-COVID growth rates could increase energy demand by several million barrels of oil a day and, of course, commodities of all stripes. A major hiccup in Russia could create further problems, but that is not my base case.

While not sanguine about the global geopolitical situation, my base case is relative improvement, Or at least the status quo maintained on many fronts and the potential for a generally positive year geopolitically. Again, the concern is the Russia/Ukraine conflict.

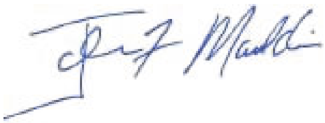
Dallas and Home Alone

Shane is in Colorado for a retreat, so I am home alone. I will also be flying to Dallas to shoot a series of videos with my partners in the oil business I will shortly be announcing. I am very excited about this project. In one way, the partial rationale for my bullish views on energy is amusing. The world is trying to suppress the supply of fossil fuels, even as demand grows. Can we in the developed world expect the billions of people living in energy poverty or the leaders of those countries to need less energy? Supply growing slower than demand? What could possibly go wrong?

Shane and I had a wonderful dinner with Jared and Caroline Dillian last week. More personal than heavy economic discussions, although Jared and I did have a few of those moments.

It is time to hit the send button. Please think about giving me some ideas about the conference up above. You have a great week. And I don't want to jinx them, but how about them Cowboys? And don't forget to follow me on Twitter.

Your seeing a lot of volatility in our future analyst,



John Mauldin
subscribers@mauldineconomics.com

http://www.mauldineconomics.com/members

Thoughts from the Frontline is a free weekly economic e-letter by best-selling author and renowned financial expert, John Mauldin. You can learn more and get your free subscription by visiting www.MauldinEconomics.com.

To subscribe to John Mauldin's Mauldin Economics e-letter, please click here: http://www.mauldineconomics.com/subscribe

To change your email address, please click here: http://www.mauldineconomics.com/change-address