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SUMMARY

- China's economy remains mired in deflation.
- China's high levels of debt and housing slump are concerning.
- We view China as an unattractive investment.

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China: The Sun Continues to Set in the East

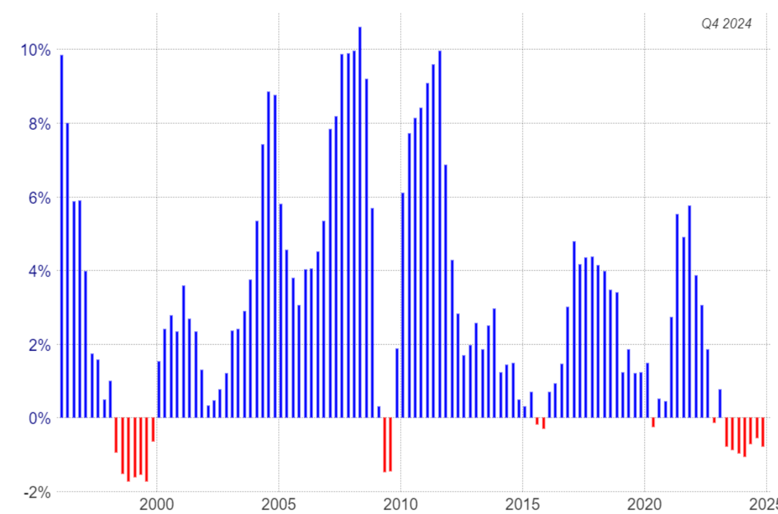
China's Slide into a Debt-Deflation Spiral

Much of the world's news flow last week focused on the inauguration of President Trump. While his 'Day One' policies made headlines, announcements on tariffs were conspicuously absent. We have discussed previously how tariff policy, if enacted, may affect inflation expectations, Fed policy and markets. We will refrain from further opining until we have more concrete policies to analyze.

Instead, this week we turn our gaze east towards China, the world's second-largest economy behind the US. In contrast to the US economy's robust growth and dynamism, China now stands as a cautionary tale of structural decline, in our view. In August 2023, we published a *Strategic View* entitled "China: Is the Sun Setting in the East?", where we concluded that China was a country whose economic fortunes were fading due to both cyclical and structural issues, and that investors were better off investing in the US.

Chart 1: China Deflation Becoming Entrenched

GDP Deflator: Nominal minus Real GDP Growth



Source: LSEG Datastream, RiverFront. Data monthly as of December 2024. Chart shown for illustrative purposes only. Past performance is no indication of future results.

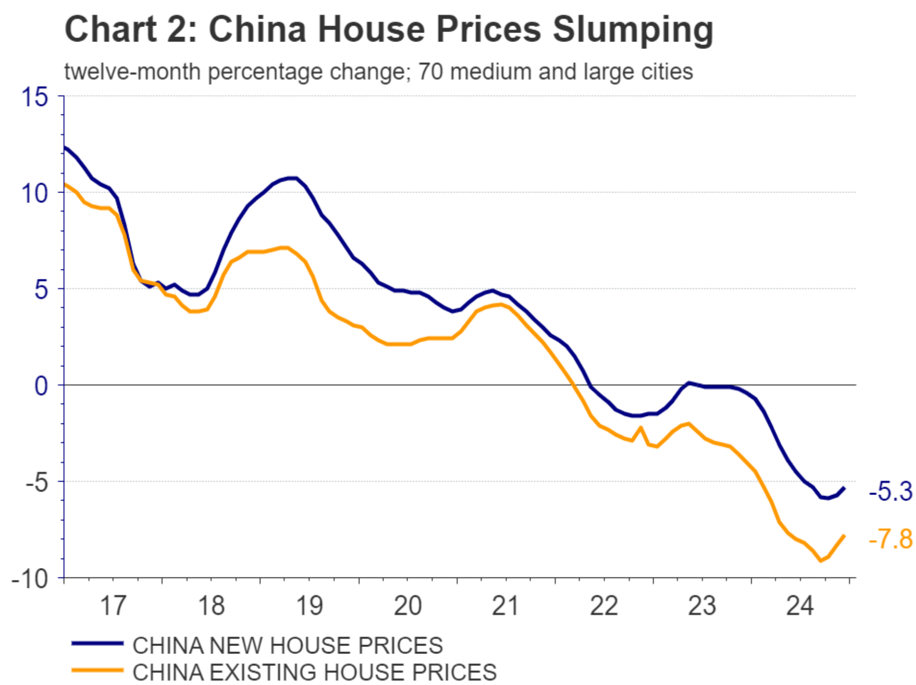
More than a year later, our conclusion remains the same – that China is not an attractive investment for US investors. In the succeeding sixteen months Chinese stocks have continued to underperform global peers, as the country has only become more externally opaque and internally unstable, in our view. Not surprisingly, foreign direct investment (FDI) in China – representing foreign ownership stakes of Chinese companies or projects - is now shrinking at approximately -27% year over year in local currency terms. While we addressed the deteriorating geopolitical relationship between the US and China in the last piece, today we focus more on China's precarious internal economics.

China Increasingly Mired in Deflation

At first glance, China's economy is showing some signs of life; recent surveys conducted by China's National Bureau of Statistics (NBS) suggest manufacturing and services activity have stabilized at moderately expansionary levels. However, inflation trends suggest a different story. In Chart 1 (above), the difference between 'nominal' and 'real' (adjusted for inflation) GDP growth – also known as the GDP deflator – has now been negative for 7th straight quarters. This is China's longest price slump since the 'Asian Contagion' of the late 1990s, before China first became a trade heavyweight by entering into the World

Trade Organization (WTO) in 2001. This slump suggests to us that China is continuing its' descent into entrenched deflation. A private quote attributed to President Xi Jinping addressing his inner circle, as reported in December by the *Wall Street Journal*, suggests China's leader is not concerned: *"What's so bad about deflation? Don't people like it when things are cheaper?"*

If credible, this quote demonstrates to us a profound lack of understanding – or at least appreciation – among Chinese Communist Party officials of how serious a problem deflation can be when accompanied by declining nominal growth. Just ask Japan, who in the 1980s rose to become the world's second largest economy before stagnating into three decades of deflationary malaise and irrelevance– a fate that could potentially await China.



Source: LSEG Datastream, RiverFront. Data monthly as of December 2024. Chart shown for illustrative purposes only. Past performance is no indication of future results.

To be clear, *disinflation* (a slowdown in the rate of price inflation) tends to be positive for an economy and for its consumers. However, an entrenched bout of *deflation*, particularly if it is driven by a lack of demand following the bursting of a debt bubble, can be devastatingly self-reinforcing. In a deflationary mindset, consumers and businesses constantly put off spending and investing for growth and efficiency, which causes a perpetual vicious cycle of underemployment and disinvestment. The Great Depression in the US, following the debt buildup and subsequent market collapse of the late 1920s, is one particularly acute example.

China's Debt Bubble Bursting in Slow-Motion

We believe a massive debt bubble in China is currently being slowly unwound, increasing the potential for an entrenched deflationary cycle. China optimists often quote official federal debt-to-GDP statistics that are lower than many Western nations. While technically 'true,' Chinese central government debt represents only a small fraction of the actual leverage that exists outside of federal channels, primarily in local government financing and through China's off-balance sheet 'shadow banking' system. While the opacity of China's financials system makes specific estimates difficult, estimates by Bloomberg, Statistics, the Federal Reserve and others have generally pegged China's total leverage in the system (counting households and non-financial corporates as well as government debt) at around 300% of GDP.

Chinese Consumer Hurt by Negative 'Wealth Effect' Due to Housing Slump

We have previously discussed in the past the demographic challenges China faces. At 1.4 billion people, their consumer base is still a massive, though shrinking economic force. Unfortunately, this consumer base is currently reeling from increasing joblessness among younger workers and a negative 'wealth effect' due to the bursting of the debt-fueled real estate bubble. House prices have been slumping for a while, and year-over-year changes turned negative a few years ago (see Chart 2, above).

According to the Wall Street Journal, Chinese consumers hold roughly 80% of their household savings in real estate, a much higher percentage than is held in cash, bonds, or stocks. To put this in perspective, the recent real estate slump has erased consumer savings roughly equivalent to China's entire yearly economic output. These residential real estate issues are also mirrored in commercial real estate, where numerous high-profile Chinese property developers have been forced to be 'taken under' by the government due to solvency issues. This is causing additional stress in the system at the local government level, as Chinese local municipalities are often reliant on land sales to fund budgets.

All of this adds up to a toxic economic brew for Chinese consumers, businesses, and local prefectures, in our view. Perhaps not surprisingly, dissident events in China have climbed 27% in the third quarter of 2024, according to Freedom House's Chinese Dissident Monitor data.

Conclusion – China Remains Unattractive for U.S. Investors

- Despite a recent rebound, the Chinese stock market remains in a relative downtrend to the US and developed markets- we expect this trend to continue.
- China's economic issues continue to 'export' deflation to the rest of the world – which, paradoxically, maybe aiding the Fed's fight against inflation. We do not believe China's struggles are a reason yet to be bearish on the U.S. market.
- US remains more tactically attractive than international, and particularly Chinese, stocks in our opinion. In our balanced asset allocation portfolios, RiverFront remains overweight U.S. stocks relative to our strategic asset allocation targets.

Risk Discussion: All investments in securities, including the strategies discussed above, include a risk of loss of principal (invested amount) and any profits that have not been realized. Markets fluctuate substantially over time, and have experienced increased volatility in recent years due to global and domestic economic events. Performance of any investment is not guaranteed. In a rising interest rate environment, the value of fixed-income securities generally declines. Diversification does not guarantee a profit or protect against a loss. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Please see the end of this publication for more disclosures.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.

Index Definitions:
Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period. As a broad measure of overall domestic production, it functions as a comprehensive scorecard of a given country's economic health.

The World Trade Organization (WTO) is a global organization that deals with the rules of trade between nations. It is made up of 164 member countries, and its goal is to ensure that trade flows as smoothly and predictably as possible.

Definitions:

The term foreign direct investment (FDI) refers to an ownership stake in a foreign company or project made by an investor, company, or government from another country. FDI is generally used to describe a business decision to acquire a substantial stake in a foreign business or to buy it outright to expand operations to a new region. The term is usually not used to describe a stock investment in a foreign company alone. FDI is a key element in international economic integration because it creates stable and long-lasting links between economies.

Inflation is a gradual loss of purchasing power, reflected in a broad rise in prices for goods and services over time.

Deflation is a general decline in prices for goods and services, typically associated with a contraction in the supply of money and credit in the economy. During deflation, the purchasing power of currency rises over time.

Disinflation is a temporary slowing of the pace of price inflation and is used to describe instances when the inflation rate has reduced marginally over the short term.

A recession is a significant, widespread, and prolonged downturn in economic activity. A common rule of thumb is that two consecutive quarters of negative gross domestic product (GDP) growth indicate a recession. However, more complex formulas are also used to determine recessions.

The shadow banking system describes financial intermediaries that participate in creating credit but are not subject to regulatory oversight.

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