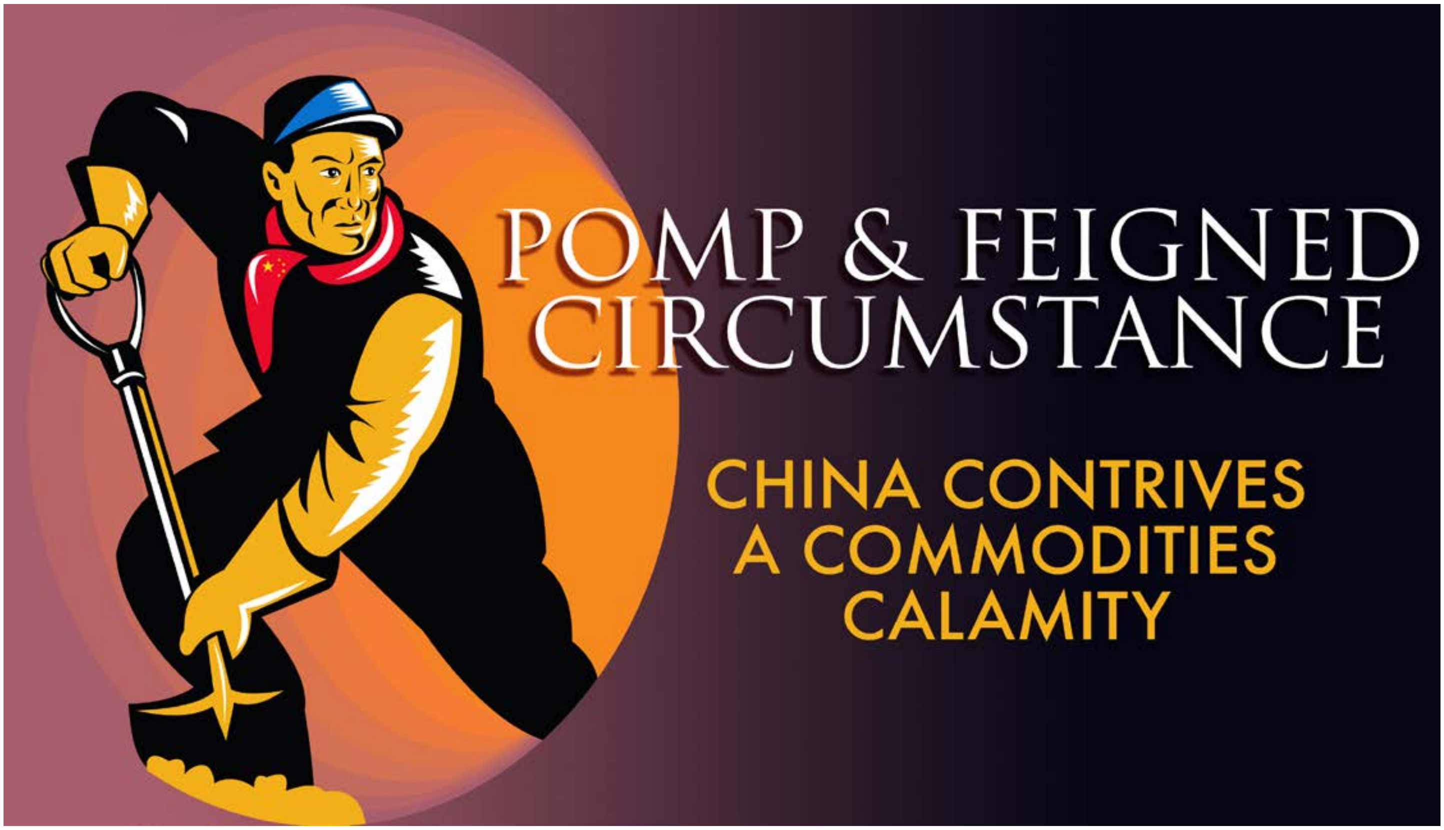


Pomp & Feigned Circumstance

China Contrives a Commodities Calamity

Sometimes miracles are sparse. At other times, they're ubiquitous in their abundance. The year 1924 was the latter. The location was Chamonix, France. The occasion was the Winter Sports Games. Such was the built-up acclaim that 10,004 paying spectators presented themselves with wallets open for the pure privilege of partaking of the ice-accented events. The money expended was well worth it.

Those early to arrive were not disappointed. American Charles Jewtraw claimed the first championship by winning the opening event in 500-meter speed skating. Alas, for us Yanks, Finland's Clas Thunberg, prevailed, claiming five medals, including three golds, in the five speed skating events on the docket.

But it wasn't individuals who inspired the International Olympic Committee (IOC) to shift from "sponsoring" to "sanctioning" – a critical distinction – as **official** the first Winter Olympics. Bear in mind, the first Summer Olympics were entered into the history books on April 6, 1896, and held, shockingly, in Athens. Ergo, the 28-year pause was notable. That said, French officials were no dolts after having hosted the 1900 Summer Olympics. A quarter of a century later, they were in a tight competition against Amsterdam, Barcelona, Los Angeles, Prague and Rome to host their second summer Olympics. But why not re-skin the cat and make official a winter event? They did just that with the success of the Winter Sports Games hosted. In 1925, the IOC amended its charter, establishing the Winter Games. Post-facto, the 1924 Chamonix games anointed the inaugural.

Hopefully, the saving grace of being the first was philosophically rewarding. The cost of hosting the games, at the time, was an estimated 10 million francs. Despite crowds that reached 60,000 per day, total receipts only amounted to 5.5 million francs. For the sake of the greater good to come, France took a huge bath. But there were theatrics and multiple miracles. The first Winter Olympics were a phenom. Some 258 athletes from 16 nations competed -- 245 were men and 13 were women. In the spirit of competitive consistency, the only sport open to women at the time was figure skating. We know that times have changed since then, but the biggest draw was…hockey. And here's where the miracle comes in.

Canada sent all of 12 athletes – 11 men and one woman. Nine of those men could skate like demons. Toronto's Granite Club members not only won all five of their matches; they outscored their opponents 110 to 3 (not a typo). The closest any team came was the United States in the gold-medal game, which Canada handily whipped with a score of 6-1. Harry Watson, the team's MVP, put up 37 goals. As fate would have it, Canada's low absolute man (and one woman)-power landed the country ninth overall in the medal count, a massively underwhelming finish for such a miraculous showing. There would be one more miracle to emerge from the games, but it wouldn't arrive for a half century.

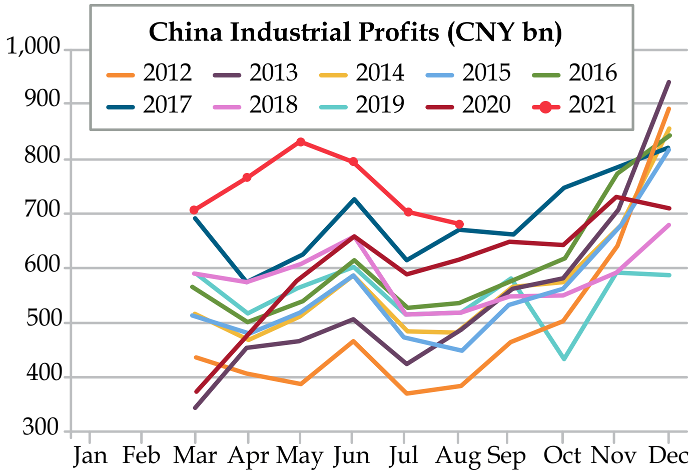
The first Winter Olympics ran from January 24th through February 5th, 1924. Some 98 years on, the Beijing Winter Olympics are set to commence February 4th, 2022. Nearly a century on, the Middle Kingdom is feverishly preparing to uphold the vision articulated by Pierre de Coubertain, founder of the modern Olympics in the 1920s, who said the "winter games have about them a certain purity."

The "energy crisis" being engineered in China should be no surprise to those looking in from the outside, as is always the case. In the spring of 2016, Zhao Kezhi, the provincial Communist Party chief, pronounced that China's northern province of Hebei -- one of the country's most polluted provinces and home to seven of its most noxious cities – would meet targets to host a clean 2022 Winter Olympics by cutting industrial overcapacity and coal consumption. To quote his vow from five years ago, "We must use the staging of the Winter Olympics as an opportunity to stimulate economic and social development, speed up our transformation and upgrading, expand effective investment and strengthen poverty alleviation." Specifically, Hebei was charged with cutting coal consumption by 40 million tons in the four years through 2017 and slash its 2013 levels of small particulate matter by almost half by 2020. For good measure, Hebei would also reduce its annual crude steel capacity to below 200 million tons by 2020.

Of course, these commitments were made in 2016, before a trade war that was followed by a pandemic many countries now believe was – intentionally or inadvertently – started in China. With that as preamble, there should be much less in the way of surprise or distress that China's Industrial Profits have disappointed. As you see in this first chart, said disappointment began years ago. That's by design.

An Intentional Deceleration in Industrial Profits

Even and especially in a controlled and contained economy, grand plans come with the risk of even grander obstacles. China's imposed directive to segue to a balanced economy, with growth inputs more evenly distributed between its mighty industrial and burgeoning consumer sectors, was never conceived by weak-minded proletariats. Rather, its leaders with an eye to global economic dominance knew that anything less than bold would never get them from Point A to Point B.

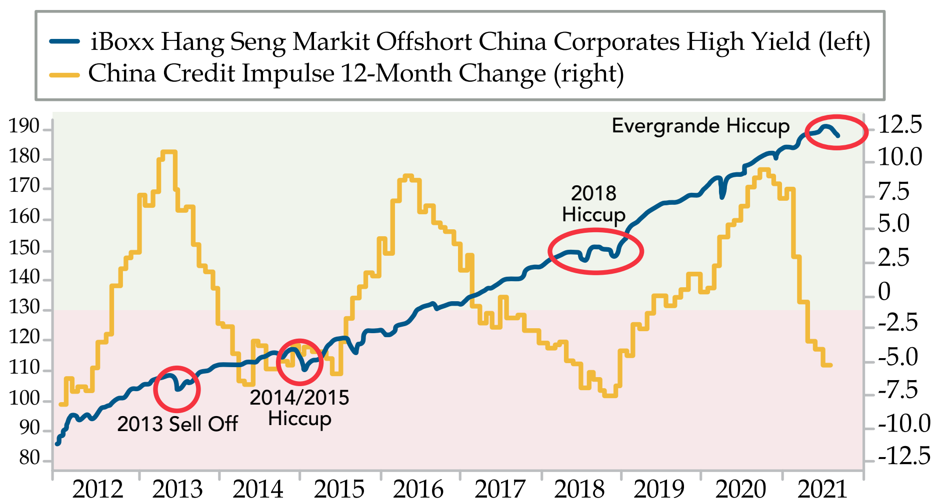


Source: The Daily Shot

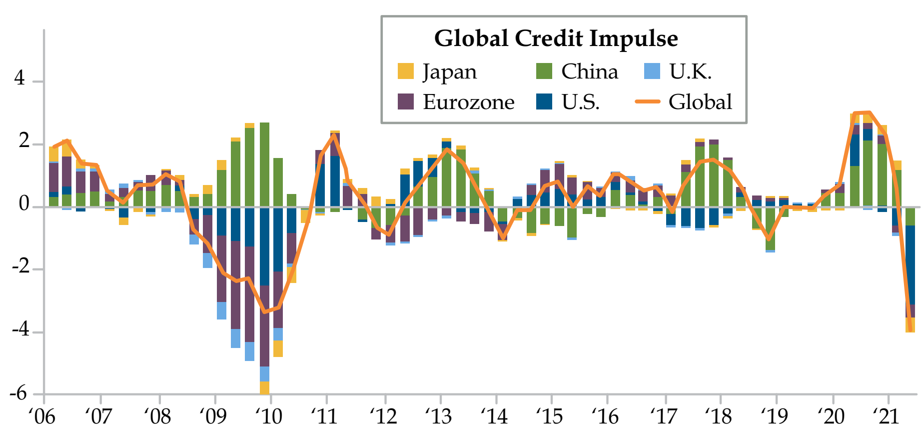
The "solution" to setbacks has always been to rev up manufacturing to offset inevitable moments of weakness in domestic consumption. Industry is, after all, what gave birth to dreaming the biggest economic dream. Drawing rural dwellers into urban centers to raise their earnings capacity was a means to that end. The tool to combat reversals in aggregate economic output is credit -- infuse factories, and by extension exports, with debt whenever growth slows to a sufficient extent to prevent official GDP goals from being met.

Past Episodes of Slowing Growth Have Induced Credit Infusions

You may note in the last two charts that the playbook appears to have changed of late. There's a reason for this that many are dawning to. It goes back to the futility of the best laid plans. Credit seeps into all corners of economies. In China's case, the property sector was on the receiving end of massive leverage. The wrinkle is that real estate speculation was fed to such an extent as to take on a life of its own.



Source: Nordea and Macrobond



Source: MMD. Calculations based on data from central banks.

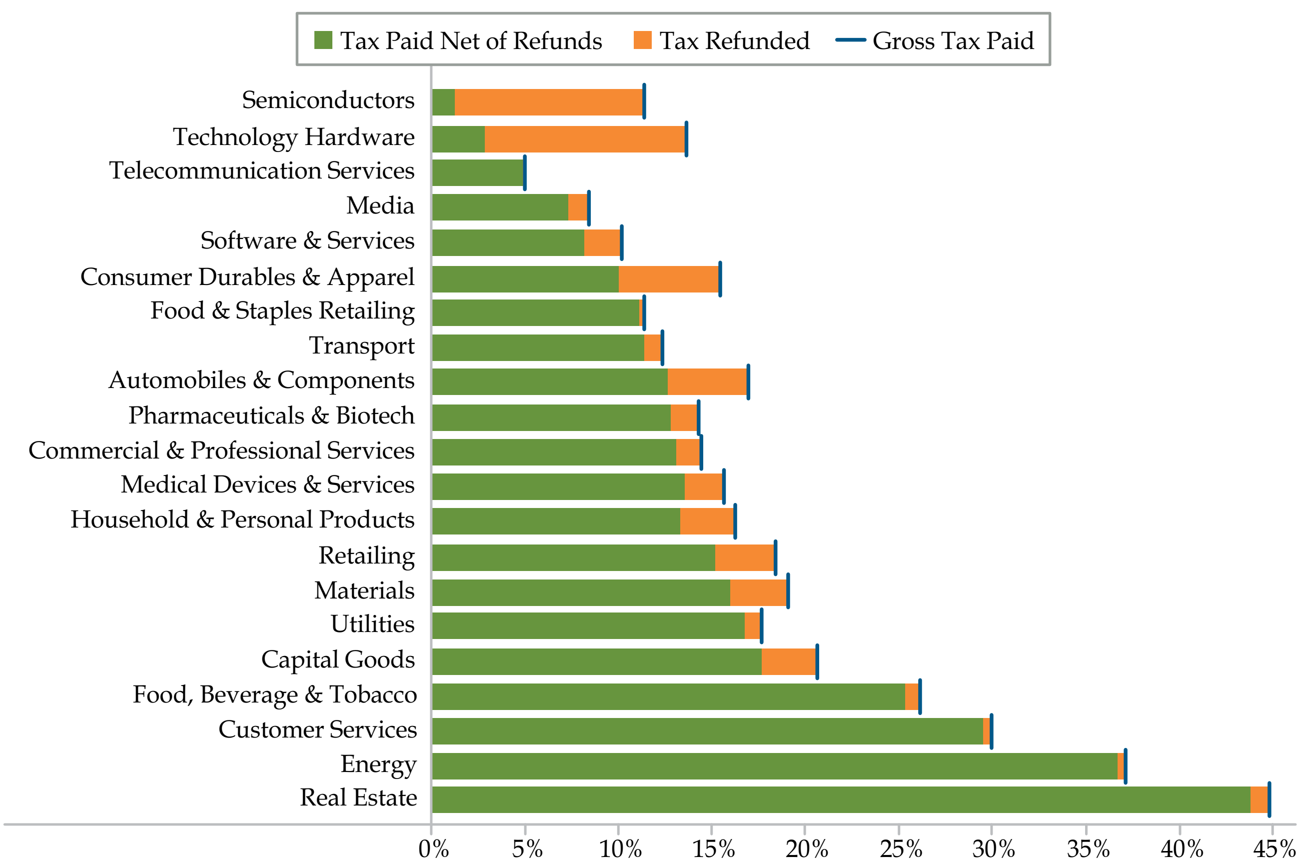
The Chinese populace is not naïve as to what the government wants of it. The risks to the downside of economic puppet masters' blueprints have naturally been to try to shield the fruits of the labor that's facilitated the escape from poverty to what qualifies for middle class in Chinese cities. This is one of the reasons Chinese officials have erected so many roadblocks to sending money out of the country. The last standing option was thus the hard asset of real estate, which brings us back to that wrinkle.

With so few mouths to feed given the restrictive demographic policies China is now desperately trying to reverse, more money than was envisioned poured into property. While initially salubrious economically, prudence morphed into speculation, which fed a bubble of epic proportions. Setting aside the dangers posed by a housing bubble in an economy in which the middle class is still in relative infancy, households came to the point where they were diverting too much of their income into real estate to the detriment of other sectors that would normally be reliant on consumption.

As we wrote several months back care of intel gleaned by our good friends at the China Beige Book (CBB), consumption was plummeting. In a recent 2022 outlook, CBB noted that, "Our data into mid-2021 showed sharply decelerating retail revenue and profits, weakening sales price gains, and the lowest level of borrowing in CBB history. Retail has gone nowhere." This was the backlash that had been delayed by the pandemic, but nevertheless flagged in China's 2019 GDP falling to a 30-year low. The real estate speculation bubble's slow burst was simply delayed, but ultimately manifested in what we're witnessing today through the prism of the Evergrande drama.

What so few grasp is that China wants for the real estate sector to come back down to earth, even if it means blowing up a large portion of its property sector to get the job done. Our other good friends at Gavekal have smartly illustrated how little incentive officials have directed to real estate vis-à-vis other sectors China hopes to build. By way of tax refunds, the government is easing the glidepath of the semiconductor, technology and consumer sectors via tax refunds and proactively starving real estate, energy and industrials of assistance.

Chinese Tax Policy Feeding Industries Hoped to Foster

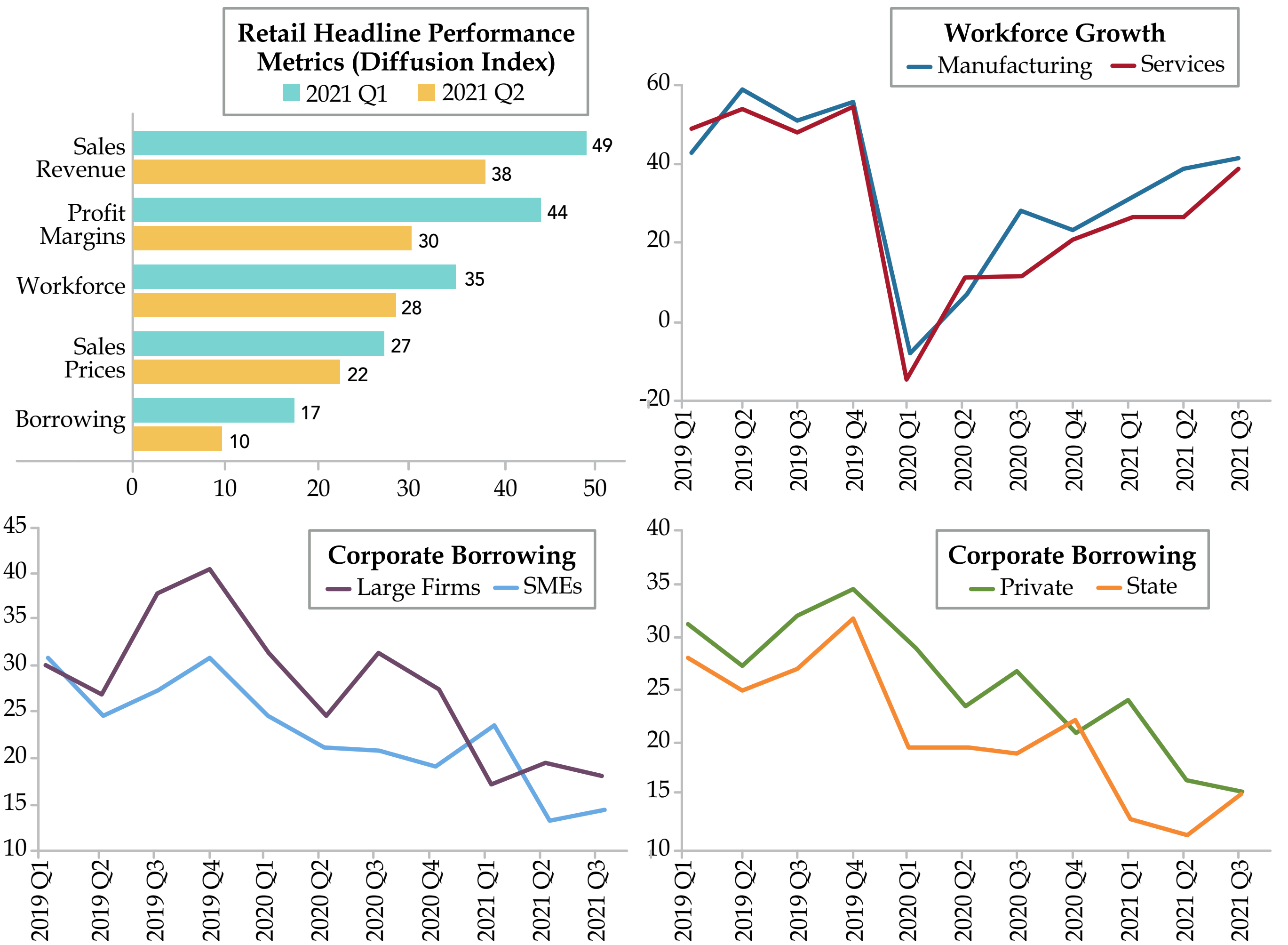


Source: Wind, Gavekal Dragonomics/Macrobond. Note: Net taxes and fees paid in 2020 by listed nonfinancial firms, by sector.

The CBB's third quarter data also illustrate how weakened the retail sector remains. But note that credit directed to ameliorate weakness in the consumer sector is not and has not been deployed since the pandemic hit. We are not witnessing the same reaction function as we have in prior cycles and periods of distress. There are two distinct factors in synchronistic play.

Aside from China's determination to curtail its property sector, you must return to the reality that Chinese growth had slowed to a three-decade low prior to the pandemic. The funds were not as readily abundant as they were as recently as the 2015-16 global industrial recession to pull the economy out of its slowdown. It's not as easy to visualize what China has not contributed to the post-pandemic global rescue effort because of how much the developed world has with the United States in pole position. But it's no coincidence that manufacturing's workforce is on similar footing to that of the services sector.

Credit is NOT Being Thrown at China's Factories to Pad Economic Growth



Source: CBD Data Analytics Platform

But this isn't where today's story ends. There's yet another wrinkle that helps explain why China has held back stimulus relative to recent history – those winter Olympics and the magnificent ambitions of leaders to put on full display the majesty of the country they hope will, in their lifetimes, dominate the global economy.

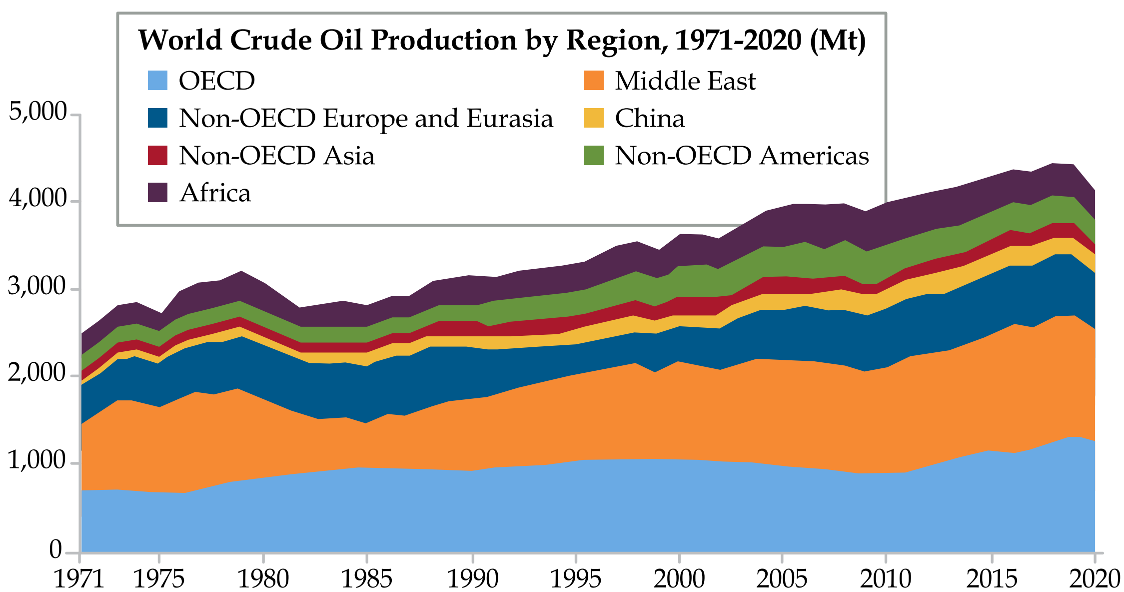
In 2016, the *Chicago Policy Review* published an article based on the findings of a paper published that explored the human element of reduced Chinese emissions titled, "The Effect of Air Pollution on Mortality in China: Evidence from the 2008 Beijing Olympic Games."

As explained, "Before the Games began, all coal plants were required to install devices to decrease emissions. High-emitting vehicles were replaced by increased public transportation options, some chemical plants in Beijing were shut down, and the government increased the price of gasoline to discourage the use of cars. During the Games, additional restrictions were put in place. Vehicles with odd numbered plates could only circulate on odd days, while even numbered plates were only allowed to circulate on even days. All cement, concrete, and lime plants were closed, and power and chemical plants were required to decrease emissions by 30 percent."

The end result, derived by comparing the air quality and death rates for a group of 34 cities between 2006 and 2010 – two years prior to and following the Olympics, was a 7% reduction in mortality in cities where emissions had been severely curtailed. At the risk of being insensitive, this obvious benefit was not what had motivated officials' measures. Rather, countless networks broadcasting from Beijing were able to do so with clear skies in the background because of efforts to clear the smog.

That very same dynamic is in motion today. The "energy crisis" in China may have some basis, especially as China remains nearly as deeply dependent on energy imports as they were 50 years ago. As illustrated in that thin yellow proportion in this next graph via the International Energy Agency, the road to energy independence for China must be laid with renewables and other mitigating endeavors to reduce the country's dependence on its allies in the energy space.

China's Energy Import Dependence Has Not Been Mitigated



Source: IEA

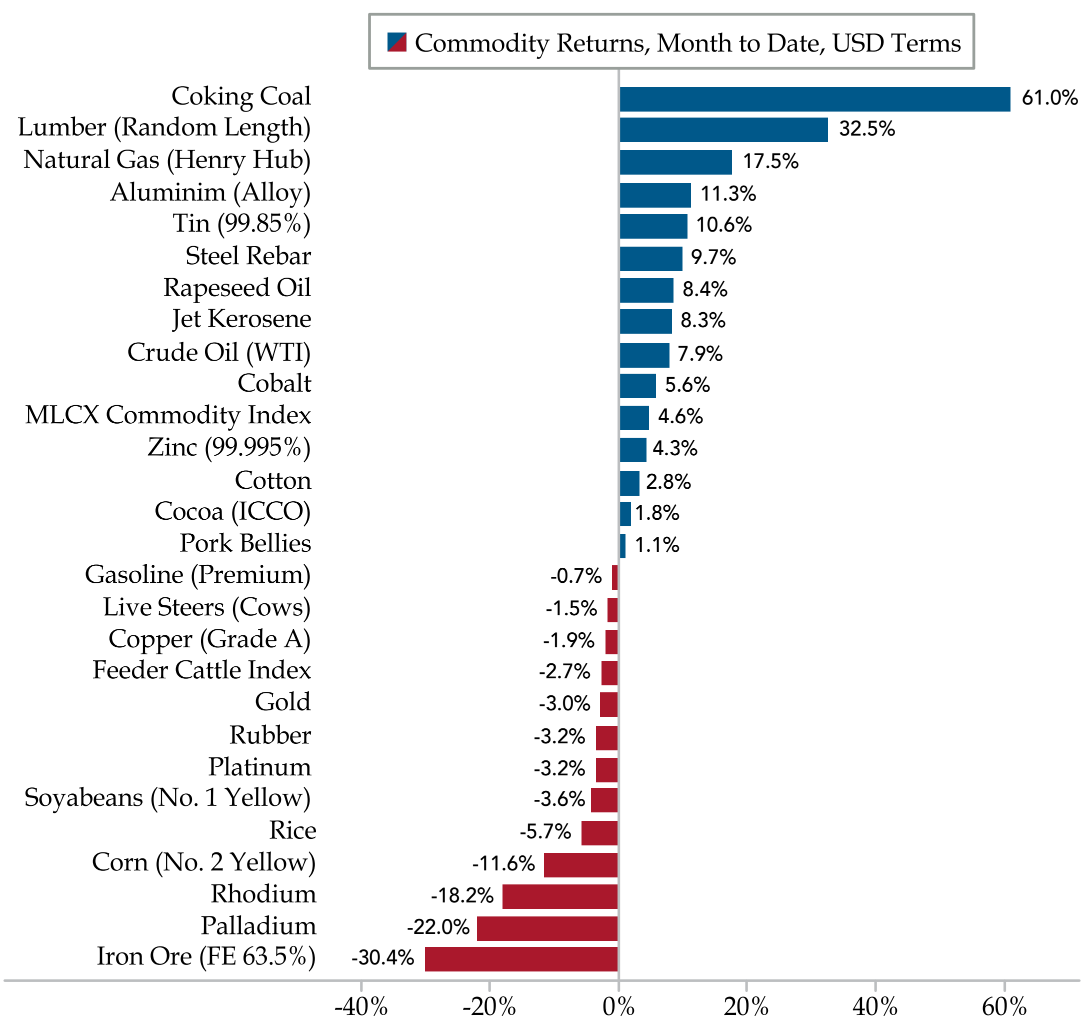
Even so, a glance back at officials' actions taken prior to the 2008 Olympics paint stark parallels that are undeniable. China will continue to purposefully slow its industrial sector to reduce emissions before the country is once again on full global display. It's no fluke that China's official factory activity contracted in September for the first time since February 2020 when the country was forcibly in a shutdown mode. August's 50.1 print hinted at what was to come despite forecasts that this month's read would stay at 50.0 rather than the 49.6 reported. It's equally nonaccidental that China's nonmanufacturing activity resoundingly beat expectations, roaring back from August's contractionary reading of 47.5 to a decidedly expansionary 53.2, which we know is exaggerated given the CBB data on the ground are not nearly as strong.

All of this said, China is taking a baby step to dull the pain of slamming the brakes entirely on its industrial sector. Though the International Olympic Committee has signed off on restrictions announced today, that are in some ways harsher than those imposed at the Tokyo Summer Olympics, the absence of foreign spectators and a 21-day quarantine for participants will nonetheless lessen the need to pull off the same level of picture perfection as that portrayed in 2008. The Olympics will, however, be open to Chinese residents. (Why hold back when the objective is spurring domestic consumption?)

The language of the joint IOC and International Paralympic Committee was dutifully supportive of the countermeasures proposed by local Beijing organizers: "This will facilitate the growth of winter sports in China by giving those spectators a first-hand Olympic and Paralympic experience of elite winter sports, as well as bringing a favorable atmosphere to the venues. All parties feel for the athletes and the spectators from around the world, knowing that the restriction on spectators from outside mainland China had to be put in place in order to ensure the safe holding of the Games this winter."

China's leadership will still be acutely sensitive to the presence of the broadcasters' presence from all corners of the planet who will descend on Beijing in force. In other words, the industrial slowdown will continue to be pressed. And that's big news for armies of commodities investors. It's an understatement to say that commodities returns have recently been all over the map. Viewed through the prism of what China (and the rest of the world) do and do not need though, the differing directions make some sense.

Not All Commodities Returns Are Created Equally Amidst Data Havoc

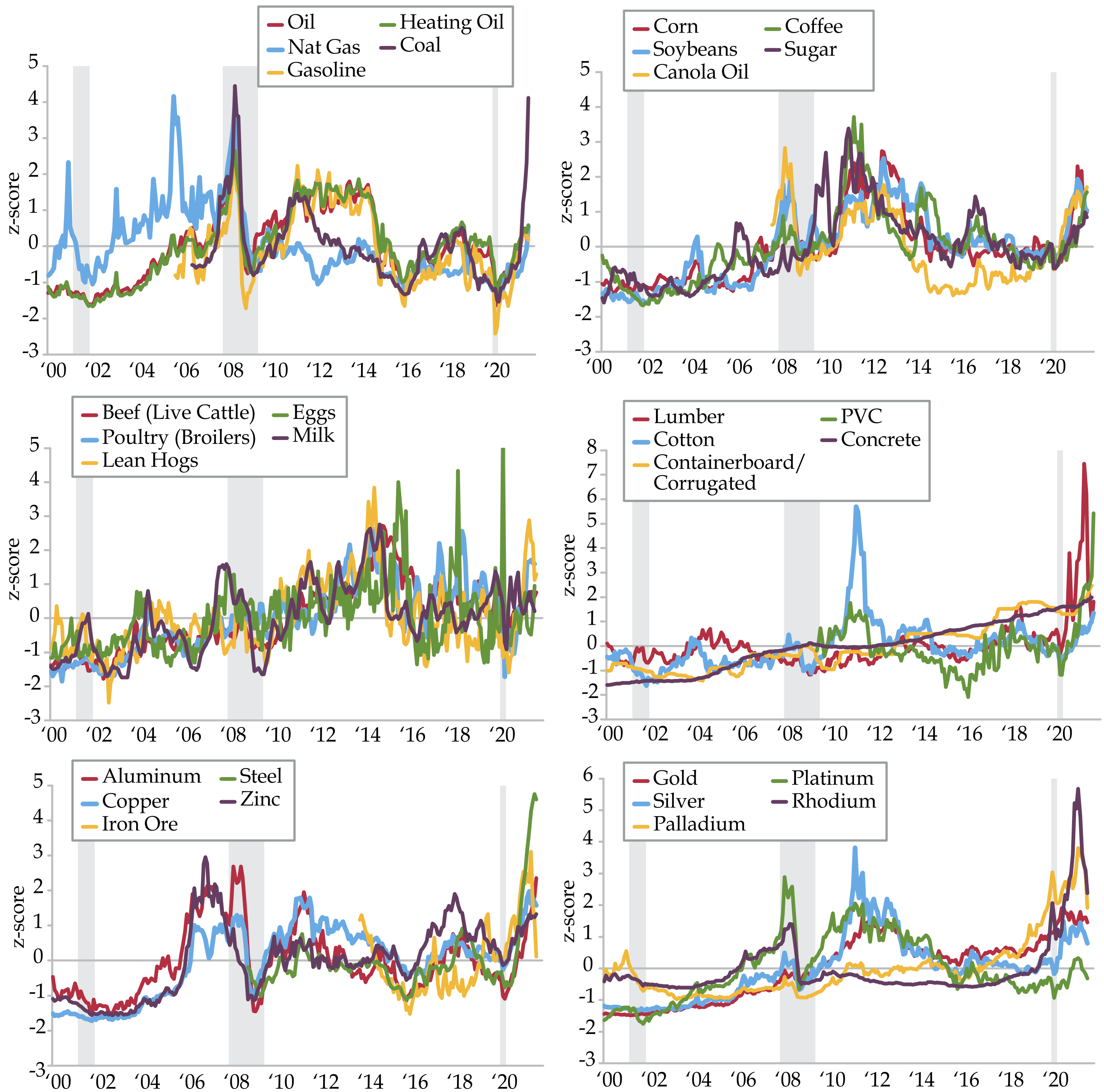


Source: Refinitiv Datastream, Acorn MC Ltd.

There is something to be said for normalizing data to see what the true standouts are on a historical basis. That feat can be accomplished by z-scoring pretty much anything, including commodities. Defined as the deviation from the mean adjusted for volatility, plainly stated, z-scores are a quick means by which to identify outliers.

Housing in America has caused its own idiosyncratic disruptions. As hard as it may be to believe, lumber persists as an unusual case study – higher than it's traditionally trended and likely to remain relatively elevated until homebuilders complete construction on lots that have made it all the way to the laid sewage stage (there are a lot of them and a housing slowdown can't force builders to pull back). Ditto that mentality on the steel and concrete fronts. PVC is in a similar camp and has been electrified by Mother Nature restraining North American production in multiple iterations.

Can China Force a Commodities Correction Outside Energy?

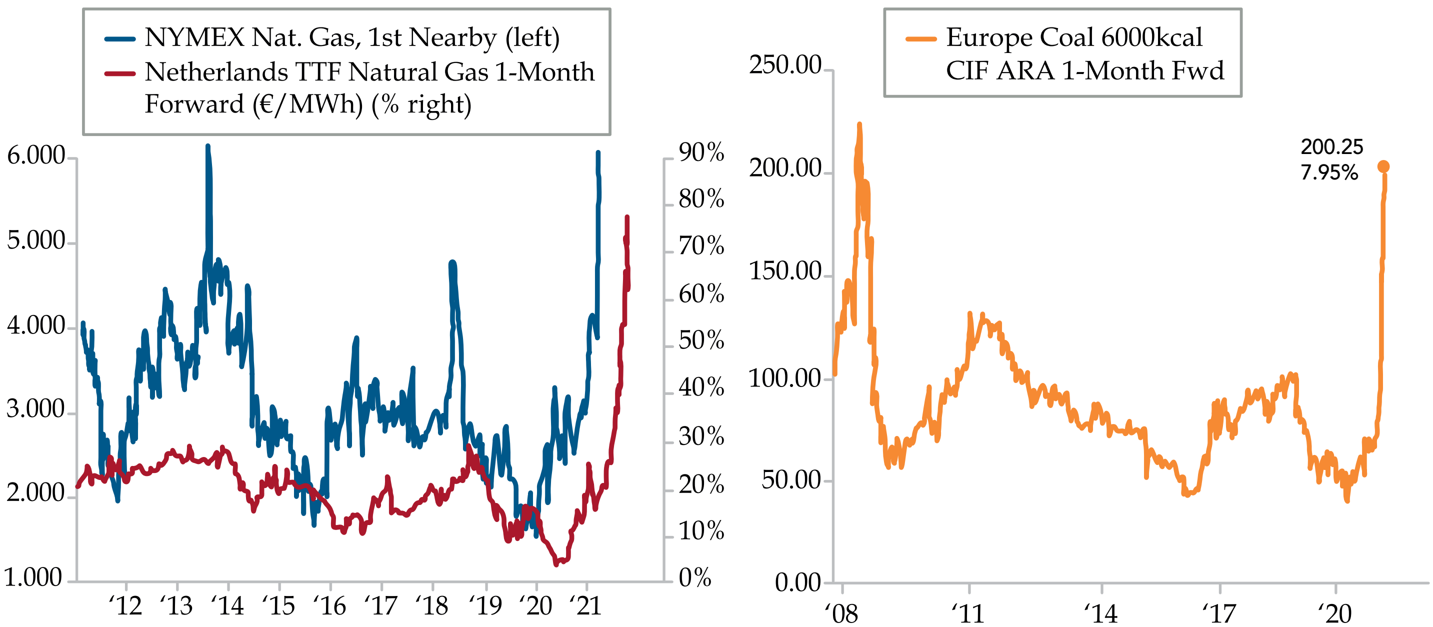


Source: Quill Intelligence, Bloomberg. Recessions shaded.

But note that Rhodium and Palladium are coming back to earth among precious metals. They may best exemplify the reduced U.S. fiscal impulse reverberating across the globe. And don't lose sight of how bizarrely depressed gold, silver and platinum are given stagflation pressuring central bankers to tighten against their will. Policy mistakes in either direction will make these abandoned safe havens that much more attractive to incensed investors.

With this qualifier as prelude, the outliers are conspicuous in their absence. We know coal is, and will be, nuts until the natural gas shortage is righted. As much as the recent surge is remarkable for upside on natty, it's staring you in the face given it's not standard deviations north of its norm. The upside from here is not capped. Politics will continue to influence this corner of the commodities as Russia plays a nasty game of hardball now that it's got license to do so – a parting gift from Angela Merkel.

A Long, Cold Winter Awaits and
Underscores Support for Natty Gas and Coal

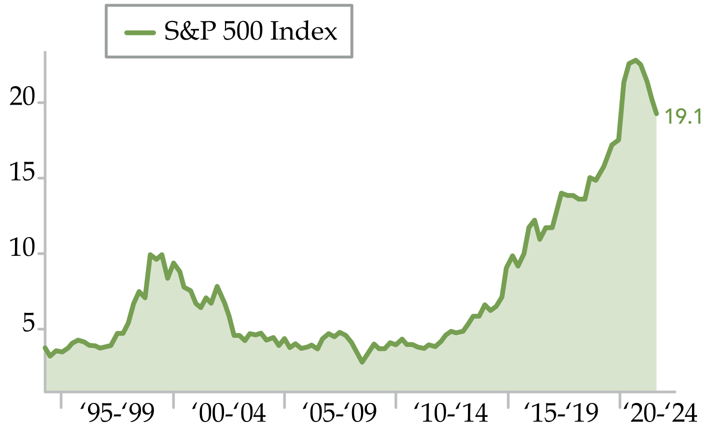


Source: The Daily Shot
Source: The Daily Shot

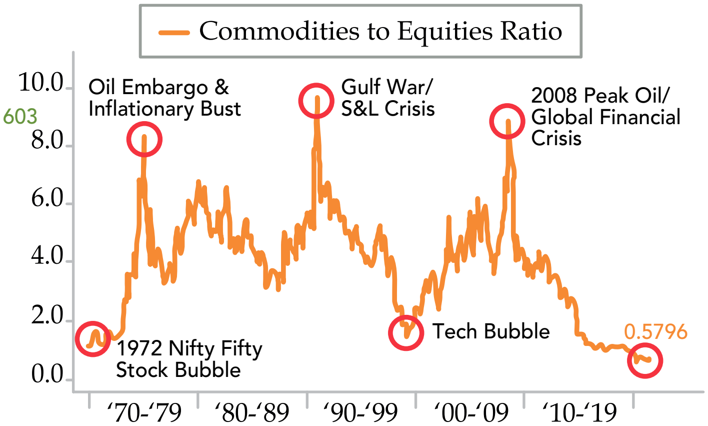
Commodities remain cheap with a capital 'C.' The relative value narrative theme that's been hammered home for the past few years is intact. But with the glaring exception of energy and inputs that feed U.S. housing, investors must bend to the reality of a purposefully plotted industrial slowdown in the world's marginal consumer of most commodities, at least in the near term. Once the Olympics have come and gone, China will have no choice but to pump up its industrial sector with zero regard for the environment. But that's a 2022 event and, at last check, we're still in 2021 with the start date of the Winter Olympics not hitting until February 4th.

Perspective is also in order given how insanely overvalued stocks are thanks to passive investing juicing valuations as never before (more on that in next week's *Quill*). Relativity is not as plain as it's depicted in these dueling graphs that arguably exaggerate commodities' attractiveness. The time will come to capitalize on what's plain to see. But the case to be made is not as cut and dry as history suggests.

Commodities Remain a Screaming Buy Vis-à-vis Stocks…However…



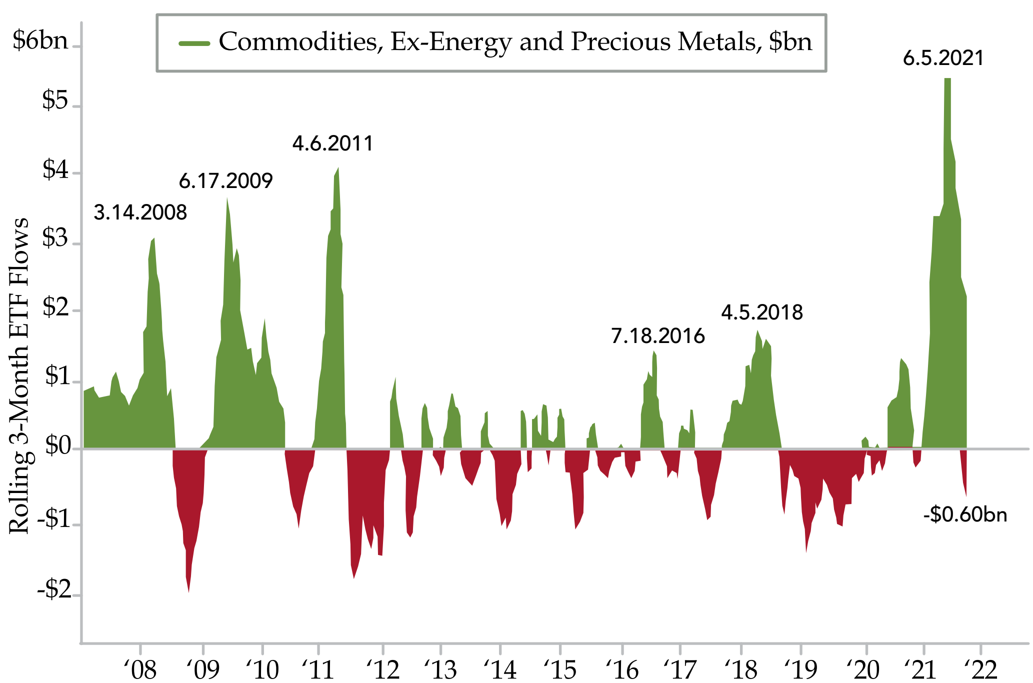
Source: Peter Boockvar, Bloomberg



Source: Crescat Capital

Some investors have begun to clue in to the reality of the ultimate global stagflation that's setting in, as short-lived as it may prove to be given it will be a natural governor of aggregate economic output. The flirtation with what's to come is evidenced in the first outflows from commodities funds, ex-energy and precious metals (again, a critical point), of the post-pandemic era. Global demand for commodities must be prevalent to sustain their bloated prices.

The Teflon Commodities Sector
Sees its First Post-Pandemic Outflows



Source: The Daily Shot

The tricky swing factor is the difficulty in sustaining demand when the world's biggest source of agnostic commodities pricing is descending into a political morass that will claim economic victims, plural. As endearing as the ideal of American exceptionalism is, the difference between prior contemporary episodes and where we are today is the identity of the marginal buyer. China has, for a fiscally charged moment, been displaced by the United States, but for a less than commendable reason. To lean on an overused cliché, there is no such thing as a free lunch.

For investors, the predicament comes down to neither of the world's two economic superpowers being in a strong enough position to carry the rest of the world. Direct investment is fleeing China when it needs validation most as money has taken fright to officials' machinations to coerce its overheated property sector to cool. Back in the States, ugly politics can no longer be ignored as a sovereign default has entered the scenario analyses.

If nothing else, we can seek and receive redemption from one Anders Haugen, the second miracle of the inaugural 1924 Winter Olympics above and beyond the Canadian hockey team's ridiculously laudable showing. Though he had to wait 50 years, he was, in the final analysis, awarded the bronze medal for ski jumping. Due to a 1924 marking error, he had been deprived of his rightful third-place result. But at the age of 83, in 1974, his case prevailed, and his victory was officialized. We can only hope that leaders of the free world, led by in the U.S., also find their way to righting the fiscally profligate wrongs that have placed the country in its perilous position.

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