Letter n°99

Towards an economic war, the sectors to avoid in the stock market.

“An appeaser is one who feeds a crocodile, hoping it will eat him last” Churchill.

Awakening from a naïveté denounced in other circumstances by Churchill, many countries are becoming aware of the Chinese threat in numerous future sectors.

- ***China is placing increased emphasis on exportation***:

There is no respite and much dismay observed in the struggle for fair trade with China.

Real estate in China, which was previously 25 to 30% of the GDP, can no longer serve as an engine of growth. Consumption, accounting for around 40% of the GDP, is too weak to take over in this aging country with a declining population and a high gross savings rate of around 30% (compared to 14% in the Eurozone). Chinese authorities more than ever intend to promote exports of industrial goods, but they increasingly face barriers erected by Western countries.

- ***China provides financial support for this policy:***

According to McKinsey, China allocates 2 to 5% of its GDP to industrial policy to support strategic sectors, while the EU, despite being handicapped by energy costs and declining demographics, only allocates 1%.

Let us examine, successively, Chinese competition and the defensive measures taken by China's clients and competitors.

Chinese competition:

On the supply side, China is by far the world's leading exporter with $3.4 trillion in exports over a year. According to the World Bank, it accounts for 14% of global exports, half of which are destined for OECD countries, and it is responsible for 31% of global manufacturing production. For reference, just 20 years ago, it accounted for only 5% of global exports and 10% of manufacturing production.

China exports half of its manufacturing output, resulting in a trade surplus of 2% of GDP. This Chinese manufacturing surplus is twice as high as that of Japan in the 1980s or, later, Germany.

China intends to replace its traditional exports such as textiles, furniture, and components, and has been successful in doing so. During the first two months of the year, Chinese exports increased by 7%, and in fact, considering price decreases, probably even more in volume.

Furthermore, China is the essential consumer of a number of strategic products. It purchases about 70% of the world's aluminium or iron ore production, 60% of copper and soybeans, and even 20% of oil.

Finally, China holds the weapon of rare earths at its disposal, with 60% of global production, essential for smartphones and electronics.

- ***The offensive:***

For the first time in 2023, China's trade with the 140 countries along the Silk Roads surpassed trade with OECD countries, and China can wield financial leverage as it has lent nearly $250 billion to emerging countries over the past twenty years. Its exports to the 10 ASEAN countries alone exceeded exports to the United States. China is also expanding its relations with Russia and the Persian Gulf countries. In the Middle East, it purchases 40% of its crude oil imports and exports goods worth $110 billion.

The "Made in China 2025" plan has increased support for numerous sectors deemed to be the future.

In 2023, China invested $680 billion in green energy, accounting for nearly 40% of the global total and almost double the amount recorded in the United States. Chinese companies are striving to improve their utilisation rates, which are around 70%, but investments are so significant that these rates are at risk of deteriorating, potentially fuelling price wars. Consequently, they are accused of unfair competition.

The three promising sectors - green energy, electric vehicles, and batteries - currently contribute only 11% of GDP compared to 25-30% for real estate. These three sectors represent 4% of its exports, approximately $150 billion, compared to around $500 billion for other electronic products, but they are exposed to protectionism.

China has also heavily invested in strategic metal refining and holds 70% of the global manganese market, slightly less for cobalt, over 50% for lithium, and 40% for nickel.

Beyond these sectors, China is preparing for hydrogen and accounts for 40% of the world's electrolyser production.

- ***The electric vehicles offensive***:

In 2023, investments increased by 18%, and China became the world's leading exporter of vehicles, totalling 5.2 million (including 1 million electric vehicles), compared to 4 million for the Japanese. Just five years ago, China exported four times less than Japan.

The global electric vehicle market is worth over $500 billion. According to an American think tank, Chinese electric cars received $125 billion in aid between 2009 and 2021.

With over 7 million vehicles, surpassing the EU's 3 million and the United States' 2.5 million, China holds more than 50% of the electric vehicle market.

In electric vehicles, Chinese costs are 20 to 30% lower than European costs. In China, sales of electric or hybrid vehicles account for more than a quarter of total vehicle sales.

BYD sold 3 million electric vehicles in 2023, holding a market share of over 20%, but it has the capacity to produce 4 million in China, not to mention what the company will produce worldwide at competitive prices.

Five other Chinese manufacturers are among the top ten: Geely with 6% market share, GAC 4%, Chongqing, SAIC, Li Auto, each with 3%. For comparison, Tesla has less than 15% of the global market and has lost 30% of its market capitalisation since the beginning of the year. VW holds 6%, Fiat Chrysler 5%, Mercedes and BMW each 3%. Thanks in part to MG, a subsidiary of the Chinese SAIC with 230,000 sales, China has significantly increased its vehicle sales in the entire EU, Switzerland, and the UK, reaching 353,000 compared to 200,000 in 2022.

The starting price of BYD is $12,000, while Tesla's is $39,000. In 2023, BYD sold 242,000 cars abroad, including 16,000 in Europe. The group announced the construction of an assembly plant in Hungary to bypass tariffs. This year, the group aims for 400,000 sales outside of China, but it seems ambitious as the cars have defects and the global electric vehicle market seems to be slowing down.

The decrease in the Producer Price Index (PPI) signifies exporting deflation. Thus, BYD has reduced the price of its electric vehicles sold in Germany by 5 to 15%.

- ***The batteries offensive:***

The global battery market represents around $150 billion.

China holds 60 to 70% of the global battery market. In this strategic sector, Chinese companies are partnering with Korean companies to mitigate the risks of taxation. This is the case for a small group of electric battery material companies such as CNGR Advanced Material, Ronbay Technology, a leader in nickel electrode production, and Zhejiang Huayou Cobalt, the largest Chinese producer of components for electric batteries.

- ***The solar offensive:***

The global solar market represents approximately $250 billion. China accounts for over 80% of solar equipment manufacturing, with companies like Jinko Solar, Risen Energy, and LONGi Green Energy. China is the top customer for these three sectors, with 55 to 65% of global demand.

In 2010, Europe produced one-third of the solar panels sold worldwide. Today, that percentage is negligible. Europe only produces 3% of the panels required to meet the 2030 target of 42% renewable energy and suffers from production costs twice as high as those in China. In the United States, according to Wood Mackenzie, the gap in production costs is even more significant.

Over the past four years, imports of Chinese solar panels to Europe have quadrupled. Examples of this unfair competition include Swiss company Meyer Burger's decision to close its German site for manufacturing photovoltaic panels, the bankruptcy of Norwegian Crystals, a major manufacturer of components for solar panels, and the collapse of Austrian company Energetica Industries.

In 2023, the Chinese installed more solar panels than the Americans did in the past, and they increased their exports by nearly 40%, with prices halved.

The Chinese hold 80% of the global market due to massive subsidies and economies of scale in the vast Chinese market. They have access to land and electricity at preferential costs and benefit from cheaper labour. These factors are likely to erode the initial advantages of European industries in solar or wind power.

Longi Green Energy Technology holds 20% of the global market for photovoltaic modules and seeks to penetrate Western markets through subsidiaries located outside of China, in Vietnam and Malaysia, and even in the United States through a joint venture with Invenergy in Ohio. However, governments are vigilant.

- ***The semiconductors offensive***:

China has also decided to invest in semiconductors because its trade balance is deficit by approximately $200 billion. In 2024, its capacity expansion will surpass that of all other countries combined. Government subsidies will total $150 billion. Such investments will impact the utilisation rates in the manufacturing of the most mature semiconductors.

Defence organisation:

Today, in the West, as well as in India and many other countries, competition from Chinese state-owned or semi-public groups is feared, and protective measures are being implemented. This is because they have massively benefited from state subsidies and face overcapacity issues (40% in batteries, 50% in solar).

- ***Measures by the EU and Australia against China***:

Europe, frustrated by a trade deficit with China, which rose from €180 billion in 2019 to €400 billion in 2022, continues to seek precautionary measures. Like the United States, Europe is striving to reindustrialise its territories in future sectors related to energy transition. Thus, numerous projects in sectors such as batteries and energy storage are emerging in countries like Italy and Ireland.

The EU holds a strong technological position in wind energy (as indicated in the Pisani Ferri report in 2023) but is vulnerable in hydrogen production through electrolysis.

However, in these future sectors, competition is fierce, and market shares are firmly established.

Europeans lament a 15% tax on European vehicles sold in China, while Chinese vehicles face no more than 10% taxes upon entry into Europe.

The EU proposes to seize and destroy goods partially or entirely produced by some of the 27.6 million forced labourers (Uighurs or others).

Similarly, the European carbon tax will heavily impact Chinese exports as two-thirds of electricity produced in China comes from coal-fired power plants.

Some developed countries rely on sales to China and prefer to be more measured in their defence. This is the case for South Korea, Australia, and to a lesser extent, Japan and Germany.

Germany is restraining the EU from adopting protective measures against China because it exports a lot to China, twice as much as the combined exports of the UK, France, and Italy. Four German companies, namely the three automakers plus BASF, account for over a third of investments in China. Australia, aware of political tensions with China, its largest trading partner, accounting for 30% of its trade, intends to promote investments and exchanges with Southeast Asian countries, which are already more significant for Australia in terms of volume than the United States and Japan.

- ***Measures taken by countries in the "Global South"***:

Brazil complains of unfair competition from Chinese products in steel, tires, and chemicals, and Brazilian producers are demanding tariffs. In January-February, Brazilian imports from China increased by one-third. Lula remains cautious because in 2023, Brazil exported $105 billion to China (much of it soybeans) and imported $53 billion, but the tax exemptions on Chinese electric vehicles are ending, and taxes will be imposed.

Other countries in the "Global South" also complain of unfair Chinese competition. For example, Mexico has imposed tariffs of 5 to 25% on many Chinese products, Thailand for steel, Vietnam for wind turbines and steel. Turkey imposes a 40% duty on Chinese electric vehicles. Additionally, India imposes taxes between 25% and 40% on Chinese solar panels.

Conclusion: ***"The East wind prevails over the West wind," as Mao*** stated in one of his slogans.

As we have seen, this is evident in exports, but defence is organising both in the West and in the South.

- ***The slowdown in China has two internal consequences and one external consequence***:

Firstly, the reduced attractiveness of the Chinese market results in a decline in FDI, which was between $100 billion and $400 billion per year in the 2010s. According to Chinese authorities, they declined for the first time by 8% in 2023 to $157 billion.

Secondly, the number of foreigners present in China has decreased since the health crisis. According to the British Chamber of Commerce, the number of Britons living in China has halved since the Covid crisis. Similarly, the number of South Koreans has decreased by 30% since 2019, the number of Japanese by 13%, and the number of Americans has dropped significantly.

Finally, the risk for the rest of the world is the continuation of exporting deflation, as the Chinese Producer Price Index (PPI) is negative, since China is the world's leading exporter, and the Yuan is weak.

- ***The economic war benefits only a few emerging countries***:

When measuring the attractiveness of different regions by the net inflow of long-term capital, few emerging countries stand out. India is one such example, with inflows of direct investments and portfolio investments close to 1% of GDP in value, and Africa, with flows between 2 and 3% of GDP in value. Considering the low domestic savings in India and Africa, these capital inflows remain insufficient to cover needs and finance essential infrastructure development.

- ***The economic war poses a dilemma for developed countries:***

Certainly, nearly 85% of the world's stock of FDI is in the hands of Western countries. However, they have never been as indebted as they are now.

States would like to provide subsidies to reindustrialise and accelerate the energy transition, but they face financial constraints.

The dilemma for Western countries is clear and cruel. Refusing Chinese products would mean delaying the energy transition; accepting them would mean killing off the last European or American groups. In this context, it is difficult to predict the survival chances of the remaining European manufacturers.

- ***In this context, several sectors should be approached cautiously in the stock market***:

This includes all sectors, no matter how promising they may seem, caught in the whirlwind of overcapacity and Chinese competition. We're talking about the sectors examined in this Letter: electric vehicles, as seen in Tesla's recent decline, batteries, solar power, basic semiconductors, and wind energy. This is especially true considering that China's competitors (such as the United States with the IRA, among others) also subsidise to aid in relocation. The risk of overcapacity is therefore amplified, and we cannot ignore progress; for example, in the case of batteries, the adoption of new standards.

- ***On the military front***:

We have discussed economic warfare, but of course, military expenditures could also be analysed. India, Japan, South Korea are strengthening their security cooperation to protect themselves from China, and the United States is doing the same. However, let's leave that for another Letter.

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