Aviator Update – August 2023
Lindsey Lawrance

Meanwhile In China…

Depending on how closely you watch *finance-land*, you'll be well aware that things are heating up again within the Chinese economy. And not in a good way…

I've been meaning to get around to a China update for a while – now seems like a very appropriate time. China is our largest trading partner and therefore what goes on in their economy could have an appreciable impact on us – we'll have a bit of a look at that also.

As a word of warning, this note is a little lengthy. The reason for this is because in order to understand the challenges currently facing the Chinese economy, you need to understand the road that's brought them here.

I hope you stick with me for this journey however if you can't, I've offered a few summary points at the end for you to take away.

China – a brief (crude) history

China as we know it today was born in 1949 when the Communist Party finally won the protracted war with the Kuomintan-led government of the Republic of China that had been going since the 1920's. The final phase – the Chinese Communist Revolution – came at the end of World War Two and culminated in Communist Party forces overthrowing the Republican forces, seizing control of the mainland and forcing the remaining Republican leaders to flee to the island of Taiwan. Both maintained they were the legitimate rulers of China and sporadic fighting continued until 1979.

[Side-note: If you don't fully understand the recent hostilities between China and Taiwan, this is basically the reason – Taiwan is essentially part of China and I expect they'd like it back.]

The new Communist Party didn't make a great start in terms of global relations – the year after seizing power around 1 million People's Liberation Army soldiers filed across the border to fight United Nations troops in North Korea. This resulted in a trade embargo with the West lasting more than two decades.

Economically, the "rise" of China began in 1979 under the leadership of Deng Xiaoping. Prior to then, the Communist Party under the leadership of Mao Zedong maintained a tightly-controlled centrally planned economy. Most economic production came via State-owned

enterprises ("SOE's"). Private enterprises were basically outlawed, as was foreign investment.

Mao passed away in 1976 with Deng Xiaoping managing to secure leadership in 1978. He inherited one of the poorest nations on earth and a population growing increasingly disenchanted with the Communist Party.

Deng realised that reforms were essential and opening up to the world was an important part. They began to introduce free market principles – starting with moves such as handing more managerial power of SOE's over to local governments and enabling them to operate and compete under free market principles.

He reached out to the West, in search of technology and know-how to help drag China into the modern era. Their large population was an attraction for the Jimmy Carter administration overseeing the U.S. at the time, and a flourishing trade relationship ensued.

From the get-go, the trade relationship wasn't perfect. China quickly demonstrated that it had no regard for intellectual property rights and the theft of intellectual property was a constant source of tension throughout the '80's and '90's (and still is today). However, despite a burgeoning trade imbalance, the US was broadly happy with their Chinese customers.

During the Clinton administration, after a lengthy process that required US Congressional approval, China was accepted into the World Trade Organisation in 2001… ushering in the "made in China" era we presently live in.

The reforms that began under Deng's leadership in the '80's certainly didn't have a goal of ending communism. Their goals were to make their system work better – to introduce greater efficiencies based on free-market principles and an ultimate goal of restoring Chinese prosperity and dignity on the world stage. The pursuit of what became known as their "Socialist Market Economy".

Although a lot of central control was relinquished, the entire country remained – and remains to this day – "centrally-planned". Throughout this period of reform, key features of the policies pursued essentially sowed the seeds of the problems China faces today.

Economic Growth Model:

It's helpful to conceptualise China – any country for that matter – to have a certain economic model. What really drives the economy? Developed nations are principally services-based with services being responsible for over 70% of our economy. That's partly a result of the natural process of moving from "developing" to "developed" but its also heavily influenced by society and governmental forces.

Further on this point, over the past 20 years many people have gushed over China's rise – how they would soon be the largest (and thus most important) economy in the world. Within this, it was implied that China would inevitably become a "developed nation".

But have you ever wondered why so many nations just seem to stagnate in their level of "development"? History shows that reaching "developed nation" status isn't an inevitably. In fact, it's the rare outlier that manages to organise itself and push through to "developed".

China's economy is very different to that of a developed nation.

Under Deng, foreign trade was for the first time in the modern era considered important. Deng knew that trade and trading partnerships with the west would deliver technology and also investment funds. As part of their plans, "special economic zones" were established to grow into major commercial and industrial centres.

China had (has) an enormous population base of extremely low-income people. Putting this labour pool to work could do a lot for the nation.

The Chinese government initiated policies based around *mercantilism* – policies designed to maximise exports and minimise imports. Being slightly blunter, the Chinese [cough] "cheated" on international trade.

Under an open market economy with a floating currency, something rather annoying happens when your economy is growing strongly thanks to exports – the global value of your currency rises.

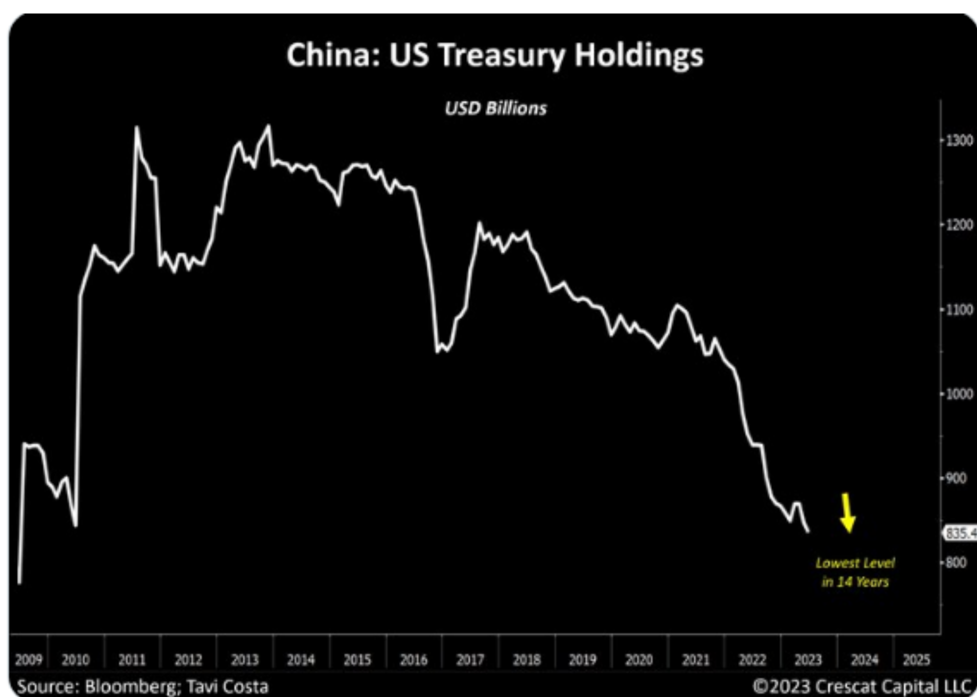
Thankfully, under their centrally-planned economy, China had a solution to this – have a "closed capital account" - control your currency!

China exports to the world "stuff" and receives money for it in return. Under free market forces, the weight of this money flooding in – often in US dollars – would pressure your currency higher. But a higher currency means that your exports are not as competitively priced on a global basis – that's not good when you're trying to maximise exports. It also would mean the Chinese population would be able to afford more global goods. That's also not desirable when your goal is to run a massive trade surplus with the world.

Conceptually, a key feature of China's economic model since reforms began has been a big virtual customs office at the money border. Virtually all external monetary transactions go through the government. When a huge volume of USD is seeking to be turned into Yuan, the government grabs it at the gate and "issues" Yuan at the prevailing exchange rate that they want. They are then left holding a big pile of foreign currency. What to do with it? US treasury bonds are a good place to park it!

China amassed a huge stockpile of U.S. government debt. This has broadly been misunderstood. The general narrative has been that the U.S. has become "reliant" on China to fund its budget deficits. No, not true. The holdings are a direct consequence of China's economic policies. By seeking to run a massive trade surplus with the world (the U.S. in particular) combined with currency controls, China amassed a massive stockpile of "foreign assets".

There's been a few murmurs lately about it unwinding:



That's a direct reflection of current economic weakness – capital has been fleeing China (as best as it can with the closed capital account), forcing authorities to draw on the stockpile of foreign reserves in order to manage the currency. They aren't somehow "losing faith" in U.S. treasuries. They aren't "diversifying away from U.S. dollars". They're scrambling to manage the tidal wave of foreign capital leaving the nation owing to economic weakness.

[As a side note, global investment banks have in recent months being commenting how they have experienced significant capital flows from China/emerging markets to the U.S. – they highlight that its been a significant driver of recent share market strength in the U.S.]

Or course, most Chinese residents are very restrained in their ability to shift money out of the country. That's a key feature of their economic model and current property woes.

Investment:

Investment has been the other major driver of Chinese growth – the “other lever” in their economic model.

If you think about it, China essentially “started from scratch” in the late ‘70’s when Deng took over. They needed a lot of “stuff” – infrastructure, housing, factories… The success of their mercantilist trade policies spurred the need for more stuff – more factories in the special economic zones, more housing in those areas for all the workers migrating to the cities for work.

Its therefore totally understandable that the last 40 years has essentially been a non-stop construction boom. However, the key problem they have created is that the economy has become incredibly reliant on “building stuff” for economic activity and employment.

There’s also very powerful “vested interests” keen for this model to continue. It’s hard to get rich in China if you’re not “one of them” – one of the Communist Party, that is. Although current leader Xi Jinping is incredibly powerful, he can’t run the country by himself solely according to his principles. While many of the Chinese elite have gotten rich off their economic model, Xi has his work cut out for him trying to convince them they need to make some radical changes for the good of the nation.

In the simplest sense, that’s the Chinese “economic model” – exports and building stuff. It’s become engrained in their economy largely thanks to the actions of their government.

“GDP targeting”:

We all know that GDP is basically a measure of the size of the economy – the sum of all the goods and services produced in a certain period. In most nations, its merely an “output” – our Australian Bureau of Statistics tallies up all the numbers at the end of the period and then reports “the size of the economy was $XYZ representing an ABC% increase from the prior period”.

Not in China. Since the ‘90’s, a feature of the Chinese governments’ periodical “5-year plans” has been a certain level of GDP growth. GDP has been an *input*, not an output.

This has had a major impact on the economy and the cementing of those “drivers” of growth. Recall that reforms included handing greater responsibility and autonomy over to regional governments. A feature of these GDP targets resulted in this sort of hypothetical exchange between state and local governors:

Central Governor: “*7% GDP. That’s our target for this year. What are you doing to help achieve that in your area*?”

Local Governor: "*We're well on track with that new subway project and we're in the final planning stages for a new soccer stadium*."
Central Governor: "*Excellent work! Keep it up*!"

Residential property played a major role in this sort of activity also. This hypothetical exchange seems typical of many:

Property Developer: "*We want to build a big new residential development on that parcel of land over there.*"
Local Governor: "*Yes! Great idea. I grant your project development approval. We will begin the arrangements to sell you the land… and then we will hastily tell the peasants currently living on that land to find a new place to live! And then we will begin with plans to extend infrastructure such as roads and train services to your new development*".

GDP targeting has largely ended in recent years under the stewardship of current leader Xi as he seems to realise it began causing more harm than good.

What pays for this?

People see images like this of the Shanghai skyline…

… and often gush "look at China… wow they are so rich!"

But how does all this development get paid for? Seriously – the workers, the steel producers, plumbers, glaziers, the architects… engineers - how do they get paid? Where does the money come from?

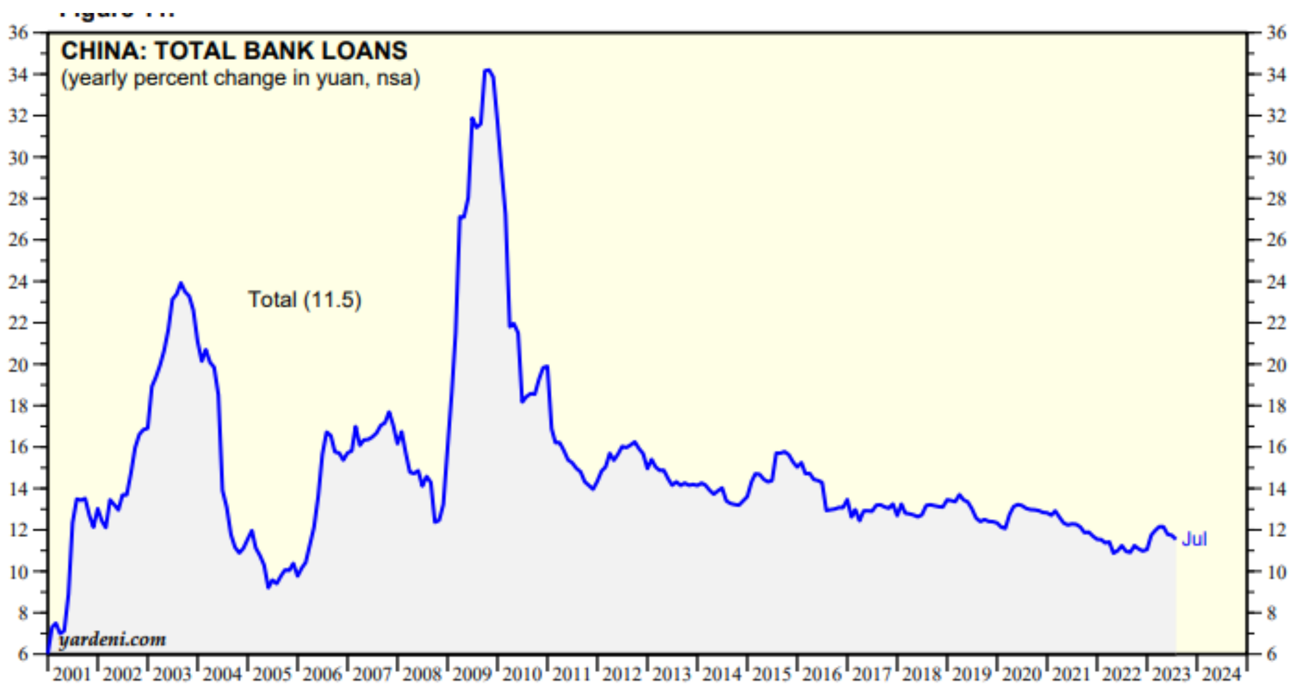
If that hurts your head a little, it should – it's a rather abstract idea that few people ever really stop to think about… let alone seek to understand.

The economic concepts of capital formation and deployment are long and complex so we'll skip over all that today. But to a large degree, the answer to how all this development is paid for is simple:

Debt.

When China "started from scratch" about 40 years ago, this basically included its debt burden. But in the last 20 years in particular they have been busy piling on the debt. Here's a few charts thanks to Yardeni Research.

First, here's the annual percentage change in bank loans:

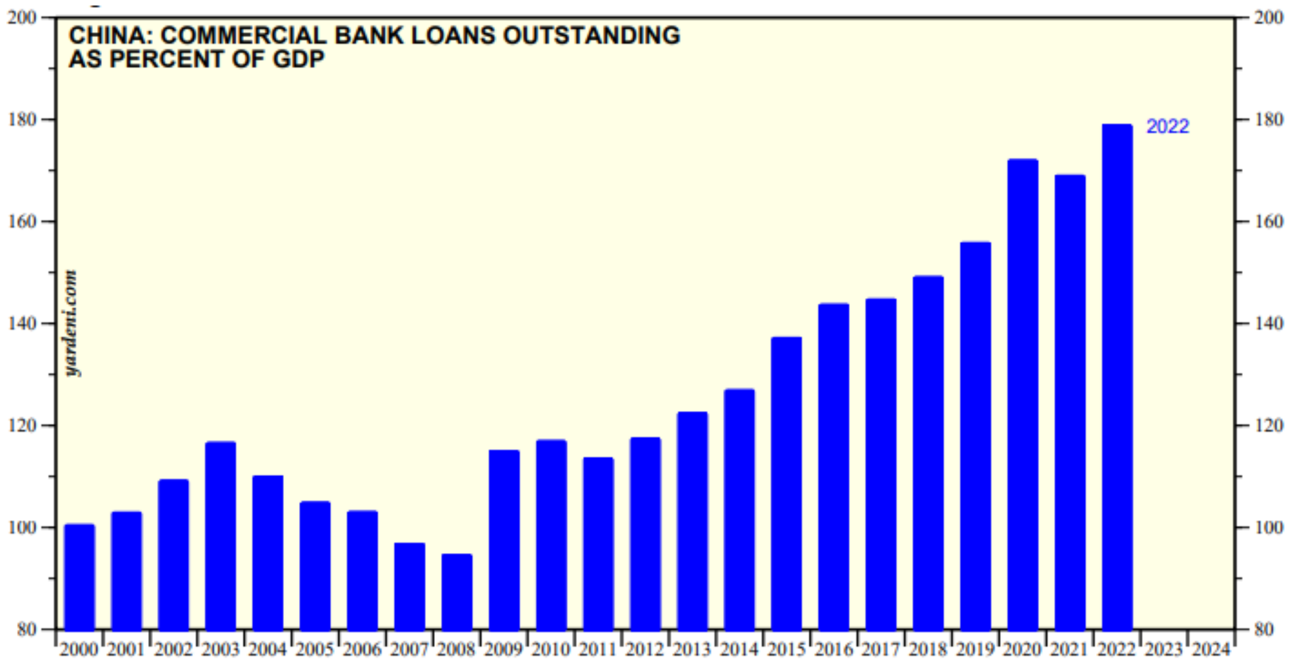


Source: People's Bank of China and Haver Analytics.

Just from a brief visual inspection, what shall we say loan growth has been averaging over the last decade? 13% per year? Looks about right…

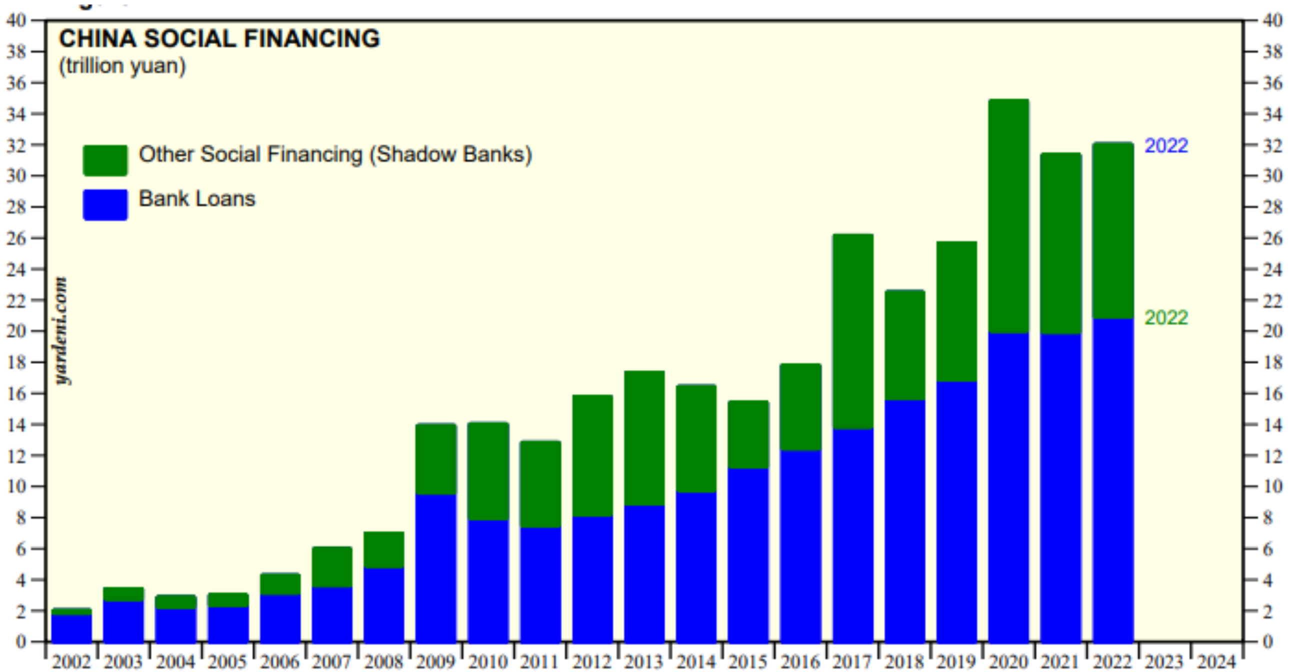
[Side note: check out the huge spike in 2009 – over 30% increase in just one year! Remember that? The "Global Financial Crisis". China yanked hard on that lever! We'll discuss this a little more later…]

Here's how bank loans outstanding have been tracking as a percentage of GDP:



Around 120% of GDP to 180% in a decade – not bad!

There's another piece – non-bank lending. In China, this is often referred to the "shadow banking system". Data is known to be a bit rubbery as its hard to fully know exactly what activity is going on. Here's the official data – "other" on top of bank loans:



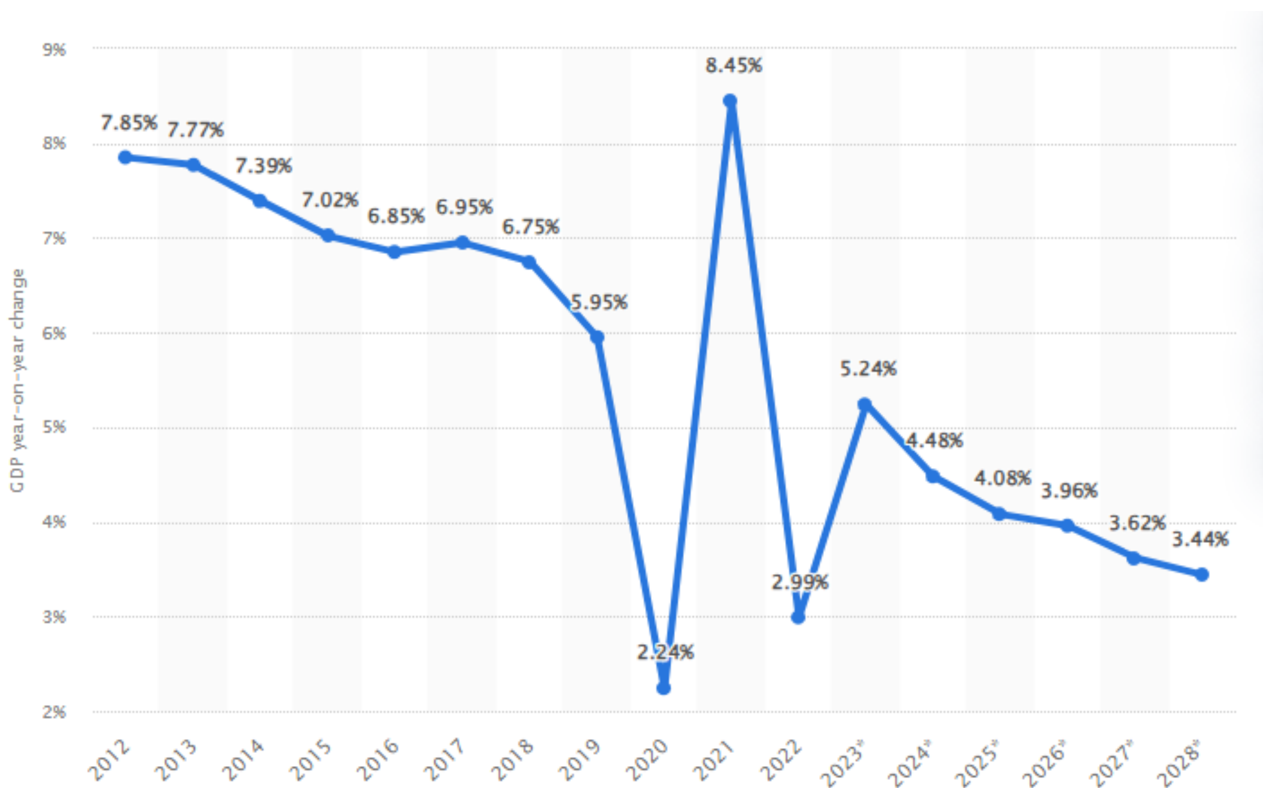
So bank loans are around 21 trillion yuan. Shadow banks adding around 11 to take the total to 32 trillion yuan.

Yardeni didn't have a chart of "total social financing to GDP", but when we know bank loans are around 180% of GDP and shadow banks are around half again, total debt to GDP must be around 270%.

It's also worth noting that there's rumoured to be a lot more debt in China that's hidden. In particular, its reported that "Local Government Financing Vehicles" are holding massive amounts of debt. These entities were set up to fund infrastructure projects undertaken by local governments. It's currently being reported that defaults on these debts are also rising at an alarming rate.

At this moment you might be thinking "numbers… but what do they mean?" Let's add some context…

Here is a chart of China's GDP annual % growth over the past decade:



Just for fun, this chart includes the IMF's estimates of GDP growth for the coming few years.

Now, returning to those debt charts, bank loans have been growing at… let's say 10%. And non-bank activity has been around half that. Then whatever isn't reported on top of all that. So total debt has been increasing at maybe 15% of GDP (more than that, but let's be "conservative").

15% growth in debt within an economy growing at… let's be generous and say 5%.

I trust you see a major problem there.

Also note how shadow banking has been a growing slice of the pie over the last 5 or 7 years – that's important in all of this.

China-watchers agree that the debt-fuelled development model is past its "best-before" date. Indeed, its well-known that the Chinese leadership understand their difficulty. They know things need to change, but this will prove difficult and time-consuming. But it also means the Chinese might not revert to old ways at the current junction – I'll explain what I mean by that later.

The debt situation has to an extent been exacerbated by China's closed capital account. With Chinese citizens being unable to get much money out of China, their only investment options are internal.

An important driver of China's debt burden has been ***financial repression***. Recall that in many years over the past decade or two, we've been used to hearing about China's GDP growing at 7%, 8%, even 10%. During much of this period, inflation has been running at a similar sort of clip.

And yet interest rates during much of these periods might have been 5%, 6% or 7%. In other words, in "real" (inflation-adjusted) terms, interest rates have been negative.

Economically, this basically means a transfer from savers (the general population) to borrowers (big corporates and SOE's). Borrowers being subsidised by savers. And when interest rates are negative, the more you borrow the better your prospective returns. This is important in the context of the imbalances that have manifested as well as the incredible debt burdens being shouldered by many organisations.

Lending Standards:

The way in which lending decisions are made in China has been massively distorted by their special form of "socialist market economy". You've had a central government pushing the nation to create activity – to a large degree via capital-intensive investment. Many of the entities creating the activity are local governments or state-owned enterprises. Banks, in turn, are in some way pressured to extend credit.

When you think about that, it's understandable that what developed is a system whereby banks don't so much lend based on the economic merits of the project being planned or the creditworthiness of the borrower…

They lend based on the strength of the perceived government guarantee extended to the borrower.

The offices of Harbin Pharmaceuticals are a famous example.

Gilded ceilings. Luxury amenities. The company is partially state-owned. If such an entity wants to borrow some money for basically any reason, a lender won't knock them back. It doesn't matter whether they are profitable (and most SOE's are known to be unprofitable) – the perception is their loan is implicitly backed by the government. And remember, even a silly, unnecessary project like the above consumes a lot of man-hours… creates some good GDP!

Leader Xi understands that Chinese debt levels have become unsustainable and the government has been working hard in recent years to reduce the excessive reliance on debt (unsuccessfully to date). He has even called this sort of unproductive investment "fictional growth".

The role of property:

We can begin to apply a lot of the above to the residential property market:

- A large population with few investment options available to them.

- Financially repressed via negative interest rates.

- A central government actively encouraging construction activity in the interests of GDP growth.

- Local governments heavily reliant on land sales to developers to meet their revenue targets.

Is it any wonder that Chinese property went crazy?

Respected China-watchers (including some within China) have been very comfortable calling Chinese residential property "a bubble" for years now. Who am I to argue?

Some of the statistics about the market are incredible. Estimates suggest that the real estate sector is around 30% of the Chinese economy – close to double most countries. Further, investors in China are prone to leaving properties empty rather than living in them or renting them out. Estimates are that perhaps one quarter of Chinese housing stock may be empty. Incredible – empty houses capable of housing tens of millions of people!

Investment in property comes in various forms. Property developers generally need to raise funds before the can get finance for a project. Two sources are pre-sales (often demanding 100% of the sale price upfront, not just a tiny deposit) and issuance of "wealth management products".

These wealth management products are basically corporate bonds aimed at retail investors. Some of the names of these products are hilarious – things like "super lucky fortune". Apparently, it's very typical for developers to solicit investments from staff as well as prospective buyers. So for some investors they have significant exposure to the developer.

2 years ago…:

Almost precisely 2 years ago we were exploring a lot of this in the context of Evergrande.

Evergrande was the most indebted property developer in the world. Many billions in debts with estimates being that their total debt may be 3% of Chinese GDP. They employed circa 200,000 people with many, many more people providing services upstream or downstream. Hundreds of projects on the go across dozens of cities.

Evergrande ran into major financial difficulties. We discussed how actions by the government aimed at trying to reduce leverage in the sector seemingly helped push it over the edge – reliant on a constant stream of financing in various forms to meet its obligations, the threat of default caused lenders to back off.

We discussed how the creditors exposed to the risks would be in all shapes and sizes – sure, banks will be on the line. Corporate bonds including foreigners. And also individuals via

wealth management products as well as pre-purchased apartments… a lot of stakeholders stand to get burned. Surely at least a few being wealthy Communist Party insiders.

We discussed that debt-fuelled investment is a key driver of economic growth – evolving from the economic policies China has instigated. Debt is known to be rising unsustainably and the government knows they need to stop this. And a lot of asset allocation decisions are made not based on what makes economic sense but who people see as "safe" – backed by the government.

We suggested that the Chinese government has the know-how and financial means ("credibility") to make the whole Evergrande situation go away. They could bail out everyone.

But we suggested they wouldn't want to. That would only re-enforce the perception that all investments/loans to large businesses are "risk-free" because the government will always bail them out. Pure moral hazard.

But Evergrande was so significant that a complete failure would result in major losses, major disruption in the property market...

The realisation by investors of all kinds that "shit, we can actually lose" would reverberate throughout the country – paralysing the property market...

A market we discussed is a major part of the economy, a key driver of economic activity, employment and store of wealth for the entire country...

And the broader corporate bond market would likely seize as well…

The Evergrande debacle was "resolved" as we'd have expected. It kinda went away, right? The government basically "managed" a wind-down of operations, doing their best to ensure some losses were felt by some parties but also ensuring not too many "ordinary people" lost.

As a coincidence, just a few weeks ago Evergrande filed for bankruptcy in New York – seems they will soon be formally laid to rest.

Fast-forward 2 years…

Evergrande's decline resulted in a new company assuming the title of China's largest property developer – a company called Country Garden.

It just defaulted on its debt – missing two bond payments.

Additionally, its reported that, over the course of the 2 years since Evergrande got into difficulties, companies responsible for around 40% of Chinese home sales have in fact defaulted. What a mess!

The turmoil has seen suppliers and contractors go unpaid. Homebuyers – some that have fully-paid for their properties – have been left without their apartment. Protests and boycotts have been widespread.

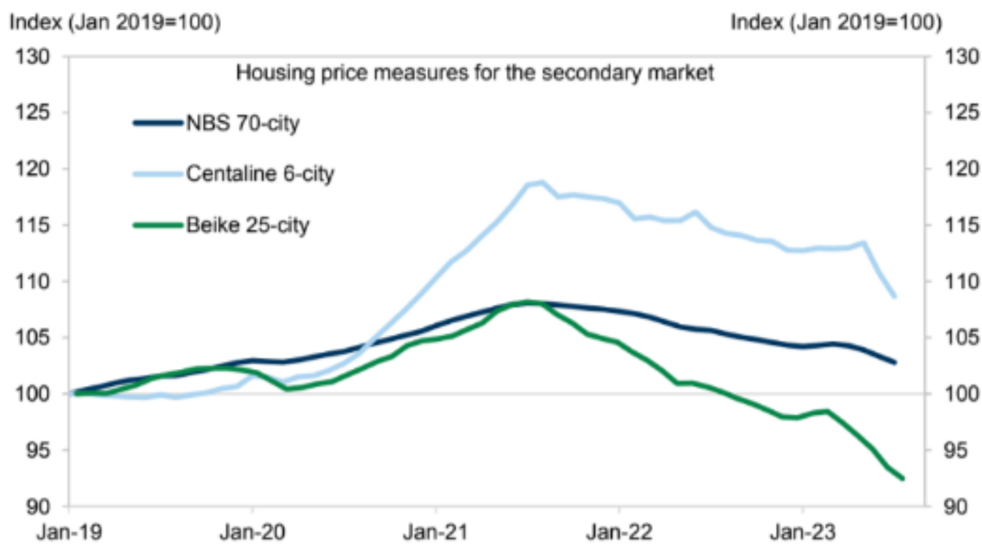
Confidence in the real estate sector has understandably plummeted. With it, sales have plummeted. Its reported that property sales are down by around a third in 12 months. Country Garden's sales fell by around 60! – no wonder they are experiencing some liquidity issues! They are projected to deliver 700,000 new apartments this year! They aren't on track to do half that at the moment.

Bigger Picture

Despite the government's efforts, trust in the property market has taken a major hit.

The property sector grew to be a very large component of the economy – responsible for significant amounts of employment and economic activity. It was largely built on a view that property prices only ever went up. Given the financially-repressive economic policies, it was one of the few sectors where Chinese could invest – a decline in values would deliver a profound "wealth effect" across the entire economy.

The property sector has basically stagnated. Property prices are [gasp] *falling*!



The impact in terms of activity and employment is profound.

Their economy surely is in a precarious position. Youth unemployment is at record levels. Consumer-centric measures like retail sales have declined.

What's a (communist) government to do?

I've often described China's economy as a set of levers in the control room. There's a few main levers and a few related dials.

To illustrate, refer back to that first chart above regarding annual percentage change in bank loans. Notice the circa 34% annual change during the global financial crisis.

Remember that a major driver of China's economy is exports. The global financial crisis resulted in a global recession and a significant decline in demand for "stuff" from China's customers.

Factories began to struggle – laying off workers. People were unhappy.

In response, the government pulled a few levers – it stimulated those other key areas of their economy – building activity.

It ordered regional governments to build. It ordered banks to lend – hence the staggering 30-something percent of GDP worth of debt created in just one year.

It worked! China is remembered as having a "good financial crisis" – displaced factory workers found jobs in construction and the economy motored on.

The problem then was a spluttering of the "exports" part of the economy. This was overcome by pulling hard on the "build stuff" lever.

Now, a key component of the "build stuff" side of the economy is spluttering. Builders are struggling – laying off workers. People are unhappy.

Could the government do the reverse of 2008? Could they yank on the "exports" lever and engineer a surge in demand for exports? Probably not. They already have such a large slice of global demand and any increase really is more contingent upon demand than supply.

[As a side-note, a recession in their customers' economies (U.S., Europe) at this juncture would pose a real challenge. If demand for Chinese goods materially declined – like in 2008 – that would add significant further strains at a very bad time.]

What else could the leaders do? What other levers do they have?

Well, they do have the public-sector "build stuff" lever.

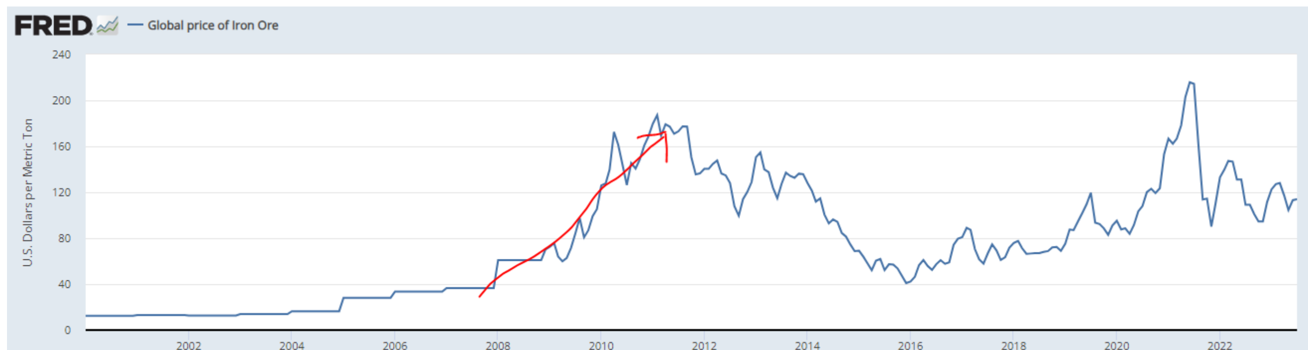
They could engineer a surge in investment in that area – new high-speed trains, new soccer stadiums, new airports, new hospitals.

But remember, all of that stuff isn't "free". It all needs to be financed – either via new debt or a significant increase in taxes. It also needs to be "productive" or else it just adds to an already unsustainable debt burden.

Broader Implications

Before we continue to attempt to gaze down the path ahead for China, let's take a brief detour and explore some of the broader ramifications that might unfold due to China's current predicament.

Recall how China responded to the Global Financial Crisis by engineering a massive construction boom. This had flow-on effects. The construction activity put a rocket under raw materials prices. Here's the iron ore price showing an explosion from around US$40 per tonne to nearly $200 over the course of a few years



Over the past 14 years since the GFC, iron ore has grown to be Australia's largest export. Partly because of this, China has grown to be Australia's largest export partner. Here's the annual tonnage of iron ore exported by Australia over the past decade:

A rise is again expected this year – over 900 million tonnes of iron ore is projected to leave Australian shores. A handsome slice going to China.

The Chinese residential property industry has been a fervent consumer of a lot of this.

If you study markets such as commodities, what you learn is they often form fairly stable equilibriums. When supply is capable of meeting demand (generally the case for most commodities, despite commentators sometimes gushing about an inability to meet demand), prices tend to be "relatively" stable.

It follows that "shocks" impacting either supply or demand can have significant impact on prices.

Remember the oil price a few years back during Covid? It went negative!

If construction activity continues to stall it would amount to a demand shock. A logical outcome will be a decline in the iron ore price. Quite possibly a significant decline. Its still well over US$100 per tonne. Why couldn't it fall back to $40?

That would have a profound impact on Australia's "terms of trade". That's even if we're optimistic and feel that a decline in volumes exported is not at all impacted.

[As a side-note, I better clarify my stance on Australia and resources. Mining is a major industry in Australia – it has been practically forever. I do not forecast that will change.

Some very smart finance guys are very bullish on resources – particularly those such as copper that are needed to "greenify" the planet. It's a logical argument that I agree with. Australia is in a great position to help deliver what's needed – we're the "lucky country".

But resources have always been cyclical. While mining will be a huge industry in Australia for the foreseeable future, market prices can fluctuate significantly. Simply, I foresee potential for some significant price declines as the waves of natural economic cycles ripple throughout the world.]

The path for China

As I've commented in the past, China has been somewhat of a joke in the hedge fund community for a decade or more. They have a deeply unbalanced economy. An economic model that's totally unsustainable. Yet, at least until now, it keeps motoring forward.

The imbalances have to resolve. They have to and, one way or another, they will. At some point…

Earlier we discussed how debt levels have been growing in excess of 15% of GDP whilst growth has dramatically slowed. Understand that this basically means debt needs to grow by roughly this amount just to keep the economy stable at minimal growth.

It follows that one rebalancing scenario is a debt crisis. A scenario where debt gets to such a level that the economy simply can't absorb the additional debt needed to keep growth going. It all basically just stops.

It's a very plausible scenario. As noted earlier, significant global economic weakness would help make this scenario more plausible as it impacts China's exports. A debt crisis is a very bad scenario that could lead to other scenarios. For example, the economy could be sufficiently devastated that millions of unemployed people become very disenchanted with communist leadership… it could result in a revolution.

But there are other scenarios.

There have been a number of historical precedents in this area. Rapid growth within a deeply unbalanced economy. Japan pre-1990 is such an example.

In these examples, the imbalances were resolved slowly. Not painlessly – significant losses were borne by many. But the economy "muddled along". The economy experienced what's commonly referred to as a "lost decade" (or "decades").

I believe China has the capacity to "engineer" such an outcome. Bluntly, I suggest this is the "optimistic scenario".

A big part of this scenario entails "extend and pretend".

To illustrate, consider that, in a way, losses have already occurred. The holders of Country Garden debt have basically already suffered losses. Barring a resumption to rising property prices, the off-the-plan buyers of properties over the past 12 months will suffer losses. And that's even assuming they actually get to take delivery of their property!

Remember "equilibrium" – *somebody has to hold every asset at every point in time until its "retired"*.

This is where losses can be managed and assigned by the government. The Chinese government will need to "bail out" certain parties via buying the assets from them. Then basically doing the financial equivalent of "burying them in the forest."

They'll do this. It won't revive growth, but it will hopefully "stabilise" the economy in a state of low growth… for a decade or so…

Related to this, there's been a bit of fanfare the last month about "unexpected" interest rate cuts. Examining this for a minute in the context of the Chinese economy further highlights the mammoth task ahead for the Chinese leadership.

Ultimately, they need to rebalance their economy – away from exports and building stuff and more towards the consumer.

This means getting a bigger slice of the economy in the hands of the consumer.

By cutting interest rates, they rob savers (mostly less-wealthy consumers) from additional income. This passes as a subsidy to debt issuers – the property sector that you're trying to "deflate" in an orderly way.

"But…stimulus…"

Many people are eagerly awaiting the announcement of major stimulus – just like 2008. Sorry, its not coming. There will be stimulus – positive announcements aimed at boosting confidence. But I'm afraid its fairly evident that the Chinese leadership realise that *major* stimulus risks doing more harm than good at this point – the longer they prolong the rebalancing, the greater the risk of a disorderly debt blow-up. Maybe it's too late already.

In summary…

I've repeated today a lot of what I said 2 years ago. Much of this I've discussed for a lot longer than that. Nothing "new" or unexpected has happened for quite some time.

China has a deeply unbalanced economy which it created via its own economic policies. The imbalances *will* resolve – the only questions are when and how.

A major debt crisis is a real possibility.

Some commentators expect the Chinese government to repeat old habits by embarking on massive stimulus. I'd say this is unlikely – they know this risks doing more harm than good.

Some commentators are wondering whether the bust in China will cause a global "growth shock" and be a principal driver of a global recession. We know that major economies like the U.S. and Europe are already barely skirting recession so a further hit won't be helpful.

But on the flipside, we also need to acknowledge that such a scenario would be very bad for China at this point – the decline in export demand will only exacerbate their problems.

I perceive myself to be somewhat of an optimist. I think Japan offers an instructive roadmap on how China plays out. I sense a "lost decade" coming up. Excesses slowly worked through, growth barely positive, significant losses realised but assigned over time.

Even under this “optimistic” scenario, the demand shock to resources may well result in significant price falls – particularly our key exports like iron ore. This will rip a hole in our economy with fairly unpredictable ramifications (a falling Aussie dollar being a likely candidate).

I want to end this long commentary the same way I ended my comment two years ago in relation to Evergrande. I said the following:

It must be more than 10 years ago now when I was watching videos of outspoken British Hedge Fund manager Hugh Hendry strolling around brand new, empty business parks in China looking for tenants. I’ll end this with a quote of his from those days:

“I don’t know if there’s a Confucius saying about this or not, but if there is its wise man not invest in overcapacity.”

Indeed. Good luck China – you’re going to need it…

This document contains information which is the copyright of Aviator Capital Pty Ltd (AFSL 432803) or relevant third party. Any views expressed in this transmission are those of the individual, except where the individual specifically states them to be the views of Aviator Capital Pty Ltd. Except as required by law, Aviator Capital Pty Ltd does not represent, warrant and/or guarantee that the integrity of this document has been maintained nor is free of errors, interception or interference. You should not copy, disclose or distribute this document without the authority of Aviator Capital Pty Ltd. Aviator Capital Pty Ltd does not accept any liability for any investment decisions made on the basis of this information. This information is intended to provide general information only, without taking into account any particular person’s objectives, financial situation, taxation or needs. It does not constitute financial advice and should not be taken as such. Aviator Capital Pty Ltd urges you to obtain professional advice before proceeding with any financial investment.