

MARKET COMMENTARY

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The China Syndrome

A 1979 action movie appropriately named *The China Syndrome* brought to the big screen the sheer terror of an accident at a nuclear power plant.

The term “China syndrome” referred to a fictional scenario in which a severe meltdown of a reactor’s core would violate the concrete containment vessel and burn its way to the other side of the earth, that is, to China. In reality, the nuclear fuel would continue to cool as it breached the barrier, burned through soil, and reached groundwater. In fact, the release of a radioactive cloud of steam as the core cooled would create the greatest danger. Unfortunately, we’ve since learned through experience that such disastrous scenarios can become reality.

Tragically, a meltdown occurred at the Three Mile Island plant in Pennsylvania just two weeks after the release of the movie. Subsequent disasters at Chernobyl and Fukushima have vividly underscored the dangers associated with nuclear energy. The long-term impact on human and animal life, in combination with the catastrophic ecological damage, are two of the reasons why the development of nuclear energy has stalled. The science may be safe, but the variable of “pilot error” or malicious intent can never be fully eliminated or underestimated.

With the benefit of hindsight, we can all identify the likely causes of a disaster. Perhaps the safety systems were in need of repair or updating. Maybe there was a design flaw. It’s possible that the people in charge weren’t properly trained.

Drawing the Comparison

In the movie, Jack Lemmon portrays an emotionally disturbed plant supervisor whose warnings of “it’s happening” went unheeded. He was prescient enough to notice unusual vibrations. He was convinced that faulty gauges were providing incorrect readings. But he was ignored, not simply because others were unable to see the flaws, but because they were unwilling to. The plant owner, politicians and regulators had too much at stake to admit to a systemic failure that would incite panic.

The current China crisis, although it has nothing to do with nuclear energy, bears some resemblance to the movie in that warning signs are being ignored. In this case, we’re alert to the potential of Chinese policymakers mismanaging their economy, leading to a systemic financial crisis and an economic hard landing. And the ramifications most likely would be felt across the world in a manner similar to the events that led up to the financial crisis of 2009.

The warning signs of an impending bubble bursting are abundant. Moderating Chinese growth is having a dramatic impact on the ability of Chinese policymakers to manage a smooth transition from investment to consumption, from

manufacturer to servicer, and from exporter to importer. Constrained by overcapacity, high debt burdens and a rigid currency regime, China is attempting to micromanage a soft landing. However, a more severe decline is becoming more and more likely.

Deleveraging Process

When China's economy was expanding by 10% year after year, it was generating demand for everything from oil to iron ore. The sheer size of its population and its potential to achieve a higher standard of living seemed to be a justification for a shortage of everything. In 2008, that all changed. Suddenly abundant global liquidity and reckless credit creation ceased. Global growth slowed, the deleveraging process began, and demand for Chinese products cooled. To offset the weakness from softer export markets, China began the biggest debt-fueled infrastructure investment in the history of mankind. Unfortunately, domestic demand has been insufficient to match the additional supply, particularly within property markets and specifically with residential housing.

Attempts to cool the property markets through more restrictive lending and regulation have diverted savings to publicly traded stock markets. In essence, a state-sponsored bull market in stocks is intended to offset the financial damage from the bear market in property.

We'll know only in hindsight whether the bull market in stocks is a bubble, though our guess is that it is. The meteoritic rise per the Shanghai Composite Index happened in just 11 months from a low of 2,033 on July 11, 2014 to a high of 5,178 on June 12, 2015, and has since corrected to 3000. A 40% correction constitutes a bear market; but as we saw in the United States in 1987, not all stock market crashes result in economic crashes. What makes the Chinese more vulnerable is the broad divergence of the underlying fundamentals. Companies are creating more debt and generating greater losses while the return on equity is declining. Furthermore, those companies are finding it more difficult to generate the cash needed to service debt. While events since 2009 have taught us that liquidity can drive stock prices far past valuations, eventually the speculation ends. The rapid decline in commodity prices, particularly for oil and iron ore, tends to confirm our concern about the prospect of slower

growth.

The Source of the Chinese Boom

The Chinese boom appears to have been built on cheap, abundant labor and an undervalued currency. There was a desire on part of the developed world to import cheap products and services, and there was a willingness on the part of the Chinese saver to finance it. Today, Chinese labor rates are no longer as competitive, and its currency is overvalued. In fact, Chinese wage rates are stagnant as a percentage of GDP, and increased consumption is being funded entirely from domestic savings. The transition to a consumer-led economy requires higher wages and wealth, and the Chinese are still a long way from achieving success on those fronts.

The aftermath of the boom presents an opportunity for China to emerge as a global leader; but to get there, policymakers must move away from a managed economy and the yuan must be allowed to float. Capital must be allowed to move freely. Interest rates, stock prices and wage rates must be established in a free and open exchange. Currently, China is constrained by a less competitive regional currency, weaker export markets and excess capacity. In addition, inventories are beginning to swell. China's attempts to manage capital outflows have been less effective. The stock market bubble is bursting, and policies designed to prevent a meltdown are failing.

This is a character test for a regime that has always believed in an engineered outcome; an insular China was better equipped to obtain a desired result. But as a global leader, China must subject itself to vulnerability. It must take and manage risk. It needs to allow inefficient institutions to fail. It must respect property rights.

Confidence and complacency can create undefined challenges. The risk of a nuclear accident is so devastating that it requires extra caution and surveillance. In the case of a financial accident, signposts are generally visible, yet we tend to ignore them until it's too late. Markets are very quick to readjust to risk. The economic effects of a stock market crash in China can be as muted as those that occurred in the United States in the shadow of 1987. However, if the Chinese continue to promote policies of reduced transparency and price discovery,

they're likely to experience a market crisis more like that of 1929. Regardless, the global impact is likely to be more cooling, greater competition and increased price pressure. And the cloud could hang over the planet for quite a while, depending which way the wind blows.

A Look Ahead

The transition to consumerism is going to be a long and drawn-out process for China. Eventually, China will emerge as a global leader. In time, it will get stronger, richer and be more respected. This October, the International Monetary Fund will begin to consider the yuan in the context of a reserve currency, alongside the dollar, euro and yen, a significant signal that China is emerging as a global powerhouse. China's leadership is likely to dominate the Asian region over the next several decades, and it is now clearly one of the globe's three superpowers. The only question now is how the emerging superpower will manage its own China syndrome.

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The International Monetary Fund (IMF) is the intergovernmental organization that oversees the global financial system by following the macroeconomic policies of its member countries, in particular those with an impact on exchange rate and the balance of payments.

The Shanghai Composite is an index of all stocks that are traded at the Shanghai Stock Exchange.