Alhambra Investment Partners

The Plunge in Shanghai

For the Rest of Us, China's War on Markets is Mostly Noise

In last month's letter we flagged two events as giving the markets extra risk, concluding with a "Cautious" call. One risk was the Greek default, the other was the bursting of China's stock-market bubble. As it turned out, the first part of July world markets were focused on Greece, and the second half has been about China.

First, let's review what's going on in China. After years of flat returns, the Shanghai Composite, China's largest market, started taking off last November, adding over a quarter in 4 months. The real excitement started around March, with the index soaring by more than half in just 3 months. Then, starting in mid-June, the market turned, dropping nearly a third in a matter of weeks. The Chinese government reacted with massive stock market stimulus, including loosening credit for speculators while persecuting shorts. Since then it's been touch-and-go, with markets pushing down and the government trying to staunch the red ink.

So that we can follow along, here's a chart of the Shanghai Composite over the past year:

First let's review the standard story on what's causing all this. Then we'll look again using Austrian theory.

The mainstream wisdom is that China's bubble is popping because China's GDP growth is slowing. This slow-down erodes that old Keynesian pixie dust, confidence. Investors get scared, they sell, and things crash. Easy peasy.

The Austrian story, as always, is a bit different.

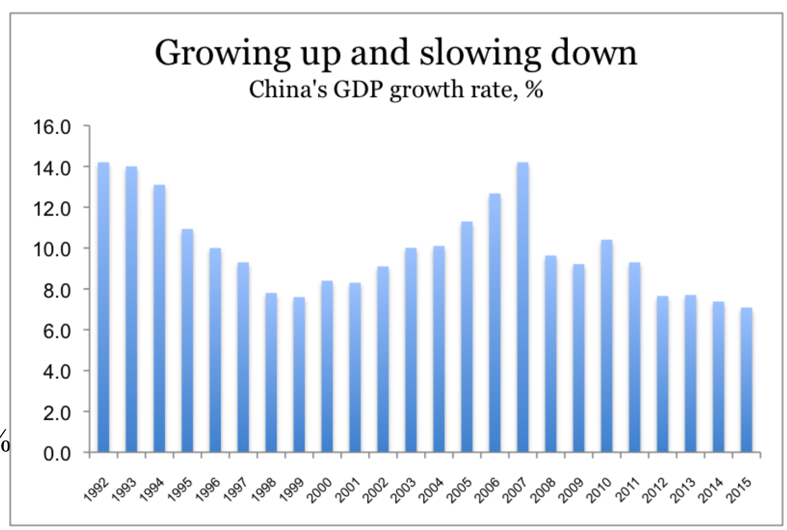
The first thing to note is that China's GDP slowing is an old story at this point. It's been slowing since 2007 – indeed, slowing unbroken since 2010.

The problem here for the mainstream story is that, if the crisis is slowing GDP, why did the bubble start in the first place? Four years after the slowing a bubble starts, then four-and-a-half years after the slowing the bubble pops? A very odd way to digest old news.

So, no, it's not the GDP slowing.

Next, we can don the Austrian hat. And in Austrian cycle theory the first suspect is always easy money. In particular, distortions caused to both the economy and to markets by easy money. And here we have a very good candidate that actually lines up with our boom: housing speculation shifting into stock speculation.

Starting in 2014, the Chinese government started trying to cool the property market putting pressure on banks to scale back property loans. We've all heard of the "ghost cities" of empty apartments and malls, and China was realizing the malinvestment was spreading. As the property market cooled, prices also started cooling. The speculators needed a new game.



The problem for China is that Renminbi money supply continued growing, thanks to low rates -- currently 3.9% real (5.1% nominal minus 1.2% inflation). This is quite low considering China's growth is about 7.5% -- borrow at 3.9% real, invest for 7.5% returns yields very easy money. This means

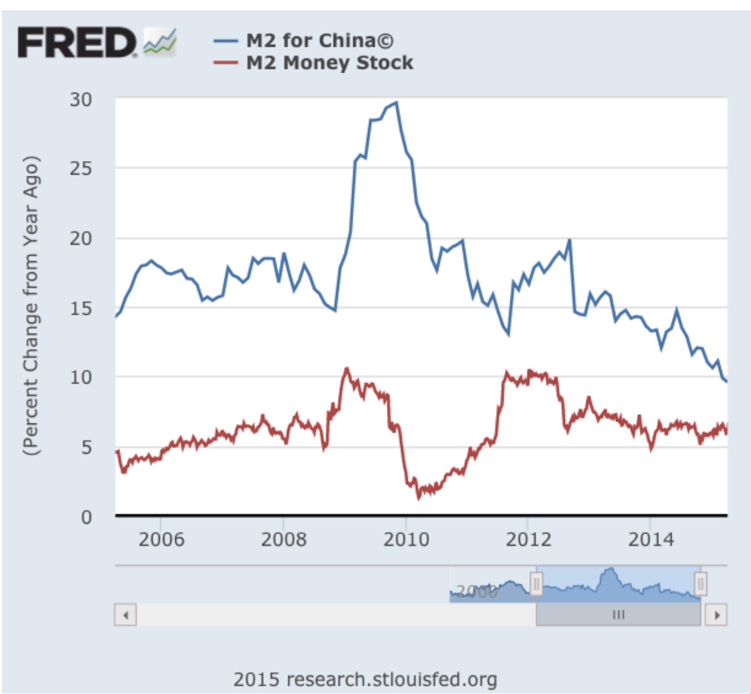
China's money supply has continued growing -- lower than in the 2008 aftermath, but still at a healthy clip of 3-5% above GDP growth.

So, by stamping down on property speculation without raising real rates, China simply squeezed the balloon. Speculators herded out of property. But banks, flush with all that easy money, were still pushing the product out. With official guidance to avoid property, then lent to the next bunch of gamblers -- stockmarket speculators. And, like clockwork, the easy money draining out of property shuffled right into stockmarkets.

So that's our bubble. Why the bust? Bubbles come and go year-in, year-out. They are constant. Particular commodities, particular industries (solar, cloud computing, even rail a few years ago). There are a number of social dynamics at work here – the best academic work goes under the name "cascades": information cascades and belief cascades.

The short of it is that people do indeed herd into, and out of, particular asset classes. And that handing scads of freshly printed money to "low-information" participants – such as the housewives, taxi drivers and pensioners that are playing Shanghai these days -- makes the shifts more violent.

Where do we go from here? Well, if the Chinese government did nothing about the stockmarket plunges, it would simply resolve itself. Bubbles have a tendency to retrace, to return to the level they started at. If the bubble lasted several years we'd want to adjust this "retrace" to whatever happened to fundamentals in-between. This tendency is simply operationalizing Benjamin Graham's observation that the market is a voting machine in the short-run, but it's a weighing machine in the long run. We'll discuss this retracing in our theory article this month.



We can eyeball this retrace straight off Shanghai's chart: somewhere between 2,500 and 3,000 on the Composite. This is between 20% and 35% down from current levels.

From an economic perspective, China ought to just let it happen: let Shanghai find its true level. Let the speculators get wiped out. Shoot one monkey to scare a hundred, as the Chinese expression goes.

In practice, if they let it happen then China's bank regulators may have to bail out some systemically important banks, or some politically connected institutional investors (e.g. state pensions). But it causes much less structural damage, and much less future moral hazard, simply letting speculative bubbles run their course.

So far, of course, China isn't following this laissez-faire policy. Unsurprising, since most governments don't -- they simply cannot let gamblers eat their own losses.

Will it work? Can China throw enough billions at stockmarkets to keep them up? China's leadership is no doubt aware of the Hong Kong precedent, where the government injected massive funds to buying up the Hang Seng after the late-90's Asian crisis. That was ultimately judged a success, in that it did indeed prop up markets.

Of course, the difference there is that Hong Kong was pasting over a "voting" episode of panic while markets found their "weighing" fundamentals. While Beijing today is doing the opposite, trying to defy gravity to keep a "voting" episode of mania permanent. So there's certainly more risk for China.

At the same time, to put this in perspective, even a "failure" by China -- meaning they throw trillions at stockmarkets and markets still plunge -- simply means we get to the correct place of lower stock values. China just runs down the credit card a bit. So, as investors on this side of the Pacific, we shouldn't really care whether or not China wastes it's money bailing out speculators.

What about the larger risks? Will bubble-busting cripple the Chinese economy? Will it spread to the rest of the world? Here, I think the risks are definitely over-blown. Worst-case scenario, China runs down its reserves while all that fast money from the bubble vanishes. But that money was easy-come, easy-go. It wasn't there a year ago. And so if it vanishes, there's trivial economic impact.

Western TV talking heads will inevitably compare any stock crash to 1929, and it's critical to remember the Great Depression was absolutely not caused by a stock-market crash. On the contrary, the Depression was caused by policies enacted to counter the effects of a stock-market crash. In a sense exactly what China's doing today -- weird policies to cancel a crash -- but the economic effects of bailing out speculators is utterly benign compared to the root-and-branch re-regulation and wage floors enacted by Hoover then FDR. So, no, unless China uses this "crisis" to wholesale re-regulate their economy, something that's not remotely on their agenda, there is no risk to the greater economy.

As little risk as this episode carries for China's economy, there's even less risk for the rest of us. A couple million speculators going bust in China has absolutely nothing to do with foreign markets, and has negligible impact on foreign company profits. Remember all those speculators are losing money they just made in the past 6 months. Easy come easy go. Character-building experience for all involved, I'm sure.

A good indicator to watch here is China's exports, chart on next page. More than GDP, Chinese exports are a shadow indicator of growth in the US and Europe. That number's been doing just fine and, if it does start to flag, only then might we take an interest in contagion to major economies outside China.

Bottom line, the drama in Shanghai has mostly short-run noise impact on foreign markets, and negligible impact in long-term.

China's bubble-and-pop is just a typical boom-phase easy-money whirl. They'll come and go. Beyond that, it's meaningless even as cycle-indicator, except to trivially confirm that, for the moment at least, the world's still in a boom.

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