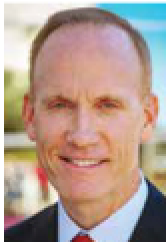
A Healthy Economic Fear of China



There's an old adage in finance concerning borrowing and lending: If you owe the bank $ 1 million, you have a problem. If you owe the bank $ 100 million, the bank has a problem.

It's all about scale.

When it comes to countries and markets, there is no scale, and therefore no problem, like the Middle Kingdom.

China is the land of the "biggest."

General Motors now sells more cars in China than it does in the States.

The country boasts more than 1.3 billion registered cell phones, the most of any nation, and basically one for every citizen.

Chinese domestic consumption is growing by double digits while consumers in the developed world keep a tight grip on their wallets. This trend has continued for a decade… but it might be changing.

Unfortunately, no one knows for sure because the Chinese are notorious for rosy projections and opaque results.

As the rest of the world convulsed during the financial crisis of 2008-09, China watched its GDP growth fall from 14.2% in 2007 to 9.2% in 2009. Something had to be done!

The Chinese government injected hundreds of billions of dollars into the economy, goosing economic growth back above 10%… for a year or so.

Eventually, even with more financial engineering, growth fell below 9%, then under 8%, and has now dipped below 7%.

To keep the factories open, China has become a posterchild for exploding debt.

Not national government debt, which stands at less than 50% of GDP, compared to the U.S. total of about 100%. In China, it's all about non-financial debt, which exploded by 18% per year between 2010 and 2015, reaching 160% of GDP and certainly well beyond that today.

Through banks and local entities, the national government funnels loans to state-owned enterprises (SOEs), which are government-run businesses.

If a factory is an SOE, it must serve two masters – making a profit and satisfying political demands. When those two goals conflict, which happens when such a company should downsize (and fire workers) to be efficient, they often choose to be politically correct. This means borrowing money to operate since they're bleeding cash.

This approach works as long as banks, at the direction of the government, keep funneling money to the losing entities. When the government grows weary of the charade, all bets are off.

Given recent statements to this effect from China's President Xi Jinping, SOEs might lose their financial lifelines, which will lead to closing businesses and job losses.

This rotation away from bloated businesses will help the economy in the long run, but it will be painful in the short-term. And the pain won't stay in China. It will ripple around the globe, washing up on foreign shores.

Recently Chinese futures for iron ore, coking coal (used in steel mills, among other places), and rebar got hammered (pun intended). It was interesting because official Chinese steel

inventory sat below normal levels.

It could be a temporary dislocation in the markets, or it could be the beginning of a slide.

Around the same time, Moody’s downgraded Chinese debt from Aa3 to A1, noting higher debt levels and a softening economy.

Hmm.

Those who sell raw materials should be concerned, and not just those who sell to China.

When the biggest buyer in the market loses interest, all suppliers take a hit.

While the ebbs and flows in the iron and copper markets are well known, there’s another market that should be eyeing China with trepidation – oil.

Every week the world gets a glimpse at how much oil sits in inventory in Cushing, Oklahoma. This measure, along with some data points in Europe, provides insight on oil supplies.

But that’s only half the equation.

To estimate where the price of oil will go next, we need to know demand. And better yet, future demand. This is where things get murky.

Chinese oil purchases have been driving marginal demand for years. As more Chinese take to the road for the first time, this makes sense.

But the country has also been adding to its strategic petroleum reserve (SPR). The problem is, no one knows the size of the reserve or how much more the Chinese will store.

JPMorgan estimated that China added roughly 1.2 million barrels of oil per day to its SPR in the spring of 2016. But it doesn’t know for sure.

The Chinese report on their SPR, but their numbers seem a tad light.

Why would a nation almost four times the size of the U.S. have a reserve less than half the size of ours? Analysts think the Chinese reserve is closer to 600 million or 700 million barrels, just shy of the U.S. SPR capacity of 735 million.

No matter what the size, eventually the reserve will be full. Unless business and consumer energy consumption ramps up dramatically, which seems unlikely given slower GDP growth and potential cutbacks at SOEs, Chinese oil demand could decline.

If it happens soon, then the slowdown will coincide with OPEC's attempt to prop up prices through continued production cuts. Falling production would be met with falling demand, thereby keeping the oil market in equilibrium at a time when U.S. inventories are near record highs.

And then there's that pesky business of U.S. fracking companies ramping up production.

Let's not lose sight of the fact that OPEC is a cartel, and is working with non-OPEC members to manipulate the markets. They need to drive up profits to help their busted budgets.

They should be very fearful of changing Chinese demand… and it couldn't happen to a nicer bunch.

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