Investment Insight

ZANACORP

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Until recently, it was fairly easy to recognise the difference between democratic, free enterprise (Western) based economic systems from their state based communist/totalitarian counterparts. Significant differences in personal freedoms, rights and reward for individual effort were obvious. Today those points of difference are not so clear. Europe's stifling socialism has seen it fall behind "Chinese style" communism that has in just 40 years spawned 698 individual billionaires (against 726 in the US). The Western legal system and culture placed individuals on the centre stage fostering the innate human condition to enquire, innovate, seek new frontiers and progress. It created the economic environment where people were free to frame their own best life based on their personal skills, efforts and preferences. Wars were fought and lives lost in pursuit of this aspiration. Although imperfect, opportunity and self interest have been powerful drivers of the affluence we currently enjoy. Meanwhile, state based systems have generally folded having failed to bring prosperity to the many. China's success until now, relied on Deng Xiaoping's vision to allow individuals to be rich and inspire others to be able to improve their lives, fashioning an economic miracle. Now Xi Jinping has his own, very different plan for China and it is attractive. He has identified the 21st century problems of ageing and income inequality and he alone is prepared to make the changes necessary to correct these imbalances, inflicting short term pain on a few in pursuit of longer term good for the many. Global Western leaders bemoan the burden on millennials locked out of the housing market and the scourge of income inequality but are not prepared to take the obvious measures to resolve either, aware that the unwinding of the private debt that has contributed to these issues would deliver pain to the many. A pain that Western people have become unaccustomed to. To preserve the status quo and protect borrowers during COVID-19, individualism was sacrificed. With unlimited funding, governments seemingly protected us, gave us money to spend while in lockdown and kept businesses alive, as few people have sufficient savings or the stomach to see their capital fall. In exchange, we obey the edicts of temporarily elected people. Our freedoms, our rights and many livelihoods have been lost to the state. In a world where owning a $1m home has more to do with one's age than one's actions, free enterprise has stacked unearned asset wealth into the hands of older people at the expense of the young, something must change and it will. As a new world order begins over the next 5 –10 years, governments will have far greater control of our lives and will be asked to support far more people. There is no such thing as a free lunch and printing money will have nasty consequences down the track. So the haves will be taxed heavily to provide for the have nots, which will not be welcomed by boomers. For the first time in many generations children will have inherited a world worse than the one enjoyed by their parents. A day of reckoning will also come for those that have borrowed heavily for investment failing to appreciate the potential impact of an unravelling of asset prices as interest rates rise in 2022/23. We believe people have only a few more years to get their house in order and their living costs. We are preparing our clients for the inevitable end of a debt driven asset boom. They all end, here as well as in China. This one is likely to be worse than most, as more people are in it. Winter is coming.

The Great Moral Hazard

The Trolley Problem

For decades experiments in ethics and psychology have examined the deeply sensitive dilemma of saving many by sacrificing a few. The trolley problem poses the question: ***If you saw a runaway tram on course to kill 5 people further down the tram track, would you pull a lever to switch the tram onto a different track to kill one otherwise safe person? Or do nothing and allow the tram to remain on track and kill the 5?*** You alone control the fate of the peoples' lives and no one else can assist.

Most responders choose to kill the 1 in order to save the 5.

Would your response be the same if the 1 was a close relative? Please stop to consider... Would you save 5 strangers and choose a loved one to die? That is the dilemma. At a much higher level, the world's leaders face a similar problem. They are choosing quite different paths.

Not So EVERGRANDE of FANTASIA

You have read and heard many times that China will dominate the 21st century. Since 2016 that premise is being increasingly questioned.

This piece aims to shed a little light on what most of us call China's economic miracle. How on earth did this country pull 600 million people out of poverty in just 40 years? Here we simply address just one of the many moving parts contributing to this.

Few Western people could genuinely understand what it is like to live in a proud country that endured over "a century of humiliation", poverty, starvation and lost self identity. That was China's situation in 1978.

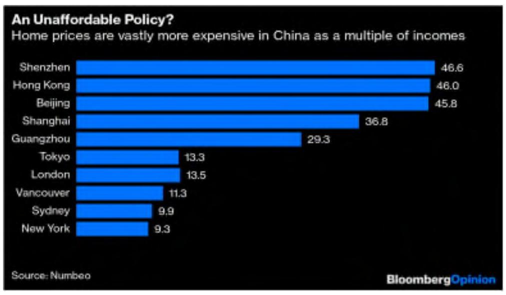
With an eye for technology and a vision for change, Deng re-engaged China with the outside world. He reformed structures to birth industries, allowed people to make profits and fostered mass migration from rural life to urban cities. To house workers in cities, Chinese property became a natural national source of employment, growth and credit . Land releases became a key plank of local government funding, rezoned at a profit, sold to developers then resold as apartments to private investors.

Comprising **29% of China's annual GDP,** property prices have increased for decades without ever falling, providing both shelter and financial security for citizens. It enjoys the favour of government and capital flows.

Property is not just an asset sector in China. With a closed capital account, investors cannot freely invest overseas as we can. Also unlike the West, having experienced poverty, Chinese households are prolific savers. With a distrust of government controlled banks and volatile shares, an estimated **70% of all Chinese savings is invested in property** making it very personal. For demographically over represented young males, pursuing under represented females, owning a house is almost a pre-requisite of marriage.

Prices have become so expensive, multiple generations contribute equity (aka extended bank of mum and dad) as collateral for high borrowings to complete a purchase. Expecting rising prices, **even for empty properties,** this magic pudding recipe is employed repeatedly by most families and most generations, as no living person has experienced a price decline.

Defying the doomsday predictions of Western sceptics calling the sector a Ponzi scheme, like the Japanese property bubble of the 1980s, the China market has continued to rise apparently because **China is different.**



This chart illustrates the extraordinary multiples of income of home prices in China's Tier 1 cities compared to other developed cities. **46x. income!**

Is Chinese property really that different?

Unsurprisingly, with demand and prices rising continuously, it has led households and property developers to **aggressively borrow and speculate.** Which brings us to **Evergrande,** employing 4 million staff and contractors. It is **the world's most indebted property company** with a debt of A$410B and unable to meet its interest bills, many struck at well over 10% pa.

In the lead up to the Evergrande default, 1.6m home buyers paid in advance and in full for "off the plan" apartments. Employees lent the company money, high yield investment products were issued to investors and properties were sold at 20% - 30% discounts, all to raise funds to meet debts. Despite these exhaustive survival measures, it was all to no avail. **Fantasia,** another mid-tier property developer, has now also defaulted.

The shares of both companies have collapsed, as has the price of their bonds, both assumed to have had implicit government guarantees. As the contagion spreads to other property industry suppliers, real estate agents, concrete and steel producers, a considerable problem appears to have emerged for the CCP. Or so it looks to outsiders.

These failures are not isolated, nor did they occur by accident.

Rising house prices contributed to debt in China doubling in the 4 years to 2020 to over 280% of GDP, alarming the Chinese Communist Party (CCP).

Housing unaffordability and growing income inequality has led to increasing discontent in China (sound familiar?). A profound policy shift by Xi to a concept of **common prosperity** and the words "houses are built for living in, not for speculation" resulted in the CCP taking charge of the property market. This coincided with a decision to **contain the rising power of corporate moguls** in technology, education, the internet and of course property. Disrupting each in turn. This is how dictatorships operate.

Evergrande and Fantasia are casualties of China's new social pivot. Recognising that China will have fewer people and fewer workers in the future demands more self reliance, more protection and more people sharing in China's wealth. A controlled reform of Deng's model is extremely bold but if it is successful, will immortalise Xi Jinping in Chinese history.

Anxious not to repeat the errors of the Japanese and their property bubble bust of 1990, a plan to directly manage China's overheated and overbuilt property problem began. The **3 RED LINES** policy was to restrict credit to developers who fail to meet 3 debt based Balance Sheet ratios. It was expected this would cool the market, eliminate smaller builders and the builders of sub standard "tofu dreg" projects currently undermining the confidence of investors in the quality of Chinese construction.

The CCP totally understands that crushing existing property systems and beliefs will lead to short term financial pain to big corporations and many investors (like killing the 1). The benefits are hoped to flow to future generations (saving the many). Backlash is expected to this plan, but unlike Western leaders, Xi is confident in his ongoing leadership and that his country is strong enough to manage the transition for the greater good.

Xi's property and other economic reforms carry a high execution risk. Controlling domestic fear and ring fencing contagion will be an challenging task, but not impossible . The CCP will choose who it saves and who it punishes. Domestic home buyers will probably be protected and foreign investors left empty handed. The CCP will look after its own and reinforce to its people the confidence that the country and the system is strong.

Many Western based economic observers waiting for the Chinese property bubble to crack now believe the Chinese model will fail. Our view is that China's domestic economy will be severely tested but as a united people, they will absorb a few years of suffering to build a better, smaller but more prosperous nation for their children. National pride and honour, though very diminished in Western culture, is China's strength. They **would pull the lever to kill the one in order to save the five.**

Could China's internal pivot skittle global confidence and investment markets? Absolutely! This is a real and present danger to global asset values for all of us, but that is not Xi's concern. He and the CCP manage only China. Now let's consider the very different way most modern Western leaders look at the debt driven global housing price problem.

During the GFC, the US allowed Lehman Bros to fail without putting in place counter measures to quarantine the fallout. As a consequence markets collapsed precipitously in March 2009. Congress swiftly adopted a "too big to fail" test to protect big corporations (saving the one).

The 1% were bailed out by US taxpayers instead of facing their day of reckoning. This meant over extended investors were spared losses from their speculation and financial cowboys were let off the hook, to play the same games for another 10-12 years, kidding everybody that debt is not a problem (so long as asset prices keep going up).

In the mad panic of 2009, there was no confidence that people would rally behind leaders or that the system was strong. **Investors around the world were fearful of losing money** from their own investment risks and what their lives would then look like. To hell with the next generations or the greater good, make the government pay to protect their capital - and they did by flooding the world with liquidity and even more cheap money.

The free market system was never designed to **privatise profits and socialise losses** (i.e. save the one, kill the five). Unlike China's planned deleveraging, Western asset markets are vulnerable to a disorderly unwinding. Mmm.

The 2022 Investment Boom

We recently shared our specific investment views directly with all Zanacorp Financial Group fee paying clients. That content is not being shared here.

Readers will be aware that we have been concerned with excessive private debt for many years. Nothing has changed. However, recognising the liberal global financial response to COVID-19 we nuanced our views accordingly.

The investment stars appear to have aligned for the remainder of 2021 and early 2022 to record a very strong period of asset price growth.

The release of people from lockdowns both in Australia and around the world in coming months, will lead to an avalanche of money spent on services, not the physical stuff we order from Amazon. Personal care, restaurants, travel, accommodation, sporting events and the arts will all boom. Pent up demand is huge and people will pay any price to satisfy their wants. That is great for employment, small business, confidence and the economy.

We also continue to see extreme levels of confidence around the world to borrow money. After all, it has never been more plentiful or cheaper. With the exception of China, house prices in every major capital city in the world have exploded from Melbourne to Mumbai. It doesn't matter what it is, or where it is, though being close to trees or water helps. The property market is white hot and rising making us feel so much richer (apologies to all locked out millennials. Don't give up hope though, as time favours you most of all).

Finally, if all of this personal spending or wealth effect from rising shares and property doesn't make the global economy boom, we now can always rely on governments to spend more on infrastructure or just put money in our bank accounts. We are apparently fighting a "war" against COVID, so money is no object. Leaders just want our vote at the next election.

With these three massive tailwinds on our backs, we believe all markets will be favourable in the near term. Macro conditions are such that many investors will go "all in" chasing the easy dollar, believing nothing can go wrong. To many, particularly those who cannot afford to lose, it will be irresistible.

It is not uncommon for booms to have a final powerful leg upwards, seducing even the most staunch sceptic to join the party. Typically, **the final months of all booms generate the highest returns of all for those brave enough to be there and smart enough to get out,** before it ends in tears.

This chart shows US equity valuations currently at **all time highs**. This would usually ring alarm bells.

The unique circumstances of 2021 suggests history is about to be re-written and everyone is waiting for it.

After Christmas we will be watching inflation prints closely. Bankers presently are relaxed with inflation "running hot" believing it to be transitory. The bond market (interest market) believes otherwise. Our collective wellbeing rests on bankers being right. That makes us very uncomfortable. Energy price rises, food price rises, supply chain disruptions and the explosion of money into the real economy may spook markets into believing interest rates may need to rise sooner rather than later. **An unexpected rush for the asset exit doors in 2022 remains a risk we all have to contend with.**

We greatly look forward to seeing clients in person over coming months.