

# The coming China crash



INTELLIGENT  
INVESTOR  
ANALYSIS & ADVICE

PUBLISHED DECEMBER 2011

**Intelligent Investor**

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Nadev Kander image of family by the Yangtze

“The numbers, no matter their provenance, are mind-boggling.”

On the walls of the Three Shadows Photography Centre in Beijing hangs an image by Israeli photographer [Nadev Kander](#). In some ways it's a traditional scene. A Chinese family is picnicking on the stony shoreline of the great Yangtze. An old riverboat drifts by, its sole occupant perched on the side of the shaky vessel, arms on knees, watching.

The vista would be unremarkable were it only that. But it's not. Above the family stands a giant bridge, carved in concrete and suspended by a series of endless columns reaching into the smog. In the distance and barely visible, the arc of the edifice bears down on silted, murky water.

The scene's tension rests between its bucolic, familial tone and the depiction of industrial China's dystopian reality: Bold, polluted and ugly. It's a metaphor for progress and its price.

Great industrialisations tend to look like this. The cities of northern England are still laced with grand, civic buildings, black-charred by the detritus of progress.

China, though, *is* different. The scale of the endeavour, the rich cultural and entrepreneurial history of its peoples and the unique nature of its political system make it so.

## The Chinese renaissance

China contains 118 cities of more than one million people. According to the [OECD](#), China's GDP has grown at an average of 10% a year for the past 17 years. Of a population of 1.34bn, [189 are billionaires and 345,000 are millionaires](#). Almost all would have become so in the past two decades.

In 1998, Chinese universities produced 830,000 graduates. Last year, there were [over six million](#). Sociologist Lian Si termed former students toiling in lowly paid jobs with barely enough time to do their washing 'the ant tribe'.

China has [over 900 million mobile phone users](#). In each of the past two years, more than 100m people purchased their first mobile phone.

In 1965 China had 12 TV stations. Now there are about 700 free-to-air stations and 3,000 cable channels. With 2,200 newspapers and 7,000 magazines, media censors are horribly overworked.

### Dark side to growth

In the past, the country hasn't shown much respect for intellectual property, at least not that of others. But a [report](#) by Thomson Reuters claims that between 2003 and 2009, patent filings grew by 26% a year. Over the same period in the US they grew by 6%. In Japan, 1%.

In 1970, 7.8% of China's newborn babies died before they reached their first birthday. In 2010 that figure had dropped to [under 1.6%](#).

The growth has its dark side. Due to the one-child policy, the country has 37 million more males than females, a statistic with harrowing implications. According to *China Today*, in 2007 over 89,000 people were killed on Chinese roads. In 2008, 250,000 committed suicide.

On 18 April 2007, China's first high speed train made the trip between Guangzhou and Shenzhen. The country now has 10,000km of high speed lines, more than any other country. The first trains were built under technology transfer arrangements with overseas suppliers. Now most components and sets are built in China. The same model to acquire technology is being used in aircraft manufacture and a host of advanced industries.

The numbers, no matter their provenance, are mind-boggling. China, which recently surpassed Germany as the world's biggest exporter, is now the world's second biggest economy and a nation starting to stretch its legs.

With over 400,000 visitors, the country is Australia's most valuable tourism market. Europe and the United States are also benefitting from a Chinese travel boom.

A *New Yorker* article titled [The grand tour](#) quotes Peter Picha, a coach driver: 'For six or seven years, I drove Japanese tourists all the time. Now it's all Chinese.' With the supply of menial labour shrinking and Chinese wage growth outpacing inflation, perhaps Mr Picha should learn Mandarin.

This renaissance—for that is what it is—is as much cultural as it is economic.

In a former knitting factory not far from Sydney's Central station, a gallery featuring

Chinese contemporary art was established by Judith and Kerr Neilson (of **Platinum Asset Management**).

A recent exhibition featured two imperial robes by [Wang Lei](#), quietly hung on a white background. Adjacent to them are the covers of a Chinese-English dictionary, opened and pressed against the wall.

The covers look oddly incongruous, too large for the pages they contain. Only a close inspection reveal that the robes are made from the pages of the book. Narrow strips of paper were dampened, then rolled and twisted into yarn.

Much of the art in the White Rabbit Gallery is like this; painstaking, beautiful and brimming with historical reference. It offers a different view of China, a view that's more sophisticated, intelligent and thoughtful.

To think that China's future prosperity is based on cheap labour, environmental degradation and the munificence of the Party is to make a categorical error. The Chinese Communist Party may be in control, but only just.

This is a nation in hurry; An entrepreneurial, creative, energetic people that for centuries have been contained, either through domestic dynasty or foreign occupation.

Now, finally, the Chinese have an optimistic sense of the future and the possibilities it holds. And Australia is a big part of their plans.



Wang Lei's Imperial Robes, made from the pages of a Chinese-English dictionary

## The problem with prosperity

Every developing nation knows it: Prosperity creates its own problems. We're an optimistic species prone to project recent experience way out into the future. If things are good, well, they'll stay that way won't they? We make decisions on that basis, often at great cost.

From this belief stems the business cycle, a real-world expression of our own psychological shortcomings. Over-confident, we spend too much and build stuff we don't need; we sell toxic loans; we buy into Ponzi schemes; we take risks we shouldn't, viewing future growth as our insurance against folly.

China is no different, except in its scale and the extent to which Australia's fortunes are tied to it.

But there is a qualitative difference between what happened in the west during the global financial crisis and what may occur in China. Whilst excessive debt is the common denominator in almost all economic downturns (the oil shock of the mid-70s being an exception), debt's origins are often quite different.

### Investment-driven

In the west, it was consumption-led. In China, it's investment driven. And that makes it of far greater concern to a nation that supplies many of its raw materials.

On 2 May 11 in that month's Director's Cut, we published an article titled [Chinese bubble trouble](#). It described the city of Ordos in inner Mongolia. Built for over one million residents, its streets lie untroubled by traffic, its buildings uninhabited. Ordos is a ghost town.

Its true significance, and those of untold construction projects all over China never likely to earn a commercial return, cannot be understood without first examining how such projects get built in the first place. To truly comprehend, one must follow the money.

A Bloomberg News report describes how workers in Loudi, a city of 1.3m people in central Hunan province, 'toil by night lights with hoes, carving out the signs for Olympic rings in front of an unfinished 30,000-seat stadium, bulb-shaped gymnasium and swimming complex'.

Loudi hasn't yet won the Olympics. Beijing held it in 2008 and there any number of Chinese cities more likely to host an event of such stature. But the construction of an Olympic complex with no prospect of actually hosting the event isn't the most surprising fact in this remarkable story.

The project is financed by a bond issue of 1.2 billion yuan (US\$185m) and guaranteed by land valued at US\$1.5m an acre. Bloomberg makes an interesting comparison with Winnetka, a Chicago suburb where land is similarly priced.

Winnetka is one of the richest places in the United States, a place where the average household takes home over US\$250,000 per annum. In Loudi, average annual income is



Image source: Bloomberg

Loudi's Olympics-less Olympic stadium

US\$2,323. Land is being valued in Loudi at prices above some of the wealthiest suburbs of the wealthiest countries on Earth.

City officials reassuringly claim the project is good for the region because it will boost property values. They also value 18 blocks of land that the city owns 'at almost four times what a similar plot sold for in May'.

Loudi isn't alone in over-valuing assets. Local governments are forbidden by Beijing, which is trying to control the pace of credit growth, to take out direct loans. Instead, they set up special purpose vehicles (SPV, remember them?) and load them up with over-valued assets to justify projects that are unlikely to earn anything like a commercial return.

In fact over the past 10 years, more than 10,000 special purpose vehicles were established by local governments. Moody's estimates that local government borrowing is about 14 trillion yuan (US\$2.2tn).

Even China's own banking regulator estimates that one third of SPVs won't produce the cash flow to service the loans. Stephen Green, head of Greater China research at Standard Chartered, assumes that at least 4-6 trillion yuan won't be repaid.

Last year, China's central government stopped the flow of money to the regions, expecting that this would have a cooling effect. According to Credit Suisse, residential land sales have fallen 30% but innovative local government officials have a workaround: set up a separate company and issue bonds, backed by over-valued land as security and get the banks to buy them.

### Banking problem

The problem moves up the chain with great ease. Another Bloomberg report quotes Victor Shih, a professor at Northwestern University in Illinois with expertise in the area of Chinese local government debt. Shih believes two of China's biggest banks by market value, Industrial and Commercial Bank of China and China Construction Bank Corp, may have problem loans equivalent to 30% of their book value.

Banks such as these also hold huge volumes of the exploding corporate bond market, a large proportion of which finance more local government projects. Much of this money ends up financing projects like those in Loudi, visually impressive but commercially next to useless.

Examples abound. There's also the [ghost city of Dantu](#), empty for most of the decade; the [Yunnan University campus](#), built to accommodate 2.3m students—current enrolment: 11,000; and [Thames Town](#), 30km outside Shanghai, an almost empty development featuring cobbled streets, corner shops and red telephone boxes.

Perhaps most shocking, at least visually, is [Harbin Pharmaceuticals sixth plant](#), a lavish riot of gold that makes the Palace of Versailles look like a Bratislava bus station. Remember, too, that this is a state-owned enterprise. Sydney residents might have their frustrations with State Rail, but their headquarters look nothing like this.

Doesn't opulence of this scale, such debt-fuelled extravagance, signify the end?

Perhaps, although in an industrialisation of this size, a portion of investment will inevitably go to waste. No one knows the true extent of the problem. These projects may be signposts to a catastrophic deliverance, or they could be a simple diversion. To understand which, we have to look elsewhere.

## China's investment bubble

Since the end of the Second World War, consumers have driven economic growth in most Western economies. Of course, there was massive investment to rebuild badly depleted infrastructure but the burgeoning middle classes, especially in the United States, heralded the birth of the consumer society.

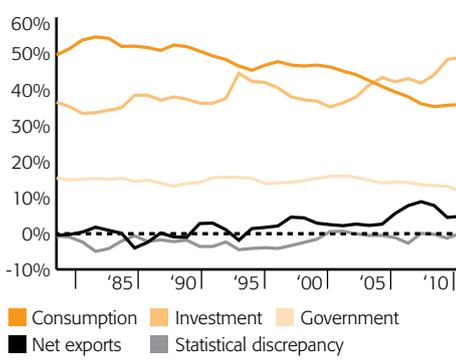
China doesn't have a consumer society. Instead, it has an investment society, and that, for reasons that will soon become clear, makes it quantifiably different, and more threatening.

Chart 1 shows the four components of GDP—net exports, consumption, investment and government—since 1979. It's a fascinating chart for a number of reasons.

First, note the long-term decline in the level of consumption, from 50% to a low 36% (in developed nations consumption usually accounts for about 65% of GDP). It's quite normal for an industrialising country to experience a decline in consumption as a proportion of GDP but if European leaders expect the Chinese middle classes to save them, the situation is even more desperate than it appears.

“Two of China's biggest banks... may have problem loans equivalent to 30% of book value.”

**CHART 1: CHINESE GDP COMPONENTS % TOTAL**



Now take a look at the black line. In the early part of the previous decade to 2007, Chinese exports contributed strongly to economic growth, although as one might expect, in the period of the global financial crisis and its aftermath, net exports collapsed.

But the Chinese economy didn't enter recession. Instead, the government embarked on a massive fiscal stimulus program, building, among other things, high speed rail tracks through places like Loudi. The country's GDP growth barely registered the impact of the crisis.

That's because the slack was taken up by a massive increase in investment, easily visible in the increase in the green line.

Steven Johnson, managing director of [Intelligent Investor Funds](#), makes an interesting comparison on his Bristlemouth [blog](#):

*Investment, or fixed capital formation, has taken up the slack, particularly in the last decade. It grew from 35% of GDP in 2000 to almost 50% of GDP today. For comparison, in the US consumption and investment represent 71% and 15% of GDP respectively. In Australia the numbers are 54% and 28%.*

If you're looking for an explanation for the increase in the iron ore price from US\$36 to US\$177 between Nov 07 and Sep 11, you've just found it. Whilst the United States is hooked on pizza and iPads, the Chinese are hooked on coal, iron ore and concrete.

John Ross, Visiting Professor at Antai College of Economics and Management, Jiao Tong University, Shanghai, makes a [compelling case](#) that this government-led increase in fixed investment was exactly the policy response needed for the times. The figures tend to bear him out.

### Chinese Keynesians

Charts 2 and 3 compare the changes in components of US and Chinese GDP for the period from Lehman Brothers' collapse to late 2010 (note: these graphs use nominal prices. Chinese real prices are unavailable). From the fourth quarter of 2007 to the third quarter of 2010, China's GDP rose by 7 trillion yuan with fixed investment—5.3 trillion yuan—accounting for 67% of the increase in GDP. In the year 2009 alone, it accounted for 95% of the increase. Consumption didn't get a look in.

In the United States, the opposite occurred. Ross says that, 'almost all components of US GDP have increased in nominal prices since the 4th quarter of 2007. US GDP increased by \$439bn, private inventories by \$118bn, the net trade balance improved by \$134bn, government expenditure increased by \$281bn, and personal consumption by \$388bn. However, US fixed investment fell by \$482bn, divided into a decline of \$236bn in residential investment and \$246bn in non-residential investment.'

In essence, the US bailed out the banks while the Chinese embarked on a massive stimulus program building roads, rail lines and bridges (plus a few empty cities). Keynes, it appears, is bigger in China than he is in Washington.

The facts bear out the success of this policy. By the third quarter of 2010, US GDP was still 0.1% below its level of three years earlier and 0.8% below the peak achieved in the 4th quarter of 2007.

By way of comparison, China's GDP had grown by 30.3% over the three-year period to the 3rd quarter 2010. As Ross notes, 'In constant price terms China added over one trillion dollars to GDP during a period when the US economy contracted.'

What could possibly be wrong with that?

## Turning Japanese

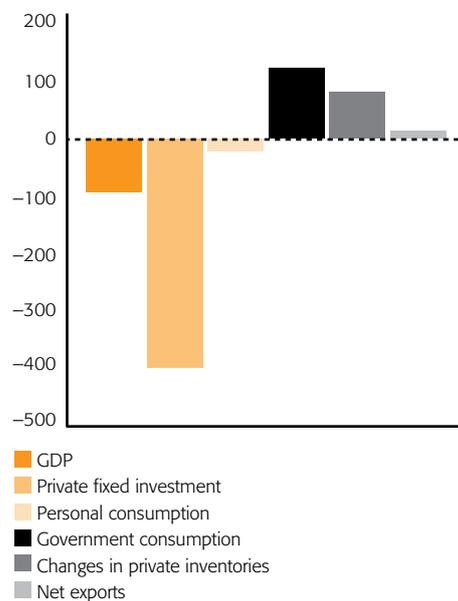
Michael Pettis is Professor of Finance with Peking University's Guanghua School of Management, where he specialises in Chinese financial markets. Owning a Beijing nightclub and record label, and having worked at what is now JP Morgan and what was once Bear Stearns, he's not your typical economist, something that counts in his favour.

In a [New York Times editorial](#) Pettis alluded to the problems of infrastructure-led growth in places like Ordos and Loudi, and the way they're financed:

*...dangerously high levels of municipal debt are only a manifestation of the underlying problem, not the problem itself. Even if the financial authorities intervene, unless they can*

**CHART 2: CHANGE IN COMPONENTS OF US GDP**

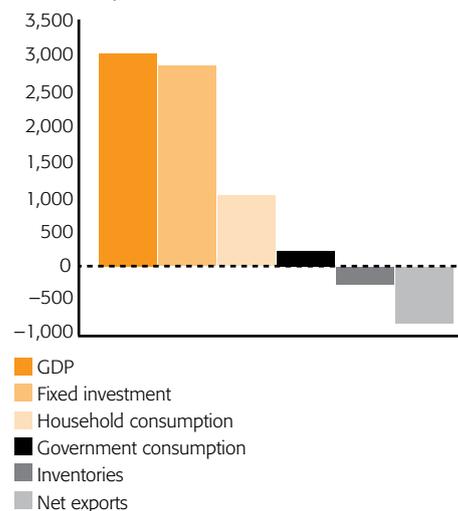
4Q 2007–3Q 2010, \$ billion at 2005 prices



Source: Calculated from Bureau of Economic Analysis Table 1.1.6

**CHART 3: CHANGE IN COMPONENTS OF CHINESE GDP**

2008–2009, Yuan bn



Source: Calculated from China statistical yearbook 2010

change the economy's underlying dependence on accelerating investment, it won't matter. They will simply force the debt problem elsewhere.

In all previous cases of countries following similar growth models, the dangerous combination of repressed pricing signals, distorted investment incentives, and excessive reliance on accelerating investment to generate growth has always pushed growth past the point where it is sustainable, leading to capital misallocation and waste.

China's problem now is that the authorities can continue getting rapid growth only at the expense of ever riskier increases in debt. Eventually, they will choose to curtail investment sharply, or the excessive debt will force them to do so. When that day arrives, they can expect many years of growth well below even the most pessimistic current forecasts.

The argument is straightforward enough. Developing economies, especially in the early stages, produce easily-identified, profitable investment opportunities. But as more funds are allocated to ever-grander schemes the system loses its ability to discriminate between profitable and loss-making investments. Momentum takes over.

The household sector pays for this overinvestment with slow wage growth, an undervalued currency and expensive real estate. Eventually, a bubble develops and speculation increases, with the whole shebang underscored by ever-growing piles of debt.

### Problems exposed

Incredible GDP growth masks the problems but eventually it's exposed. The economy, riven with bad debts and projects that don't produce an economic return, instead of contributing to GDP during their construction, subtract from it once the bubble bursts.

Chart 4 uses International Monetary Fund data to show Japan's share of world gross domestic product for the period 1980 to 2010, with forecasts to 2016. The figures on which the chart is based use an economic concept called [purchasing power parity](#) which accounts for the effects of exchange rates when comparing the value of goods in different countries.

In the period leading up to the Japanese crash of the early 1990s, the country's share of global GDP increased rapidly. After the crash, it fell just as quickly. The growth before the crash was a sham; the decline after it was the reconciliation.

Pettis argues that these figures actually understate the true effect. In 1970, he argues, Japan accounted for about 7% of global GDP. By 1980 it was 10% and at the peak of the boom at the beginning of the 90s, it was over 17%. Now it's back to 9%, just under China's contribution.

Whilst commentators pontificate about the United States and Europe facing a Japanese-style lost two decades, China has more in common with Japan than either.

In fact, in the 1980s Japan wasn't just exporting cars, lawnmowers and calculators to the world, its economic model was stuffed into a sea container and put on a ship, later turning up on a Shanghai dock.

Like China, Japan produced attractive, low cost products to deliver huge trade surpluses. Like China, it was able to do so using a pool of cheap labour and an artificially low currency. Japan's exports were incredibly price competitive as a consequence, and a source of great anxiety to its agitated trading partners.

### Bubble bursts

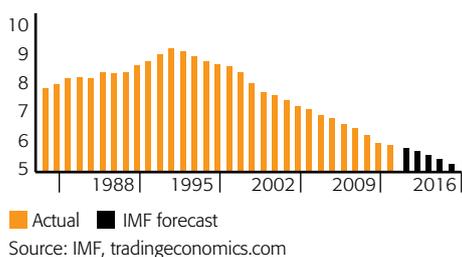
And like China, the country deployed its surpluses to invest and modernise; gleaming new buildings dotted the skylines of Tokyo, Nagoya and Osaka whilst highways and high speed rail lines connected them.

Japanese consumers, through low wages and a declining share of GDP, paid for this success; savings were eroded because governments kept interest rates low to encourage property developments and exports; real estate prices increased beyond the reach of ordinary workers; and everyday imported goods became incredibly expensive. In 1991 American humourist Dave Barry found department stores selling \$75 melons.

It's important to understand that this isn't a by-product of the model; this is the model. Investment occurs at the expense of consumption.

We all know how it ended. The long-held, mythical belief that Japanese land prices couldn't fall was shattered. Poor investment decisions were exposed and Japanese banks faced bankruptcy. The economy entered a series of debilitating recessions from which it has yet to fully emerge.

**CHART 4: JAPAN GDP BASED ON PURCHASING POWER PARITY (PPP) SHARE OF WORLD TOTAL (%)**



“ Eventually a bubble develops and speculation increases, with the whole shebang underscored by ever-growing piles of debt. ”

According to Peter Hartcher's book *The Ministry*, an *éxposé* of Japan's Ministry of Finance at the time of the collapse, in the 10 years between 1981 and 1991, the biggest 245 manufacturing companies suffered a decline in return on assets from 8.9% to 5.6%:

*"It's not that the planning people of major Japanese companies don't understand about rates of return on capital employed or discounted cash flow," said a specialist in corporate governance at the Nomura Research Institute, "they knew all about them—but they had cash and so they just had to spend it. They just didn't care about their returns".*

Hartcher reserves special criticism for the role played by Japanese banks:

*The 1988 pause in Tokyo prices sent tremors through the ranks of speculators, whose whole approach was premised on ever-increasing prices. The liabilities of bankrupted real estate companies that year multiplied by 133%—from 196 billion yen (\$1.96 billion) to 456 billion yen (\$4.56 billion)—and virtually all of this amount was attributable to companies described as speculators. Such companies accounted for Japan's two biggest corporate bankruptcies that year.*

*Did this sober the banks and tame the recklessness of their lending? Not at all...In 1990 they zoomed to new heights, powered by yet more bank lending. The banks had learned nothing. Real estate prices broke new records ...*

A similar pattern emerges in China. In the 1990s the country's big four banks financed most state-owned enterprises (SOE), many of which, in the words of [Patrick Chovanec](#), an associate professor at Tsinghua University's School of Economics and Management in Beijing, were 'not commercially viable'.

### Bad debts off-loaded

Instead of the banks writing off these bad debts, they were off-loaded into state-run asset management companies, allowing Chinese officials to claim that in June 2009 non-performing loans among the big banks stood at an easily-managed 1.8%.

Removing worthless assets from a balance sheet and delaying their inevitable recognition isn't a practice exclusive to Western banks, it seems.

The problem only appears to have worsened. Recent research from BlackRock Investment Institute suggests that in 2002 one yuan of GDP required 0.17 yuan of credit. Now it needs 0.30 yuan. Blackrock describes this as 'like a car getting less mileage per gallon of gas.'

That shouldn't come as a surprise. Pettis argues that because banks are forced to fund projects at rates that would otherwise be much higher, non-performing loans are necessarily understated and that growth can only be maintained by using ever larger licks of debt.

These loans are implicitly or explicitly guaranteed either by local or central government. But if they were assessed on the ability of the projects they finance to service that debt, Pettis claims perhaps 30% would be non-performing.

With corporate deposits down, savings deposits flat lining and the imposition of tighter reserve requirements as China's central bank fights inflation, Chinese banks are facing a liquidity crisis.

As with Wall St. in the lead up to the GFC, we can't see it because all the bad stuff has been taken off the balance sheet. Instead, it resides in trusts and corporate and municipal bonds, secured by overpriced land and projects that won't ever earn a satisfactory return.

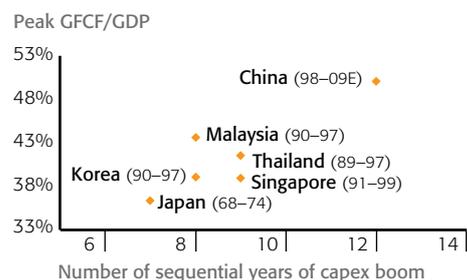
China's future won't necessarily follow Japan's recent past (see *The Economist's* counter argument, *Not another fake*) but the signs are ominous. According to the IMF and Pivot, China's investment boom is almost quite literally off the charts (see Chart 5). And Pettis is far from alone in being pessimistic about China's ability to sustain current growth.

### China's Red Flags

In March 2010, financial historian Edward Chancellor published a report titled *China's Red Flags*. It listed 10 common features of bubbles over the past 300 years, and then assessed each factor against China's current predicament. Table 1 summarises his research. It makes for uncomfortable reading.

In China, the pressures are starting to mount. Amid reports that [half of China's millionaires](#)

**CHART 5 : INTENSITY AND DURATION OF CAPEX BOOMS\***

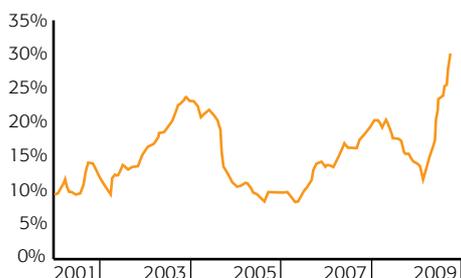


Source: IMF, Pivot

**TABLE 1: 10 FEATURES OF A BUBBLE**

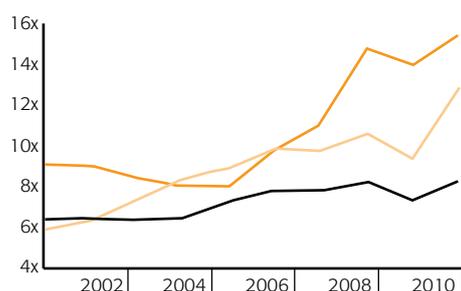
- 1. Great investment stories start out with a compelling growth story:** Check. Who isn't impressed by the idea of a rapidly industrialising country of 1.34bn people? Chancellor quotes Martin Jacques' book, *When China Rules the World*, as evidence of this confidence. Remember [Dow 36,000?](#)
- 2. A blind faith in the competence of the authorities:** Check. In the 1980s Japan was lauded for its economic system in much the same way China is now. Plenty of fervent, capitalist fund managers gaze in awe at the competence of China's authorities.
- 3. A general increase in investment:** Check. See Chart 5.
- 4. A surge in corruption:** Check. Chancellor cites China's 79th place on Transparency International's Corruption Perceptions Index, just 'below Burkina Faso'. In China, corruption is integral to the system.
- 5. The availability of 'easy money':** Check. Low interest rates promote investment and offer a fillip to China's state owned enterprises. Chancellor claims that in 2009, 'the money supply grew by nearly 30%'.
- 6. Fixed currency regimes often produce inappropriately low interest rates:** Check. The Americans have been complaining about this for years but the Chinese cling to an undervalued currency to keep exports humming along and money cheap.
- 7. Crises generally follow a period of rampant credit growth:** Check. According to Datastream, credit growth in China between 2000 and 2009 rarely fell below 10% a year (see Chart 6). In 2009 it reached 30%.
- 8. Moral hazard:** Check. China's banks have an all-but explicit guarantee that the government will save them in the event of trouble. They also have a deep and rich history of poor lending. If you know the government will bail you out, why be sensible?
- 9. Risky lending practices:** Check. Loudi? Ordos? China has plenty of sub-prime lending of its own.
- 10. Strong credit growth and rapidly rising property prices:** Check. See point 7 and take a look at Chart 7 to see how property prices are increasing at a rate well beyond disposable income, especially in the major cities.

**CHART 6: ANNUALISED GROWTH OF CHINESE PRIVATE SECTOR CREDIT**



Source: Datastream, Mar 09

**CHART 7: CHINA NATIONWIDE PROPERTY VALUE/ANNUAL DISPOSABLE INCOME PER URBAN HOUSEHOLD—CITIES**



■ Beijing ■ Shanghai ■ National average: 8.2x

Source: CEIC, Moragan Stanley, GMO calculations, Dec 09

“Senior party leadership is under intense scrutiny and pressure.”

want to emigrate, *The Financial Times* reported on 4 Nov 11 that:

*In private conversations, many of the people who supposedly make up the ruling elite of China express serious misgivings about the direction and future stability of the country, while admitting that they feel largely powerless to affect meaningful change.*

*“There is a sense that we are approaching an inevitable breaking point, when the pressures in society will boil over and consume the rulers,” says one Chinese banker with close ties to a number of powerful political families.*

*Almost all of the elements are in place for an uprising like we saw in 1989—corruption is worse today than it was then, people feel they can’t get ahead without political connections, the wealth gap is much bigger and growing and there has been virtually no political reform at all. The only missing ingredient now is a domestic economic crisis.*

The official may not have to wait too long. Pettis argues that an economic crisis is a few years away. Whether he’s right or not, the Chinese leadership understands that the country’s economic structures must change. The days of investment-led growth must end and Chinese citizens, rather than cheap money, even cheaper labour and a low exchange rate, must be the engine of future growth.

The question is ‘how?’

A government-induced slowdown is already occurring. The lending spigot has been shut off, the Chinese central bank is battling inflation and property prices are beginning to fall. The government has banned second home purchases, increased the size of deposits required to purchase a property and in some cities introduced property taxes.

It’s a start but a world away from the sort of wealth redistribution needed to give ordinary Chinese citizens real economic power. That’s what a switch to consumption-led growth entails.

Even these baby steps create challenging problems. When economic growth is predicated on ever-growing asset values, a slowdown is sufficient to give voice to disaffection with party leadership. Already, property developers are entering bankruptcy. In Shenzhen, according to an [NTDTV report](#), property turnover is down 80% compared with this time last year and real estate agencies are closing.

### Political barriers

JPMorgan analysts are [forecasting](#) that national property prices could fall 5 per cent to 10 per cent over the next 12 to 18 months, and as much as 20 per cent in some major cities. UBS are [forecasting](#) similar declines.

According to a report in *The West Australian*, in Beijing last month 177 property agencies closed their doors. Premier Wen Jiabao has said the Government stance on lowering property prices would not be reversed until they had returned to ‘reasonable levels’. In Shanghai, property investors are [protesting](#).

After the Tiananmen Square massacre of 1989, the Chinese leadership struck an implied social contract with its people: sacrifice your political freedom in return for economic liberty and a better standard of living. The contract held, mostly, for over 20 years. Now it’s showing signs of cracks.

It isn’t just property investors expressing their frustration. Forced acquisition of communal land by corrupt governments officials is provoking civil unrest across rural China. *The Financial Times* quotes a farmer in Wukan: “The hills have been sold, the sea has been sold, the land has been sold... We have no land to plough.” Resistance is mounting. Across China, a wave of [independent candidates](#) are registering for forthcoming local elections.

In the face of growing unrest and inequality, the conviction of China’s leaders’ to change their reliance on investment-led growth will be tested. The easy option—to lower interests rates, pump prime the economy and give the bubble just a little more hot air—will be seductive.

The more difficult but necessary course of action—to recalibrate a huge economy towards consumption—requires the beneficiaries of the boom carrying the cost. Someone has to pay the price.

More than at any other time since Tiananmen, senior party leadership is under intense scrutiny and pressure. They would be all too well aware of Karl Marx’s belief that powerful elites would never willingly give up their power. And yet that’s what’s being asked of them.

If China is to change the nature and structure of its economy, a devolution of political and economic power from the Party and its well-connected apparatchiks to ordinary Chinese is a pre-requisite. If this transition is to be made at all it is likely to be tempestuous.

## Preparing for a China crisis

The Chinese investment boom explains to a large degree our current prosperity. Without it, we wouldn't have a resources boom of our own; Australia's terms of trade wouldn't be anywhere near as beneficial as they are; The government debt-to-GDP ratio wouldn't be as modest as it is; we wouldn't have a comparatively high dollar; and the local property market probably wouldn't be among the world's most expensive.

In the event that China does crash—and a mild slowdown would be enough to inflict significant damage—all the factors that currently play in our favour would reverse. It's a potentially calamitous situation that could rapidly take Australia from a safe haven to the eye of the storm.

How should one prepare for such an eventuality?

On 11 Aug 11, in the midst of the early August market panic, we published an article titled [How to feel the fear and buy anyway](#). Rapid market falls are environments in which our investing psychology is seriously challenged. This article, which we're going to quote at length, offered advice on how to prepare your portfolio for adversity and how to prepare mentally for the opportunities that adversity brings.

Be it a European sovereign debt crisis, a global banking crisis (the two aren't that different) or a collapse in China, your preparation should be much the same. Keep to these eight steps and you'll avoid most of the damage and set yourself up to take advantage of the opportunities the fall out will bring.

### 1. Hold cash (but not all in Aussie dollars) and make sure (some of) it's quickly accessible

This almost goes without saying. Almost. If you've been following our advice of the past year or so, this shouldn't be a problem. Members have been repeatedly urged to increase their cash holdings in preparation for a time such as this. But there's a caveat: In the event of a China crash, the Australian dollar is likely to retreat very quickly.

Holding cash in Australian dollars won't protect you, which is why you should consider holding at least part of your cash holdings in foreign currency. Or you could invest a portion of it in companies with large overseas earnings (see point 3) or internationally-focussed managed funds, which will have much the same effect, though there is the possibility of capital losses.

You also need the ability to act quickly. Ensure that cash is not stuck in a three-month term deposit or requires an overnight bank transfer before you can use it. It should be available through your broking account at a moment's notice.

Again, though, there's a caveat. Cash has two purposes: One as an investment and the other as facilitator, allowing you to snap up a few bargains when the time comes. Don't confuse the two. If you view a particular portion of your cash holding as an investment, it makes sense to put it in a term deposit. For that part that you want to allocate to future opportunities, it doesn't.

### 2. Position your portfolio towards high quality businesses

Unconventional economic policies produce unforeseen consequences. Best-of-breed companies are the best defence against the not-so-invisible hand of governments and central banks. This is not the time to wildly speculate.

If you haven't prepared, go through your portfolio now and weed out those stocks that aren't good enough to survive and prosper in a far tougher environment (see next section). That's the reason we recently sold down Infomedia at a big loss to our Income and Growth portfolios.

And don't hold stocks in your portfolio just because they've been there for years. If better opportunities exist outside your portfolio, take advantage of them. You don't have to make your money back in the same stock.

### 3. Seek international diversification

Australia's terms of trade are off the charts, which is why our current [Buy list](#) is filled with high quality businesses that generate large amounts of cash from overseas.

Around 20% of your total portfolio should be invested in international stocks, either through local funds like **Templeton Global Growth**, most recently reviewed on [8 Aug 11 \(Long Term Buy—\\$0.73\)](#), other internationally-focussed investment companies like **Magellan**, or managed funds specialising in international stocks. **Platinum Asset Management** is but one such example.



The chinese character for crisis is made up of two symbols, one for danger and one for opportunity.

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“ Don't hold stocks in your portfolio just because they've been there for years. ”

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'Most investors want to do today', warns distinguished UK investor Andrew Bolton, 'what they should have done yesterday'. Don't look back in a few years' time regretting a missed opportunity.

Use the high Australian dollar to acquire already-cheap overseas businesses and enjoy a double-whammy. Cheap, high quality businesses with large overseas earnings, purchased with a very strong currency, positions your portfolio to do very well if and when the economic tide turns against Australia.

#### 4. Have a watchlist with buy prices

This is a great technique to sideline emotions that can prevent you from acting. If you know what you want to buy and at what price, when the time comes you'll be more able to do so. Over the past few months you may have read articles on our preferred stocks and the prices at which we'd become interested. [Blue chips dominate best buys list](#) from 9 Aug 11 was but the most recent example. You may want to tailor a watchlist for your own purposes.

Developing such a list gets the commitment principle working in your favour, especially if you show the list to friends or display it in a prominent place. That way, you get social proof working for you as well.

As senior analyst James Greenhalgh says, 'If you're fuzzy about what you want to buy, or what yield you're looking for, you're less likely to act. You need to train yourself to *want* price falls, which involves systematically developing a watchlist beforehand.'

#### 5. Prepare an action plan and buy gradually

Now you've got the cash and an idea of what you want to buy at a particular price and yield, you need an action plan. Again, this technique relies on you committing to a course of action before gut-wrenching emotion takes over.

Do not pile in all at once. Buy gradually, acquiring more shares as prices fall. As senior analyst Gareth Brown says, 'Things might get worse, but we're buying stocks with a long-term margin of safety, knowing we have more cash to put to work if prices fall further. Buying at the point of maximum pessimism is a great ideal, but impossible to confidently execute without the benefit of hindsight. Buying gradually in fearful times and sticking to high quality companies at prices cheap enough to offer a good margin of safety is a more realistic aim.'

Naturally, famed investor Jeremy Grantham does it differently. Instead of a dollar cost averaging approach described by Gareth, he recommends a few big bites: 'A single, giant step at the low would be nice but without holding a signed contract from the devil, several big moves would be safer.'

Whatever your preferred approach, make sure you choose one and stick to it.

#### 6. Stick to portfolio limits, especially with regard to banks

There's every chance that a few of the stocks on our [Buy list](#) won't work out as expected. That is the nature of investing. The portfolio limits ensure that the damage these failures might do to a highly concentrated portfolio won't be fatal to a more diversified, well-structured one.

As in many areas of life, we need to stay alive long enough to get lucky. Don't kill your portfolio by loading it up with a few highly speculative stocks. Concentrate on the many blue chip opportunities and diversify, paying close attention to the portfolio limits. Right now, you don't have to sacrifice quality for high potential returns.

That applies with particular force to the banking sector. A fall in Australian house prices, especially at a time when global credit markets are tight, could place very heavy pressure on our major banks. We recommend they constitute no more than 10% of your entire portfolio.

#### 7. Watch out for resources stocks

In recent years we've only recommended a handful of resources stocks. If you're going to buy resource companies, consider those that are potential beneficiaries of strategic shifts in an industry, like **Origin** and **Santos** (see page 12).

The flood of resource floats over the past few years is much like the wave of Internet-related stocks in the late 1990s. Remember the first point of Edward Chancellor's 'bubble' list: Great investment stories start out with a compelling growth story. China has been a compelling growth story but that doesn't mean it always will be.

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“ Cheap, high quality businesses with large overseas earnings, purchased with a very strong currency, positions your portfolio to do very well if and when the economic tide turns against Australia. ”

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## 8. Challenge your evolutionary impulses and buy anyway

We're programmed to respond to fear because, in the past, it's been a successful way of not getting eaten. But in the sharemarket, fear inhibits profitable, rational action.

These practical steps will help you to act when the time comes. But we also need to constantly reassert a few fundamental truths about investing that are in conflict to our typical reactions to uncertainty and rapid share price falls.

- If you want certainty, you're going to have to pay for it: When everything's going well, you won't get anything cheap. Bargains are a product of a climate of fear. If you want to buy cheap stocks, you have to feel the fear and buy anyway;
- Accept that prices may fall after you've bought in: You can't pick market bottoms or tops but if you're buying high quality businesses cheaply, that shouldn't stop you from buying more when prices fall further;
- Separate price falls from underlying business performance: The market can be quite irrational. To avoid getting caught by the herd, focus on business performance, not macro issues (important as they may be) or media headlines. This is the major, long-term determinant of share price direction.

Of course, it may not happen, but as every boy scout knows, there's a lot to be said for 'being prepared'.

## Portfolio implications

Having covered the generalities, let's now examine the specifics. What stocks are most exposed to a China crash? Which ones offer most protection? And finally, what might a portfolio positioned to prosper in the wake of Chinese tumult look like?

Table 2 lists the top 20 ASX-listed stocks by market capitalisation, with accompanying explanations of the extent of their exposure to a China crash.

**TABLE 2: TOP 20 STOCKS AND THEIR EXPOSURE TO A CHINA CRASH**

COMPANY (ASX CODE)	EXPOSURE TO CHINA?	EXPLANATION
BHP BILLITON (BHP)	Yes—Direct	BHP's significant coal, iron ore, metals and oil operations would suffer from likely price falls in these commodities.
RIO TINTO (RIO)	Yes—Direct	More exposed than BHP because of its greater dependence on iron ore, likely to be the commodity most exposed to a China crash.
COMMONWEALTH BANK (CBA)	Yes—Indirect	The big four banks are indirectly affected by a China crash due to the knock-on effects of a likely fall in property values and increase in mortgage stress and bad loans. The partial funding of their loan books using international money markets may also cause some problems.
WESTPAC (WBC)	Yes—Indirect	As above
NATIONAL AUST. BANK (NAB)	Yes—Indirect	As above
ANZ BANK (ANZ)	Yes—Indirect	ANZ is perhaps more exposed than other banks due to its Asian operations, although a China crash might allow it to pick up distressed assets at attractive prices.
TELSTRA (TLS)	No	Telstra's Hong Kong carrier, PCCW may be affected but the overall impact is likely to be small.
WESFARMERS (WES)	Yes—Both	The company's coal operations would be adversely affected but its improving Coles Supermarkets division may offset this to some degree.
WOOLWORTHS (WOW)	No	With excellent defensive qualities and an exclusive domestic focus, Woolworths offers good protection against a China crash.

Continued overleaf...

*“Bargains are a product of a climate of fear. If you want to buy cheap stocks, you have to feel the fear and buy anyway.”*

**TABLE 2 CONTINUED...**

<b>COMPANY (ASX CODE)</b>	<b>EXPOSURE TO CHINA?</b>	<b>EXPLANATION</b>
<b>WOODSIDE PETROLEUM (WPL)</b>	Yes—Direct	Most of the company's future production is contracted LNG but right now, production is based on oil, which is likely to suffer price falls in the event of a China crash.
<b>NEWCREST MINING (NCM)</b>	Yes—Both	Newcrest is a significant producer of copper, which offsets its gold production costs. In the event of a China crash copper, after iron ore, is the most exposed metal. Whilst the company would benefit from an increasing gold price, its production costs are likely to be far more expensive.
<b>WESTFIELD GROUP (WDC)</b>	Yes—Indirect	Property owners, seeing the value of their homes fall, may curtail spending but this effect may be partially offset for Westfield by a lower Australian dollar. This would make its overseas earnings far more valuable in local terms.
<b>CSL (CSL)</b>	No	One of the few direct beneficiaries of a China crash. With almost all of its sales generated from exports, it's likely to see profits rise in local terms with a fall in the Aussie dollar.
<b>QBE INSURANCE (QBE)</b>	No	As above, although QBE's mortgage insurance division would be adversely affected. As its 'float' holds primarily US bonds, declines in major banks and resources stocks wouldn't affect its investment activities much. If there is an effect, it's likely to be offset by the benefits of a lower Aussie dollar. But, as with all insurance companies, lower interest rates may present some problems.
<b>ORIGIN ENERGY (ORG)</b>	No	As a retailer of domestic electricity and gas, Origin is largely protected from a China crash.
<b>FORTESCUE METALS (FMG)</b>	Yes—Direct	A serious Chinese slowdown won't bankrupt many of the stocks on this list but Fortescue is a major candidate for exactly that.
<b>AMP (AMP)</b>	Yes—Indirect	Funds management operation is likely to suffer in the event of share price declines in banks and major resources stocks.
<b>SANTOS (STO)</b>	No	Slightly more oil exposure than Origin but not enough to put a dent in the business. Much the same defensive qualities as Origin.
<b>SUNCORP (SUN)</b>	Yes—Indirect	Likely to be more affected by lower interest rates and a drop in underwriting activities. Its investment division would also suffer from a likely decline in share prices in major banks and resources stocks. Unlike QBE, it wouldn't benefit from a lower dollar.
<b>COAL &amp; ALLIED (CNA)</b>	Yes—Direct	Will be hit pretty hard, although a lot of its production is contracted. When those contracts start to expire, then the real effects will be evident.

“ If your portfolio is stocked with banks and resources companies then you're highly exposed to a China crash. ”

Now compare this list to your current portfolio. If you're feeling slightly uncomfortable, then one of the principal objectives of this research has been achieved.

If your portfolio is stocked with banks and resources companies then you're highly exposed to a China crash. If you own other stocks in the housing sector and lesser blue chips like Orica and Iluka, that's especially so.

Energy stocks are a more nuanced case. Whilst commodities like metals, particularly copper, and iron ore will suffer badly, companies such as Santos and Origin, with their domestic focus and gas resources, offer significant protection.

Although it depends very much on personal preference, we'd suggest that no more than about 20% of your portfolio is exposed to China, either directly or indirectly.

That then begs a question: If you have to sell some stocks to meet that limit, what percentage of your portfolio should you hold in cash and, with the remainder, what stocks should you hold?

## Cash allocation

Let's deal with the cash issue first. The very first recommendation in the section titled 'Preparing for a China crisis' makes the case for cash. Not only is this a safe asset in the event of market turmoil, it actually allows you to take advantage of the opportunities a crisis delivers.

But there's little point holding all your cash in Australian dollars and then suffer from its collapse. A better approach is to hold some cash in foreign currencies and a portion in local companies with strong overseas earnings, or overseas-listed stocks.

We can't offer you advice on the exact proportions; that's really up to you. But as a pointer, let's take your Research Director's portfolio (see Table 3) and see how he's approached this dilemma.

It should be noted that Nathan is an especially conservative soul, which is how we and our members like him. That explains his cash holding of over 50% of his total portfolio. Other analysts hold between 10% and 30% of their portfolio in cash.

You get the idea. Holding cash, in reasonable sums, and holding at least some of it in a currency unlikely to depreciate as quickly as the Aussie dollar in the event of a Chinese crash, is a mighty sensible strategy.

**TABLE 3: NATHAN BELL'S PORTFOLIO ALLOCATION**

CASH		STOCKS	
USD	AUD	ASX-listed	Overseas
27%	26%	33%	13%

## China crash protection portfolio

Let's now examine what ASX-listed stocks you might consider for that portion of your portfolio not in cash, overseas-listed stocks or intentionally focussed managed funds.

**TABLE 4: THE CHINA CRASH PROTECTION PORTFOLIO**

COMPANY (ASX CODE)	PORTFOLIO ALLOCATION LIMIT	LATEST RECOMMENDATION*
QBE INSURANCE (QBE)	7%	22 Sep 11 (Strong Buy—\$12.17)
INFIGEN ENERGY (IFN)	3%	12 Oct 11 (Hold—\$0.29)
SPARK INFRASTRUCTURE (SKI)	5%	29 Aug 11 (Long Term Buy—\$1.315)
WOOLWORTHS (WOW)	5%	3 Nov 11 (Long Term Buy—\$23.91)
MAP GROUP (MAP)	5%	15 Nov 11 (Long Term Buy—\$3.50)
ORIGIN ENERGY (ORG)	4%	16 Nov 11 (Long Term Buy—\$14.58)
SANTOS (STO)	5%	16 Nov 11 (Long Term Buy—\$13.41)
CSL (CSL)	4%	21 Oct 11 (Long Term Buy—\$31.37)
METCASH (MTS)	5%	26 Aug 11 (Long Term Buy—\$4.04)
NEWS CORP CLASS B SHARES (NWS)	5%	12 Aug 11 (Long Term Buy—\$14.75)
CHALLENGER INFRASTRUCTURE* (CIF)	4%	20 Oct 11 (Long Term Buy—\$1.09)
F&P HEALTHCARE (FPH)	3%	25 May 11 (Long Term Buy—\$2.29)
COMPUTERSHARE (CPU)	6%	8 Nov 11 (Long Term Buy—\$8.31)
TEMPLETON GLOBAL GROWTH FUND (TGG)	4%	8 Aug 11 (Long Term Buy—\$0.73)
WHK GROUP (WHG)	6%	28 Oct 11 (Buy—\$0.835)

\* Correct as of 15 Nov 11

There are a number of important caveats when considering this list of stocks. The first is that, whilst these companies offer protection against a China crash, that doesn't mean their stock prices won't fall should that occur.

A European sovereign debt crisis, intertwined with a US double-dip recession and a China crash might well result in the very worst economic conditions in decades. It's quite possible that, under these circumstances, the global banking system would come under great stress and a new, perhaps more virulent strain, of the GFC would ensue. Stockmarkets around the world would tumble.

The stocks listed above may not fall by as much as major banks and resources companies, for example, but they would almost certainly fall. To invert the familiar, a falling tide lowers all boats. This portfolio's *raison d'être* is about offsetting the risk of a China crash, not eliminating it altogether. The emphasis is on living to fight another day, not avoiding the battle. If you want to do that, cash is your only genuine option.

“ Whilst these companies offer protection against a China crash, that doesn't mean their stock prices won't fall should that occur. ”

### Stock exclusions

The second point concerns the companies not on this list. If you examine our current [buy recommendations](#), many companies, including **Westfield Group, Abacus Property Group, Macquarie Group, Perpetual** and **Servcorp** don't feature in the portfolio above.

That's because they don't offer specific insurance against a China crash. We will continue to recommend them generally, but not for the express purpose of this report: preparing for a China crash.

That doesn't mean you should sell these stocks but, as discussed earlier, we do recommend that if you do own stocks such as these, they should constitute no more than about 30% of your portfolio.

Computershare's inclusion also warrants an explanation. With approval granted for its acquisition of BNY Mellon Shareholder Services, this company's future revenues will be heavily weighted towards the US dollar. In the event of a China crash, whilst revenues in US dollar terms are likely to come under pressure, this effect will probably be more than offset by a tumbling local dollar.

Finally, notice that, despite our buy list featuring Azumah Resources, there aren't any gold stocks in the China protection portfolio. That's not an oversight. Azumah is highly speculative and yet to actually produce any gold. There are other, more attractive, options to gain gold exposure.

On 20 Apr 10 we published the second part of [The case for gold](#). It offered three ways to obtain exposure to the yellow metal: physical gold, gold instruments and exchange traded funds.

Your resources analyst, a firm believer in the idea of gold as a hedge against catastrophe, is once again combing the gold sector for suitable opportunities.

### Complex and necessary

Adjusting your portfolio to deal with the threat of a China crash is a complex but necessary task. Hopefully, this detailed examination of the risks that China poses, and how you can respond to them, will stand you in good stead should that risk eventuate.

The China crash may never happen, or we might have to wait a few years before its effects reach our shores. But that's no reason not to act now. Don't regret the fact you didn't take the opportunity to prepare.

## Further reading

■ **China's Ghost Cities** [www.smh.com.au/tv/show/dataline/chinas-ghost-cities-20111109-1n6r9.html](http://www.smh.com.au/tv/show/dataline/chinas-ghost-cities-20111109-1n6r9.html)

■ **China Smack Harbin Palace** <http://chovanec.wordpress.com/2011/09/09/apres-nous-le-deluge>

■ **Slideshow on China's empty villages** [www.businessinsider.com/pictures-chinese-ghost-cities-2010-12#this-19-billion-development-is-packed-with-blocks-of-empty-houses-5](http://www.businessinsider.com/pictures-chinese-ghost-cities-2010-12#this-19-billion-development-is-packed-with-blocks-of-empty-houses-5)

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**DATE OF PUBLICATION** 23 November 2011



