Mission Impossible: Why China's Soft Landing Will Look like the One We had in the US in 2007-2009

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Dear Fellow Investors:

Last week the Federal Reserve Board released the minutes of its meetings in 2006. There were discussions of the current economy, numerous credit tightening moves and a consistent belief in the idea that the US and its policy makers could engineer a "soft landing" from our grossly over-heated residential real estate bubble. As we now know, the landing that we had from our real estate bubble was the hardest landing since the "Great Depression". In the opinion of Smead Capital Management, this is all symptomatic of free market capitalism and the way the economy cleans itself after years of excesses. It is not an indictment of the Fed or any monetary authority in other countries. Here are a few examples of quotes from these meetings in 2006:

March 27-28, 2006—(Ben Bernanke) "Again, I think we are unlikely to see growth being derailed by the housing market, but I do want us to be prepared for some quarter-to-quarter fluctuations," Bernanke says. He identifies housing as a crucial issue, but adds that he agrees "with most of the commentary that the strong fundamentals support a relatively soft landing in housing.

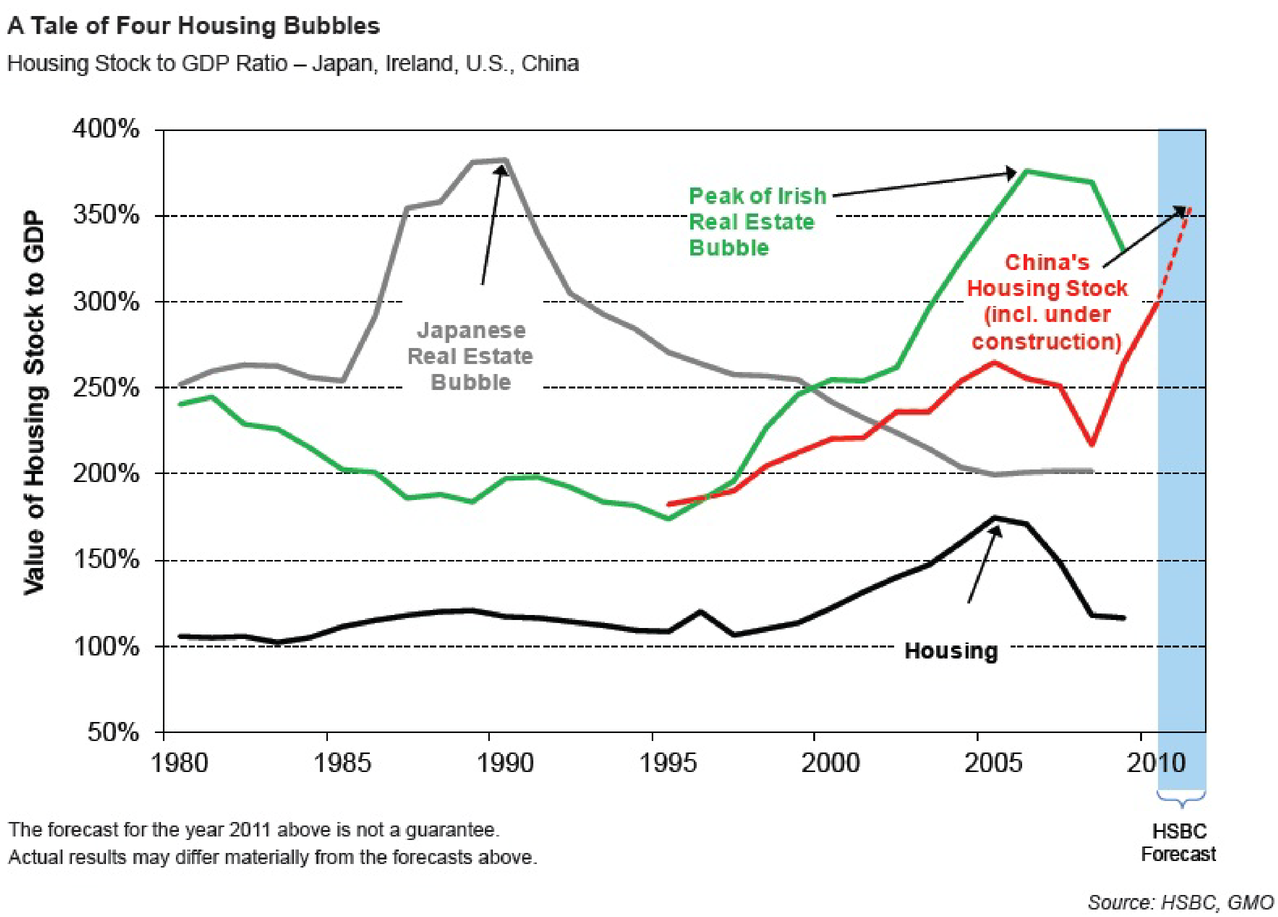
May 10, 2006—(Ben Bernanke after being warned by Board Member Susan Bies about securitization risks) Bernanke acknowledges the risks, but doesn't sound overly worried: "So far we are seeing, at worst, an orderly decline in the housing market; but there is still, I think, a lot to be seen as to whether the housing market will decline slowly or more quickly. As I noted last time, some correction in this market is a healthy thing, and our goal should not be to try to prevent that correction but rather to ensure that the correction does not overly influence growth in the rest of the economy."

Dec. 12, 2006-- The meeting that closes out the year sees policymakers showing little rising awareness of the storm coming their way. Indeed, much of the conversation officials have was about employment and inflation. Some of the evidence of rising weakness in housing was seen largely as a correction for past excess, rather than the genesis of the worst financial crisis since the Great Depression.

The US Federal Reserve Board has been trying to smooth out business cycles for almost 100 years. By late 2006, our monetary policy makers were not close to understanding the problems the economy was facing from the meltdown that the residential real estate market was going to create.

Why was our landing so hard and what can be learned as you analyze other massively overheated real estate markets like China? First, everyone believed and got caught up in the mania. From the first-time homebuyer to the investors owning multiple homes to the condo flippers, nearly everyone bought into the idea that real estate only goes up. Second, there was no geographical diversification safety. Florida, Arizona, California and Nevada were the most over-heated, but every state allowed too much debt to get attached to its homes. Third, the banking system got poisoned. Loan losses critically damaged the balance sheet of the major mortgage lending and securitization companies. It was so wide spread that the states of Illinois, Georgia and Washington have ranked in the top five states for the most bank failures even though they didn't have the worst performing price action. Lastly, the liquidation in the stock market in 2008 and drastic fall in consumer confidence allowed the breaking of the real estate bubble to deeply impair the entire economy.

The chart below shows us where we are in China at the end of 2011 compared to other housing bubbles in the last thirty years:



Source: "Between Errors of Optimism and Pessimism" GMO White Paper September 11 by Edward Chancellor

China's real estate bubble has had nearly everyone believe in it and has had additional forces driving it. The belief is first driven by movement of Chinese citizens from rural areas to the cities. The popular myth is that 20-30 million people are moving to the cities each year. According to work done by Kynikos Associates, less than a total of 120 million individuals have urbanized into China's urban centers since 1998. The mythical part is not directional, but magnitudinal. The urbanization levels are closer to 9 million a year, which is a far stretch from the 20-30 million believed.

The real estate bubble has happened all over the country and has spread to every town of over one million people in China. Beijing and Shanghai are the most populated and have seen prices reach the most extreme multiples of household income. A lack of trust in stocks and low interest rates in banks have driven Chinese citizens to invest in what is close by and easier to understand. Private property investments have only been around for ten years and they had only gone one direction in China until last summer.

Most of the housing built in the last ten years in the major cities has been condominium projects. These developments have been funded by the four largest government owned banks in China. These loans are made to special purpose entities formed under the blessing of local municipal government officials. Of these loans made in 2009-2011, the range of estimates of loan losses on these projects runs between 70% (former party official Yin Zhongqing) to 30% (Fitch). Since these loans are equal to $2.5 trillion US dollars, it means that between $750 billion to $1.75 trillion could be written off by the four largest government owned banks in China. This would wipe out the equity of these banks many times over.

Lastly, we believe that when someone finally yells “fire” and there is a rush to sell out of the ownership of multiple condo dwellings, prices will plummet in China. When prices plummet, then consumers in China will back off aggressively. Simultaneously, a huge credit contraction will unfold and China will be faced with a deep recession/depression, in our opinion.

The Chinese version of the Federal Reserve Board has been around for thirty years. The head of China Investment Corporation, Yin Liqan, was interviewed last year by David Faber on CNBC. He said, “Our government (meaning China) over the last 30 years has developed a very much, you know, sophisticated skills to manage the macro economy.” Here are some of the recent quotes of major China experts and policy makers referring to the “soft landing” that they hope to engineer for their economy, even though the price of homes to average household income appear to be twice in China what they were at the top in the US:

The Economist
Is this the soft landing?
Jul 13th 2011, 20:39 by R.A. | WASHINGTON

--THERE has been a fair amount of anxiety over the state of the Chinese economy of late. News of unexpectedly large debt burdens among Chinese local governments generated a wave of concern that recent Chinese growth has been entirely unsustainable. As the government was forced to turn off the credit tap, some supposed, property prices would fall and a hard landing would result.

That seems an unlikely scenario to me. Chinese debt burdens are manageable and its property market dynamics are quite different from those that prevailed in western bubbles markets prior to the crash. That doesn't mean that all is entirely well in China, however. Many observers have taken some comfort in the latest GDP report from China. Output rose 9.5% year-on-year in the second quarter. That constitutes a moderate slowdown from growth in the previous quarter, and was a little above expectations. It would seem that the government's efforts to slow credit growth have not precipitated an uncontrollably rapid downturn in activity.

Bloomberg
World Bank Sees Soft Landing for China as Asia Withstands Europe: Economy
Nov 22, 2011

--Bert Hofman, the World Bank’s chief economist for the East Asia and Pacific region, talks about the prospects for China's economic growth and its implications for the region. The World Bank said China is heading for a soft landing of growth in excess of 8 percent next year, and with most Asian nations has fiscal scope to cushion its economy from an escalation in Europe’s debt crisis. Hofman spoke yesterday in Singapore with Bloomberg's Haslinda Amin.

Miningmx Reporter
Soft landing in China forecast
Jan 6, 2012

--FOURTH quarter company results should support expectations of a slowdown in minerals demand, some of it seasonal, but for 2012 a soft landing in China would buoy metal shares, said Goldman Sachs in a report published January 3.

Goldman Sachs Global ECS Research team estimated China's gross domestic product will slow to 8.2% in 2012, a relatively soft landing for the economy, providing sufficient growth to remain supportive of metals. And if there is some softening in commodity prices, it may be enough for China to launch another stimulus programme rather than risk lower growth, Goldman Sachs said.

At SCM, we believe all the pieces are in place for a “hard landing” in the China real estate markets. By the end of 2012, this bust in real estate will start to affect the major banks in China and severely inhibit policy maker’s ability to stimulate the economy. Credit contraction will follow in 2013, in our opinion. Commodity prices could come down as much as 50% in anticipation of drastically reduce Fixed Asset Investment and energy use in China. In other words, a “soft landing” in China following one of the biggest real estate booms in history is a “Mission Impossible”!

Best Wishes,

William Smead

This Missive and others are available at www.smeadblog.com.