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Mr. Dhillon's experience includes start-ups, venture capital, seed funding, and heading companies in construction and international power development. His extensive experience gives him in-depth knowledge and intuitive insights into macro and micro, national and international, geo-political and economic realities and trends. He has been invited to speak on international business at various forums, including as an expert witness for the Standing Senate Committee, Government of Canada, on "The Rise of Russia, China and India".



Global Economies – The Escalating Train Wreck Part 1

Over the last two years or so we have been consistent in our assessment that the Global Economies were not recovering regardless of equally consistent rhetoric to the contrary. As we had anticipated, years of record low interest rates (*in the West near zero*) and multiple rounds of 'Quantitative Easing' by the global Central Banks, have failed to reignite sustainable global growth, and in fact have set up the global economies for a pending 'Crash II'. And since we never really recovered from the first one, except pile on more unproductive debt, this one will be more severe and prolonged.

In our last Report (*May 12, 2015*) and before most global experts would acknowledge it, we had had the courage to state that China was in a 'hard landing'. We had also anticipated Greece's possible default. Both those events are now recent history. China's economic unraveling is practically front page news every other day, and its Government's dramatic and at times panicked actions 'to hold it all together' at any cost, is sending increasing shock waves through the global system. In Europe, everybody, including the Greek Government, decided once again to 'kick the can down the road' rather than deal with the intractable and unsolvable problems of its un-repayable debt. Greece's problems are by no means over. Greece within the Euro Zone is a pressure cooker on high, and little internal explosions are already taking place. So, the seemingly slow-motion, endless train wreck that has been the global economies in the past 6 years, gathered momentum in the past months, and is now hurtling towards a worldwide deflationary implosion.

But the Global Central Banks won't let it if they can help it, you say. Ultimately, they can't help it. In June of 2015 the collapse started in China's stock markets and would have ripped across the global financial markets,

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making the last financial crises look pale in comparison, if the Chinese Government had not thrown 'everything and the kitchen sink' into slowing down and delaying the stock market's free fall. Now the Chinese Government is in full panic mode and in the past two days has shocked the financial markets Worldwide by unexpectedly and materially deflating their currency. That serves notice to the rest of the World that China is now forced to enter the global currency wars, to further try and prevent the catastrophic implosion that is now threatening its economy.



As we have consistently maintained in our previous Economic Reports, the Global economies are encumbered with over capacity (*nowhere more so than China*), low consumer demand (*especially in the 'Developed Economies'*) and a massive and growing over-hang of unproductive global debt, now estimated to be *over \$200 Trillion* (a toxic brew indeed). That historically unprecedented level of debt has artificially inflated asset prices worldwide, and has set up the global economies for a deflationary implosion.

Yet, the Central Banks keep doubling down on their hereto failed policies to create a sustainable recovery. Their quest to save the global economies, through more debt, rather than the required structural reforms and the washing out of past excesses through the natural market cycles, was doomed from the start. After 6 years of injecting the sagging economies with Trillions of newly minted (printed) cash, most of the global economies are still struggling to stay afloat and are needing additional 'liquidity support'.

On March 9th, 2015, the European Central Bank committed an additional €1.0Trillion (*approximately €60 Billion a month*) to its bond buying program, till September 2016 or beyond, to prop up the Euro Zone economies (*Mario Draghi's famous "Whatever it takes" policy in action*). Economic growth in the 1st Quarter of this year was 0.4% and inflation in June (2015) was at 0.2%.

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Manufacturing PMI in July was 52.4%, but it is expected to decline in the remaining months of 2015 as the global economic conditions continue to deteriorate, and the Euro Zone comes under increasing external pressure.

After 6 years of increasingly desperate measures the Euro Zone is still struggling to maintain positive economic growth as the Chart below indicates, and the near Grexit continues to haunt the collective Euro Zone psyche, as that danger isn't over yet, and some of Greece's acute problems, are problems still festering in some of the larger Euro economies like Italy, Portugal, Spain and France, which could again become threatening as the global economic condition continue to deteriorate.

[Greece is still doomed and will continue to be till its creditors finally capitulate and forgive all, or a large portion of its un-repayable debt. If they don't, then Greece shall remain bankrupt and dysfunctional, and eventually its people will truly revolt, resulting in its exit from the Euro Zone.]

Markit Eurozone PMI and GDP



Europe's ongoing economic problems are of course affecting China, as demand from Europe continues to be weak, negatively impacting China's exports. In the early part of this year, and in the face of gathering economic deceleration, the Chinese Government panicked and abandoned its much ballyhooed reform agenda from the Third Plenum (November 2013) and ordered the People's Bank of China (PBOC) to unleash unrestrained fresh economic stimulus, in spite of the increased danger of a bigger implosion.

So far this year the PBOC has responded by injecting hundreds of Billions in new cash stimulus, lowered lending rates, eased reserve requirement of its banks, and lately committed 'whatever it takes' to prop up its collapsing stock markets, which included almost half a Trillion in a direct share purchase program.

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Additionally, the Chinese Government ordered a ban on short selling on pain of possible imprisonment, a ban on share selling by management and large shareholders of the major listed companies for at least 6 months, and ordered an aggressive promotional campaign to 'encourage' the public to buy shares, because it was their patriotic duty to do so. At the height of the panic, almost 50% of the stock market (*over 1400 companies*) halted trading in their shares, to prevent catastrophic price declines (*so much for a soft landing*).

The Chinese Government's unabashed and unrestrained intervention in its stock markets revealed a number of truths about modern China:

- One, that regardless of its declarations to the contrary, and its pretensions towards free-er markets, China is and will remain a totally 'controlled economy' under its current political system;
- Two, any declared aspirations towards major economic and social reforms that everyone was hoping for, just got shelved indefinitely;
- Three, when panicked, the Chinese Government will always act in the best interest of its own preservation, rather than reform for the public good (*to be fair, as most governments most often do*); and
- Four, the economic problems that China faces today are in equal proportion to its past excesses.



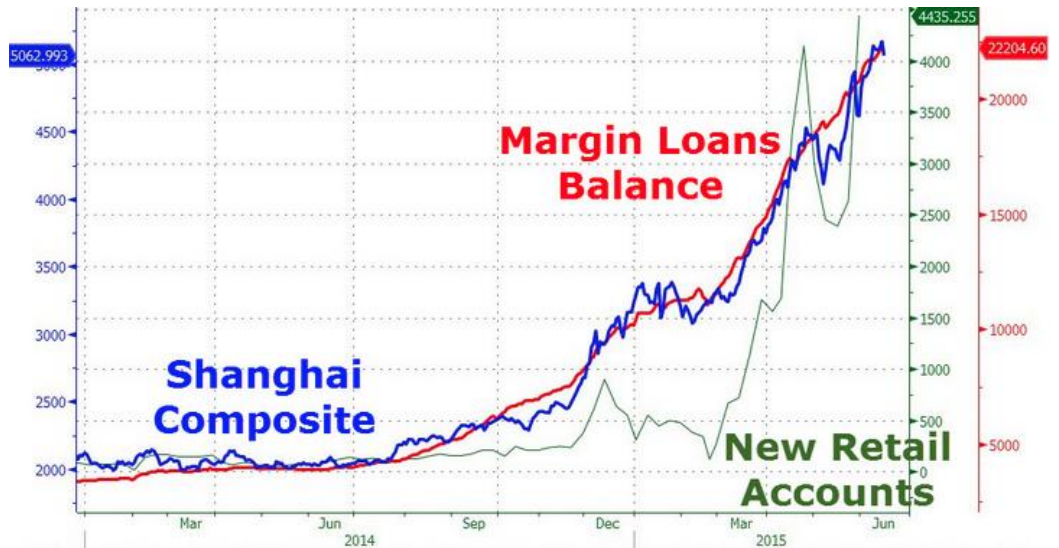
In spite of the unprecedented government 'hostile takeover' of the capital markets, China's markets continue to grind downwards, prompting the Chinese Securities Finance Corp. (CSF), a Chinese Government agency tasked with the unenviable task of propping up the slumping stocks markets, to ask for an additional 2 Trillion Yuan (*\$322 Billion*) in funding over and above the 3 Trillion Yuan it has already received, to arrest the free fall (*Bloomberg*). The 5 Trillion Yuan that CSF feels it needs to support the stock markets, is indicative of the scale of China's potential stock market rout.



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It is estimated that China's stock markets lost \$4.0 Trillion in value in its June 2015 plunge. And, if it hadn't been for the Chinese Government taking total and effective control of the stock markets, the value destruction would have been far worse. More importantly, the total collapse of China's stock markets would have triggered a domino effect in its financial markets as most of the margin buying was through China's massive 'shadow banking' which is estimated to be over 2 Trillion Yuan (*over \$300 Billion*). Needless to say, China's shadow banking in totality, as it also bank rolls a lot of the real estate ownership and development, business and personal debt, apart from having fueled speculation in the stock markets, is large enough to threaten China's banking and financial system. Hence the understandable panicked reaction of the Government.



Chinese Equities in Freefall: The Crash That Took Us by Surprise

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The Chinese Stock Market Has Been in Free-fall Lately



Market Realist

Source: NYSE

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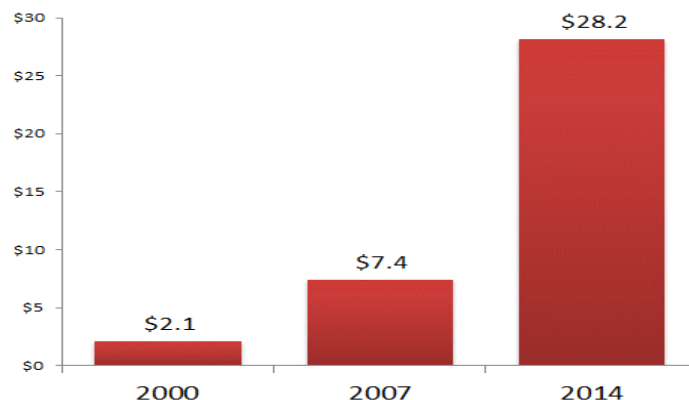
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Further potential decline of the stock markets is almost inevitable. In China's immature stock markets, the 90 Million plus trading accounts are owned primarily by financially unsophisticated retail investors, and were opened because of recent strong government promotion encouraging ordinary citizens to invest in the stock markets, as diversification from real estate investment. The people invested because of their complete trust in the Government's ability to control the assumed perpetual rise of the stock markets. The sudden break and the subsequent 33% fall broke that trust.

Now as the Government tries to hold the market up by outright and massive buying intervention, stop 'trade' and *criminalizing* 'short selling', and by threat of force, and imprisonment for those who do not comply, that confidence is eroding further. The enforced support, instead of building confidence is creating a dam of selling pressure which will break at the first opportunity. It is only a matter of time till another steep decline is triggered by panicked selling. For the relatively small percentage of international investors (the China bulls) who believed in the misguided notion, and the wishful thinking, that China was seriously moving towards a greater free market economic and financial system, their faith is also shattered. They now realize that China is and always will be, under the current political system, increasingly more autocratic and 'communist' than before, not less.

And then there is China's economy. Most serious China followers have not believed the 'on command' GDP numbers trotted out by the Government (*currently pegged at 7%*). Most of the experts that know China well, estimate the current GDP numbers to be closer to 3% to 4%. If that is so (*and we have been saying all along it is so*), then it stands to reason that the other economic statistical numbers given by the Chinese Government are equally suspect. And while it is difficult to know the true numbers reflecting the reality of the Chinese economy, one thing is for certain, China's economy is in real trouble. It is burdened with very significant excess manufacturing capacity, legendary mal-investment in redundant infrastructure, and outrageous debt growth. Since 2007, China has added over \$21 Trillion in additional debt (*when we add the over half a Trillion dollars in early 2015, to the 2014 number*).

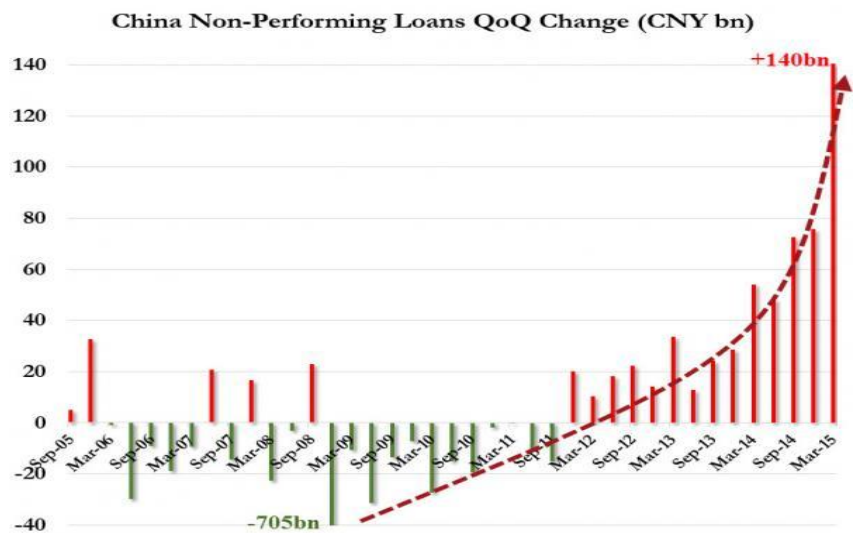
Total Chinese Debt
(in USD Trillions, per McKinsey)



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The problem with such rapid escalation in debt is that most of it has been used to keep economic activity going in spite of excess capacity in almost all sectors of the economy. As the excess capacity starts to pull economic expansion back on itself, it insures that the vast amount of liquidity unleashed in the past 7 years, as investment in manufacturing – land, real estate and infrastructure development – and lately in the financial and stock markets, will end up being categorized as mal-investment. That will insure a tsunami of defaults, bad debts endlessly rolled over, wealth destruction, and ultimately huge write downs. The Chart below indicates the rapid escalation of non-performing loans. The numbers are undoubtedly conservative as they are Government estimates, but the rate of rise is representative of the problem.



There is now a consensus building amongst China watchers that this is the beginning of a long and hard unraveling of China's unprecedented and historic \$28+ Trillions of mal-invested debt.

The Chart below shows the fundamental problem that China faces today. Namely, both external and internal demand is slumping. For a country whose stunning rise in the past three decades was predicated on its fearsome capacity to build and export most of what the World's consumers needed, its gargantuan production capacity today faces a shrinking demand.

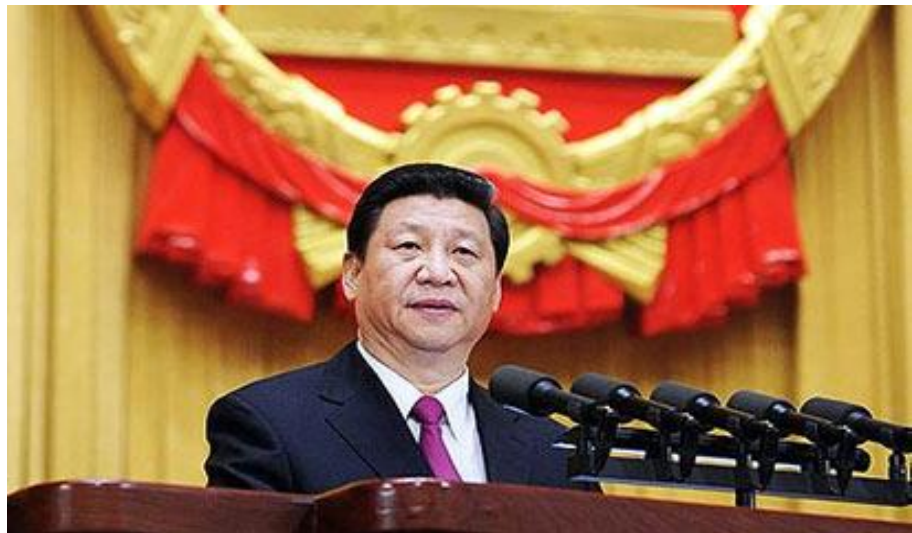


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Therein lies China's problem, massive over capacity in the face of falling demand, which is exacerbating all its other problems. Universally, debt is manageable if revenues continue to cover the cost. But when revenues shrink enough to make the cost of the debt unsustainable, everything starts to fall apart. In China, at the corporate, municipal and regional government level, it is falling apart, with the Central Government trying to keep it together. China's presumed control of all its internal economic matters obviously has limits. As Global demand continues to slip and external markets shrink, China's extraordinary excess capacity, built in unprecedented timeframe (*mere 3 decades*), with unprecedented debt, is going to exact a very painful price as more and more of China's assets become NPA (*non-performing assets*). Many Trillions of dollars worth of assets will have to be written off over the coming years. True reforms will need to be undertaken to build a robust internal demand to compensate for the lack of external demand. And, greater autonomy will need to be incorporated into the economic system to bring efficiency and competitiveness to an economy that has run its course in its present structural form.

In between this time and those future days, China faces a serious challenge in holding itself together as its economy unravels. Faced by increasing internal problems, China, in our estimation, will do what it has done historically, turn inward and become more control focused. In fact, it is already doing just that. China's President, Xi Jinping, has consolidated power and made it quite clear to the Party members that political power and the well being of the 'Communist Party' supersedes all other matters, including economic. In handling all anticipated economic problems (the new normal), the Party will act forcefully and autocratically to preserve its hold on absolute power, just as it did in the recent stock market crash, by taking direct control and suppressing all market forces.



As to the question, how much will China's economic problems affect the rest of the World? A short answer to that question is – a lot! A financial meltdown,

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if it occurs, will send severe reverberations into the global financial markets and may trigger other major markets to sharply and massively contract through justifiable fear. A serious unwinding of China's economy will affect not only the satellite countries that has to-date supplied its gargantuan manufacturing and construction industry with raw materials, (*Canada, Australia, Brazil and Russia*); parts, labour and services suppliers (*Taiwan, Japan, Vietnam, North and South Korea*); but it will also affect the global trade, and developmental/financial flows that emanate from the World's second largest economy to other countries. And then there will be the psychological effect.

China has so dominated the global economic centre stage in the past two decades with its extra-ordinary growth rates and the resultant consumption of raw materials, that its forced retrenchment, as is already happening, will trigger re-entrenchment of the global economic psyche, as the rest of the nations try and adjust to the more than the material hole that China's retrenchment will create globally. On one side of the scale are the commodities, the price and demand which are already at historic lows, and on the other side are the luxury items, the foreign travel and major external investments. China is the proverbial '800 pound gorilla' in the economic, political global room, and injuries, even if self inflicted, make it dangerous for all.

