

Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we consider the state of the Chinese property market, which appears to be heading for a major fall. We also discuss the issue of rising prices and concerns over the prospect of a permanent rise in inflation.



EXECUTIVE SUMMARY

- Chinese property developer Evergrande is the most high-profile victim of excess in the Chinese property market, being unable to pay its debts and facing collapse
- A collapse of the Chinese property market can be expected to negatively impact Australia, given our exposure via commodity exports to China
- Rising shipping and postage costs are just one symptom of a general pickup in the prices of goods and services, leading to concerns over the potential for rising inflation



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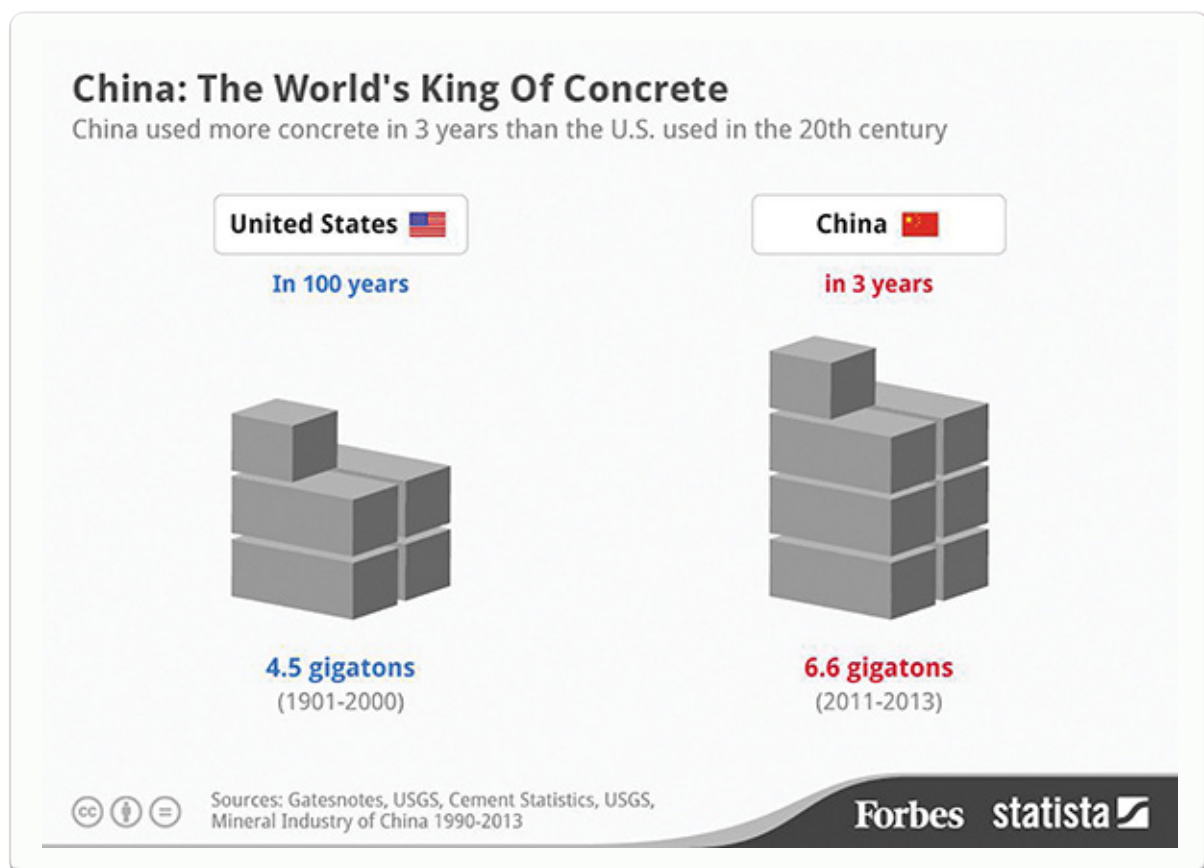
INVESTMENT PORTFOLIO MANAGERS

THE CHINA SYNDROME

Clients with long (and good) memories may recall the 1979 movie, *The China Syndrome*, starring Jane Fonda, Jack Lemmon and Michael Douglas. The actual movie had nothing to do with China of course; the title referred to a fictional meltdown at a Los Angeles nuclear power plant where the radioactive components would melt their way through the earth 'all the way to China'. Unlike the movie, China is the actual focus of this edition of our quarterly newsletter, with a close look at the prospect of a 'meltdown' of the Chinese property market.

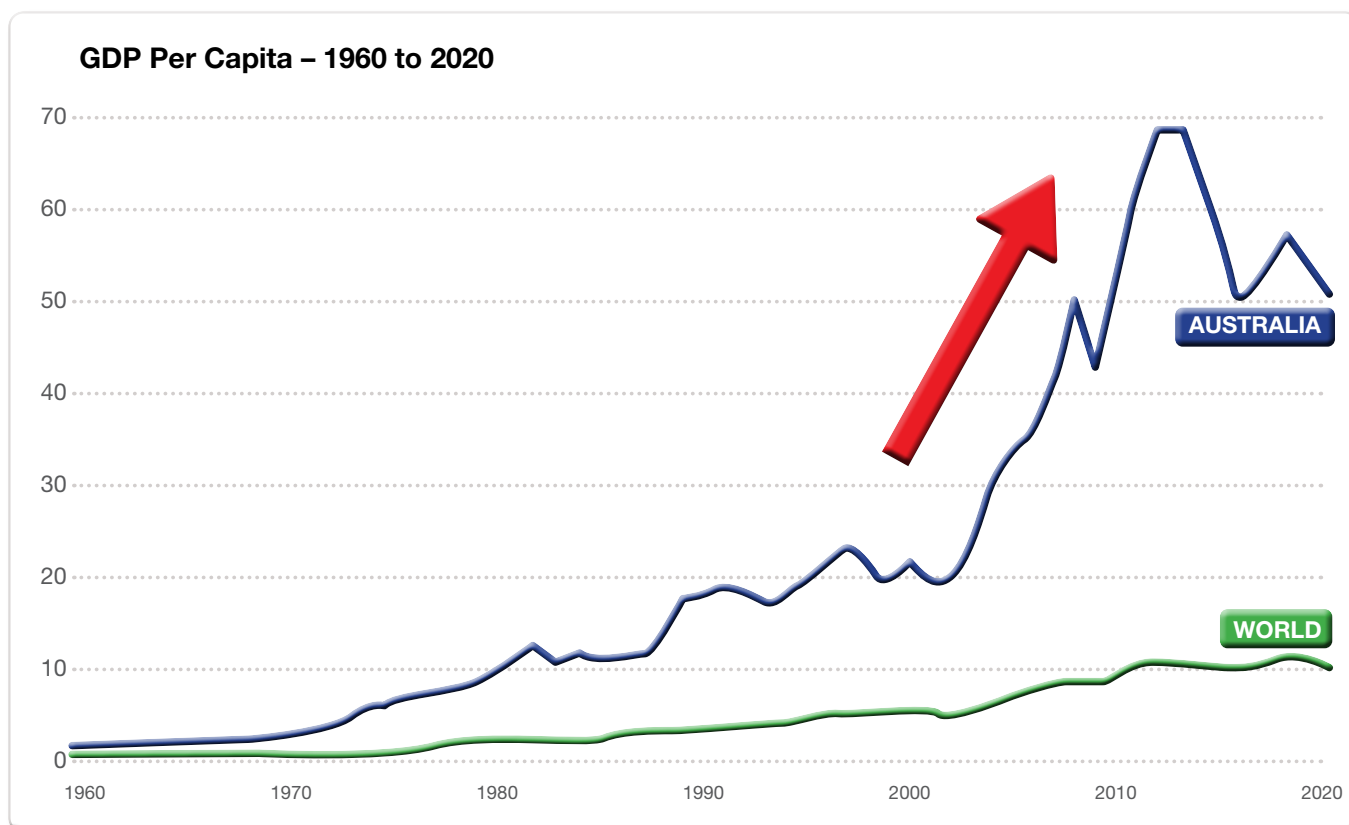
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One of the defining events of the past twenty years or so has been the mass urbanisation of rural China. According to some sources, the number of Chinese citizens living in cities increased from just 18% of the population in 1978, to over 60% by 2020. While this still lags behind many developed countries (Japan's level of urbanisation is around 92% of the population), it is the sheer scale and speed of the urbanisation process which has had such a marked impact on the world. In 1970 it was estimated that around 124 million Chinese lived in a city – by 2020 this had increased to around 860 million. Of course, these additional 700 million or so city dwellers needed accommodation, which led to a construction boom which dwarfed anything the world had yet seen. For example, between 2011 and 2013, a very short three-year period, China consumed more concrete than the United States used between 1901 and 2000.



This is probably not news to many Australians – after all, to use concrete in construction requires steel reinforcement, which in turn requires a significant amount of iron ore to produce the steel...enter BHP, Rio Tinto and other Australian iron ore miners. It's no exaggeration to say that the process of Chinese urbanisation was a major contribution to the growth in Australian wealth over the past few decades.

The chart below illustrates this quite clearly. It shows GDP per capita (effectively total wealth on a per person basis) for both Australia and the rest of the world, from 1960 to 2020. The red arrow highlights the incredible growth in Australian GDP per capita from about 2003 to 2015 or so. This period coincides with the initial surge in China's urbanisation at the turn of the century, which led to a rise in demand for iron ore and the first major China-associated mining boom.



There are many politicians that would no doubt like to claim credit for the incredible growth in Australian wealth since the start of the century, but the truth is that Australia simply happened to be in the right place, at the right time, and with an abundance of iron ore (and other commodities) desperately needed by China.

Of course, just like a pendulum swings both ways, this reliance on China poses risks too. The Australian economy (and the federal government's fiscal position) is effectively hostage to China, as unfortunate producers of beef, wheat, barley and wine have been finding out. The issue facing the mining industry, however, is not so much the result of political machinations by the Chinese government, but the fact that the Chinese property market, a voracious consumer of Australian iron ore and other commodities, is potentially on the verge of collapse. This has become evident with the news that China's second largest property developer, Evergrande, is in financial difficulty.

Not so grande

Evergrande Real Estate Group was founded in Guangzhou in 1996, just in time to catch the start of the Chinese urbanisation wave. Catering to middle- and upper-income would-be apartment buyers, Evergrande grew rapidly, eventually listing on the Hong Kong stock exchange in 2009. By 2020 the company had expanded dramatically, becoming the second-largest property developer in China. Annual revenue topped US\$77 billion in 2020 and the company was ranked number 122 in the Fortune Global 500. By the end of 2020, the company had over 120,000 employees and had investments in operations as diverse as theme parks, sports teams, electric vehicles, music festivals, banking and agriculture. As fast as revenue rose, however, so did the company's level of debt, to the point where it currently owes around US\$320 billion to a range of international and Chinese lenders (as a comparison, Australian company Transurban, which owns most of the toll roads in Australia, has around AU\$17 billion of debt).

Problems first arose last year, as the pandemic caused a slowdown in property sales that lasted for months. Evergrande, like other developers, had pre-sold new apartments prior to their construction and the collapse in new sales caused a cash crunch at the company. At the same time, Chinese authorities moved to cool the rapidly over-heating property market, instituting the 'three red lines' policy, which effectively barred Evergrande from taking on additional debt. As the money dried up, the company even resorted to paying suppliers with unfinished apartments instead of cash, a move not well received. Matters came to a head last month, when Evergrande missed an US\$85 million interest payment on some of its dollar-denominated debt (although it did subsequently make an interest payment to Chinese debtors, a move which angered (and worried) overseas lenders).

The general expectation is that the Chinese government will act to ensure that Evergrande's problems do not pose a systematic risk to the property market or the financial system. However, they have shown a reluctance to bail out the company, which would not only set an unwelcome precedent, but would also do little to slow the overheating property market.

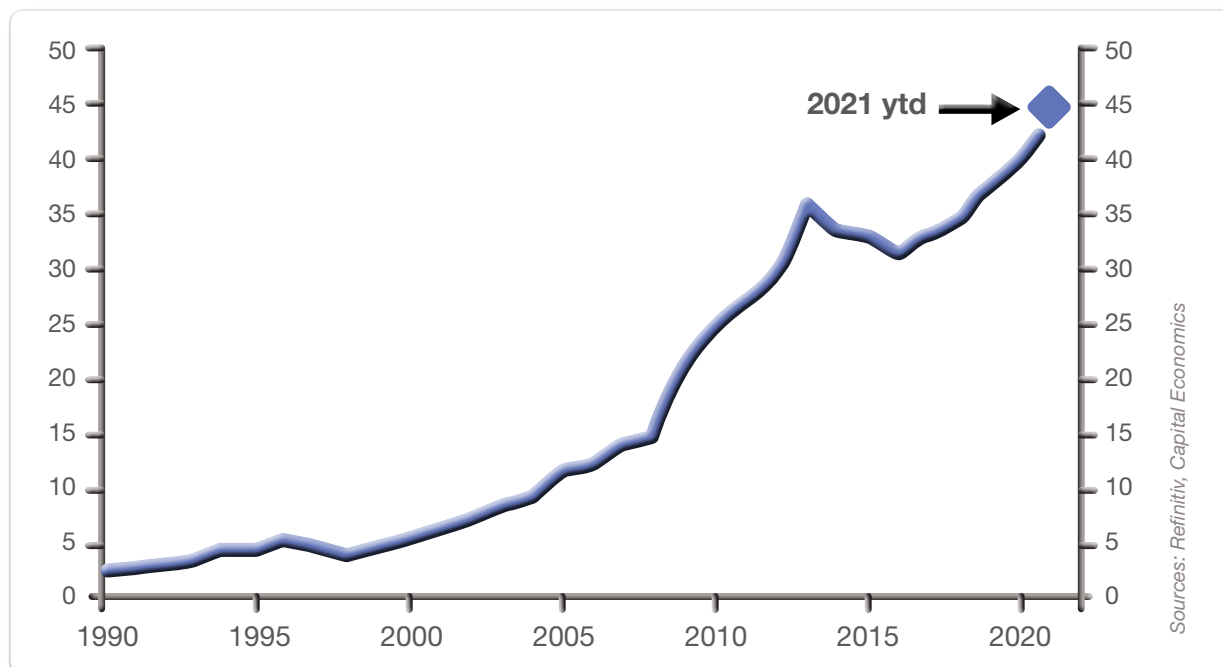
If Evergrande was to collapse, what implications are there for China, and thus also for Australia? The initial casualties, who can expect little sympathy from officials, would be Evergrande's shareholders and lenders. In all likelihood, both of these groups will be wiped out, although it seems as though buyers (around 1.6 million of them) who have pre-paid for yet-to-be-completed properties are likely to be protected to some extent.

The most significant outcome of an unstructured and messy Evergrande collapse would be the impact on the Chinese property market, which would see a further fall in property sales. Commodity suppliers such as Australia, Chile and South Africa are directly exposed to the Chinese property sector and would see a commensurate drop in demand for their natural resources. To a certain extent we are seeing this already, with the iron ore price falling from around US\$230 per tonne as recently as July this year, to around US\$115 today, although not all of this fall should be attributed to Evergrande's woes.

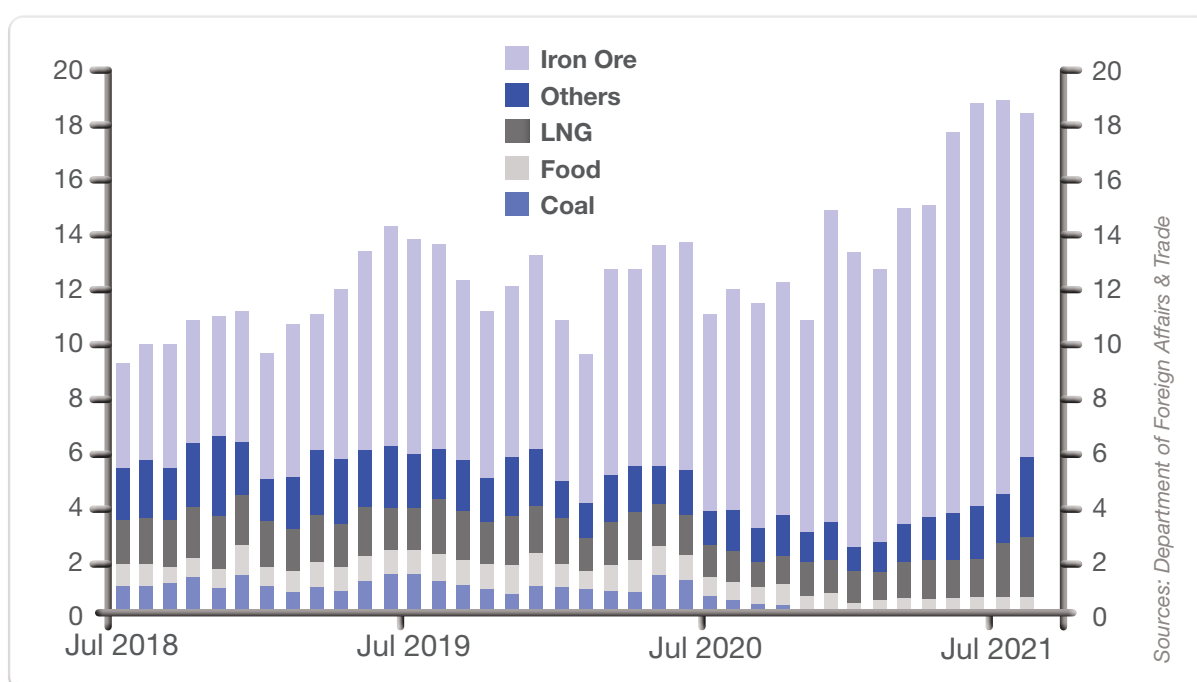
An Evergrande collapse does increase the risk of a hard landing for the property market however, which authorities will want to avoid. While there is a definite plan by authorities to slow the housing market, a hard landing has the potential to impact other parts of China's economy, which is already exhibiting a slowing rate of growth.

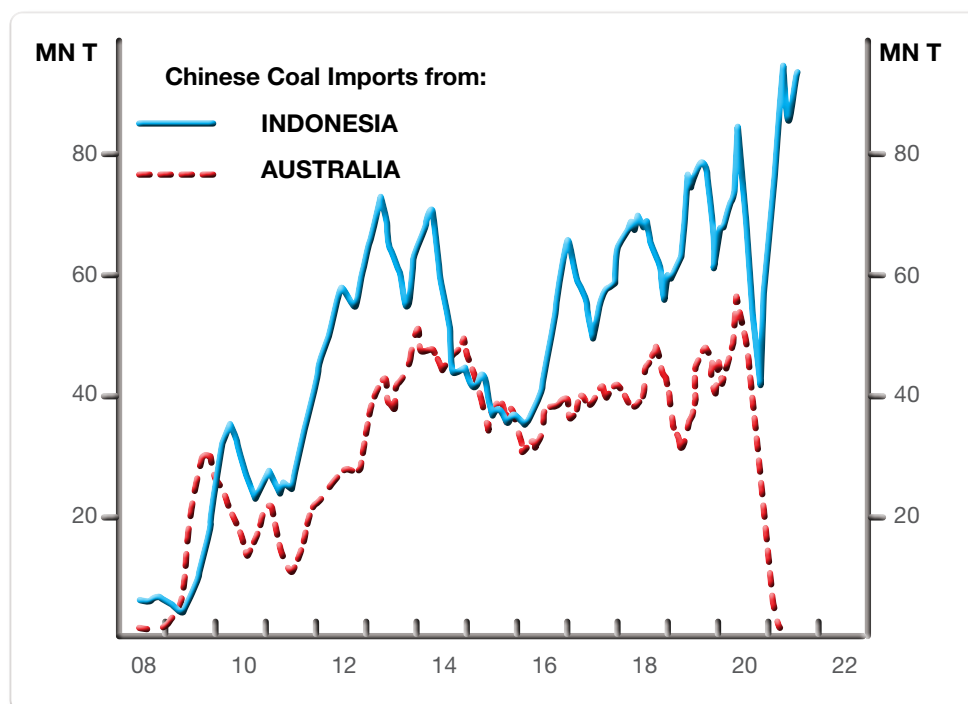
The impact on Australia

It's not hard to see how the collapse of the Chinese property market (particularly the development aspect of the market) will impact Australia. In the first eight months of this year, 45% of all Australian exports went to China - a record level (as shown in the chart below):



While the proportion of Australian exports sent to China is growing, the mix of exports is changing. Due to Chinese policies, food and coal imports from Australia have been falling (witness the decision by China to impose punitive tariffs on Australian wine in 2020), replaced by iron ore. Iron ore now makes up around 70% of total shipments to China, compared to around 40% in 2018.





The upshot of these changes is that Australia and the miners, BHP, Rio Tinto and Fortescue, are more exposed than ever to China. This is worrying in the context of the woes plaguing the Chinese property sector, as residential property construction accounts for a third of China's total steel usage. Compounding these issues, is China's latest Five-Year plan, which puts more emphasis on reaching certain environmental goals, such as pollution levels and CO2 emissions. As part of this process, it is likely that China will start to shift away from using blast furnaces in steelmaking (which use a combination of iron ore and coking coal to produce steel) to using much less polluting electric arc furnaces (which typically use scrap steel as an input).

As of writing, the Evergrande issue is very much a live issue – Evergrande missed an interest payment on one of its loans as recently as the 11th of October and will formally be declared in default by 18 October if no funds are forthcoming. As yet there is little sign that the Chinese government will move to bail out Evergrande and prop out the ailing property market, although this is one potential outcome expected by China watchers. Nevertheless, China's property woes will certainly act as a headwind as we enter the final quarter of 2021.



WHY EVERYTHING SEEMS SO EXPENSIVE

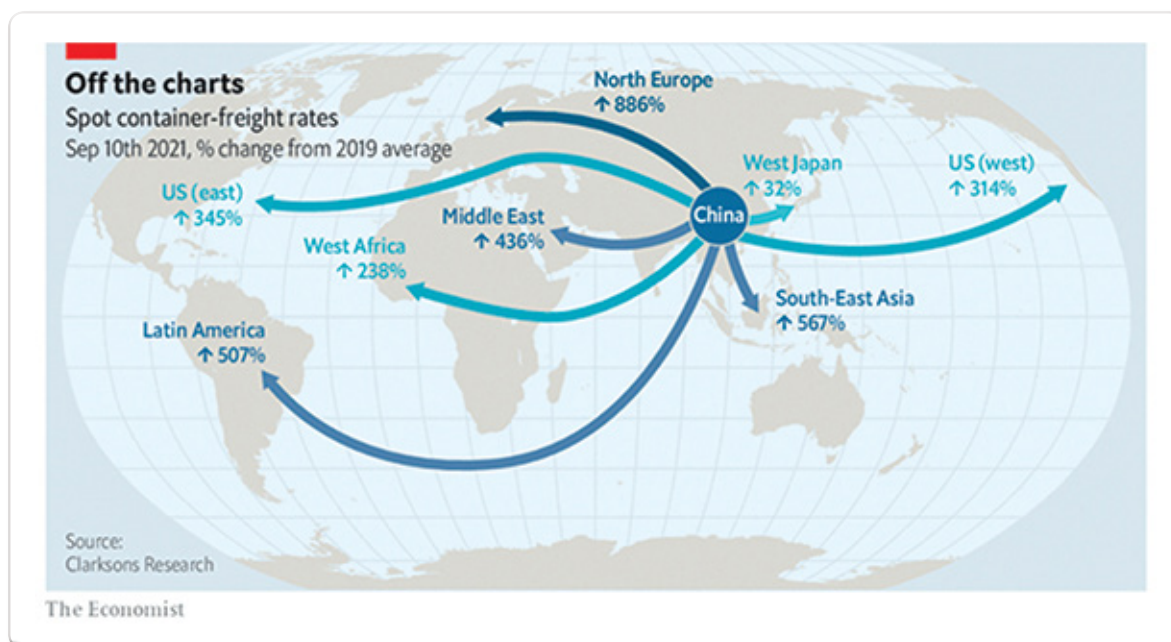
While the prospect of a collapse in the Chinese property market is of concern, the other issue facing global markets is the spectre of rising inflation. By now most people would be aware of rising prices for many goods, be they motor vehicles, mobile phones, computers or just about any product that arrives on a container ship.

The primary cause of these problems is the Covid-related impact on global supply chains. While these problems were not evident last year, as retailers, wholesales and producers ran down their inventory, the world as a whole has reached a point where 1.) goods are not being produced quickly enough to meet demand, and 2.) the ability to ship goods around the world has been hampered by the secondary impacts of the pandemic, resulting in a significant increase in shipping costs (be they by air or by sea). For example, the number of flights into Australia on a daily basis is a fraction of the number prior to the pandemic – all of those flights included an air cargo component which has simply evaporated (typically 45% to 50% of air freight is transported via passenger aircraft).

Sending freight via the sea is no better, with global shipping costs also increasing exponentially. The increased cost of shipping is clearly illustrated in the chart below.



Part of the reason for the explosion in shipping costs is the fact that a significant proportion of the global shipping fleet (around 11%) was mothballed in early 2020 as the pandemic spread through the world and shipping companies understandably expected a collapse in global trade. Instead, the reverse happened, and global trade ballooned as stimulus cheques flowed into bank accounts all over the world and a bored populace during lock-down whiled away the hours by shopping online. If you are wondering why that book, iPad or new pair of shoes costs that much more, the graphic below outlines the significant increase in shipping costs from China to the rest of the world.



The cost to move goods around the world is important as it potentially feeds into the pricing decision of nearly every product we consume or use. Even those goods or products manufactured within Australia either contain a proportion of imported components or involve the use of imported machinery or equipment. Importers, wholesalers and retailers are left with little choice other than to pass on the increased costs to their customers, although some may be in a position to absorb the higher transportation costs.

Usually such an increase in costs is viewed as a temporary event, unlikely to last much beyond the point where transport costs fall to more normal levels. However, this event is occurring at the same time as the world is experiencing a pickup in demand as more and more countries gradually remove some of the restrictions put in place to control the pandemic. In short, excess demand plus limited supply equals higher prices.

As prices continue to rise, the concern facing policymakers is that workers begin to factor inflation into their decisions regarding salary levels. Demands for pay increases tend to be muted when prices are steady or falling, however the expectation of higher prices can lead to workers demanding pay increases which match or exceed inflation expectations. This is effectively how Australia operated prior

to the Wages Accord implemented by the Hawke government. Essentially, if the prices of goods (and services) continue to rise for an extended period of time, there is inevitable upwards pressure on wages, and increasing wages are not a transitory event but can lead to a cycle of ever-increasing inflationary expectations and ever-increasing prices. In the early 1980's, it took decisive action by the US Federal Reserve to end this type of self-fulfilling cycle, which was only achieved by increasing interest rates to 20%, thereby crushing inflation (along with the economy) and severing the nexus between wages and inflation expectations.

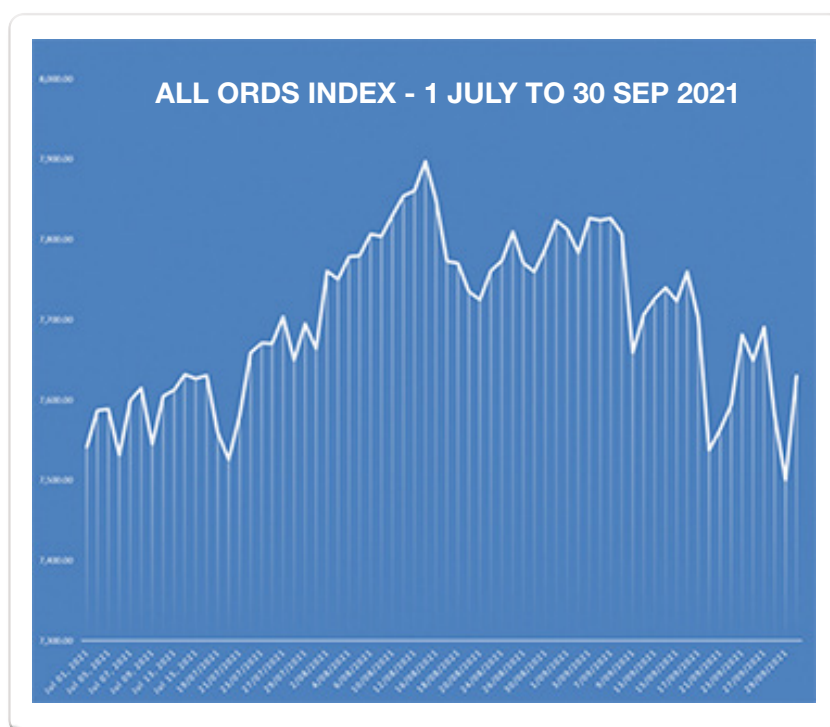
In part, the stock market weakness through the past six weeks was driven by these fears – that rising inflation will require central banks to raise interest rates, with an accompanying negative impact on the stock market. The question yet to be answered however, is whether the current inflationary environment is likely to be permanent or transitory? Clients may recall that prior to the onset of Covid-19 there was concern over deflation, the opposite of inflation. Yet only 18 months later, the focus has shifted completely.

Among economic commentators there are disagreements regarding the anticipated duration of the current inflationary conditions – some expect price increases to be temporary and wash through the economy within 12 to 18 months, while others foresee it morphing into an era of permanently higher inflation. While we tend to lean towards the view that the price pressures are likely to be temporary, we recognise that the global economy is in a very unusual situation as it navigates its way through the pandemic and the usual relationships and rules may not hold. In terms of our approach to investment selection, we have endeavoured to adopt a path which we see as appropriate, regardless of the eventual outcome with respect to the inflationary debate.



THE STOCK MARKET DURING THE SEPTEMBER QUARTER

With rising concerns over the Chinese property market and the prospect of inflation, the stock market gave up ground towards the end of the quarter, with the ASX All Ordinaries Index finishing at 7,629, only 88 points (or 1.17%) higher than the value at the start of the quarter. This was despite the index setting a new record high part-way through August.



The quarter also saw the conclusion of the year-end reporting season, with companies reporting full-year results for the 2020/21 financial year. In general, the reported results were well received, although many results were still impacted (either positively or negatively) by the pandemic. For example, online retailers continued to benefit from the changed spending habits of locked-down consumers, while businesses which involve the ability to travel or congregate reported relatively weaker results. However, as Victoria and New South Wales move to relax their pandemic-related restrictions in the last quarter, we expect to see a gradual normalisation of company operations and financial performance.

CONGRATULATIONS TO ANNETTE

On a more personal note, we just wanted to pass on our congratulations to Annette, who in August marked 20 years with the firm. Annette keeps the portfolio and administrative side of the business operating smoothly and seems able to match the output of at least three people. We look forward to another 20 years!

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Justin Baiocchi



Ray Griffin



Michelle Higgerson

We hope you have enjoyed this edition of our quarterly newsletter. As always, should you have any queries, questions or feedback, please do not hesitate to contact us. We trust that you and your families remain safe and healthy in these uncertain times.

With kind regards,

Justin, Ray & Michelle

FACTS & FIGURES AT A GLANCE

| | Rate / Value | Change from last reading |
|---|---------------------|--------------------------|
| Australian inflation rate (annual) | 3.8% (Jun) | +2.70% |
| Australian unemployment rate | 4.6% (Sep) | -0.3% |
| RBA Cash rate | 0.10% (Sep meeting) | flat |
| ASX 200 Index | 7,629 | +88 points |
| Australian \$ vs. US \$ | \$0.7206 | -2.77c |
| Australian \$ vs. UK £ | \$0.5361 | -0.56c |
| Australian \$ vs. Euro € | \$0.6215 | -1.04c |

This newsletter provides general information only. Before making any financial or investment decisions, we recommend you consult a financial planner to take into account your particular investment objectives, financial situation and individual needs.



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