# Economic Update

# The Lucky Country

*October 2021 edition, By Chris Boag*

The global economy has continued its strong recovery with the global GDP expanding 6.5% in 2021 after -2.1% in 2020. It is forecast that the global economy will have another strong year as major economies recover om the pandemic. The recovery will continue to be uneven as COVID-19 outbreaks challenge the economic reopening. High consumer savings support the reopening growth expectations. Inflation and central bank reactions will likely determine the longer-term pathway while other issues such as the collapse of major companies (Evergrande) and supply chain issues (energy crisis) could derail the economic agenda.

Evergrande is one of China's three biggest property developers, and its in trouble due to new regulation in China know as the 'three red lines'. Evergrande has over AUD$400b in debt and has recently defaulted on its debt obligations. Evergrande is a significant company, and its collapse could send shockwaves not only through China but the world.

Evergrande has now skipped another USD$ interest payment. No doubt China will try to ring fence the situation. China's objective will likely be to try to save the small home buyers, investors, and suppliers. We expect an eventual default / collapse of Evergrande however China may take over some projects and deliver them. On a project-by-project base, Evergrande will effectively become a State Owned Enterprise. China's State Owned Banks will look after domestic debt but foreign Bond holders will lose most of their money, shareholders will likely lose all their money. The focus is on maintaining a stable society (protect the small guy), there is no protection or support for the foreign investors.

Its messy but a controllable situation, spill over effects cannot be ignored though. Evergrande is likely the largest USD$ debt issuer in Asia. Their collapse will impact other Chinese companies, particularly those with USD$ issued debt to foreign investors. Could this cause a run on the debt? It's uncertain, but clearly is a risk. Small property developers have defaulted on debt payments so there is clearly a broader problem here that could escalate.

For the banking sector there is no doomsday scenario. The banks have exposure to property development, but the main exposure is with domestic home loans, somewhat similar to Australian banks.

From an economic perspective property is a big sector for China. Property sales have been slowing over recent years. This is the hot season for sales, but sales have contracted further exacerbating the slow down.

China may need to step in to assist smaller property developers who are struggling to find foreign financing. Wide scale defaults on foreign debt could be possible. Overall, we anticipate required reserve ratio (RRR) cuts and a rate cut. China may see a bit of a slowdown this quarter and may be a drag on next year's global GDP.

Iron ore demand could be the collateral damage for Australia. We have already seen iron ore prices tumble from a peak of about USD$230 per tonne in July to USD$90 in September. The price fall was being driven by several factors and the Evergrande collapse will only add weight in the short term. This will impact the Australian economy however we are the lucky the country. While the iron ore price has tumbled, a global energy crisis has been evolving.

Royalties from iron ore will fall and dent the government budget, however, the global energy crisis that has been developing has led to a spike in the price for thermal coal, LNG, and oil in preparation for a repeat of last years very cold northern hemisphere winter. LNG spot prices have surged in response to demand from China and Europe. China has told its companies to buy energy 'at any cost'. As such, Sinopec has out bid European rivals for LNG contracts. Gas shortages in Europe are being driven cuts to Norway's gas production and stronger gas-powered demand reflecting the calmer weather and thus reduced wind power

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generation, and the phase out of Europe's aging nuclear power plants. Russia is also in the mix, they too have concerns of supply for their winter but are also due to complete the gas pipeline to Germany by the end of the calendar year.

Ironically, China may need to buy more thermal coal from Australia after previously banning it. The price has rallied well above China's target buy price. This is a problem, as Chinese power plants (like most worldwide) sell electricity at regulated prices. Electricity tariffs have been relaxed to keep electricity generators afloat.

Oil prices are not immune from the crisis. Oil demand is likely to pick up as high LNG prices force a switch to oil. Oil markets are set to tighten as OPEC+ has remained cautious about adding new supply. A cold northern winter could see further and sustained upside for energy markets.

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This brings us to the topic of inflation. To-date the discussion has centred around the premise that current supply chain disruptions will lead to a transitionary bout of inflation. However, the energy crisis was not anticipated in the mix (as far as I am aware) by central banks. The inflation debate will heat up in 2022 as economies continue to recover from the pandemic and supply chain issues bite harder. The unprecedented fiscal expansion (printing of money that has ended up as savings in your bank account) at a time when interest rates are at historical lows is the fuel of inflation and time will tell just how transitionary or permanent these inflationary forces are.

The consensus base case remains that inflation will be transitionary, all-be-it the timeline has now been pushed out. The risk is that the longer these supply chain issues persist the more probable that these inflationary pressures are converted into permanent price increases (think transport costs due to rising oil and prices and thus higher prices at the petrol pump). In an environment where inflation is high and interest rates are rising, companies with genuine pricing power will be the ones most likely to succeed.

How central banks react will be interesting. In Australia the RBA has called on APRA to help cool the housing market. The next step is withdrawn from quantitative easing and then to increase interest rates. In the US this is likely to commence in 2022 and in Australian by late 2023. The risk is that rate hikes come sooner if transitionary inflation sticks. No matter what, interest rates will rise, its just a question of timing.

Economic recoveries are always a bumpy road. This one is no different. The Evergrande collapse is an event along the way to recovery which will have implications for the global economy, particularly Australia and our base metal exporters. As the lucky country the energy crisis will likely save us from any material economic damage. As the economy opens, our significant savings and pent-up demand may feed further into supply chain issues which, combined with the global energy crisis, could feed into longer term inflation

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