PRIVATE WEALTH ADVISORY
A Phoenix Capital Research Publication

Weekly Market Update: 8-4-15

Dear Subscribers

The investment world is greatly underestimating the significance of what is happening in China. Generally speaking, the consensus view is that China was in a stock bubble that has burst, but the Chinese economy remains structurally sound and is growing at roughly 7% per year.

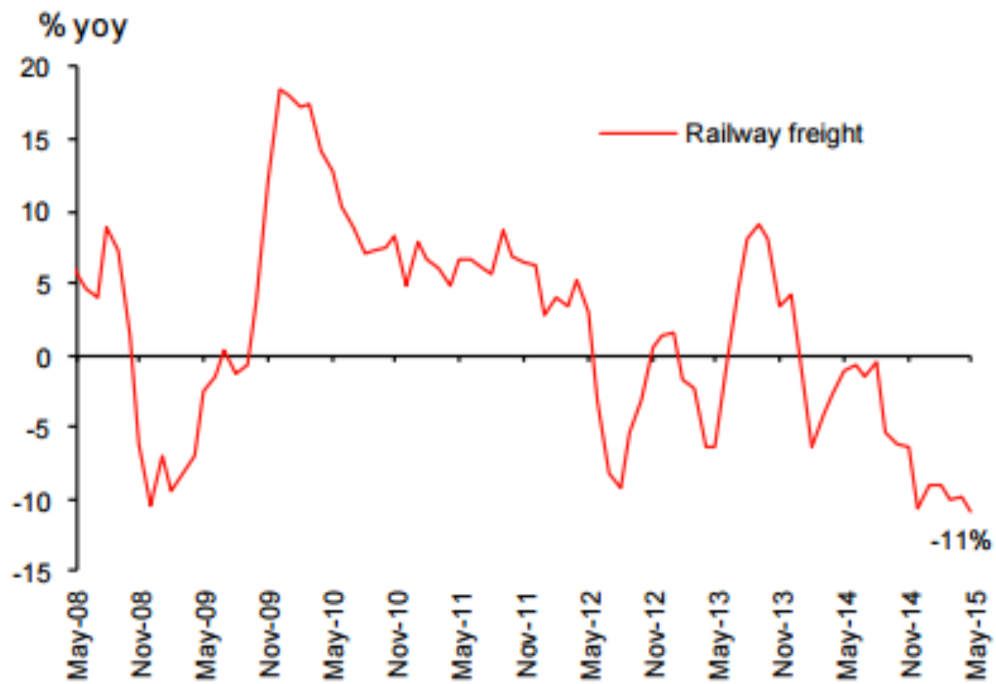
This is completely bogus.

Firstly, China is not growing at 7% per year. China is lucky if it's growing at even 3.5% per year. As I have stated previously, back in 2007 the current First Vice Premiere of China, Li Keqiang, admitted to the US ambassador to China that **ALL** Chinese data, outside of electricity consumption, railroad cargo, and bank lending is for "reference only."

Of these three, bank lending is the most dubious because Chinese banks have leant money to anything with a pulse for the last six years (more on this shortly). For this reason, to get an accurate picture of China's economy, you cannot look at GDP or traditional metrics. You HAVE TO look at rail traffic and electricity consumption.

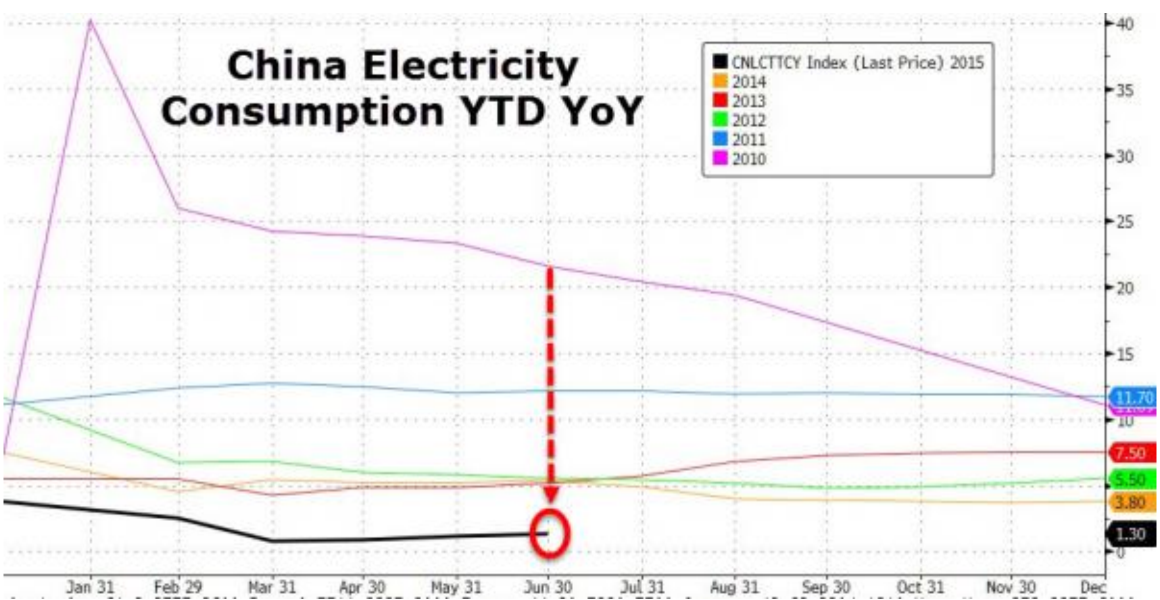
The bad news is that China's rail freight traffic has collapsed even worse than it did during the 2008 Crisis. Year over Year, rail traffic was down 11% in May 2015 and it has been collapsing in a near straight line since the summer of last year.

Fig 44 Railway freight fell 11% in May



Source: Wind, Macquarie Research, July 2015

Moreover, as ZeroHedge recently noted, China's electricity consumption for the first half of 2015 was the worst in 30 years.



Source: ZeroHedge

This does not suggest that China's problems are isolated to stocks. Rather, I would argue that China's economy is in fact in far worse shape than most realize.

The implications of this will be massive for the investment world.

According to official forecasts, China is meant to account for 33% of all global GDP growth going forward. With China's economy growing at 3.5% at best and collapsing at a pace not seen since the Asia Crisis at worst, the world is due for a rude awakening it comes to grip with China's slowdown.

We've already gotten a taste of the impact of China's slowdown in the commodity space. Indeed, by the look of things, the "phony demand" driven commodity bull market of the last 15 years is over.

This is just the beginning… the coming months will see a lot of guidance and forecasts revised **<u>downward</u>** as the world comes to grips with the severity of China's slowdown.

As I asserted in last month's issue of *Private Wealth Advisory* deflation is back. And once again, China is going to lead the response to it.

Back in 2008, when deflation reared its head, China's Government lead the charge in addressing the situation. Indeed, one could easily argue that China has lead global monetary policy throughout the "recovery" of the last six years.

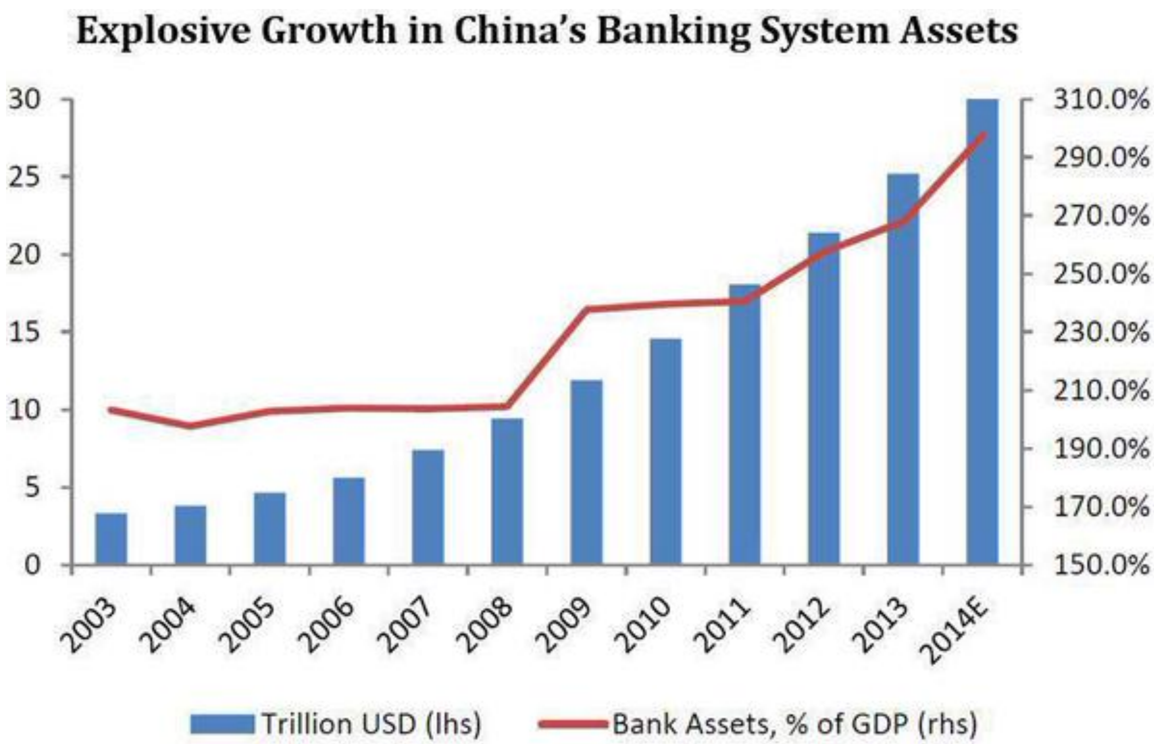
China's post-2008 policies included:

1) Launching a single stimulus program equal to 16% of China's GDP.

2) Funneling $18+ trillion into the economy via the Chinese shadow banking system (an amount equal to over 200% of Chinese GDP).

Both of these policies DWARF the response by the US Government to the 2008 collapse. Imagine if the US's 2009 stimulus program had been $2.72 TRILLION in size. **That is the monetary equivalent to what China did with its 2008 Stimulus**.

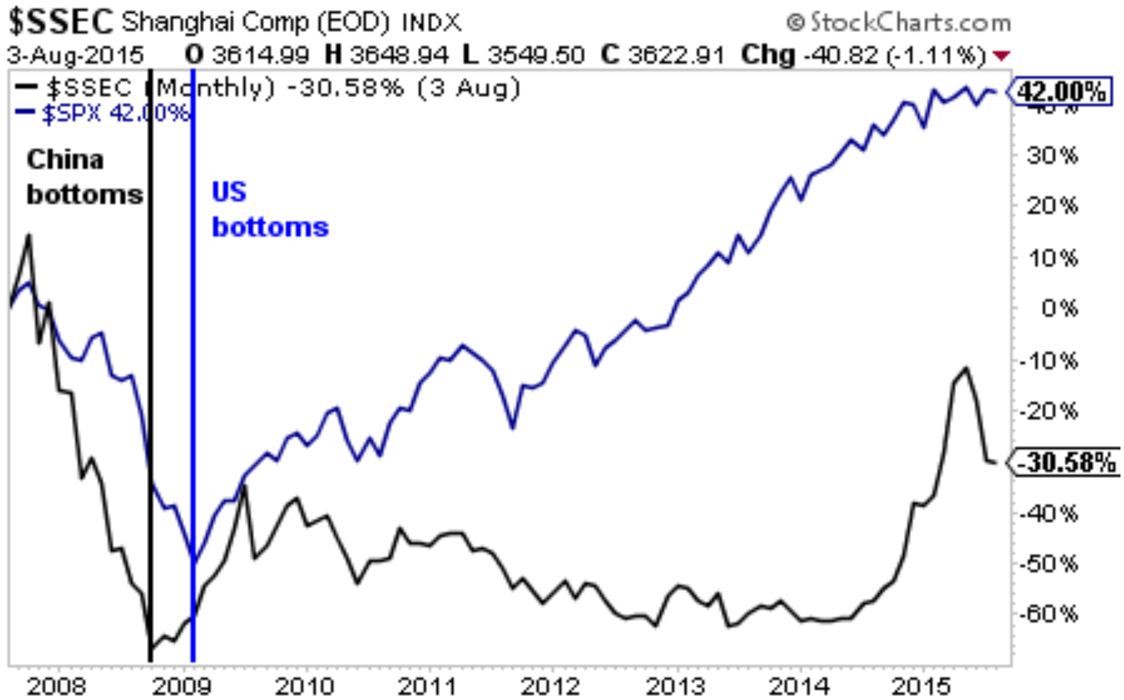
As for the growth in China's banking system, the below chart courtesy of Medley Global Advisors summates the situation nicely.



Source: Logan Wright, Medley Global Advisors

All told, since 4Q08, China's bank assets have increased by more than the Fed, ECB, and Bank of Japan's balance sheets **combined.**

In short, China did the same things every other country did to combat the Crisis…it just did them **earlier and more aggressively**. As a result both the Chinese economy and the Chinese stock market bottomed before the US's did.



With China's stock market now crashing, we are discovering the following items about the financial world:

1) That 99% of analysts happily buy into any popular investment theme without doing any real work

2) That Governments around the world are actively trying to hide their failure to generate economic growth by inflating stocks (and creating paper wealth)

3) That when the mess comes crashing down, Governments will go ballistic to try and prop everything up… printing money at a pace that will be exponentially greater than that which occurred in response to the 2008 crisis.

Regarding #1, 99% of analysts bought the China economic miracle hook line and sinker. Indeed, now that all three of China's bubbles (stocks, real estate, and shadow banking) are imploding simultaneously, the biggest story in the financial media is whether China's GDP number is accurate.

Anyone with a working brain who bothered to do a little research knew that China's GDP number has been a complete fiction for years (possibly decades).

The fact that even today there is a debate on this subject only confirms that the media is more interested in projecting a particular narrative rather than actually presenting accurate information.

Consider the following headlines from the six months building up the China bubble bursting.

China's stock market is not in a bubble (January 2015)

China's bull market 'has just begun', not a bubble: People's Daily (April 2015)

The China Bubble That Wasn't (May 2015)

Gartman says China bull market is still alive (May 2015)

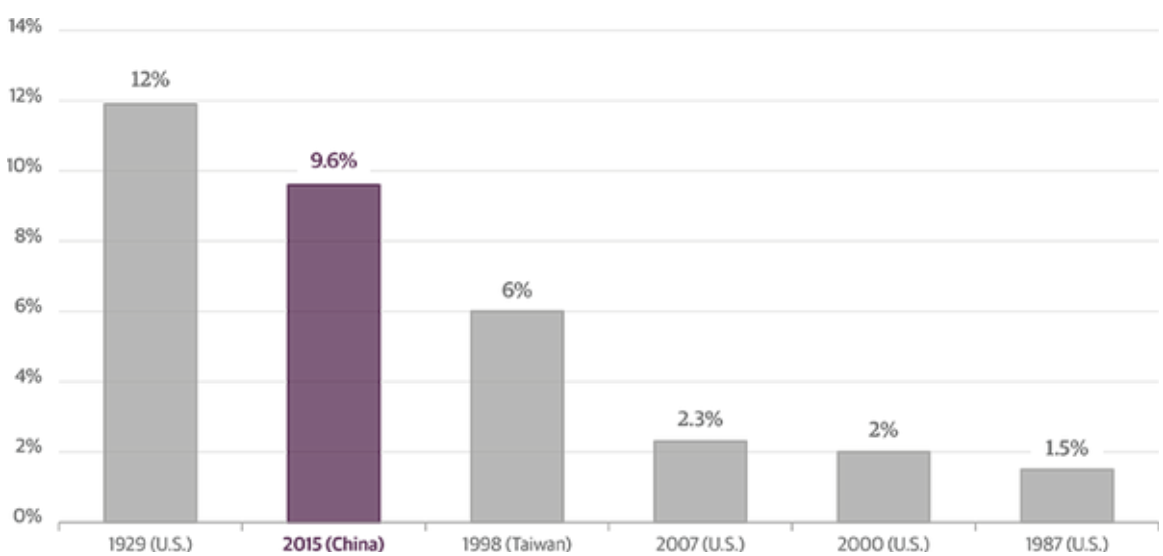
This nonsense hasn't ended despite China CLEARLY being in a bubble and that bubble CLEARLY bursting. The below headlines are all from July 2015… published AFTER the Chinese stock market imploded.

Surprising Reasons Why China's Stock Market Is Not In A Bubble (Forbes)

What Warren Buffett's favorite indicator says about China's stock market (Fortune)

Goldman Sachs Says There's No China Stock Bubble, Sees Rally (Bloomberg)

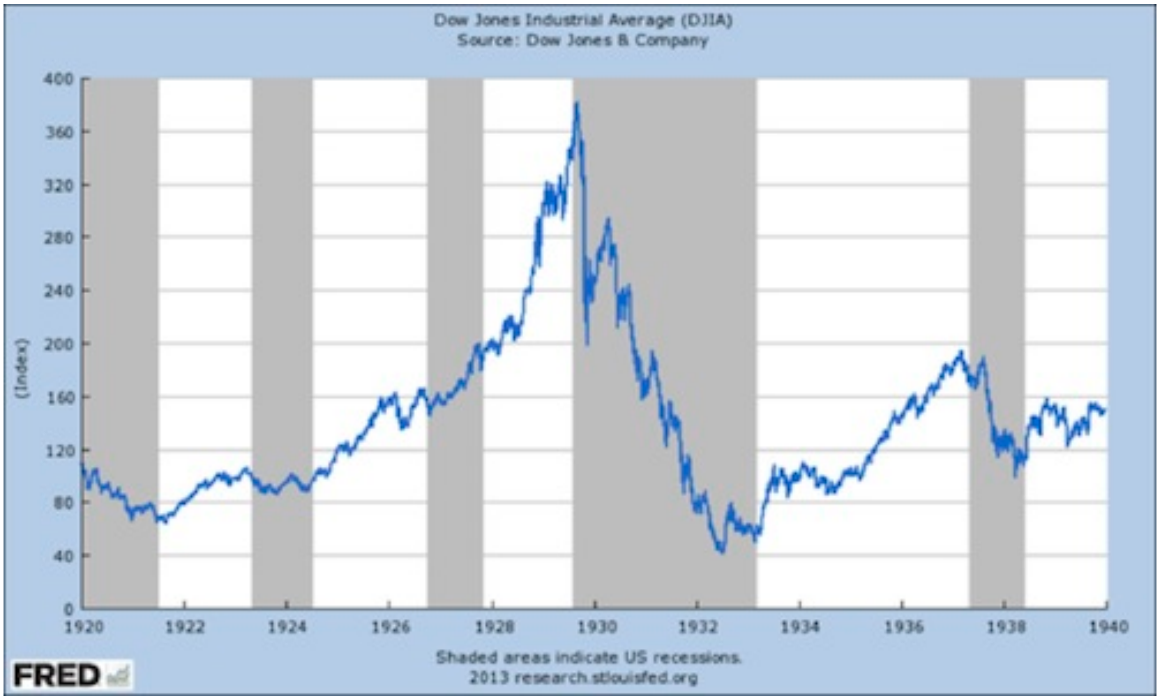
This is simply astounding, especially when you consider that the only stock market bubble in the last 100 years that involved more margin debt relative to market cap than China's recent stock market episode was the great US 1929 stock bubble.



H/T Meb Faber

Margin debt is money that is borrowed for the **express purpose of buying stocks**. It is nothing short of outright leverage in an asset class that is extremely volatile. And nearly 10% of China's entire stock market cap was based on this!

The only comparable bubble in the last 115 years was the 1929 US stock bubble. When that bubble burst, stocks lost 90% of their value over the next 24 months.



In the simplest of terms, China's stock market was clearly in a bubble. Anyone with a functioning brain knew it. When stocks rally so much that corporations stop engaging in manufacturing to start day trading (and record the gains from their portfolios as "income") **you are in a stock market bubble.**

> ***Chinese companies are turning to an unlikely source for profits in the soft economy: the country's red-hot stock markets.***
>
> *Take Dong Jun, who earlier this year shut down his factory making lighting equipment and electrical wiring and let go some 100 workers. The 50-year-old comes to the plant in the eastern city of Yancheng almost daily,* ***<u>but spends his time trading stocks on behalf of his company, Yanwu Keda Electric Co.</u>***
>
> *"Manufacturing is a very hard business these days," said Mr. Dong, chairman of the company.* ***"I want to make some money from the stock market and use the profits to restart my manufacturing business later, when the economy turns for the better."***
>
> *http://www.wsj.com/articles/chinese-firms-put-cash-to-work-in-stocks-1434463023*

Regarding #2, it is now clear that globally policy makers have failed to generate any sustainable economic growth post 2009.

As a result of this, Governments and Central Banks have been increasingly pointing to their stock markets rising as a benchmark for success. The below quote from 2010 by former Fed Chair Ben Bernanke illustrates Central Bankers' thinking on this subject:

> *This approach eased financial conditions in the past and, so far, looks to be effective again.* ***Stock prices rose and long-term interest rates fell*** *when investors began to anticipate the most recent action. …****And higher stock prices will boost consumer wealth and help increase confidence,*** *which can also spur spending…*
>
> *http://www.washingtonpost.com/wp-dyn/content/article/2010/11/03/AR2010110307372.html*

This is how Central Bankers see the world. China is no exception. Stocks are the name of the game because frankly the response to the 2008 crisis has failed to generate any meaningful growth anywhere else.

Finally, regarding #3, (monetary response to the next crisis) since the Chinese stock bubble burst, China has announced that it will:

1) Halt all IPOs.

2) Ban short-selling in some companies.

3) Ban large shareholders from closing or selling positions in six months.

4) Arrest those involved in undermining stock market stability (anyone it wants to arrest).

5) Create a "balance fund" backed by the Central Bank, 21 brokerages and the Chinese sovereign wealth fund. The fund will be used as a kind of Plunge Protection Team for China.

6) Issue a number of small bailouts of brokerages and financial firms.

7) Launch a new stimulus program ($40 billion)

8) Cut interest rates.

Having found that these measures failed to ignite another leg up for Chinese stocks…

… Chinese authorities have become even more aggressive in dealing with the situation. Indeed, most recently Chinese officials have begun an all out witch-hunt for those selling stocks.

> *The markets regulator, the China Securities Regulatory Commission (CSRC), **wants the trading records to try to identify those with net short positions who would profit in case of further falls in China-listed shares**, three sources at Chinese brokerages and two at foreign financial institutions said.*
>
> ***The regulator has declared war on "malicious short sellers"** or those it deems are trying to profit from a fall in share prices, rather than adopt a short position as a financial hedge.*
>
> ***"The implied threat by the CSRC is that anything that is not a hedge is a no-no,"** said a source in Hong Kong with knowledge of the requests. This person added that foreign brokers were likely to comply as best they could with the requests.*
>
> *http://www.reuters.com/article/2015/07/31/us-china-markets-csrc-exclusive-idUSKCN0Q50H120150731*

The phrase "anything that is not a hedge" effectively opens up ANY short or hedge to investigation and prosecution. China's government and regulators are desperate to find scapegoats. Even those who are merely hedging will likely be investigated.
It is this policy that is most important for understanding China and its response to the crisis.

This move to crack down on "evil speculators" and those who are trying to "undermine stability" reveals that the entire "China is going capitalist" story was a complete myth. China was not and is not a capitalist country. It is a gigantic Centralized Fraud run by corrupt bureaucrats…

Speaking of which…

> *After China's stocks crashed in June, the government put more than $400 billion at the disposal of a little-known state agency, the China Securities Finance Corp., **<u>headed by an academic and bureaucrat named Nie Qingping. It was told to save the market.</u>***
>
> ***The agency's unique mandate is to intervene in the market to buy stocks**, with money borrowed from the central bank and other sources, in order to help prop up share prices…*
>
> Nie, *the 53-year-old chairman… is of a professor with 25 years of experience watching stock manias -- **<u>who still got blindsided by China's latest crisis.</u>***
>
> ***"The latest rally has the characteristics of a structural bull market**," Nie wrote in an article in March, joining a chorus of officials and state-media commentators talking up the market's prospects**<u>. As one of the architects of China's move to allow margin financing, in which people borrow money to buy stocks, Nie played down concerns that debt-funded stock purchases were rising too quickly.</u>***
>
> *http://www.bloomberg.com/news/articles/2015-08-02/meet-china-s-stock-rescue-chief-he-never-saw-the-crisis-coming*

So an academic who didn't see the crisis coming is meant to save the world? This is Bernanke 2.0 the China Edition… the only difference is that China doesn't have the world's reserve currency.

What China *DOES* have is the ability print an absolutely staggering amount of money without a Congress or any other governing body holding it back.

To that end, **China is now actively spending $29 BILLION per day propping up stocks.**

> ***The state-owned China Securities Finance Corp. has been spending up to 180 billion yuan a day ($29 billion) to try to stabilize stocks, a person familiar with the situation said earlier this week.***
>
> http://www.wsj.com/articles/in-china-stocks-late-jolts-are-new-normal-1438284814

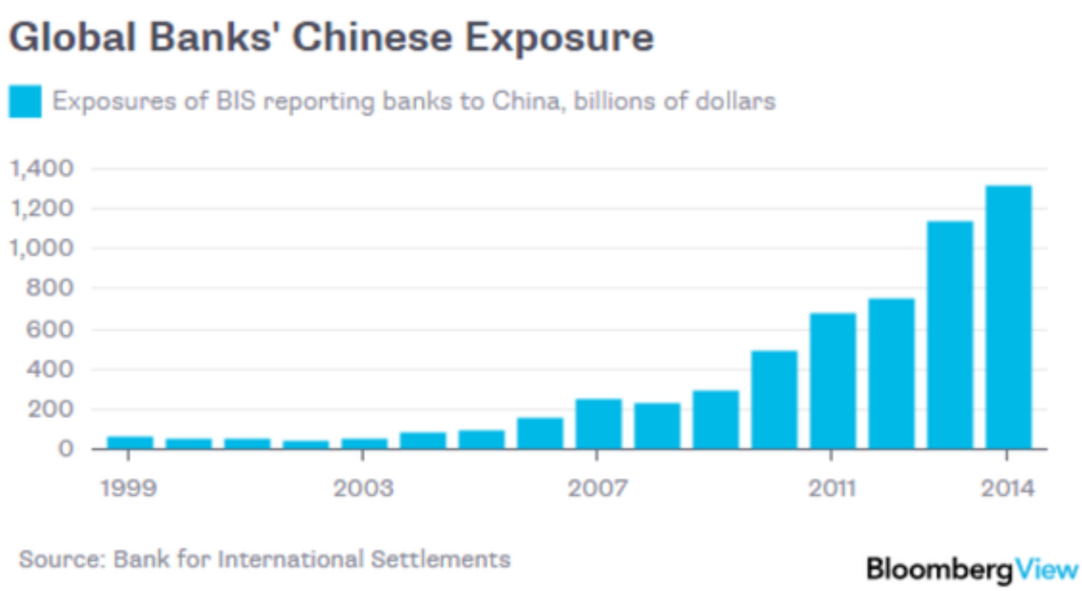
The average income for college graduates in China is $2,500 per year. So the Chinese Government is spending the equivalent of 11.6 MILLION people's annual incomes **per day.**

In the US, an equivalent amount would be $527 BILLION or **half a TRILLION DOLLARS PER DAY.**

This is the most important aspect of this week's update… and I want you to understand it clearly: that when the next Crisis hits, the monetary response by authorities will be beyond anything the world has ever experienced.

China lead the world in responding to the last deflationary episode. It is doing the same today. Whenever the crisis spreads globally, Central Banks will go ballistic to prop the markets up.

I do not know when this will happen precisely, but given that global banks have over $1.4 TRILLION in exposure to China, I wouldn't be surprised to see some kind of derivatives implosion start in the next 8-12 weeks.



Indeed, if there's one thing the China market crash has shown us, it's that when the next crisis begins, it will happen quickly.

We, in the US, got a taste of this earlier this week with Apple (AAPL) share's collapse following a hiccup in the "infinite growth forever" theme.

Let's be blunt here… Apple's results were truly incredible. **The company posted $49.6 billion in quarterly sales, up a staggering 32% from sales for 3Q14.** This growth did not come as the expense of profits with **<u>gross margins rising and net profits increasing 38%.</u>**

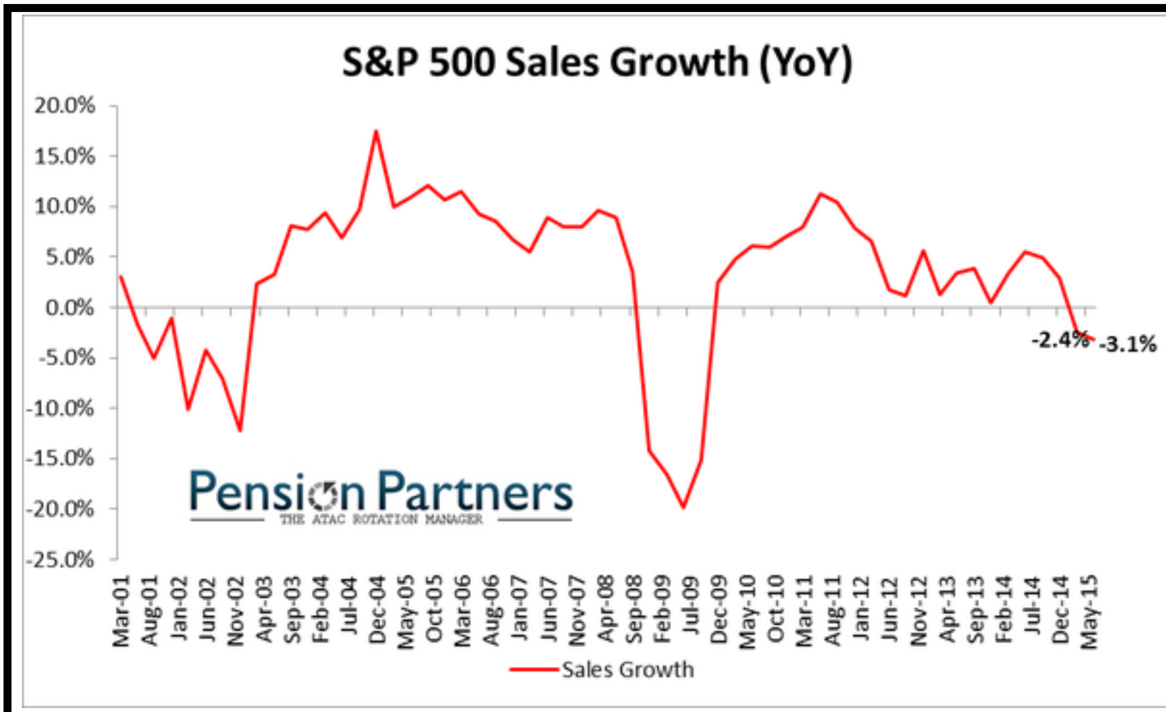
This is an unbelievable quarterly result, especially at a time when nearly half of corporations are showing **a contraction in sales**.

Despite this, Apple's stock sold off hard, losing $60 billion in market cap and falling below its 200-DMA for the first time since 2012.

Why?

Apple sold only 47.5 million iPhones down from 61.17 million last quarter. The mega-growth story didn't live up the hype and Apple shares took a severe hit.

This will be spreading throughout the market in the coming weeks and months. The stock market rally in the US is being driven by fewer and fewer companies. And this is occurring at the same time that corporate sales (which ultimately drive earnings) have fallen back below 0% for first time since 2008.



China is the global canary in the coalmine. Do not underestimate the impact it will have on global stock markets. China lead the US markets down during the last crisis. It's doing it again now.

This concludes this week's market update. I'm watching the markets closely and will issue updates as needed. Thus far we've reserved our shorts to the Emerging Market space, but I believe we'll have ample opportunities to short the US markets in the coming weeks as the contagion spreads.

Barring new developments you'll next hear from me next week in our regular weekly market update.

Until then…

Best Regards

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Phoenix Capital Research