Unbounded Wealth: John’s Take 9-19-24

China Implosion

Last week, I shared one of my favorite charts showing that the amount of stock bought on margin is exploding.

The chart illustrates that many speculators are leaning bullishly. When a shoe drops and everything swings back the other way, the downside is magnified by these weak hands due to forced selling.

Of course, margin loans don't help us predict *when* that shoe will drop. While we cannot time every squiggle in the market, we can assess the big picture clearly and understand where we are on the risk spectrum.

That's one reason I was so excited to work with Harry Dent a decade ago. His demographic work is awesome and helps one clearly see the big trends without sweating the small and impossible-to-figure stuff.

This week, I wanted to talk about shoes that might drop.

U.S. investors think that everything revolves around the local market.

Collectively, we are massively underweight in international markets.

U.S. stocks account for about 60% of global market capitalization despite the economy accounting for about 25% of global value. The most common approach to investing is "buy and hold the S&P 500 index fund," so investors aren't focused on other markets.

So, when a shoe drops out of the blue, not from the U.S., it will catch us by surprise.

There’s an old saying that when the U.S. economy sneezes, the rest of the world catches a cold.

China is the second-biggest economy in the world in terms of nominal GDP. Several trends suggest that it is under stress.

If China sneezes, it will filter through to the U.S. It's unavoidable, and we should be concerned.

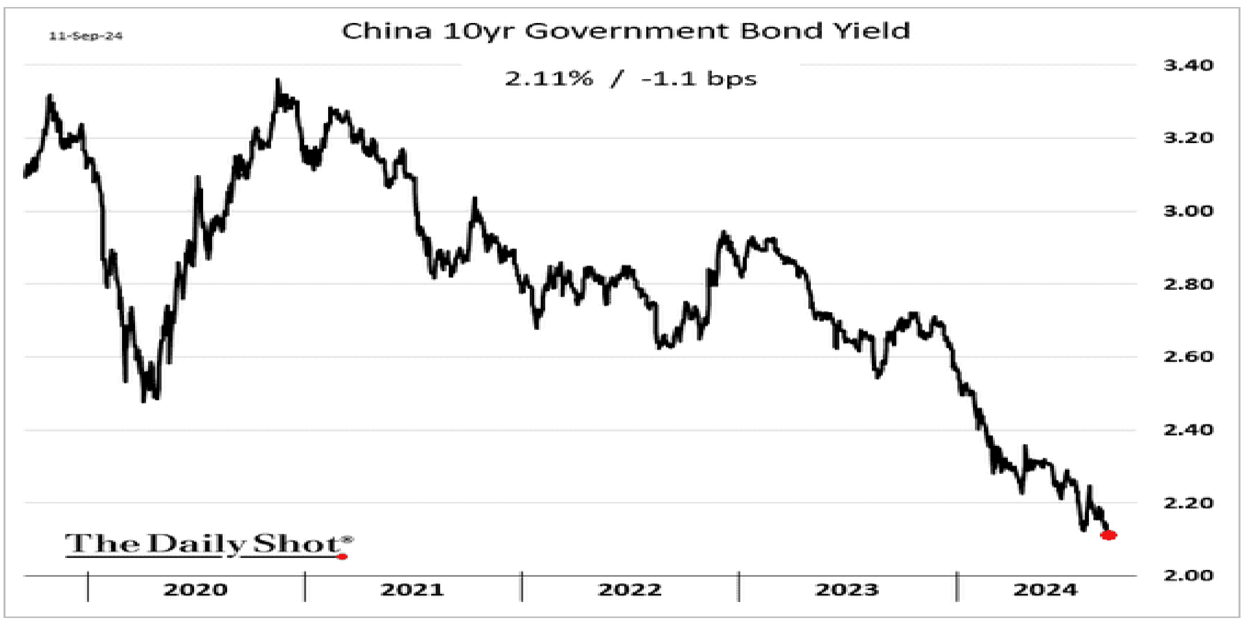
And be prepared.

My retirement account systems have been cautious recently after being bullish for a long time, and my proprietary *Risk-O-Meter* has been stuck in neutral for a while. There hasn't been an outright “sell” signal, but the easy, low-risk market buying opportunities are nonexistent.

While my strategies do not analyze Chinese markets directly, many indirect factors go into my models, alerting me to changing trends *before* stocks react.

The first warning sign that trouble is in China is the imploding yield on its 10-year government bond.

Look at this chart below.



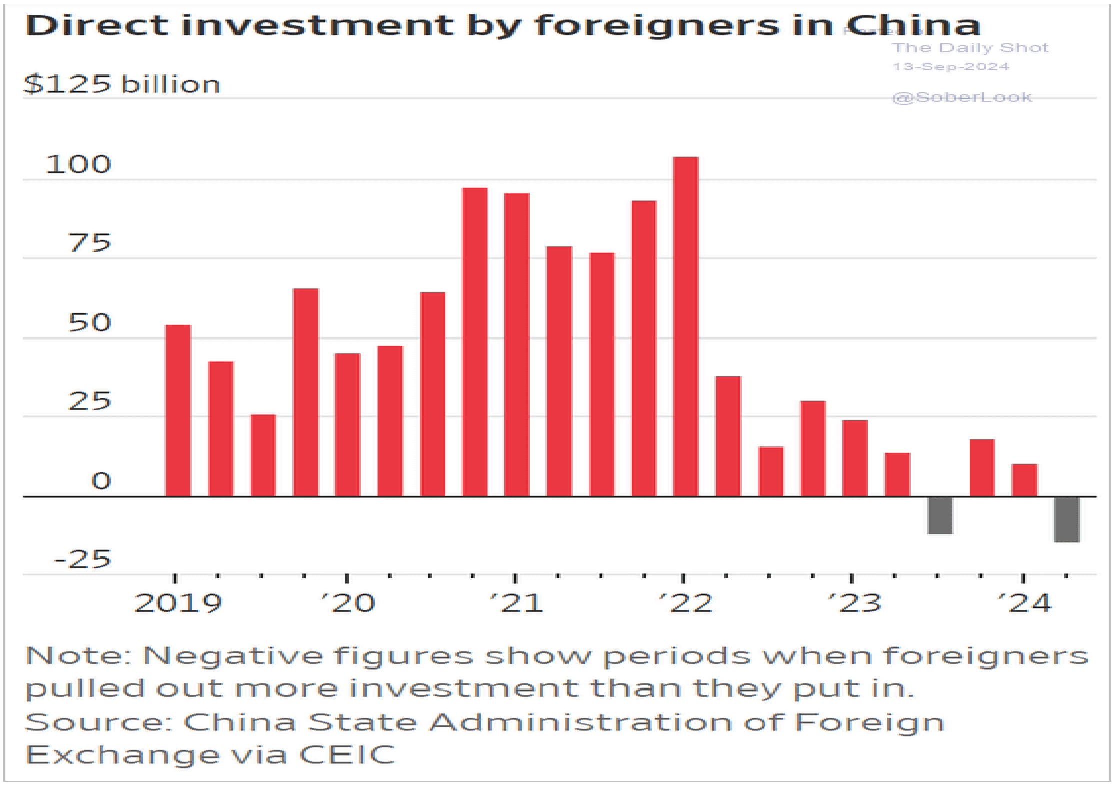
Over the past four years, yields have been persistently down. This freefall indicates that deflation may be taking hold in China.

On the next chart, we can see that corporate spreads have widened, indicating stress in the system. The spread surge and reversal have happened in just the past couple of months.

Meanwhile, foreigners are yanking their investments in China.

Investment outflows are a *big* problem.

As the chart below illustrates, after years of persistent investment, the last four quarters of foreign investment were relatively flat. The September number will be of particular interest because if it's negative, it could start a new trend.



Lastly, commodity prices are softening.

Look at rebar prices below.

China has been in expansion mode for decades. Cities get built seemingly overnight.

But does anyone live in those cities?

Is it all smoke and mirrors?

I think so. Despite pumping liquidity into the system, real estate prices are softening, commodity prices are weakening, and foreigners are withdrawing their money.

The last point concerns me. When outside money stops flowing, it's big trouble in today's global economy. Investment flows can keep the house of cards standing for a while.

Years even. However, just like it takes a year to build a house, it only takes 20 minutes to burn it down. Thus, I'm concerned that China is at the tipping point and the crash could happen fast.

I'm also skeptical because China's economy is opaque.

China has reduced the number of economic indicators it reports by a substantial amount. The government has cracked down on Chinese firms providing more useful data. Less transparency about anything is always a red flag.

Furthermore, one guy runs the entire show over there.

As a result, we are now firmly planted at the riskier end of the risk spectrum and need to avoid complacency.

Next week, I'll discuss an investment theme worth monitoring regardless of China's problems, interest rate moves, or who wins the election in November.

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