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Something to Think About

OAKWORTH CAPITAL BANK

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According to the Federal Reserve, loans and leases on the books of US commercial banks in the United States totaled in the neighborhood of $6.785 trillion in December 2007. The amount of deposits banks had to cover these loans totaled $6.664 trillion. In other words, banks were fully "loaned up." Also according to the Fed, loans and leases at US commercial banks were about $8.518 trillion in November 2015, and banks had around $10.962 trillion in deposits.

Further, foreign investors a substantial percent of outstanding American debt, public and private, a little less than $10 trillion. So, no matter how you slice it, the US economy was highly leveraged and highly indebted to third parties. If we caught a cold, the rest of the world was going to catch pneumonia. As we all well know, we did indeed get sick in 2008, and the rest of the world felt it and then some.

Unless you have been completely off the grid thus far in 2016, you know the global stock markets have been absolutely awful. The most oft-given explanation for this is concern over Chinese economic growth and its overextended financial system. After all, from what I have read, the Chinese debt market is something like 262% of Chinese Gross Domestic Product or thereabouts.

That is a lot of debt, trillions of dollars of the stuff. Who really knows what is going on in China, and what in the world is going to happen if all heck breaks loose in the bond market over there? As Dean Wormer might have said: "Slow, opaque and illiquid is no way to go through life, son." True, so true.

I mean, if the US can cause a global financial crisis, why in the world can't the Chinese? That is a great question, and the easy answer is: "because the US is the US, and China is China."

While this might seem like a very cavalier attitude, a financial system panic in China doesn't have the same, shall we say, global tentacles as one in the good old U.S. or A. This is because China largely lends to itself, and the Chinese banking system is basically owned by the Chinese central government. You can liken it to Washington owning, say, 85-90% of Wells Fargo, JP Morgan, Bank of America, and Citigroup.

Of course, foreigners have some exposure to the looming mountain of Chinese debt, either directly or indirectly. However, the Chinese themselves have way more, way more, with the government itself largely on the hook for just about all of it, in some form or fashion. Foreign investors? From what I have read, they own something like 3% of the Chinese bond market….virtual peanuts.

Think of it this way: the Chinese treasury issues debt, and commercial banks gobble up about 70% of it. Since either the central or provincial governments own controlling interests in the banks, in so many ways, the Chinese government is largely self-financing. If Beijing owns roughly 90% of the money center banks, you can reasonably intuit it, albeit somewhat indirectly, takes down upwards of 60% of its own issuance.

Admittedly, this is a oversimplification of the issue. However, the fact remains: if Chinese borrowers start defaulting on their debt en masse, the central government goes under OR turns on the

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printing presses. Even its massive foreign currency war chest won't be able to save its hide. So, what do we do? Basically, grin and bear it. How do you like that?

Oh, I have read far more complicated analyses on the subject than the one I just gave you. The worst case scenarios are pretty grim, to be sure. Still, no matter how hard I try to complete the mental gymnastics floor exercise in my head, I just keep coming back to: the government isn't going to let itself fall, is it? It has been playing a financial shell game for years, and owes itself a great deal of money. I am sure it wants to pay itself back at some point.

Have you ever seen the movie "Me, Myself and Irene"? It is a ridiculous, almost mean-spirited, story about a man with multiple-personality disorder, which really shouldn't be funny. However, when the two separate identities, Hank and Charlie, get into a fistfight near the end, brother. As the Charlie personality implores: "you are only hurting yourself." That is kind of how I would liken a Chinese financial crisis to be to some small extent.

Well, maybe I wouldn't laugh in spite of myself over it.

This is what perhaps has me scratching my head over the consternation about China. Okay, China's economy is going to slow, which should almost be a given. At some point it just gets impossible to keep growing at 10% every year, as the starting base keeps getting bigger. Further, its trade surplus was ultimately going to narrow as the average Chinese became wealthier and consumed more. Finally, you know, maybe all that steel and cement capacity as well as those massive ghost towns just aren't all that necessary.

However, that doesn't mean China is going to fall off the map, far from it. It has simply entered a transitional period where it shifts from capacity buildout to more consumption. Consider this: consumer expenditures make up roughly 68-69% of the US Gross Domestic Product equation. They constitute about 38-39% of China's. To that end, I fully anticipate an improvement in Chinese living standards far in excess of its final GDP number. It will just be shifting the variables in the C+I+G +/- net exports equation. G will remain relatively constant; net exports will not be as additive; I will likely be flat, and C could very easily grow at enviable growth rates for a very long time.

The more I stew on this, the more I think the following: there were a lot people holding off on rebalancing their asset allocations at the end of 2015 because they didn't want to realize a significant capital gains tax consequence in a flat to negative year . Further, after a really nice run from 2009-2014, equity allocations were undoubtedly a little skewed to the upside across all accounts.

As I told a client this week: it isn't too hard to imagine, say, a large pension fund with a long-term target equity allocation of 50%. After letting it ride for a few years, the allocation had increased to 55%. After all the volatility last year, the powers that be decided to reallocate back to the target. This isn't a wholesale liquidation of equities, not by any stretch. However, what happens if enough funds and individuals are all doing the same thing at the same time after a very volatile year which produced next to no return?

What with virtually everyone and their brother calling for humdrum returns and volatility again in 2016? Trust me, there haven't been a lot of buyers out there thus far this year. Throw in problems in the Middle East, and, voila, the confusion over just what is going on in China takes on new importance...you get to a point when the sell-offs start

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feeding on themselves, even though no one's macroeconomic or even market forecasts have changed significantly for the year.

Then we have the issue of low energy prices. The talking heads are now having us believe low energy prices are anathema to economic growth. Not so long ago, they told us high energy prices were a curse. Which is it? Surely, there will be some pain in this sector, and has been. However, if the average consumer has more money to spend on goods and services that have a higher economic multiplier effect than what we spend at the pump, I am not certain how that is a bad thing in aggregate. Have I mentioned consumer expenditures make up 68-69% of the GDP equation?

In the end, the tea leaves aren't currently portending an economic collapse. Unfortunately, their aren't predicting rampant economic growth and massive market returns either. There is nothing in the bottom of our cup which suggest anything substantially different than a repeat of last year. Of course, things can change, but, as I type, we are viewing January as a correction as opposed to a market meltdown.

If the US banking system ever gets as leveraged and overextended as it was in 2007, we will be headed for the exits faster than the next person. However, we are an extremely long way away from those conditions and overall market valuations aren't here nor there (in fact, you could possibly argue stocks could support a higher multiple with interest rates as low as they currently are).

Quite simply, the US isn't China, and the US is in okay shape. When that changes, we will let you know.