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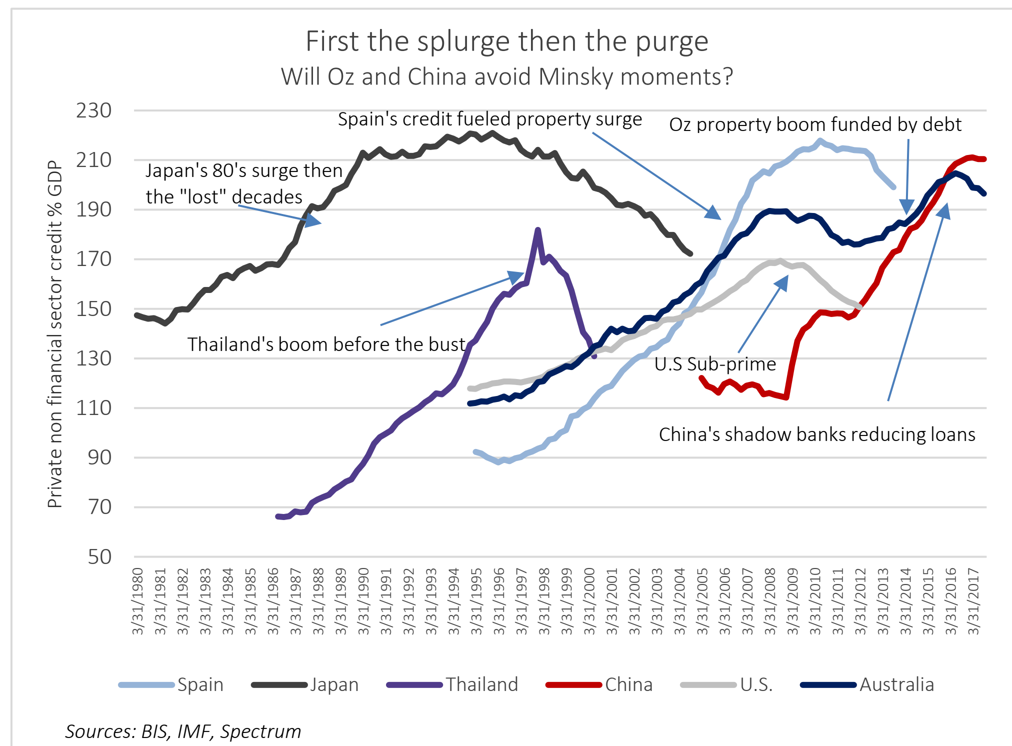
Our double Minsky risk

The good times have long rolled on for both China and Australia. Both have enjoyed continuous economic growth for over twenty years. The concern is, as the famous U.S. economist Hyman Minsky said, "the longer things are stable, the more unstable they will be when the crisis hits"[1]. A common theme for countries of the past was a build-up of private sector debt to record levels.

In Australia, the leverage villains come mainly from households. In China, it is the business sector that has piled on the loans. As the graph below shows, private sector debt to GDP in both countries is at around levels that came before other countries had financial calamities. While this does not mean a crisis is assured or near, the risks are elevated. For both China and Australia, these risks also look to be rising.

So, what do we look for to prepare for a potential fallout? Abundant liquidity made the bubble and a lack of liquidity will probably undo it. The pace of any lending reversal may determine whether it is a gradual deflation or a severe disruption. At present, while credit keeps flowing, we keep investing, preparing for a correction while watching for a halt of funding to these markets.



Sources: BIS, IMF, Spectrum

What is a 'Minsky Moment'?

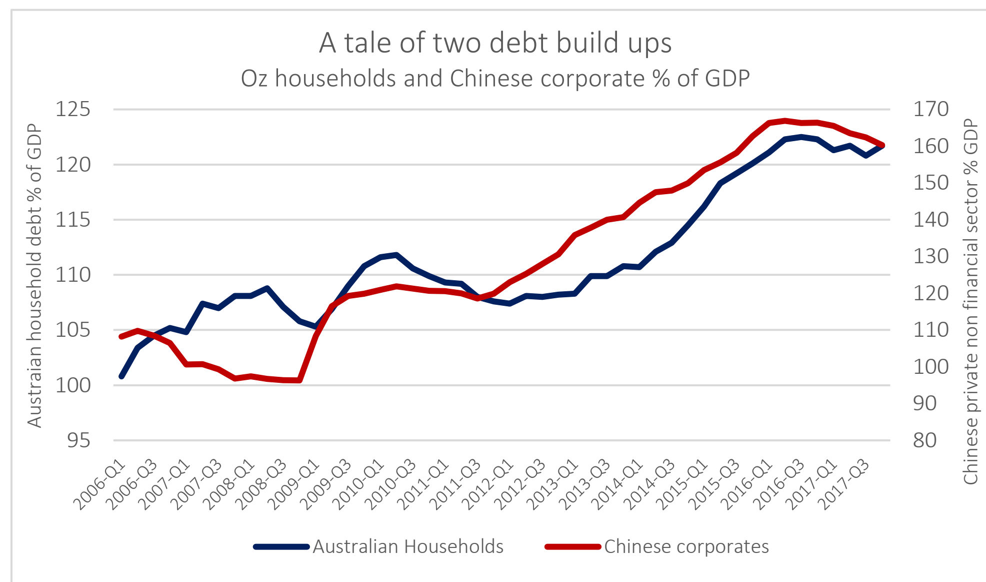
The saying came from U.S economist Paul McCulley in relation to the Russian debt crisis of 1998. It was inspired by the famous U.S. economist Hyman P Minsky. The relevant Minsky theory focuses mostly on the conditions that lead to the vulnerability of an economy or market of falling into a crisis – *the moment.* The "instability emerges as a period of relative tranquil growth is transformed into a speculative boom. This occurs because the acceptable and the desired liability structures…change in response to the success of the economy"[1]. The longer the stability period the greater the risk of instability.

Dodge one bullet but another one waits in the chamber[2]

As discussed by many market pundits for years, including Spectrum, Australian household debt is at worrying levels at around 120%.

The problem is, even if household debt does not cause excessive problems locally, a rapid deleveraging in China would likely hit local financial markets. A large debt reduction in China will risk lower than expected demand for our goods from our major export market.

Conversely, we doubt a domestically-driven downturn locally would raise an eyebrow in China's financial markets.



When do the warning signs begin "flashing amber"?

What we look for as a warning sign of a Minsky moment is when credit availability starts to shrink.

This typically follows mounting loan and bond losses. Lenders' confidence then starts to wane. Loans become harder to obtain. The marginal borrowers cannot access refinancing. This causes more defaults or distressed selling. Lender confidence falls further. And then a vicious negative loop can kick off.

This is the usual playbook for the start of past credit crises across the globe.

China's Minsky status: amber

China's well-intended current efforts to cut pockets of excessive corporate leverage bring the risk of a Minsky moment closer in our view.

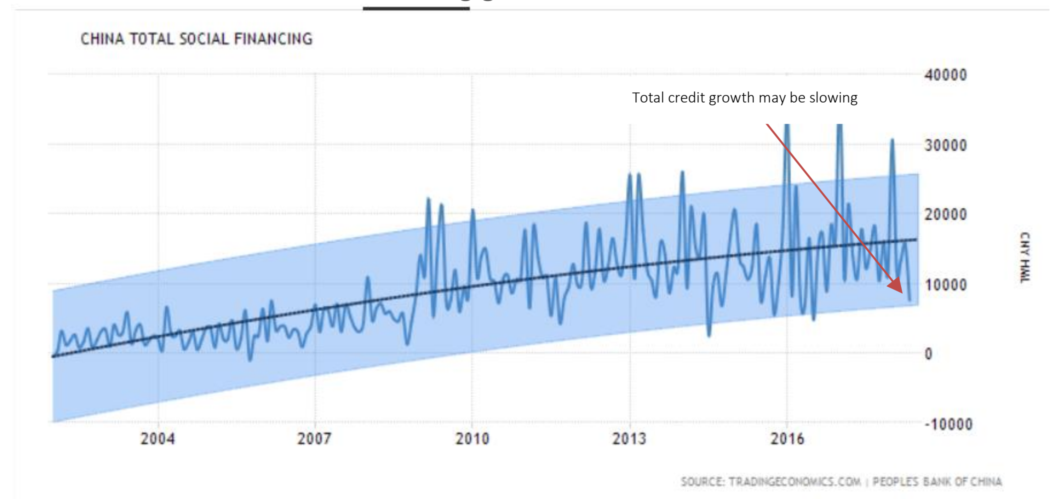
In October 2017, China's central bank governor warned specifically of a Minsky moment for China. In the reported statement, he noted high corporate leverage and rising household debt.

One key step was to reduce lending from yield chasing "shadow" banks. The concerns were that these key providers of speculative lending were an unsustainable source of finance that promoted poor allocation and management of capital.

"Shadow" bank lending in China is now falling. Much of this slack, though, is being taken up by the stable government-controlled and regulated banks.

The net impact, however, is an overall slowing of lending growth as measured by "Total Social Financing".

Total lending growth in China slows

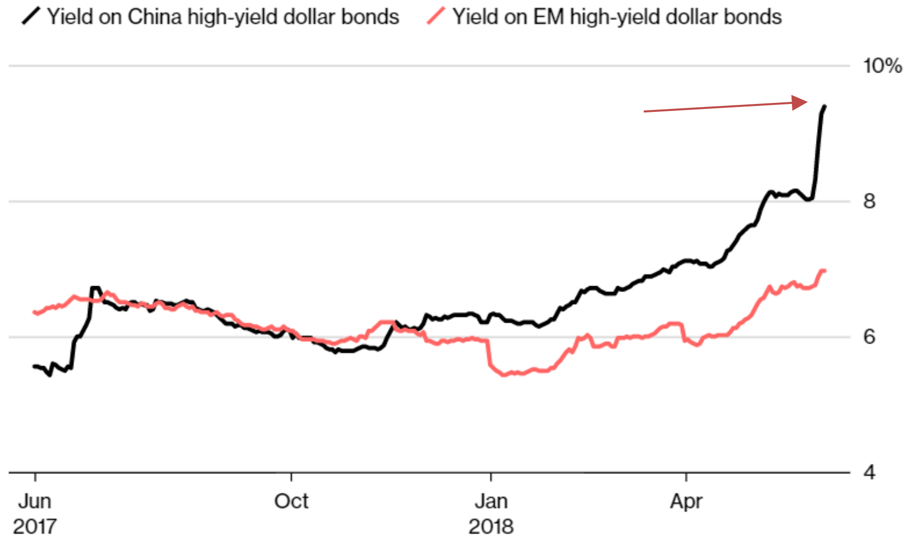


Further efforts to smooth the transition of China Inc.'s loan book to a more sustainable basis are:-

- the recent cutting of reserve requirements,
- direction to the banks and lenders to help finance medium, small and micro businesses, and;
- tax cuts.

Looking forward, if these measures do not work and bad loans increase, China may look to socialize the credit losses, as it has in the past, reducing the disruption to the economy.

Notwithstanding the steps taken, a key fall-out from the reduction in credit availability can be seen in the Chinese corporate bond market. Bond default rates are accelerating and credit spreads on corporate bonds have jumped.

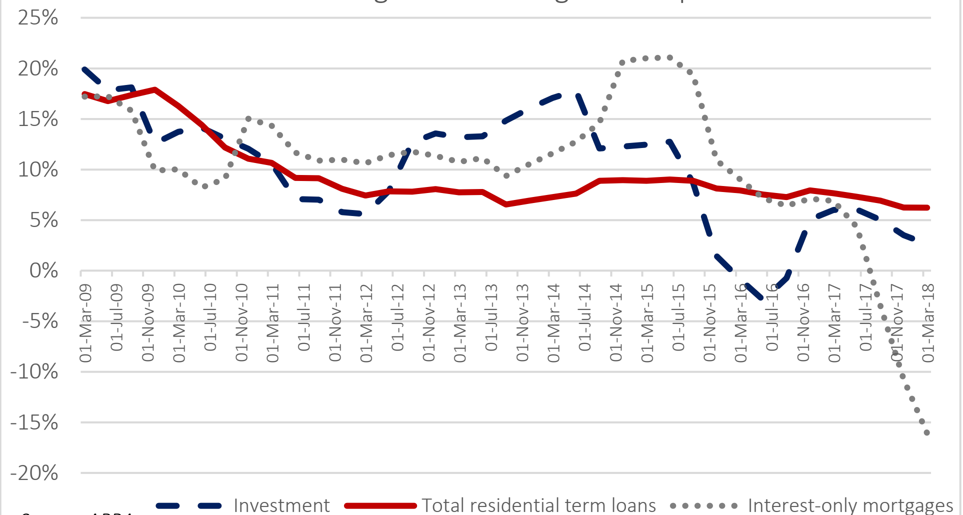


Should defaults continue to mount a stampede for the exit could begin. And then we are one step closer to a Minsky moment.

Australia's Minsky status – green to amber

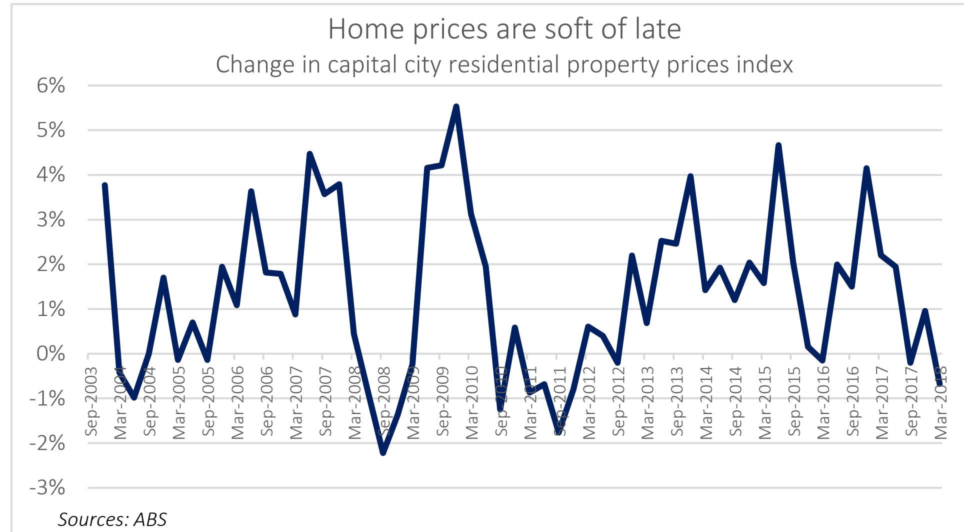
At present there are a few anecdotal warning signs of a credit cycle turning in Australia. Several factors are contributing to this:-

- APRA's initiatives to lower the risk of loan books.
- A reaction to findings of lax lending from the current Royal Commission.
- Softer home values.
- A possible realization by lenders that interest only loans can be very risky and hence reducing them – as shown below.

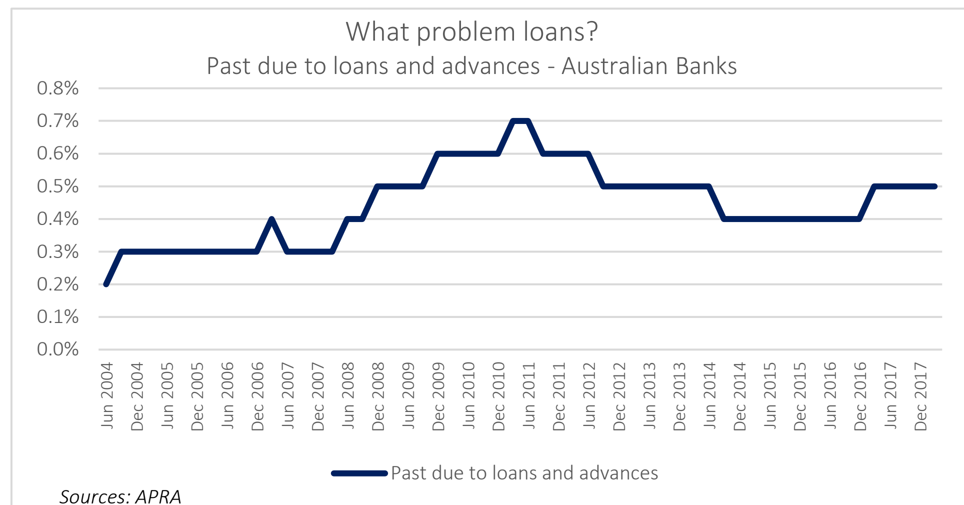


At the same time, mortgage interest rates are under pressure to increase due to rising wholesale finance costs. Foreign demand for residential property also appears to be less than the past few years. Auction clearance rates have fallen.

Given these factors, it is of little surprise that national home prices have dipped lately.



Despite all the above, loan losses from mortgage lending remain negligible. And until this changes we expect banks to remain willing and able to fund the bulk of the demand for domestic residential property mortgages.



The risks of a turning in the Australian credit cycle are rising but the lights are not flashing amber – yet.

Timing is paramount

Many of the concerns noted above were relevant several years ago. They may be present for the extended future. The point being pre-conditions of a crisis do not ensure a crisis will evolve in a set time or even at all.

As an investor, we attempt to prepare for the worst and watch for the early signs of them turning into reality. Until the warning lights start flashing amber, we look to maintain a medium risk position in our investment portfolios with a plan B ready to deploy.

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1. Hyman P Minsky - Stablizing an unstable economy
2. Paraphrased from Neill Wallace

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