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gs INVESTMENTS

China's Lehman Moment?

Late last month, Evergrande, one of China's largest property developers with over $300 billion in debt, failed to make interest payments on one of its bonds. This news left some wondering if this was a Chinese "Lehman moment" in reference to the Lehman Brothers collapse in the fall of 2008. Many people consider Lehman's sudden bankruptcy as the trigger that led to the 2008 financial crisis resulting in a steep decline of housing prices and millions of home foreclosures. The news sent a short-lived chill throughout global markets as banks around the world were scrambling to assure their clients and investors alike that their exposure was limited.

Just as speculation caused a housing bubble in the U.S. in the late 90's and early 2000's, China has experienced its own speculative housing boom. In Shenzhen, China's fourth largest city located near Hong Kong, prices of modest apartments sell for $1,000 per square foot. This is on par with prices in many of the worlds most expensive cities such as Paris, London, and San Francisco. The difference, however, is that the average Chinese living in Shenzhen makes only about 1/5th the salary that someone makes, for example, in the Golden Gate City. According to the International Monetary Fund's house price to wage ratio, China has 7 of the 10 most expensive cities for residential housing.

To understand how this issue came about, it is important to look at some of the important aspects of the Chinese housing market. In the late 1980's, most Chinese lived in dreary state-owned apartments. By the late 1980's, China slowly began to allow privately owned housing. As the economy grew and incomes rose, many of the old apartments were torn down and replaced by millions of better-quality high-rise buildings. At the same time, the country began a huge urbanization migration, from 19% of people living in cities to over 60% today. Chinese cities, which are prohibited from levying a property tax, raised much of their revenue by selling their "collectively owned" land to developers at continually increasing prices. This led to the creation of huge property development companies that took on significant debt to buy the land and build homes to satisfy the growing housing need. This steady demand also led to a constant increase in the value of housing property. When compared to China's underdeveloped financial system and volatile stock markets, housing seemed like a sure "investment" bet. This led us to where we are present day.

According to a Goldman Sachs study, the housing market in China is $52 trillion, about twice the size of the U.S. market. In China, over 70% of Chinese household wealth is tied up in housing. This compares to 25% in the U.S., with most of the balance in stocks, bonds, and closely held businesses. Home ownership in China is so popular, that 90% own their home compared to 65% in the U.S. In fact, second and third home purchases have really taken off leaving 65 million units (20% of urban supply) empty. Housing has become of such cultural importance that it is nearly impossible for a male to be considered for marriage if he does not own a home, or even two. This is especially important in a country with a large male to female imbalance. While some of this excess housing inventory may eventually be filled, that outcome faces some stark headwinds.

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The massive urbanization movement has stalled, and the Chinese overall population is nearing its peak. The one child policy from 1979 – 2015 has led to a rapidly aging population. The workforce peaked in 2012, and some forecasts project the Chinese population to shrink dramatically over the next several decades. While the one child policy has ended, birth rates have hardly rebounded. In fact, in 2020 birth rates fell a further 20% to an all-time low as the pandemic spread. Birth rates continue to remain low because of the soaring costs of raising a family, due in large part to the cost of housing which ironically was built mainly for one child families. It appears that China faces a paradox. It will take a large increase in birth rates to maintain the current demand propping up inflated home prices, but on the other hand, it may take a collapse in housing prices to promote that very same increase in birth rates.

What does that mean for investors in the U.S.? we are somewhat insulated as U.S. manufactures and banks have limited exposure to the Chinese housing market. However, there are some concerns regarding China's economy that could limit China's future growth. First, housing represents 29% of China's GDP and many developers could be in for a severe set-back. Second, with a lot of wealth built up in these often inflated, incomplete, and rapidly deteriorating empty homes. A significant price decline could impact many Chinese investors financial security. Finally, China's cities that rely on selling land as a source of revenue will have to look elsewhere for funds. Initiating a property tax now would probably only exacerbate a real estate decline. With all that said, there are some key differences from the U.S. housing bubble that could soften the blow to China's overall economy. First, according to Forbes, only 18% of houses have outstanding mortgages compared to 50% in the U.S. The loans that do exist were not sold to banks and investors across the globe. This mitigates the chances of mass foreclosures and contagion follow on effects we experienced here. Second, the Chinese have a very high saving rate of 40% that could help buffer any potential severe downturn in the Chinese economy. Finally, China has a tight grip on the banks and the overall economy. It is clear to most economists that they are trying to cool off this speculative binge, but they cannot allow a collapse that threatens the government either. Some see this as an opportunity to turn China away from housing as a key driving force of growth to a more balanced economy. So, the Chinese leadership walks a tight rope. Let us hope for a soft landing and that they do not fall.

Are Our Highways are Being Held Hostage?

In a rare feat of bipartisanship, in early August the Senate passed a $1.2 trillion infrastructure bill that democrats and republicans alike have been striving to achieve for several years. However, the bill has since stalled in the House as a vote on this bill is contingent upon passing a separate $3.5 trillion reconciliation bill that contains President Biden's Build Back Better agenda.

According to Pew Research, both bills have relatively strong support among American voters. The infrastructure bill has a 51% favorable rating while only 20% oppose. Similarly, the reconciliation package is supported by 49% with only 25% opposing it. A high percentage are unsure because they don't know what is in these bills. According to a recent CBS survey, 57% did not know what was in the separate bills and only 10% know "a lot of the specifics". When asked about particular items, like taxing corporations and the wealthy, tuition-free community college, universal pre-k support, senior

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dental care, and increased child tax credits, polls show support as high as 88% for some of these items. This really is not that surprising. Who doesn't like free stuff when someone else is paying for it? Despite widespread support, the bill is hung up on democratic infighting.

One problem may be that the bill is nearly 2,500 pages with dozens of provisions, so it is difficult to define the proposal by anything other than the one feature that people do know about the bill: it's $3.5 trillion cost. While Pew Research finds strong support for the spending bills, they also find the two largest economic concerns among voters are inflation and a worker shortage. Spending an additional $4.7 trillion on these two bills on top of the $2.2 trillion already passed earlier this year may have people concerned. How will this additional spending affect prices and can we fill the "millions of good-quality jobs" the White House says the bill will create when we already have over 10 million open jobs that are unfilled. Those concerns have contributed to Biden's overall sliding support. As such, republicans now lead democrats in generic ballots heading into 2022 in the very same Pew survey that expressed support for these bills.

The most vocal democrat urging caution on all the new spending is Joe Manchin, the Senator from West Virginia. While he supports some elements of the program, he too voices concern about inflation and compares it to a tax on everyone. He is also concerned about the creation of four new entitlement programs when Medicare is already forecasted to run out of money in 2026 and preliminary social security forecasts are pointing to running short as early as 2032.

One final point that has not been covered by any of these polls is the real long-term cost of the program. The White House says the 10-year cost of the $3.5 trillion package cost is "paid for" by the tax increases over the next 10 years. While there are plenty of critics that argue the revenue forecast will fall far short of this forecast, what is not in dispute is that many of the more expensive parts of the program are only fully funded for a short period of time. In other words, 10 years of tax increases to pay for just 2-3 years of new programs.

According to the language in the current bill, the child tax credit, health insurance premium credits, universal pre-k, tuition free community college are only fully funded for 2-3 years. Then the funding either precipitously drops or the program completely expires. Are we really going to hire hundreds of thousands of teachers only to fire them in three years? In addition, states will need to comply with all the federal provisions to receive federal funding. In Minnesota, funding for two-year colleges will need to increase by 30% (In Vermont the increase is 234%) to qualify for funds. There will also be state requirements for four-year college funding and other federal compliance measures. Pre-K will also have many potentially intrusive and

Notable Quotes

"Given a 10% chance of a 100 times payoff, you should take that bet every time."
Jeff Bezos

"Don't look for the needle in the haystack. Just buy the haystack!"
John Bogle

"I don't look to jump over seven-foot bars; I look around for one-foot bars that I can step over."
Warren Buffett

"In investing, what is comfortable is rarely profitable."
Robert Arnott

"How many millionaires do you know who have become wealthy by investing in savings accounts? I rest my case."
Robert G. Allen

"Courage taught me no matter how bad a crisis gets ... any sound investment will eventually pay off."
Carlos Slim Helu

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expensive federal mandates as well. All this will require increased revenue at the state level and the potential for state tax increases. Finally, senior dental coverage does not begin implementation until 2028. While we don't yet know what all the provisions and compliance requirements will be, this program is expected to be very expensive. In addition, once fully implemented it could have a huge impact on the overall dental industry. Here again, its costs are only reflected at the tail end of the 10-year budget window obscuring the actual long-term costs.

Over the next few years, we may be looking at several rounds of additional tax increases to fund the extension of these new programs as well as covering the current budget deficit and the projected shortfalls in Medicare and Social Security that have yet to be addressed. The issue of on-going funding has not been covered by any of these polls, but it appears there is a long term economic impact that needs to be better understood.

333 South 7th St, Suite 3060
Minneapolis, Minnesota 55402
Ph (612) 371-0590 Fax (612) 371-9869
john@gsinvestments.com glenn@gsinvestments.com
greg@gsinvestments.com sheri@gsinvestments.com

GSI Tenets

GS Investments

GS Investments, Inc. is an investment management company specializing in individual and institutional asset management. Privately owned and operated, GS Investments, Inc. is run by its owners, Glenn H. Steinke, C.F.A., John G. Steinke, M.B.A. and Greg Cunningham.

Glenn Steinke, CFA brings over 50 years of investment management experience to the business. Previous capacities include Vice President and Senior Investment Officer with a major pension fund ($1.8 billion under management) and Senior Vice President with a major Minneapolis-based financial institution ($3 billion under management). Glenn is a graduate of the University of Minnesota.

John Steinke MBA offers a broad financial services background with 27 years of portfolio management experience and 7 years of banking experience including capacities as a Vice President of a $50 million bank and as a private banking office for a large, Minneapolis-based financial institution. John received his BA from Concordia College (Moorhead) and his MBA from the University of Minnesota.

Greg Cunningham Prior to joining GS Investments, Greg spent 18 years at Minneapolis-based Ameriprise Financial, a national leader in financial planning with over 2 million retail clients and $300 billion in assets. Here he worked with the Chief Investment Officer in support of the international and domestic hedge funds and with the President and General Manager of RiverSource mutual funds. Greg is a graduate of Gustavus Adolphus College in St. Peter, MN.

Sheri Ritchie brings over 28 years of financial services experience to the business. Previous capacities include client service and support positions with Dean Witter and Kemper brokerage firms and a Minneapolis-based investment management firm. Sheri is a graduate of the University of St. Thomas.

GSI Investment Philosophy

GS Investments, Inc. utilizes a balanced approach for the majority of its accounts although each account is tailored to the individual needs of each client. Taxable or tax-exempt bonds are used along with a common stock component. The division between bonds and stocks is determined by the personal objectives of each client. A need for income and a willingness to assume risk are also determinants of an account's bond/stock mix.

GS Investments, Inc. emphasizes the purchase of quality securities and employs a long-term investment style, as market timing, frequent shifts in asset allocation and interest rate forecasting are not consistent with the firm's philosophy. In-depth market analysis and many years of experience support this approach.

GSI Fixed Income Strategy

GS Investments, Inc. emphasizes a staggered maturity approach when purchasing bonds. Individual security investment grades and call protection are considered when making these investments. Quality grades of "A" or higher are favored with tax-exempt issues. Government bonds are dominant among taxable securities.

GSI Equity Strategy

GS Investments, Inc. favors stocks emphasizing quality and growth. Appropriate cyclical growth stocks and small capitalization growth stocks are used periodically as well. Additionally, GS Investments, Inc. believes that a growth oriented philosophy tends to result in less frequent trading and lower tax payments (for taxable accounts) on realized capital gains. This provides a lower cost approach for the client.

GSI Client Communication

GS Investments, Inc. emphasizes client communication. Written investment objectives as well as periodic oral and written reports are used to heighten the understanding between the client and investment manager. In addition, easy to read, detailed reporting is provided by state-of-the-art investment software in order to inform the client of portfolio progress.