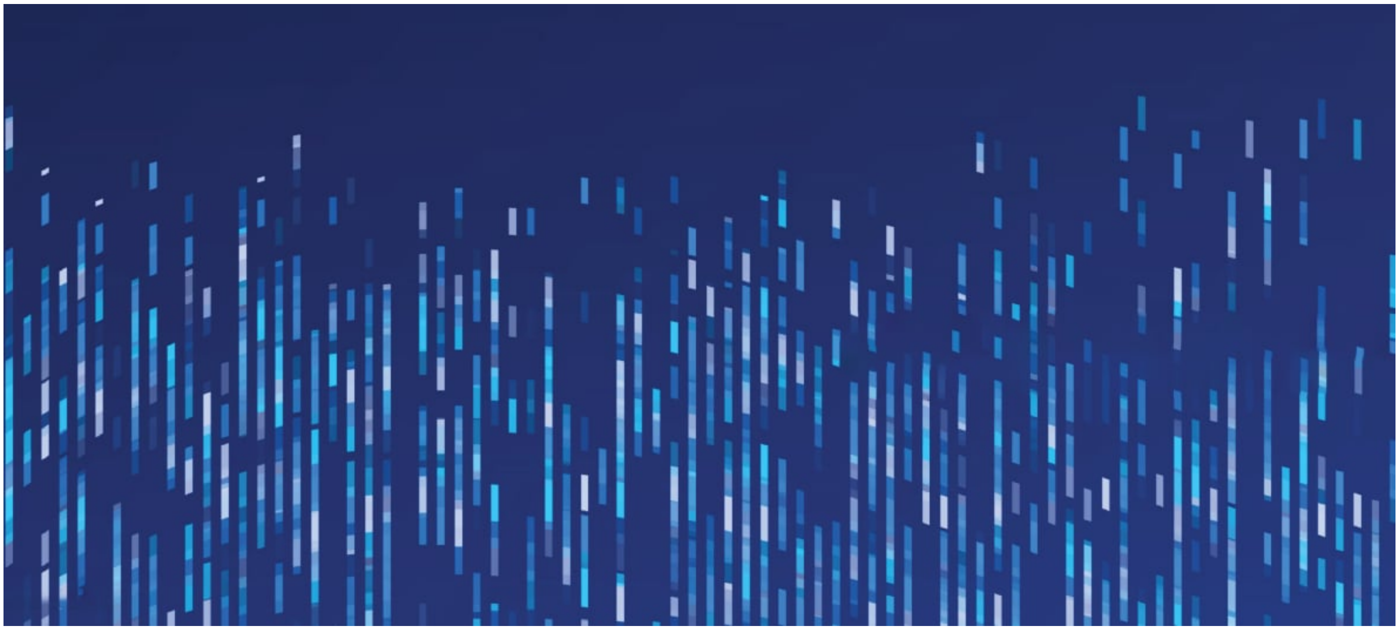

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Should We Be Concerned About China's Growing Real Estate Problems?

It's been 12 years since America's housing bubble burst, triggering a mortgage crisis that quickly snowballed into a global recession rivaling the Great Recession 90 years ago. Today, the world's second-largest economy has been struggling with its own self-induced real estate bubble for some time. Ironically, it's China's own government that's slowly popping this massive, self-induced bubble that could shake its entire economic foundation. Unlike American or Japanese real estate busts, China's stakes are much higher, as 30% of its gross domestic product (GDP) is exposed and at risk.

Before we think about the ramifications of a meltdown, it's critical to understand some basic dynamics of China's housing market. While most Americans struggle to find inventory to live in, China's speculators built hundreds of thousands of empty would-be residences. The goal was to motivate poor or rural Chinese to move into cities and for "middle class" citizens to keep upgrading into more expensive places. Ironically, government policies and initiatives to spur economic growth actually incentivized and, in fact, strongly motivated this rampant over-building and speculation (by developers and individuals) to keep China's GDP growing. And since investors had only seen the housing market go up, most strive to acquire as many apartments as they can, believing this "sure-thing" investment will continue to reap rewards. Unfortunately, these trends cannot continue, and the communist nation is facing its first bout with real estate price declines in six years.

To make things worse, this meteoric expansion and speculation brought with it tons of leverage, both at the consumer and developer level. And with this bubble starting to burst (triggered by increased regulations), Chinese developers are defaulting on their bonds. Yields on the ICE BofA index of Chinese junk bonds eclipsed 25% last week, a level not seen since the height of the Great Recession. The collective face value of the bonds in this index are $112 billion alone. Goldman Sachs estimates that nearly $200 billion in junk bond debt is outstanding. As real estate sales continue to fall in China, the question is how this mess will shake out and potentially reverberate globally. Beijing has some tough decisions to make as it seeks to slow speculation without destroying its own economy. The good news is that the Chinese government controls the banks and can force them to keep lending, even if their balance sheets look worse than Lehman Brothers. In a sense, its communist structure and untraditional financial system may actually help them buffer a systematic meltdown, but their overall exposure and the sheer potential destruction of consumer wealth could jeopardize continued growth.