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China autos may be next bubble

There is little doubt that the whole of China's auto industry is in a crisis, which will inevitably lead to bankruptcies and closures, following the collapse of construction

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Autos are the biggest market for chemicals. Their outlook matters for our whole industry. And China matters more than anywhere else. It has not only become the world's largest auto market. But it has also been key to the profitability of most major Western auto firms.

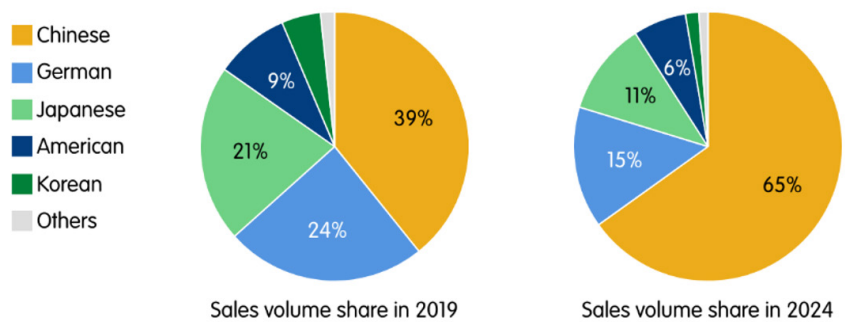
Unfortunately, however, China's outlook seems very uncertain. It has the best electric vehicle technology in the world. But the auto industry has burnt through $230bn in development costs to reach this position. And now, companies are in a major fight for survival. As Reuters reports:

"Of the 169 automakers operating in China today, more than half have less than 0.1% market share. The crowded field is reminiscent of the US auto sector in the early 20th century, when more than 100 companies vied with big players such as Ford, before the industry consolidated."

The chairman of Great Wall Motors has even suggested the industry could follow China's property industry and suffer its own "Evergrande moment". He was referencing to last year's collapse of China's largest property developer, with over $300bn of debt.

One problem, of course, is that China's financial reporting is relatively opaque. Companies often maintain several sets of accounts, for submission to different stakeholders. And Beijing has also been cutting back on the amount of data that it publishes. But even so, there seems little doubt that the whole of China's auto industry is in a crisis, which will inevitably lead to major bankruptcies and closures.

Share of passenger car sales in China



Source: China Association of Automobile Manufacturers
ECFR - ecfr.eu

China's auto sales could return to the 2010's level of 13.7m, as the downturn reinforces the attraction of robotaxis for reasons of affordability

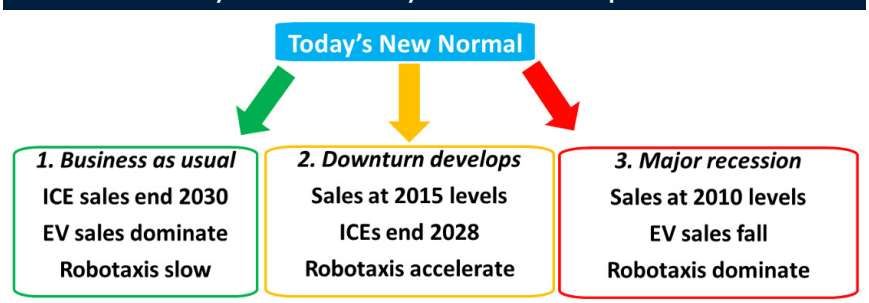
Western car companies operating in China are essentially acting as the 'canary in the coalmine', warning of the risks ahead. As the European Council on Foreign Relations (ECFR) warned recently:

"The colossal Chinese economy exports massive overcapacities of advanced manufactured goods to the world. But these goods are no longer the cheap electronics, washing machines and textiles of 25 years ago; complementarity is a thing of the past. Chinese goods now compete directly with Germany's core industrial sectors".

What is true for Germany is, of course, also true for the rest of Europe, North America and Japan. One key issue is that companies and policymakers have simply failed to notice, or chosen to ignore, the massive demographic changes that have been taking place since China joined the World Trade Organisation in 2001. Then, the western BabyBoomer SuperCycle was still underway. It was the largest and wealthiest generation in history. And it couldn't produce enough consumer goods to meet its needs. So it adopted globalisation strategies to source from China, India and other less developed countries.

But today, 25 years later, the Boomers have all joined the Perennials 55+ generation. They are still the main source of population growth in the world, and almost all of the major economies. But they are no longer having children and are instead now a replacement economy, as they already own most of what they need. In turn, global demand patterns are changing as the Perennials are essentially a more service-based economy.

China's auto industry scenarios are very different from the past



China is the poster-child for this development. It's One Child Policy from 1980-2015 caused the loss of over 100 million girls, as families prioritised boy babies. And girls who haven't been born can't have babies today. Official data confirms that only 9.5 million babies were born last year, nearly two-thirds less than the 1968 peak of 27.6 million.

Economists and politicians complain that China should pivot from supporting manufacturing to boost domestic consumption. But this is an impossible dream. The demographic collapse is now well underway. And this is revealing the reality behind the myth that China has somehow moved from absolute poverty to become 'middle-class' within a generation. In reality, official data shows that average per capita household disposable incomes were just $7500 in the richer urban areas last year, and only $3200 in rural areas.

This, then, is the background to the growing crisis in China's auto industry. And in turn, it highlights the major risks now developing for those companies who have come to rely on China for a major part of their revenue and profits. As the ECFR chart shows, foreign companies' share of China's domestic auto market has collapsed in the past 5 years from 61% in 2019 to just 35% last year:

- German companies have gone from a 24% share to 15%
- Japanese companies have gone from 21% to 11%
- American and Korean companies now have only single-digit shares

Worse still, foreign companies have been very slow to recognise that the transportation market is going through its second major transformation. The first was around a century ago, when horse-drawn carriages were replaced by gasoline-powered engines. Today, a similar transformation is underway from gasoline to electricity, and from precision engineering to software.

Of course, many are still trying to hold back the tide of change, just as they did when cars first came on the market. The UK was then the world's leading industrial power, and until 1896 it mandated that a man should walk in front of every car, carrying a red warning flag. But that didn't stop the transformation. And it seems unlikely that fossil fuel producers will have any more success today in reversing the trend to electrification.

Transport is the world's largest manufacturing industry, and responsible for 60% of oil demand. And unfortunately, the auto industry's transformation is taking place against the background of growing tariff and trade wars. Auto companies and their supply chains (including chemicals) are therefore in the eye of the storm that is now raging. So there is a clear risk that many companies will simply not survive if they fail to focus on the challenges now developing, as the scenario chart shows:

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The impact on the global auto industry and its supply chains would be dramatic, especially for those currently operating with high levels of debt and without robust mitigation strategies for survival

- Even 'Business as Usual' is a relatively unstable background. Electric vehicles (EVs) are now 55% of China's auto sales, and seem likely to be 100% by 2030 as Beijing continues its subsidies. In turn, this means that China's oil/refining industry is entering a (lengthy) endgame, as China's auto fleet will be largely electrified by 2040
- This will create major challenges for its key value chains. China has been the main source of oil demand growth for the past decade. But already this factor is going into reverse. Inevitably refineries will have to close, raising questions about the availability of naphtha and other important chemical feedstocks such as propane and butane
- There is also a real chance that a 'Downturn Develops', given President Trump's belief that China poses an existential threat to the USA. China's property bubble was 29% of GDP before it began to burst 4 years ago. And the bursting of today's auto industry bubble would add major new problems for the economy in terms of growth and employment
- It would be no great surprise to see auto sales falling back from last year's 27.6m level to 2015's 20.8m, as household incomes are squeezed by the Trade War, and relatively highly paid auto industry jobs disappear. If this happens, it will further boost the attractions of robotaxis as a cheap form of mobility, and reinforce the downturn in auto sales
- There is also a risk of this evolving into a 'Major Recession', as the global economy struggles with the impact of the Trade War, alongside the risks created by the Ukraine and Iran wars. China's massive post-2008 stimulus programme was essentially 'subprime on steroids'. And it could well end in the same way as the bursting of the US subprime bubble in 2008
- In turn, China's auto sales could return to the 2010's level of 13.7m, as the downturn reinforces the attraction of robotaxis for reasons of affordability. The impact on the global auto industry and its supply chains would be dramatic, especially for those currently operating with high levels of debt and without robust mitigation strategies for survival

China's auto market is therefore a key indicator for the likely future health of the global economy. Its transformation from gasoline to electricity, and from precision engineering to software, would be challenging enough on its own. But this challenge is being turbocharged by the fact that it is taking place alongside major demographic changes, and the rising risk of all-out Trade Wars. Forward-looking Scenario Planning, based on a wide range of potential outcomes, is now essential for survival. Companies and investors who choose to 'wait and see' risk suffering major, and unpleasant, shocks. ■

Paul Hodges is chairman of New Normal Consulting and NiTech Solutions, and the Advisory Board for Infinity Recycling. He publishes The pH Report and writes the ICIS Chemicals & the Economy Blog.