Notes from China

Basically, our observations were very much in keeping with the previous views expressed herein – confirming our scorn for the doomsayers, we found a country of almost inconceivable dynamism, in the midst of a transformation from quasi-medieval peasant economy to the predominant power of the 21st century; yet the impact of actually seeing China in motion surpassed anything we had been prepared for. Long discussions with local players regarding of the strengths and frailties of the banking sector, regional financial montages, the capital and real-estate markets, as well as the upcoming renewal of the Politburo, with the succession of Wen and Hu, were fundamentally reassuring. There are substantial problems (where are there not?) but also, China has both the means and the drive to resolve them.

Thus, rather than yet another discussion of the Chinese banking system, local finance entities, the appropriateness of capital allocation, and the sustainability of the current manufacturing model, all of which have been handled far more competently by some of our peers – notably Jonathan Anderson of UBS – we have thought long and hard about what China tells us about our own models – Russian and "Western" and the implications for the West. Our impressions follow:

A Few Simple Truths: Bullet Points – in the Line of Fire

- While the economy will be slowing into 2012, we see limited signs of any "landing" – hard, soft, or easy-over. The Chinese government is engineering a modest cooling, but we struggle to understand how a decrease in GDP growth from 11% to, say, 8.5% can be termed a "landing". One may reasonably choose not to bet on China – betting against China would, however, be profoundly foolish.

- The pace of growth has been simply mind-boggling – and totally unprecedented. China's **average annual GDP growth rate has run at over 10% per annum** for the past two decades. In 1991, China's GDP amounted to **$424.1 billion**. In 2011, it will exceed **$6.6 trillion**... a 15- fold increase. Think about it...

- The Western media are replete with predictions of an upcoming Chinese collapse – warnings that we have heard constantly for the past decades, now served up reheated by fund managers who have found themselves "short and wrong". This constant drumbeat tells us more about the workings of the Western media, and indeed, our own mind-set, than it does about China. The notion that these little yellow rice-farmers could do far better than us, and without even the courtesy of aping our political system, seems intolerable to many in the Kommentariat.

- ***Confirming our views, as we go to press, S&P has downgraded all of the major US banks (ex State Street): JPMorgan, Citi, Goldman's, as well as a few of their European peers. Only two banks were upgraded – China Construction Bank and Agricultural Bank of China.***

- The challenges faced by China are daunting, though less so than those faced by Europe or the US. The difference is that the Chinese political system is deeply purposeful, and the levers of command work remarkably well.

- Serious social tensions are growing due to rising levels of social inequality, and the Chinese party will continue to maintain a tight hold on civil society. For this we should be grateful, as any serious destabilization of China would have dire consequences for the world.

- Obviously, there was, is, and shall continue to be substantial misallocation of resources. This has been the case for the past decade at least and has not prevented continued GDP growth in the 10% range. Over-investment and over-capacity are real, but seem far less threatening given rapid economic expansiion and continuing urbanization. Bridges to nowhere rapidly become bridges to somewhere – empty trains and buildings soon become crowded trains and buildings.

- Modest property bubbles are being formed in the major cities, especially Shanghai, but since property is overwhelmingly bought for cash – not on credit – the consequences of a correction are likely to be limited.

- Vitally, the Chinese authorities are acutely aware of the danger points: the shadow banking system (Trusts), overly aggressive borrowing by the regions, and NPL problems. These are real and will ultimately result in nationalization of bad assets by the central government, however none of these factors imperils overall economic stability.
- An extraordinarily high level of competence is evinced by the central government – management of monetary, credit, and banking policy are proactive and highly professional;indeed, this appears to be a continuation of China's Confucian tradition of a highly qualified civil service standing above the changes in dynasties (*would that the Russian bureaucracy could learn Chinese!*).

- **The fundamental difference between China and the G8 is that the Chinese authorities have preserved the "power vertical",** i.e. that when the leadership wishes to change the behaviour of the main economic actors, they can do so by edict – with rapid implementation down to the village level... a huge contrast with the appalling spectacle of political paralysis now provided by both the US and Europe.

Politics

- China is not a “country”. It is a world – a civilization. Perhaps, in the Western experience, it is most akin to the Medieval “Christendom” of Charlemagne. While Europe fragmented into hundreds of states, city-states, electorates and kingdoms, China ultimately remained unitary thanks to the unique Confucian bureaucracy which survived the rise and fall of dynasties and regimes, invasions and uprisings.

- Unlike Russia, China is truly an “authoritarian state” – and with good reason. The Chinese authorities are riding a tiger. Unlike Russia, where despite a worsening mood, a popular uprising of meaningful proportions seems about as likely as in Andorra or Luxembourg, given China’s long history of violent peasant uprisings, some of which resulted in tens of millions of deaths and overturned dynasties, the Communist Party is justifiably concerned with its ability to maintain control. We see nothing to suggest that this control is seriously challenged or endangered.

- Every country re-invents its own history. The myth of the racially and culturally homogeneous Han Chinese has proved a singularly powerful unifying force and is widely subscribed to. This is not good news for peripheral Chinese ethnicities who would prefer to go their own ways – their Han constituency is nil, and territorial integrity of China is widely shared as a fundamental national goal. Cry Tibet.

- Subjectively, one feels a wave of energy in China we have never experienced anyplace else. There is constant motion, an exploding middle-class, feverish consumption, outlandish materialism, and a palpable sense of national purpose.

- Speaking with ordinary Chinese (albeit, of the English-speaking minority: students, businessmen, academics), one hears complaints about corruption, potentially toxic foodstuffs, environmental degradation, the difficulty of setting up businesses without political connections, rising food prices and the outrageous cost of getting married. On the other hand, except when trying to be politically correct, no one we spoke to expressed any desire whatsoever for “democracy”. The spectre of European and American rioting, and Russia’s lost decade, seriously degraded the concept.

- In the 15th Century, China was the world’s preeminent power – richer, far more populous, and more technically advanced than Europe. Beijing had nearly one million people when London had a mere 75,000 – Rome perhaps 50,000. China suffered a profound eclipse, climaxing in the 18th and 19th centuries – the disasters of the 19th century were due more to the internal weakness of the Mongol Qing dynasty than to European depredations, however a profound sense of national humiliation by the British in the criminal Opium Wars and the savage repression of the Boxer rebellions, as well as the 19th century “unequal treaties”, left a desire for revanche.

- The Chinese body politic is becoming increasingly nationalistic. While the Party previously encouraged this nationalism, it now appears to be concerned with its possible excesses; to the extent that China is “democratic” (i.e. that the government expresses the national mood and aspirations) there is serious reason for concern.

- The Chinese press is not as rigorously censored as one might imagine – there is continual criticism of individual figures at both the national and especially the provincial level, without however any questioning of the basic political model (*when was the last time the reader encountered a robust criticism of capitalism in the pages of the* Wall Street Journal*?*). For a good overview, see *http://english.caixin.cn/*

- As regards issues of Tibet, Taiwan, the Uighurs, and the suppression of domestic dissent, there is near-universal support for the hard line nationalist stance of the Communist Party, even among those openly critical of many other aspect of the system.

- We predicted that China would start to become more assertive towards the end of the decade. For the first time, the Chinese leadership seems to have lacked the requisite patience, jumping the gun by asserting broad claims to sovereignty in the South China Sea, driving several of China's neighbours into the arms of the Americans.

- An op-ed piece by Stefan Wagstyl in the *FT* faults Goldman's Jim O'Neill for pointing out just how little Russia/China's deviation from the Western orthodoxy has affected their economic prospects, and thus, how expensive an anti-Russian bias has been for investors. The *FT* apparently knows without a doubt how the world **should be**, and cares little for how it **actually is.** T&B is reminded of our own attempts in 1999 to sell Russia 28's (then priced at 25% of face) to European investors – many of whom, based on what they read in the press, thought them far too dangerous, preferring those fancy new American CDOs. Over the ensuing decade the Russian paper returned some 1500% – the CDOs eventually defaulted.

Russia-China

- **Russia has little if anything to learn from the West – it has a great deal to learn from China** – if only the requisite modesty were there!

- Mr Putin's answer to T&B's question – posed during the Moscow VTB conference – suggests that the Russian authorities still struggle to define a coherent policy towards their fast-growing neighbour, that old prejudices die hard, and that no less than their Western peers, the Russian ruling class has not fully assimilated the significance of the inexorable rise of China.

- Western talk about the "insurmountable barriers" separating the two countries in self-serving nonsense. China is now Russia's largest trading partner, surpassing Germany. The obvious diplomatic and economic complementarity of the two giants will lead to further growth in trade and investment going forward, though not always on the terms that Russia would prefer.

- Although Russia fears Chinese encroachment in the CIS/Central Asia, there is little they can do to stop it; elsewhere, there is almost total complementarity between the foreign policy goals of the two countries – leading to increasing cooperation in the Security Council and the Shanghai Cooperation Organization. We would expect an increase in cooperation in areas of new interest to them, and where they are in competition with the old powers of the West – Venezuela, Iran, Latin America and Africa.

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Investment conclusions

- The Chinese currency is a one-way bet: Both CNY and CHN will constitute true stores of value, and will increasingly supplant the USD in trade settlement, financial transactions, and ultimately, in sovereign reserves (the Chinese Yuan will likely have become one of the major global reserve currencies by about 2015). Only the pace of appreciation is in question – if China slows by more than we expect, the currency will temporarily cease to appreciate; it will not fall.

- Even were the feverish pace of Chinese growth to moderate, there will be a steadily increasing call on mineral resources – energy, ores, metals, foodstuff, even water. This will be hugely beneficial to the commodity exporters, Russia in particular. That said, this will not be a smooth, continuous process, and substantial volatility should be expected.

- Our very unscientific assessment of PPP valuations – based upon our travel costs: meals, whether from street-stands or upmarket restaurants, business hotels, and taxis would suggest that the Renminbi is undervalued by a good 30%. Prices should ultimately converge with the global standard via a relative strengthening of the currency.

- The Chinese stock market remains a casino providing limited access to the real economic growth story. That said, with an imminent easing of monetary policy being telegraphed by the Central Bank, equity indices should perform strongly going into the year-end, barring a total implosion of the Western financial system.

- While the “dim sum” bond market provides a low-risk/low-yield vehicle for betting on currency appreciation, we prefer currency forwards/futures, given the possibility of leveraging returns approximately 6-fold.

Uncertainty’s Rainbow

As the third major crisis of the past four years gets underway in earnest, those of us who spend our day-to-day existences amidst the virtual reality projected upon trading screens are coming to feel like rabbits on the first day of the hunt – at a minimum, intellectual flexibility has become a vital survival skill. we have emerged from a long period of semi-hibernation to discuss the two main fears currently stalking the markets – the Eurozone and China. There is good news and bad news: the good news is that, alone among the major economies, China faces no realistic danger of meltdown; quite the opposite – if we do survive, it will be thanks to the great Deng Xiaoping and his successors who have shaken up the world order as it has not been shaken since that incident in Sarajevo in 1914. The bad news is that, properly mismanaged, the Eurozone crisis could end up creating the sort of man-made black-hole which some nervous souls feared upon the start-up of the CERN particle accelerator in Geneva. The end of the world – coming to a (trading) screen near you...

Since the US leveraged finance bubble burst in 2008, the world has lurched from crisis to crisis, as several decades of rolling bubbles – from equities, to loans, to mortgages, structured products and government balance sheets, a build-up of debt almost entirely aimed at financing current consumption – culminate the only way they could: a painful process of deleveraging, which is still getting underway.

An already parlous situation is rendered frankly terrifying by the manifest failure of the liberal democratic political model to take the disagreeable steps required to forestall disaster. Any residual faith in democracy that T&B might have had was smashed by the spectre of Europe and the US doing everything **but** confront their fundamental problems.

Given the imperatives of electoral politics, the EU is systematically a day late and a dollar short, constantly putting out fires, while repeatedly failing to get out in front of the problem. The Greek crisis, which could have been averted for a few tens of billions could now theoretically cost well over a trillion. Meanwhile, the US is in denial as regards its unsustainable fiscal situation, unable to afford its hypertrophic military (6% of GDP, and 25% of total Federal outlays) and dysfunctional medical care system, with an unprecedented degree of partisan enmity engendering political paralysis, a paralysis set to continue for as long as markets will tolerate it. When they do run out of patience – and ultimately they shall – the stark choice between inflation and depression will be impose itself.

The Eurocrisis has been analysed to death, and the outcome is simply not knowable – ask 15 experts and one will get at least as many opinions – we shall thus confine ourselves to a few general observations. It has become obvious to even the most obtuse Eurocrat that there is a choice between fiscal unification and an economic disruption of unimaginable magnitude. Alas, this does not signify that rational choices will come out of a dysfunctional political system. For now, an obdurate German hausfrau threatens to pitch the West into a vortex in many ways reminiscent of 1929, accelerating the fundamental theme of our century – the Decline of the West, and the Secular Rise of China. A rich source of misconception, misinformation, and bias – in actual fact, China provides virtually the sole reason for optimism in an increasingly parlous global context. We discuss our second journey to the Celestial Empire below.

Bubble – WHAT bubble?

Given our discussions with friends and colleagues in the West before and during our recent China trip, we find it truly extraordinary how many people have managed to convince themselves that the world's largest creditor (China) is "a bubble", whilst the world's largest debtor (the US) is not...

As we have intoned previously, there is something profoundly humiliating to our sense of racial and cultural superiority to see a gaggle of yellow-skinned rice farmers convincingly beating us at our own game. Adding insult to injury, they have done so not with the liberal democratic model we have convinced ourselves to be the sole viable political system, but, instead, using an "authoritarian" model characterised by rigid political control (albeit with substantial intra-party democracy), state- directed finance, generally free markets and price-finding, as well as a complex mixture of private-public ownership. While Marxism has become largely discredited in China, the West provides a creditable parody of Marxist thinking: since The (Liberal) Theory states that no other model can possibly work, this can only mean that the Chinese system does not work – and the observations be damned!

Were China to be a bubble, we would now be in truly dire straights – having indeed blown serial bubbles for several decades with a massive build-up of credit to support current consumption, the West is now faced with unsustainable fiscal deficits, banking systems with many of the basic characteristics of a Ponzi scheme, as well as growing political paralysis and social turmoil – as "democratic" governments repeatedly fail to make the deeply unpopular but necessary choices.

As the developed world teeters on the brink of outright recession, posing a challenge to some of the smaller emergings, global growth is becoming more, not less, dependent upon a single country – China. We find that there is considerable downside protection; as our friend John Anderson5 puts it, the bulls think China will grow at 8.5% – the bears, that it will be only 3%; both numbers would be the envy of most other countries...

None of the above is meant to suggest that China does not have its share of problems, nor that major reforms will not be necessary as China outgrows its initial development model. As low value-added export industries are increasingly hampered by rising labour costs and the insolvency of their Western clientele, low-end (footwear, textiles, toys) manufacturers are relocating to Indonesia, Philippines or even Thailand. As the economy becomes more complex, diversified, and domestically focused, the financial system must be seriously restructured with less central control and more competition.

From the macroeconomic perspective, the Chinese government will continue to gradually loosen the restrictive measures imposed in order to quench the inflation and asset-price mini- bubbles following the major fiscal and monetary stimulus applied following the Lehman debacle (would that Western governments had done the same). It is a fine balancing act to maintain high growth with macroeconomic stability, but, thus far, they have made an admirable job of it.

Chinese banks have engaged in the some of the extend-and-pretend that has become so common in today's financial world, and for the third time since the beginning of the post-Mao reforms, are seeing an increase in NPLs – some of which will ultimately migrate to the sovereign balance sheet. The general system for finance of local governments is no longer

sustainable, and some regions will require assistance and restructuring; the shadow banking system will do some damage; a more efficient system of (properly regulated) lenders must be created to support small- and medium-sized enterprises. Although the lurid reports are mostly flights of fancy, there has certainly been some misallocation of investment (to invest as much as China has and not misallocate some of it would be beyond human capacity) and the funding of some fraction of the huge infrastructure build-out will ultimately be written down.

In 2008, unexpectedly confronted with a major economic slowdown with serious domestic consequences – notably the loss of some 20 million jobs, China engaged in the same sort of stimulus seen in the West. Fortunately, there were a couple of key differences:
-Chinese stimulus involved the spending of money saved during the good times – China and Russia being the only two truly "Keynesian" major economies, i.e. running truly contra-cyclical fiscal and monetary policies during the good times, and thus, in a position to employ retained savings – not debt – to stimulate their economies during a crisis. To speak of the "parlous debt dynamics" of a country holding $3 trillion in reserves should invite ridicule.

-Unlike the West, which has built up an unsustainable debt mountain simply to sustain current consumption, China has built world- class infrastructure: ports, airports, high-speed train lines, electricity transmission grids, and increasingly green-energy projects, as well as industry, highways, entire city centres, while renewing the housing stock for more than one billion people. Beijing's traffic rivals that of Moscow or Jakarta, but in addition to the existing, extensive subway system, it is simultaneously building seven new metro lines – something that would take the better part of a century to accomplish in the West.

At present, we see no prospect of major financial stimulus in China – it is simply not necessary. Growth is slowing, but the numbers remain relatively strong. The most recent non- manufacturing PMI, while decelerating, shows continued rapid growth. More importantly, employment has been unaffected, with companies in the costal areas still reporting labour shortages.

Finally, whatever happens with the financial system, the physical infrastructure remains in place – and much of it is shiny new and superb (just compare Shanghai airport – complete with a Maglev train which shoots one into the city at 450 km/hr in seven minutes flat – with the antediluvian misery of Heathrow). It should be borne in mind that **China is a country, not a hedge fund – and thus, its mark-to-market is somewhat differen**t.

Do Trees Grow to the Sky? Where does it End?

In the near term, as was the case for Taiwan, Korea and Japan, Chinese growth will decelerate as it approaches Western income levels and encounters physical constraints. This however implies at least one (probably two) further doublings of GDP; given the sheer size of China, a profoundly disruptive event.

Over the next decade China will become the world's largest economy – (indeed, in PPP terms, some have argued that it already is) and is already the world's largest automobile market, largest emitter of greenhouse gases, and the major determinant in most global commodity markets. China is the source of the majority of global economic growth, and increasingly, it is the news from China that moves global financial markets.

In short, it strikes us as somewhat quaint that the denizens of countries that are essentially insolvent – and which are currently struggling to dodge the second dip of the Great Recession – warn of a "collapse" of Chinese growth to 8%; would that they had China's problems!

Post-Scriptum – When the Flame Flickers

One of our more perceptive Italian friends argues that China is ultimately a bubble, not for the reasons cited in the West, but because, like the rest of the industrialized world, it is highly dependent upon (relatively) cheap energy sources – as these become depleted, input costs will reach unbearable levels, leading to massive economic and social disruption. We cannot disagree, although we think this is a problem widely shared by the entire planet.

Indeed, it is our contention that the global population exceeded long-term sustainable levels a good 50 years ago, and we are already living on borrowed time. The earth was simply not designed to house 7 billion increasingly well-off consumers.

Thus, 50 years from now, questions of relative performance of various politico-economic models will seem somewhat quaint – as our developmental model hits hard physical boundaries, we will most likely see some extreme scenarios unfold. Given the fact that processes which used to take a century or two to unfold now occur in less than a decade, the disruptions are closer than anyone expects. Fortunately, they are still well outside of our investment horizon... so, as we advise our readers, we too shall undertake to enjoy it while it lasts!

5 Formerly an IMF economist in Russia and China and subsequently Chief Strategist for a top investment bank, John now authors his brilliantly insightful reports under the banner of the Emerging Advisors Group – institutional investors wishing to have some forewarning of where they are going to get hit from next would be well advised to subscribe – contact jonathan@emadvisorsgroup.com