



CHINA - THE MOTHER OF ALL BLACK SWANS

THIS TIME IS NO DIFFERENT – THE OVER-INVESTMENT BUBBLE

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Chinese analysis can be divided into three periods:

1. Pre-crisis – 1998-2008 – **Late-Stage Growth Obesity**
2. During crisis – 2008 (Q4) - 2009 (Q2) – **You Lie!**
3. Post-crisis – 2009 (Q2) - today – **Super Steroids-R-Us**

Pre-Crisis - Late-Stage Growth Obesity

Growth is high, but its quality is low



Starbucks is a good example of Late-Stage Growth Obesity

	1999	2007
Company-Owned Stores	2,000	10,000
Opened Stores a Year	447	1,403
Opened Stores a Biz Day	1.8	5.5

Consequences for Starbucks

- Opened **too many stores**, in wrong locations (too close to each other, wrong side of the street etc.), signed expensive leases
- Hired **McDonalds-caliber employees**, not the Starbucks baristas
- Management took their eye off innovation

Starbucks Addressed these Issues

- **Closed stores**, terminated leases (took charges)
- **Slowed** store openings
- **Laid** off employees
- **Focused** on innovation

Chinese Late-Stage Growth Obesity resulted in significant overcapacity

- Grew at 10% (real growth) for 10 years. When building new plants, made **assumption that past growth would continue into the future.**
- The **natural demand for its goods** from the developed world **was lower.** Demand was driven, in large part, by heavy borrowing by US and European consumers – China provided the financing. Similar to **Lucent financing dotcoms** that were buying Lucent's equipment.
- **Future growth** will be significantly **lower** – China's customers (the US and Europe) are overleveraged and are deleveraging.
- Result: **overcapacity** (more on it in a few slides)

Quality of decisions was poor

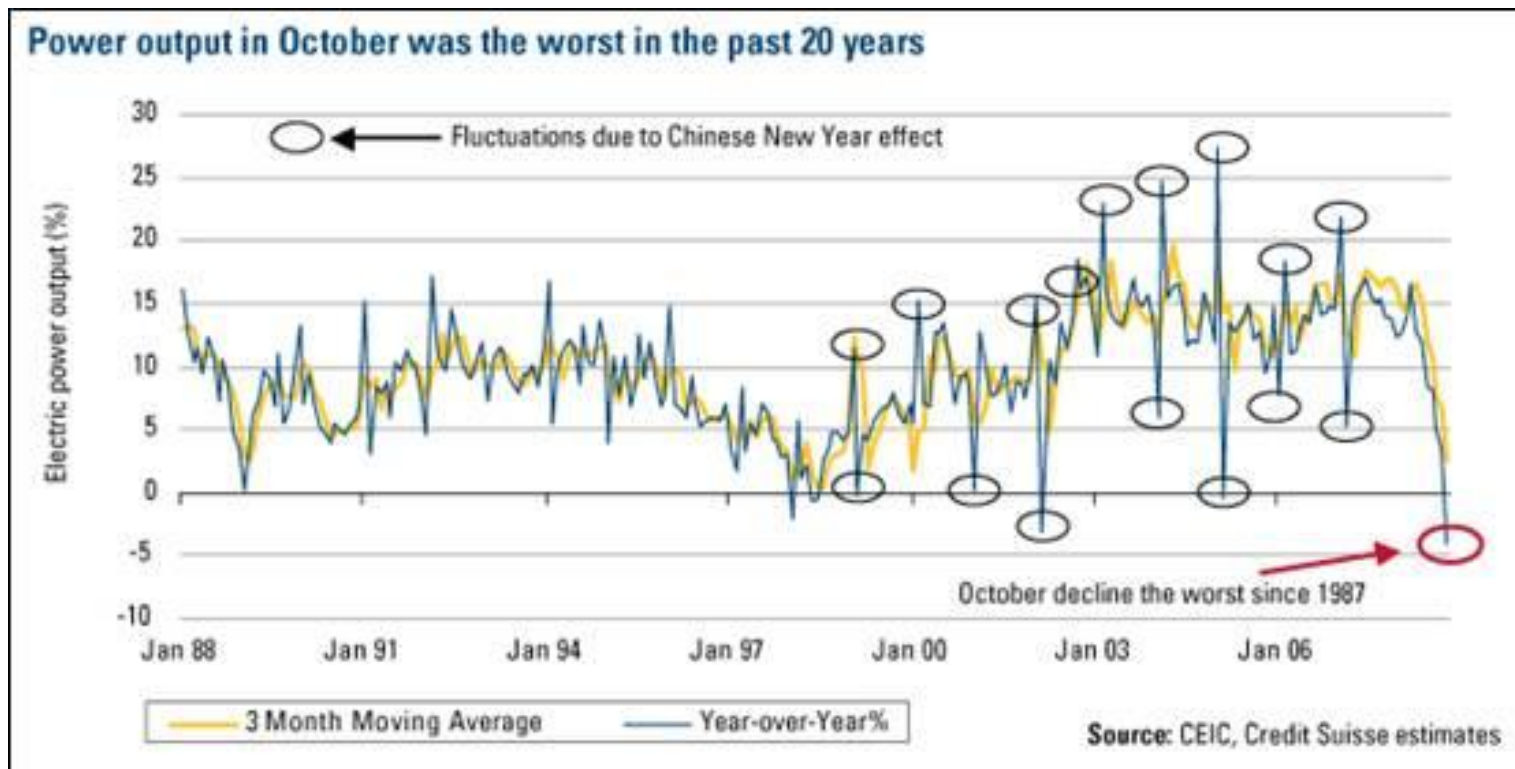
Government intervention, corruption, political capital-allocation decisions **take things to a new level of financial insanity**. Provinces are given growth targets that they must meet, and this is why the South China Mall or Ordos get financed and built.

- **South China Mall**, the second largest shopping mall in the world (second only to Dubai Mall). 1,500 store capacity, 7.1 million sq feet, opened in 2005. 99% of space empty.
- Built a city, **Ordos** in Inner Mongolia, for 1 million residents on spec. Ordos is a ghost town; it is empty.



During Crisis – You Lie!

- Global economy is contracting (its customers are buying a lot less)
- Exports are down over 25%
- Tonnage shipped in China by railroads down double digits
- Electricity consumption is declining



You'd think the Chinese economy would be declining. Wrong! China is still showing positive GDP growth numbers of 6-8%.

How does China achieve growth in this environment?

It doesn't. The **Chinese government lies**. The government cares deeply about **ideology**: it **censors** media and internet, sends people to **jail** for writing anti-government articles. Making up GDP numbers is just one of many tools.

Post-Crisis – Super Steroids-R-Us

China will do anything to grow its economy

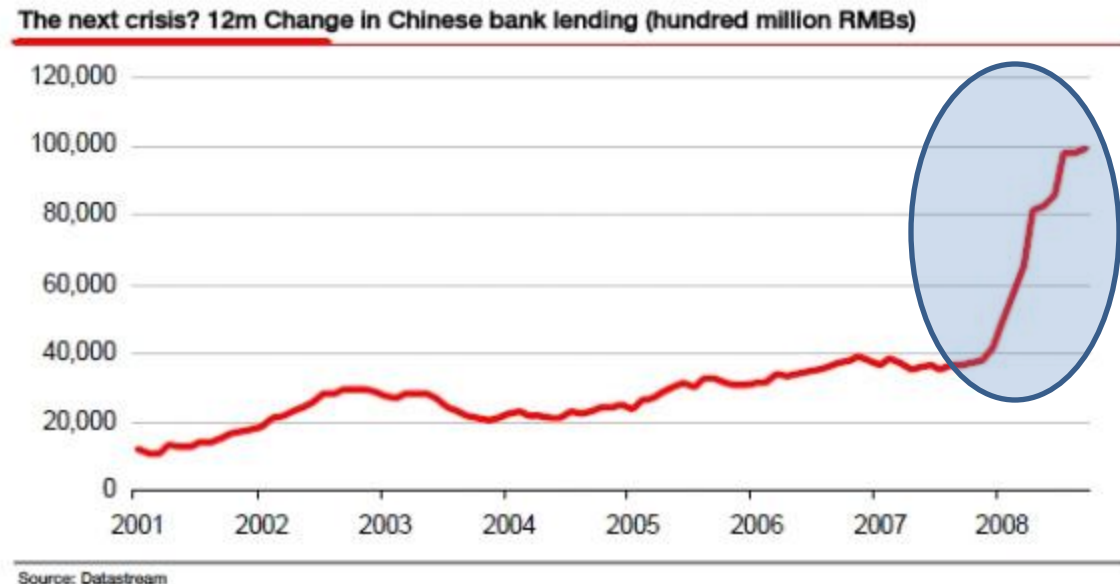
- Farmers moved to cities in search for jobs. **No social safety net** – lose a job, no unemployment insurance, hospital only accepts cash. This explains the high savings rate.
- **Hungry people don't complain, they riot** – government is afraid of political unrest.
- Chinese chose **growth at any cost**, even if it was profitless, with bad loans and uneconomical projects.
- Once you look at what's taking place in the Chinese economy through this lens, the **decisions of its leaders start making sense**, or at least become understandable.

Hence comes the stimulus package

- Stimulus is at 14% of GDP – the largest, in percentage terms, in the world

Unlike the developed world, China has **much greater control over its economy**:

- It can **force banks to lend**.
 - It can **force State-Owned Enterprises** (1/3 of the economy) **to borrow and spend**.
 - Not a touchy-feely democracy, it can **build** bridges, highways, skyscrapers a **lot faster with less paperwork** and fewer property rights considerations.
- **Lending goes vertical**



- The **quality of loans** that are **pumped into an economy through a fire hose cannot be good.**

Analyzing the Chinese economy while it is growing at superfast rates is like analyzing a **bank during an economic expansion** – all you see is reward. But the defaults – the risk – are masked by constantly increasing new business that is profitable at first (or did not have a chance, yet, to default). The true colors of that growth only appear after the economy slows down and new accounts mature.

- Here is what Jamie Dimon, CEO of JP Morgan, thinks of Chinese banks and their lending:

“... too difficult to know what you are buying: many of them do not yet have integrated systems, possibly a meaningful amount of political loans...”
[emphasis added] (Source: [email](#) uncovered by TheStreet.com)

- Despite **the rest of the world still battling recession** and its exports declining, **China started to grow**, but this growth is **completely stimulus-driven**.
- The most efficient way (**if your goal is to have full employment**) to inject money into the economy is **through construction projects**.

Overcapacity that existed before the crisis is taken to new extremes

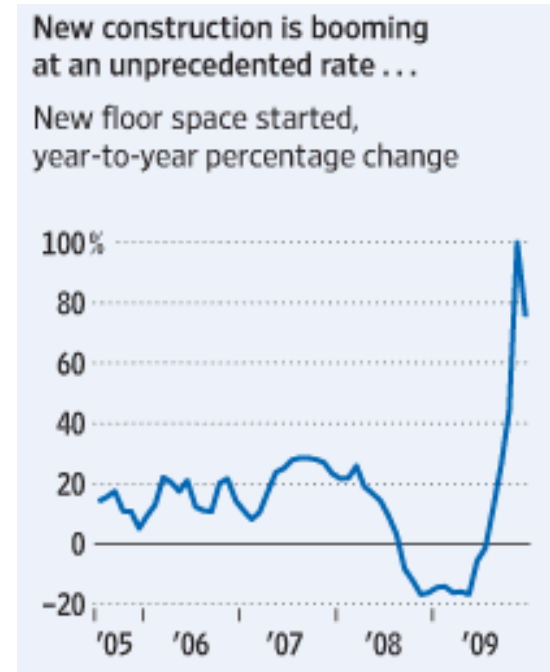
- **Excess capacity in cement** is greater than the combined **consumption of the US, Japan, and India** combined (source: [Pivot Capital](#))
- **Idle production of steel is greater** than the **production of Japan and South Korea** combined (source: Pivot Capital)

National average property prices up 20% in 2009



Source: [WSJ](#), January 19, 2010

Floor space constructed is up 100% in 2009



Source: [WSJ](#), January 19, 2010

“There's currently 30 billion square feet of Chinese real estate in the works, which would work out to a 5x5 cubicle for every man, woman, and child in the country.” – [Jim Chanos](#)

Beware of False Axioms

An axiom is a proposition that is **not proved** but **considered to be self-evident** and doesn't require proof.

In the **US** a false axiom was: ***Real estate prices never decline nationwide.***

- **Used by all market players** in the US: the Fed, rating agencies, banks, etc...
- It was **supported by 50+ years** of data.
- **Unconditional belief** in this axiom **lead to its violation**, as it **resulted** in overbuilding (**overcapacity**) and **over-indebtedness**.

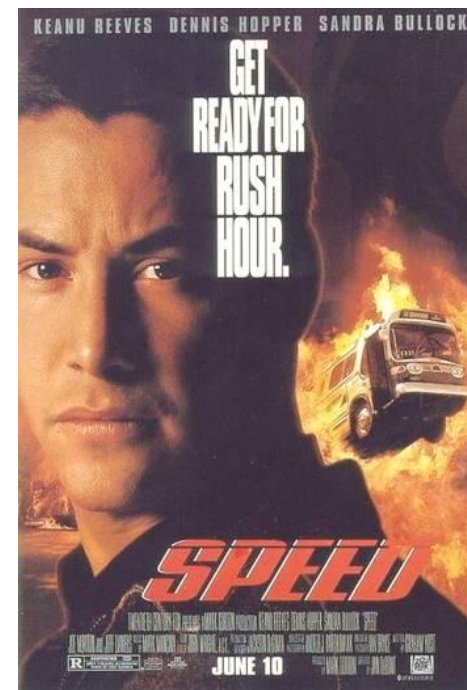
Chinese axiom: ***The economy will enjoy strong growth.***

“Office vacancy levels are at about 20% in Beijing and 16% in Shanghai. Those are high rates by U.S. and European standards, but the new space is **expected to be absorbed quickly thanks to the strong growth of the Chinese economy.**” [Emphasis added] [Wall Street Journal](#), January 13, 2010

Past 30+ years of growth **doesn't equal future** growth: significant overhang from **overcapacity**, future **bad debt**, **lower** demand from the **US** and **Europe**

What if the Chinese economy doesn't grow?

- **High operational leverage** – it is a manufacturer to the world. This is further exacerbated by excess capacity everywhere you look.
- **High financial leverage** – debt, easy loans are a choice of financing.
- High financial leverage + high operational leverage = **high total leverage**
- Like the movie *Speed* with Keanu Reeves, **China is a bus with 1.3 billion Chinese** on board. If the economy slows down below a certain level (or declines) the result will be ____ . I'll let you fill in the blank.
- If/when its economy slows down, **China will be the mother of all Black Swans!**



Additional points:

- China's **economic system** is **not superior** to ours, its **government** just has **more control** over its economy. We don't trust our government being involved in the economy; the **Chinese government is not any better**.
- **Economic bubbles** are usually just a **good thing** taken **too far** (think railroads in 1890s, internet in 1990s) .
- **Everyone wants a shortcut to greatness**, but there isn't one. It would be great if the word (economic) *cycle* only existed in a singular form, and the only cycle we had in the economy was happy expansion. But as heaven couldn't exist without hell, or capitalism without failure, economic expansion can't exist without recession.
- I'm **facing** a lot of **skepticism** today about **China**. The same way, if **in 1989** I was telling you that the **Japanese economy was on the verge of severe decline**. We know how the Japanese story played out: a bust of banking, a real estate bubble, a contracting economy, deflation, ballooning debt, etc.

- **China** was a significant **beneficiary** from **global growth** and will **suffer lower** future **growth**.
- Will the Chinese **consumer pick up** the demand **slack** for the US and European consumers? This **may happen**, but it will **take decades**. US and European consumers are two-thirds of much larger economies. The Chinese consumer is only one-third of the Chinese economy.
- Will China transition into the next Japan or South Korea? Intellectual property rights and property rights are weak in China – a prerequisite for this transformation.
- The world focuses on Chinese financial strength of \$2.4 trillion of foreign reserves. Myopic way of analyzing a country (or a company) as it only focuses on the asset side of the balance sheet but ignores liabilities – government-backed loans which are in trillions of dollars as well.

Consequences of the Bust of the Chinese Bubble

- What happens in China **doesn't stay in China** (not any more); it spills over to the rest of the world.
- China will turn from a **wind** in the sails of the global economy to its **anchor**. The impact will be felt in many, and unsuspected, places.
- It will **tank the commodity markets**, commodity producers, and commodity-exporting nations. (Incremental demand from China collapses, oil prices follow, taking the **Russian** and Middle Eastern oil-centric economies with it). According to GaveKal Research, China accounts for 15% of **Brazil's** exports (up from 1.5% a decade ago).
- Demand for **industrial** goods will **fall off** the cliff. China consumes a lot of those goods – \$550 billion worth annually (according to GaveKal Research).
- Chinese appetite for our fine currency will diminish, driving the dollar lower against the renminbi and **boosting** our **interest rates** higher. No more 5% mortgages and 6% car loans.

- **Political instability** in China is a possible outcome from a significantly weakening economy.

Additional Reading Material:

- Every article I ever wrote on China can be found here - <http://3.ly/chinaread>
- Jim Chanos presentation on China - <http://bit.ly/c6ZQ2D>
- Michael Pettis blog - <http://mpettis.com>
- Patrick Chovanec - <http://chovanec.wordpress.com/>

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