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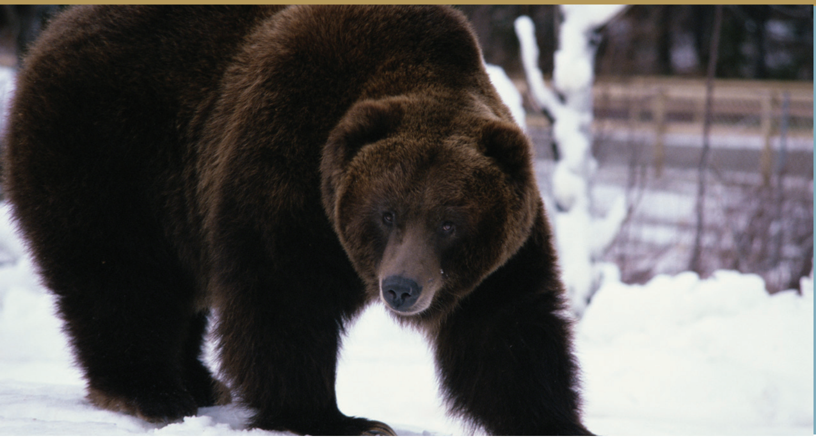
THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

WINTER WARNING



The Sino-American Syndrome

For the past three decades, China's economy has been defying the odds with gross domestic product (GDP) growth rates averaging in the range of 8% to10% on an annual basis.

All of China's economic expansion, whether focused on domestic infrastructure projects such as new roads and bridges, or on foreign trade policies which emphasize exports, has been at the direction of a communist political regime. Since China boasts a population in excess of 1.3 billion people, all working like beavers to improve their standard of living compared to western lifestyles, it is incumbent upon the Chinese leadership to maintain the citizenry focus on their economic well being, not only for reasons of domestic prosperity, but also, to forestall any sign of social or political unrest. The wars in Iraq, Pakistan and Afghanistan, notwithstanding, already this year the Chinese Politburo has witnessed societal violence and bloodshed in Russia (Vladivostok, Moscow and the Caucasus), Kyrgyzstan (Bishkek), Thailand (Bangkok) and India (West Bengal and Bihar). Indeed, Zhou Yongkang, China's security chief, in a recently published speech acknowledged that the task of maintaining social stability "was still extremely onerous."

Simultaneously, the Chinese leadership is struggling to cope with what it ascertains as a gradual shift in the global balance of economic power, in China's favour. Certainly, the recent global financial crisis has given significant impetus to the realization of the shift in economic power from Europe and North America to Asia. In 2009, China overtook Germany to become the world's largest exporter, albeit partly at the expense of Japan whose share of Asian production and exports has declined markedly, as a result of deflation. Indeed, Asia's share of the world economy has risen steadily, from 18% in 1980 to 34% in 2009. While Asia accounted for 35% of global automobile sales in 2009, China continues to set the pace, reporting an increase in passenger car sales of 63% to 1.26 million vehicles in March from a year ago; as well as trade deficit of $7.2 billion (U.S.), the first monthly deficit in 6 years. The migration of Chinese workers from an agrarian location to China's cities, and not just the coastal ones like Shanghai and Hong Kong, continues unabated, with some analysts predicting that one billion Chinese will be city dwellers by 2025.

All of the above represents the culmination of three decades of strong economic growth in China, from which we can draw a parallel to American gross domestic product (GDP) growth in the 1910s and 1920s. Through that period, America experienced tremendous growth in construction, transportation and manufacturing and as the world's largest creditor nation, she had the propensity to innovate and expand on many fronts, that even by 1913, per capita income in the United States was nearly ten times that of China. All through the 1920's, speculation and increased risk taking became manifest in the stock market, culminating in the market crash of October 1929 and the depression years that followed. We believe that the same economic progression is currently unfolding in China and it is being led by excessive speculation, not only in the stock market, but also, in real estate.

The Chinese Housing Bubble

In 2009, fixed-asset investment in China accounted for more than 90% of the country's GDP growth, with residential and commercial real estate investment comprising almost 25% of that total. Nothing has driven China's economic growth rate more than real estate investment. Andy Xie, an independent Shanghai economist, declares: "China's property market is (in) a massive bubble." According to data compiled by real estate consultants Colliers International, residential prices in 70 large and medium-sized cities across China soared in 2009, with 50% to 60% increases in Beijing and Shanghai. As economist Xie observes, house prices in China in relation to per capita income are by far, the highest in the world. The housing price-to-income ratio in urban China is over 20, which means it takes an average citizen's wages for 20 years to afford an average residence. By comparison, the highest ratio for an American city is 8.2 in Honolulu, Hawaii. In its most recent budget report released in March, China's Ministry of Finance drew attention to debt levels being incurred by local governments undertaking massive infrastructure and property development projects. However, an oversupply in both the residential and commercial real estate markets has recently reflected a pricing downturn. According to Colliers, vast areas of commercial space lie vacant in Beijing and rents are slightly lower than a year ago. Residential prices, according to data reported by China Realty Research, may now be on the verge of weakening.

In SOHO China's 2009 annual report, Chairman Pan Shiyi states: "While recognizing the enormous potential that lies within China's real estate industry, we need to remain sober-minded and prepare ourselves to respond to the aftermath of the financial crisis and issues arising from government stimulus policies. These policies, while boosting China's economy, have complicated the overcapacity problem in literally all industries. The Chinese economy today is largely sustained by government policies rather than market forces; this is particularly true of the property sector. Investment is a major driver in China's growth. Sizeable investment in the property market has caused prices to skyrocket across China. In some places, residential property prices more than doubled in 2009. However, consumption power did not increase step by step, so real demand remains weak. The gap between the growth of the real economy and the property industry is the underlying cause of high vacancy rates. The full recovery of the real economy will take a much longer time."

The Black Hole of Bank Loans

In 2009, not only did Asian financial firms successfully underwrite eight of the ten largest initial public offerings (IPOs), but also, more than twice as much capital was raised via IPOs in China and Hong Kong as in America. So far this year, several Chinese banks have announced their own IPO, or private placement plans to raise capital and replenish their reserve ratios, somewhat reduced from last year's lending boom. Indeed, China's fifth-largest lender, the Bank of Communications marketed a 42 billion yuan ($6.15 billion U.S.) rights offering last month. Similar announcements were made by two other Chinese financial institutions, namely the Bank of China and the China Merchants Bank. According to Aviate Global, a Hong Kong brokerage firm, as much as 250 billion yuan has been raised in the past six months. Last week, the Agricultural Bank of China announced its IPO which analysts believe could raise over $20 billion (U.S.), representing the largest initial public offering ever. Agricultural Bank, whose primary focus is on rural lending, received a large state bailout in 2008 and is the last of China's main four state-owned banks to attempt a listing in Shanghai and Hong Kong. The Bank has at least 24,000 branches, more than 350 million depositors and assets totaling 8.6 trillion renminbi. By nature, choosing to be skeptical rather than gullible, we believe these capital infusions portend a massive surge in bad debts that will inevitably surface from the remarkable expansion of credit in 2009. When that happens, China will react by bailing out its banks and thereby, become a net seller of U.S. Treasurys in the process.

Zhang Jiangou, Chief Executive Officer of China Construction Bank (CCB), the world's second largest bank by market capitalization, concedes that CCB operates under a different set of rules compared to banks in western economies. In short, there is little room for innovation. Recently interviewed by the U.K. Telegraph, Mr. Jiangou explains: "We are a state-controlled bank and we must fulfill our social responsibility. We must develop our (lending) strategy in line with central government policy." As the CEO of one of China's 'big four' state-operated banks, Mr. Jiangou has been directed to implement a liberal lending policy this year; which begs the question of how loans will be allocated. In the past, considerable sums have been loaned to state-operated giants and corrupt local governments. Stephen Green, an economist at Standard Chartered, recounts: "Many of the loans are secured on local government guarantees, so a lot of the projects have no hope of making a profit. Loans in China are booked on a 'bullet basis' meaning lenders don't repay the capital; they only pay interest until the loan matures several years later and then the capital is repaid 100%. As long as the borrower is making interest payments, the loan is classified as performing. So, we will only really know about the problems here five or more years down the line." As far as installing a risk management policy against bad loans, Mr. Jiangou cites: "We have four rules. We want to have a correct amount of loans. The structure of our loan book must be reasonable. The quality must be good and the pace must be proper."

To Bite the Hand That Feeds

As at March 31st. China possessed $2.447 trillion (U.S.) of foreign exchange reserves, of which approximately, $900 billion (U.S.) was invested in U.S. Treasury notes and bonds. It is also evident that the U.S. Treasury must nurture a healthy working relationship with China to ensure its continued participation in forthcoming Treasury auctions, well into the future. Since China continues to pursue its own foreign exchange rate policy, maintaining a cordial Sino-American financial relationship is often perceived as a complicated and daunting task by the Americans. For the last two years, China has maintained its currency pegged at 6.83 yuan (renminbi) to the U.S. dollar, an undervalued level according to the Obama administration. U.S. Treasury Secretary Tim Geithner is now counting on a series of forthcoming meetings with Chinese officials, including the June G20 summit meeting in Toronto, hoping to orchestrate an upward revaluation of the yuan. Mr. Geithner recently cited: "China's inflexible exchange rate has made it difficult for other emerging market economies to let their currencies appreciate."

Many U.S. lawmakers believe that Beijing is keeping its currency artificially low, giving Chinese exporters an unfair advantage over international competitors, exacerbating a massive trade imbalance with the United States and damaging its industrial production and job creation. However, Chinese Premier Wen Jiabao has consistently resisted attempts from the West and within China, to allow the yuan to appreciate. Last month, Mr. Jiabao stated: "The Chinese currency is not undervalued. We oppose all countries engaging in mutual finger-pointing, or taking strong measures to force other nations to appreciate their currencies." While talks continue, Mr. Geithner has postponed a U.S. Treasury report, scheduled to be delivered to Congress on April 15th. investigating China's foreign exchange policy. If the Treasury report were to determine that China has been manipulating the value of its yuan, it would allow the U.S. administration to impose duties on Chinese imports. In an interview with Bloomberg News, David Gilmore, a partner at Foreign Exchange Analytics in Essex, Connecticut noted that Mr. Geithner's new approach will give Chinese officials breathing room to relax currency controls "without looking like they're bowing to American pressure."

Source: Analysys International

Ten Reasons to Identify China's Financial Bubble

Edward Chancellor, author of "Devil Take the Hindmost" sees 10 red flags which point to excess in China:

1) "Great investment debacles generally start out with a compelling growth story"

2) "A blind faith in the competence of government authorities"

3) "A misallocation of investment capital"

4) "Great (economic) booms are invariably accompanied by a surge in corruption"

5) "Strong growth in the money supply"

6) "Fixed currency regimes often produce inappropriately low interest rates"

7) "Crises generally follow a period of rampant credit growth"

8) "Moral hazard is another common feature of great speculative manias"

9) "Investments financed with credit"

10) "Dodgy loans are generally secured against collateral, most often real estate"

While the above reasons are all present within the Chinese economy to varying degrees, the extent of China's public sector debt remains undisclosed and is underappreciated. Professor Victor C. Shih of Northwestern University in Evanston, Illinois and author of "Factions and Finance in China: Elite Conflict and Inflation" spent months researching borrowing transactions by over 8,000 local Chinese government agencies and entities. Professor Shih argues that Chinese municipal and state debt is of such magnitude that an eventual bailout of these regional governments could substantially reduce China's foreign exchange reserves. In a recent Bloomberg News interview, Professor Shih stated: "China's hidden borrowing may push government debt to 96% of gross domestic product (GDP) by 2011, increasing the risk of a financial crisis in the world's third biggest economy. The worst case (scenario) is a pretty large scale financial crisis around 2012. The (economic) slowdown would last at least two years and maybe longer."

Conclusion – A Sign of the Times

During the 'great depression' of the 1930s, the United States of America was the world's largest creditor nation. Eighty years later, America is now the world's largest debtor nation, burdened with $12.7 trillion (U.S.) of debt, while China has become the world's largest creditor nation. As previously mentioned, there is a growing realization that economic power is gradually shifting from Europe and North America to Asia, led by the Chinese. This is in keeping with the long term historical trend that global economic leadership always gravitates to the world's largest creditor country. The above notwithstanding, China now finds itself on the brink of an economic depression of the magnitude which took a huge toll on the United States in the 1930's. From October 1929 to July 1932, the Dow Jones Industrial Average (DJIA) declined by 89% and didn't regain its 1929 peak until November 1954. By comparison, the Shanghai Composite Index peaked in August 2009 at 3,500. Despite the 60% to 70% recovery in North American equity markets from their lows of March 2009, the Shanghai Composite Index now stands at 3,129 – already down 10.6% from the high.

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