Shadow over Asia

by David Galland, Managing Editor, The Casey Report

*An interview with **Vitaliy Katsenelson***

TCR: What our readers are looking for is a better sense of China and Japan, both of which are very important in the context of the global economy. As we have to start somewhere, let's start with China.

Today the conventional wisdom is that somehow the Chinese economy is better managed than its competitors, very similar to how people viewed Japan in the 1970s and 1980s. Back then people were absolutely convinced that Japan was the superior country with superior policies and that its economy was unstoppable. We all know how that ended.

So, let's start there. Is China's system better than everyone else's? Is it really possible the Chinese economy can keep steamrolling along?

VK: A few months ago, I watched a movie about Ayn Rand and it talked about how Americans in the 1930s looked at the Soviet Union's flavor of managed economy as being superior to the American version of capitalism. At the time America was just coming out of the Great Depression, so that view made a lot of sense. So in the short run, and especially after the ugly side of creative destruction has paid us a visit, the grass of managed economy may look greener.

So when we look at China, the conventional wisdom says that the government is very, very smart, and therefore they can do a very good job in steering the economy in the right way. Chinese government may have the best intentions, its leaders may have IQs of 250 each on a bad day, but it is impossible to centrally manage an economy of China's size.

I am a big believer that in the boxing match between a visible and an invisible hand, though the invisible hand may lose a few rounds, it will win the match every time. Last century we had the most amazing economic experiment take place when after World War II, Germany was split into two countries with different economic and political systems. But they were the same people, with the same language and culture, separated by a wall. We know how that story ended.

Of course, for a time, having government control over the levers of the economy can have advantages. For example, by taking prompt action, the Chinese government was able to pull the economy out of the recession remarkably fast, basically by fire-housing the stimulus package that was equivalent to 12% GDP. That's the advantage. The only problem is that these kinds of short-term advantages come with long-term, painful consequences.

For example, when you have a huge government presence in the economy, you also have a huge bureaucracy, and bureaucracy brings corruption. This is one of the reasons why China is rated so poorly on Transparency International's annual corruption rating. Corruption breeds misallocation of capital, because the capital flows not to the best use, but it basically flows to whatever the political connection or whatever the bribe is directed to.

In addition, when you have a government-managed economy, it creates excesses. China has huge excesses in the industrial sector, as well as in commercial and residential real estate. We see plenty of evidence of these excesses, but they are likely to be much greater than we can measure today as they are covered up by robust economic growth. The true magnitude of these excesses will come to the surface once the economy slows down.

TCR: In essence, you've got a relatively small group of individuals who are making big decisions about China's economy and where production should be, in what sectors, etc. If history is any guide, that really can't last, yet many people seem to think it can. That said, China's economy has certainly done remarkably well in the global economic crisis. In fact, according to their government, their GDP is almost back to where it was pre-crash. Why?

VK: Sure, the growth you see today in China is there, but it's not a *sustainable* growth. It's not a growth that you'll see a few years from now. That is an important point for readers to understand.

TCR: Why is it not sustainable?

VK: Because the growth is being induced by government spending, by a misallocation of capital.

I'll give you an example. The vacancy rate on commercial real estate in China is fairly high, but they still keep on building new office buildings because they think they will always grow. So therefore as long as they keep building, that activity will be registered as growth, until they stop. And when they do stop, they'll drown in overcapacity, and they won't be building new skyscrapers for a very long time.

TCR: We read that note you sent about the South China Mall, which is pretty stunning. It's the second largest mall in the world but is mostly empty.

VK: That's right. But as outrageous an example as the South China Mall is, there's an even more outrageous example – namely that the Chinese built an entire city, Ordos, in Inner Mongolia for 1.5 million residents and it is completely empty. These are classic examples of the sort of excesses going on in China.

TCR: The equivalent of building bridges to nowhere, but on a very large – Chinese – scale.

VK: Exactly. There are no shortcuts to greatness. As long as they keep building new bridges, the economic numbers will register that there is growth, but at some point the piper will have to be paid, and these projects have a negative return on capital.

TCR: It seems the Chinese are following the script Japan used to dig itself out of its postwar doldrums, deliberately keeping their currency low in order to build an economy on the back of low-cost manufacturing. But that game inevitably has to end – already we see more and more things being made in Indonesia, Pakistan, India, and so forth. If China loses the manufacturing core of their economy, won't they be in big trouble?

VK: Well, once you move manufacturing to other countries, it's very difficult to get it back. So you could probably argue that China will maintain its manufacturing advantage for a while.

The problem with China is pretty much the same as with any bubble. Though it may have had a solid foundation under it, it is simply a good thing taken too far. If you look at the railroad bubble in the United States, the country did need railroads, but we built too many.

The same thing happened with the technology bubble in 1998. The Internet was transformative to our economy, no question about it. But, again, it was taken too far.

There are some other countries that are lower-cost producers than China, but they probably can't do it on the same scale that China can. But my point is that China is just a good thing taken too far, and if you add government involvement and corruption into the mix, you will get a bubble that is taken a lot further than you would normally expect.

One way of thinking about it is that the actions taken by the Chinese government, especially after the recent global recession, have basically supersized the bubble that was already forming.

TCR: Their government is sort of a holdover from a largely bygone era when many nations were communists, so isn't it true that they need to maintain some fairly strong forward momentum, otherwise they could run into some political problems? Is that why they were so quick to unleash the massive stimulus or encourage their banks to lend an amazing amount of money? You have a chart showing those loans amounted to 29% of GDP in 2009. What kind of quality of lending can that be?

VK: Let's try to understand why the Chinese government did the things they did. As everyone knows, the Chinese economy grew at a very high rate for a long period of time. When the global economy slowed down, their economy slowed down as well (though official numbers did not show it). The Chinese government is extremely concerned about the economy slowing down because that is likely to lead to political unrest. A lot of that potential friction comes because a lot of people moved from villages to the cities. China has an almost nonexistent social safety net system. So people who lose jobs don't complain, they riot.

So, yes, the Chinese government is afraid of political unrest, and therefore they quickly released a tremendous amount of stimulus into the economy, then followed it up with encouraging bank loans equal to 29% of GDP in 2009, a huge increase. When you infuse this much debt into an economy, it's impossible to have good capital allocation decisions. While the economy is growing, the bad debt won't be so apparent, but it certainly will be when the economic growth slows.

A good analogy might be that when you analyze a credit card company that is growing very, very fast, and that has opened new accounts, you don't see the bad debt because that debt is covered up by new loans. The true nature of the past lending decisions only becomes obvious when the company's growth falls off.

One way to think about the Chinese economy is by comparing it to the bus in the movie *Speed* with Keanu Reeves and Dennis Hopper. In the movie, a bus was wired with explosives that would blow up if the bus's speed dropped below 50 miles an hour.

Since China is manufacturer to the world, that manufacturing business comes with a lot of fixed costs. Factories, equipment need financing, and they are mainly financed by debt – another fixed cost. The high level of fixed costs doesn't afford China an economic slowdown, but when it happens, the consequences will be dire. High fixed costs are great when revenues are rising as income grows at a faster rate than sales. But they are devastating to profitability when sales decline: costs decline at a slower rate than sales and you start losing money, fast.

TCR: Interestingly, there's clearly a slowdown in the U.S. and Europe, China's two biggest markets, so you would assume that China's export industries would have suffered a fairly sharp decline since the go-go days before the crash. That has to be putting pressure on their growth. How important to the Chinese is it that the U.S. and the European economies recover and Western consumers get back into the game?

VK: I think a return of U.S. and European consumers is extremely important to the health of the Chinese economy. Some analysts think China's internal demands can overcome the demand decline from U.S. and European consumers, and I think it is possible in the long run. But in the short run, I don't think that's possible. Let me explain the reasons for that.

Chinese consumers represent one-third of a 5-trillion-dollar economy. If you look at the size of the U.S. and European Union together, they are equal to a 30-trillion-dollar economy, and the consumers there constitute about two-thirds of those economies.

So on the one hand, you have U.S. and European consumers representing 20 trillion dollars in purchases, versus Chinese consumers at about 2 trillion dollars. In other words, U.S. and European consumers are 10 times the size of the Chinese consumers. As a result, a very small change in consumption in the U.S. and Europe has to be overcompensated by a huge increase in consumption in China, and that is going to be very difficult to do, especially considering that the Chinese currency is kept at artificially low levels. That, of course, diminishes the purchasing power of the Chinese consumer. Over time the Chinese consumer will play a larger role in the economy, but it's going to take a decade, not months – not even a few years.

TCR: You're pretty bearish on the outlook for China; do you have a theory about what might trip them up? What's the thing that readers should be watching for that would suggest things are starting to unravel?

VK: It's very difficult to know exactly what's going to be the straw that breaks the camel's back. It could be a slowdown in the Japanese economy, or a double-dip in the U.S., or some other factors that are not apparent to us today. It could be just the simple fact that the Chinese government is trying to put the brakes on the economy and mistakenly does too much.

I don't trust government-reported statistics, thus I'd watch numbers that the Chinese government is less likely to fudge: electricity consumption, which was down during the global recession, same-store sales of American fast food restaurants in China, tonnage of goods shipped through railroads, and, though they may lag, sales by American and European companies in China.

TCR: If you look at inputs like copper imports and even copper stocks in Shanghai, by all appearances China is at least pretending that it's business as usual. In fact, I think in August they imported 22% more refined copper than they did the year before. But if this is just to build bridges to nowhere, then it supports the idea that this is not going to be sustainable.

VK: That's right. That is the problem with looking at this kind of data, because a lot of it is going to building things that have a negative return on capital. Therefore, you look at the data and the data does not really tell you that much – until it does. Because, basically, it's the government's involvement that is driving a lot of the demand.

You can make the same argument that the U.S. economy was doing great in 2004, 2005, 2006, despite the obvious problems in real estate and its financial system. Likewise, a lot of people said great things about what was going on in Japan in the late '80s. Of course, the U.S., and Japan before it, were experiencing huge real estate bubbles that few saw as being a problem, until they were.

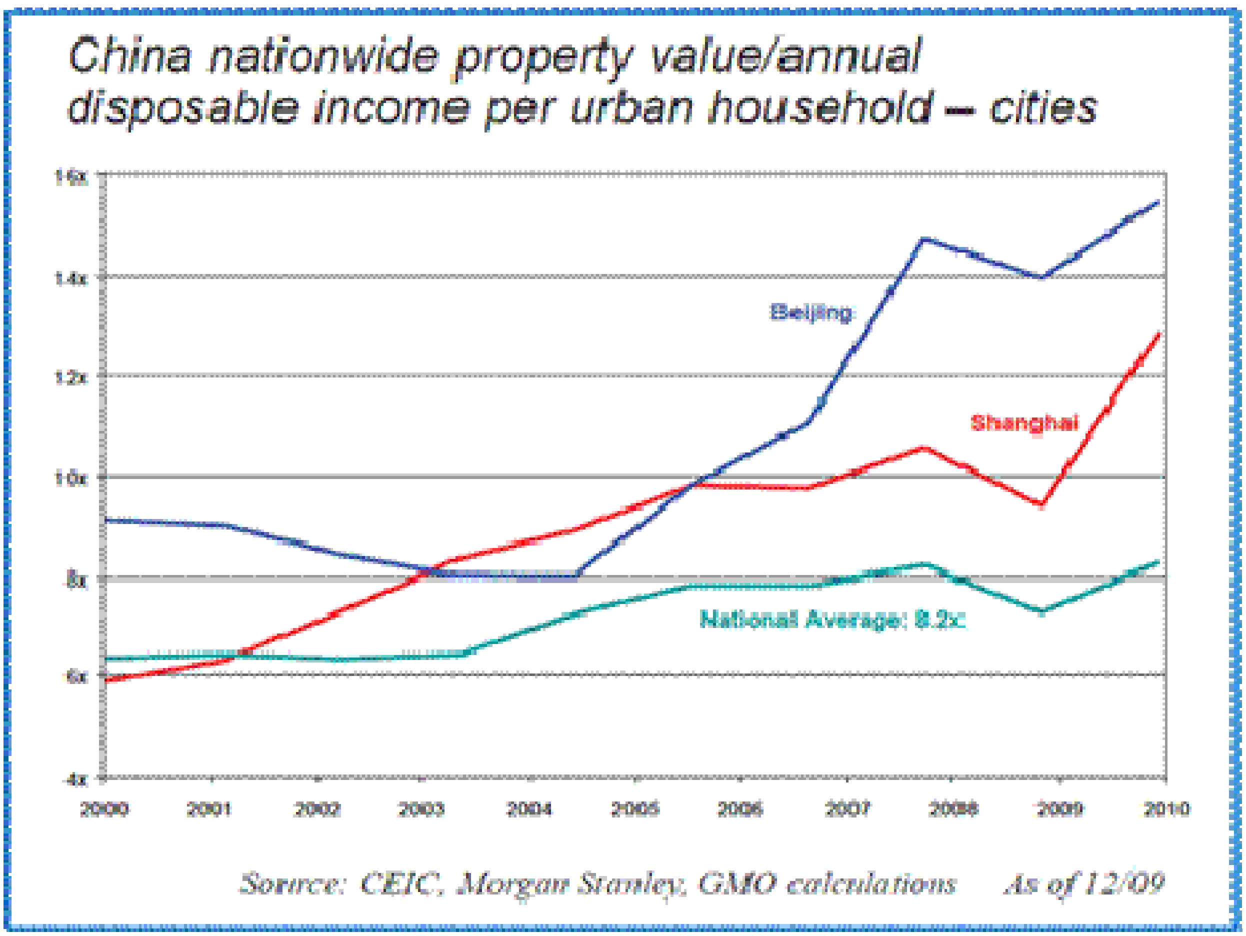
There was a recent article in the Wall Street Journal talking about a Chinese state-owned enterprise that operated salt mines, but now it's building office parks. Those are kind of the signs you start seeing in an economy in the late stages of a bubble, where a state-owned enterprise starts building real estate projects because it's almost like you can't lose money doing this. But one thing that makes predicting the end of this bubble very difficult is the amount of firepower the Chinese government has. The government can drive this bubble further than a rational observer would expect.

TCR: Because they've got so much in the way of reserves?

VK: Because they have a significant influence over the economy. Chinese government can force banks to lend and can force companies to borrow and spend (or build).

TCR: On the topic of real estate, I was speaking to a very well-off Chinese friend recently who had bought a very expensive apartment in Beijing. When I asked him about buying at bubble prices, he commented that it really didn't matter. The money was almost irrelevant, given the status that came from having an apartment in that particular part of town. He said it was very good for his business and that he didn't really plan on using it very much. It was an interesting perspective, how he saw real estate.

VK: In the same way that everyone in the United States decided they "must" own a house, this belief was reinforced by continuously rising house prices. You can see how big a problem this became in big cities such as Beijing and Shanghai where the affordability ratio is horrible, so the property-value-to-income ratio in Beijing is pushing 15. In Shanghai it is over 12. If you look at the national average, it is over eight times.



TCR: Can you explain that ratio to our readers?

VK: You get the ratio by taking the property value and dividing it by annual disposable income.

Basically, if you spent all your money, after you paid your taxes, just to pay off the mortgage, it would take you 14 years – which means you didn't pay for food, electricity, etc.

This ratio is important because it helps put the scale of the Chinese real estate bubble in its proper context. In Tokyo, at the peak of the massive Japanese bubble, the ratio stood at nine times. In Beijing it's already 14 times. In Shanghai it's over 12 times. The national average for China is pushing 8.2 times right now. So housing affordability is very, very low, and the housing prices are extremely high.

Here is another interesting piece of data: property investment in China in 2009 was 10% of GDP, up from 8% in 2007. In Japan, at the peak of its bubble, it did not exceed 9%; in the U.S. it never exceeded 6%.

A recent study found that 64.5 million apartments basically don't use electricity because they are empty. Chinese people buy those condos, and they don't rent them. Similar to new cars in the U.S. when taken off the lot, in China an apartment is worth less once rented out. So they just keep them unoccupied with the hope to flip them, and you know how that story ends.

TCR: Yes, after Japan's real estate bubble collapsed, prices in the major cities fell by about two-thirds and have rebounded only very little from the post-crash lows.

If a lot of Chinese lost a lot of money in real estate, one has to assume they're going to be very unhappy. I recall a conversation with another Chinese man who lives in the States half a year and in Beijing half the year. When I asked him about the real estate bubble in China, his comment was, "Well, the government would never let it fall," and he said the same thing was true of their stock market. To put it mildly, he had an inordinate amount of faith in the Chinese government's ability to prop up bubbles.

VK: As you can tell from my accent, I was born in Russia and spent half of my life in Soviet Russia. From my direct experience, the Russian propaganda machine was very, very powerful, and so many people believed how smart the leaders were and that they could do nothing wrong.

China is not that much different from Russia in that respect. Due to the government's control of the media, the average citizen has been brainwashed into thinking of the government with respect. They has led to an unconditional belief that the Chinese government walks on water, that the laws of economics are somehow suspended when they touch things (except they also did a fine job convincing not just their own citizens but the West as well). Sure, they have a greater control of the economy, but at the long-term cost we talked about earlier. That's point number one.

Point number two can be understood by asking why people are buying those apartments, why are they buying this real estate? In part it is because if they put money in the bank – where the government basically sets the rates on savings accounts and the checking deposits – they are getting very little interest on their savings. Therefore they look at real estate as basically a form of savings.

Some analysts will argue that it can't be a bubble because of the lack of leverage, given that in China you have to put 30%-40% down when you buy an apartment. It is a large down payment. But think about how much wealth will be destroyed when real estate prices decline – and that in itself could trigger a serious crisis in China because it would destroy a lot of wealth, and that could lead to political unrest. So that would be very important psychologically and for the political stability of the Chinese economy.

TCR: What would typically trigger the end of this real estate bubble?

VK: To some degree, a real estate bubble is like a Ponzi scheme. As long as there is an incremental buyer, prices keep going up, but at some point everybody who wants to buy a house has bought a house, so when an incremental buyer is not there, the prices start declining and then it becomes self-feeding. It's very difficult to time the end, but there is always an end.

TCR: What about commercial real estate?

VK: If you look at commercial real estate, it's often one subsidiary that is borrowing money from another subsidiary to put a down payment to build or buy a building. And a lot of times land is used as collateral. As land prices decline, so the loan-to-value ratio can jump through the roof very quickly when real estate prices collapse.

TCR: Talk a little about the renminbi. The Chinese government has been making noises about possibly allowing it to rise against the dollar, but from a practical standpoint, can they actually afford to let that happen?

VK: They could let it rise on a very gradual basis, but they absolutely cannot allow it to rise very rapidly because that would quickly diminish the value of the foreign reserves. But there is a conundrum. When the Chinese economy bursts, there is a very good chance the renminbi will actually depreciate, because you are going to have a flight of capital leaving China. So right now you may argue that China's currency is too cheap, but during the crisis it's probably going to get cheaper.

TCR: What's your general sense about how much longer they can keep the game going before they collapse? And is collapse the right word?

VK: I really don't know. In the case of Japan, their government basically ran out of chips. I think the Chinese government still has enough chips to keep the bubble going awhile longer. These bubbles usually last longer than the reputation of the person who predicts their demise.

TCR: Do you think it will occur within a decade?

VK: I think so, yes. GMO became famous for predicting the Japanese bubble collapse, but they started predicting it in 1986, so they were "wrong" for a while because it actually burst in 1989-1990. The point being, these bubbles typically last longer than you would expect, but it's going to burst.

TCR: Let's talk for a minute about some of the potential implications of a bursting Chinese bubble. There are some fairly obvious ones, like Chinese real estate, but there are a lot of somewhat less obvious consequences, for example the hit this would cause to the Australian economy because its export sector depends heavily on China.

VK: China has been responsible for a very large portion, if not all, of incremental demand for commodities in recent years. If you're talking about copper, about oil, or pretty much all the industrial commodities, China was responsible for a very large portion of the demand. When the economy slows down and the bubble bursts, then the demand for those commodities will decline dramatically.

It's going to impact economies that benefitted tremendously from China's ascent, so Australia will be impacted, Russia will be impacted because oil prices will decline and Russia is basically a commodity-driven nation. Brazil will be impacted. Any economy you can think of that benefitted from China's ascent will get hurt from its descent as well.

Let me clarify this. I'm not saying that China will cease to exist or that it's going back to the stone-age – I'm saying there is a bubble and it’s going to burst. It's going to go through readjustments.

TCR: But it will be a serious crisis.

VK: The bubble burst will have significant consequences.

TCR: So you'd be cautious on sort of base commodities.

VK: Yes. But also think about industrial goods. Getting commodities out of the ground, building empty shopping malls, ghost towns, and bridges to nowhere requires a lot of equipment. Industrial goods companies benefitted tremendously from Chinese demand. In the past, those were very cyclical companies, and it seems like this time they almost didn’t have a normal cycle. They declined but then came back very fast because the demand came back very fast, and a lot of that demand came from China.

TCR: And what would you invest in, are there any opportunities you see?

VK: Unless you short stocks, it's very difficult to see an opportunity in a Chinese downturn. As a portfolio manager, I look at it as a risk, and I say, all right, what can I do to immunize my portfolio from that risk. I have very little exposure to commodities and industrial stocks, and very little exposure to countries that will get hurt from China's bursting bubble – the countries we mentioned, like Australia, Brazil, Russia, etc.

TCR: Canada would have to be on that list.

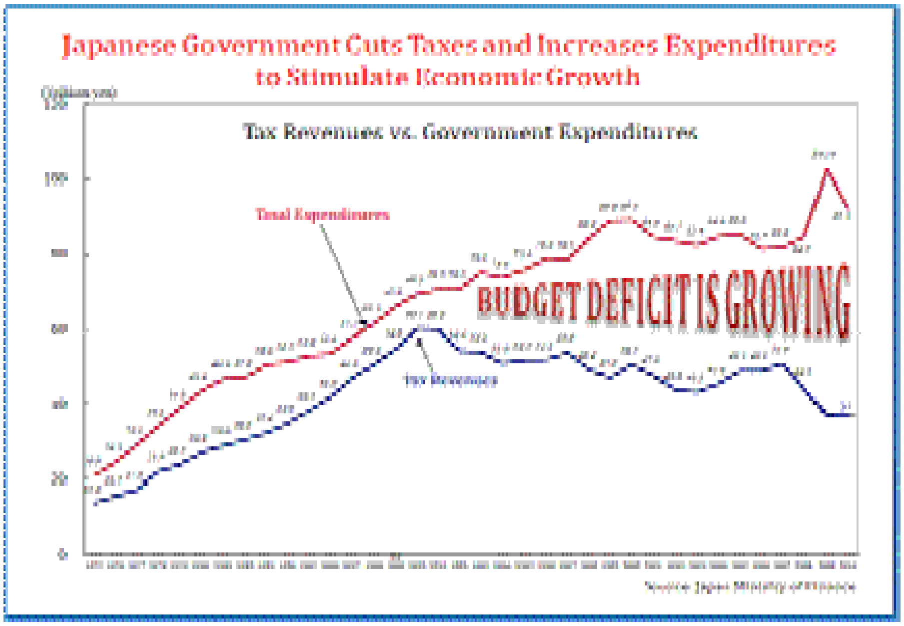
VK: Yes, very true.

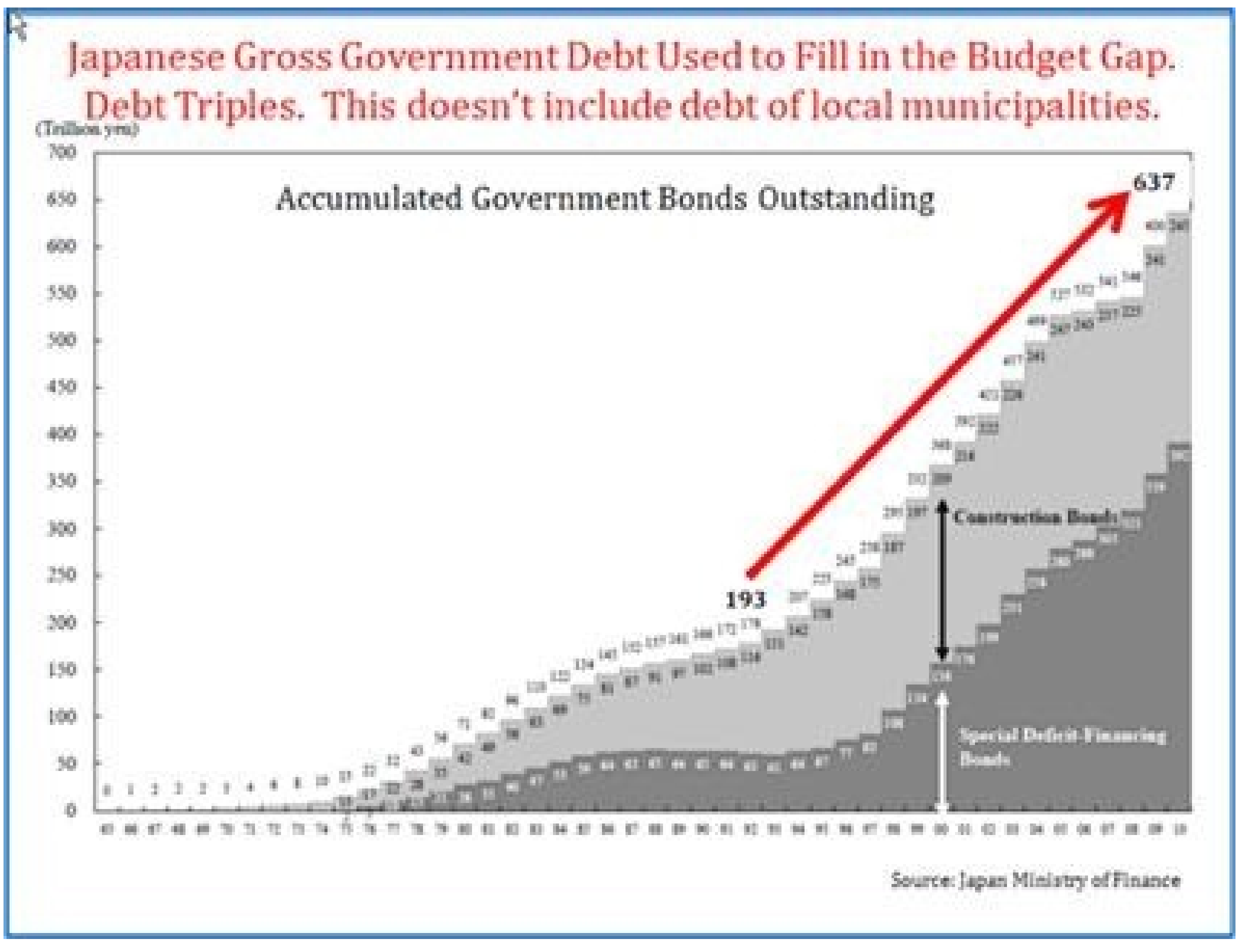
TCR: Let's talk briefly about Japan. Bud Conrad, our chief economist, has done a lot of looking at Japan and concludes that it's basically past the point of no return. What are your general thoughts on the implications of that country tipping back into a serious crisis? After all, it’s a very big economy, and so that would have to have a big impact on the world.

VK: Japan's story is very simple. The economy slowed down in the 1990s. To keep the economy growing, the government lowered taxes and increased government spending, sending budget deficits up. In order to finance those deficits, the amount of government debt has tripled.

The only reason they were able to finance that debt was because over 90% of the government debt was purchased internally; therefore, thanks to Japanese interest rates declining from 7.5% to 1.4%, the government was able to dramatically increase the amount of debt without the total borrowing costs going up.

Today, Japan is one of the most indebted nations in the developed world, and its population demographics are horrible because every fourth Japanese is over 65 years old. There’s no immigration into Japan, and the population is aging rapidly, and the savings rate went from the middle teens to quickly approaching zero.

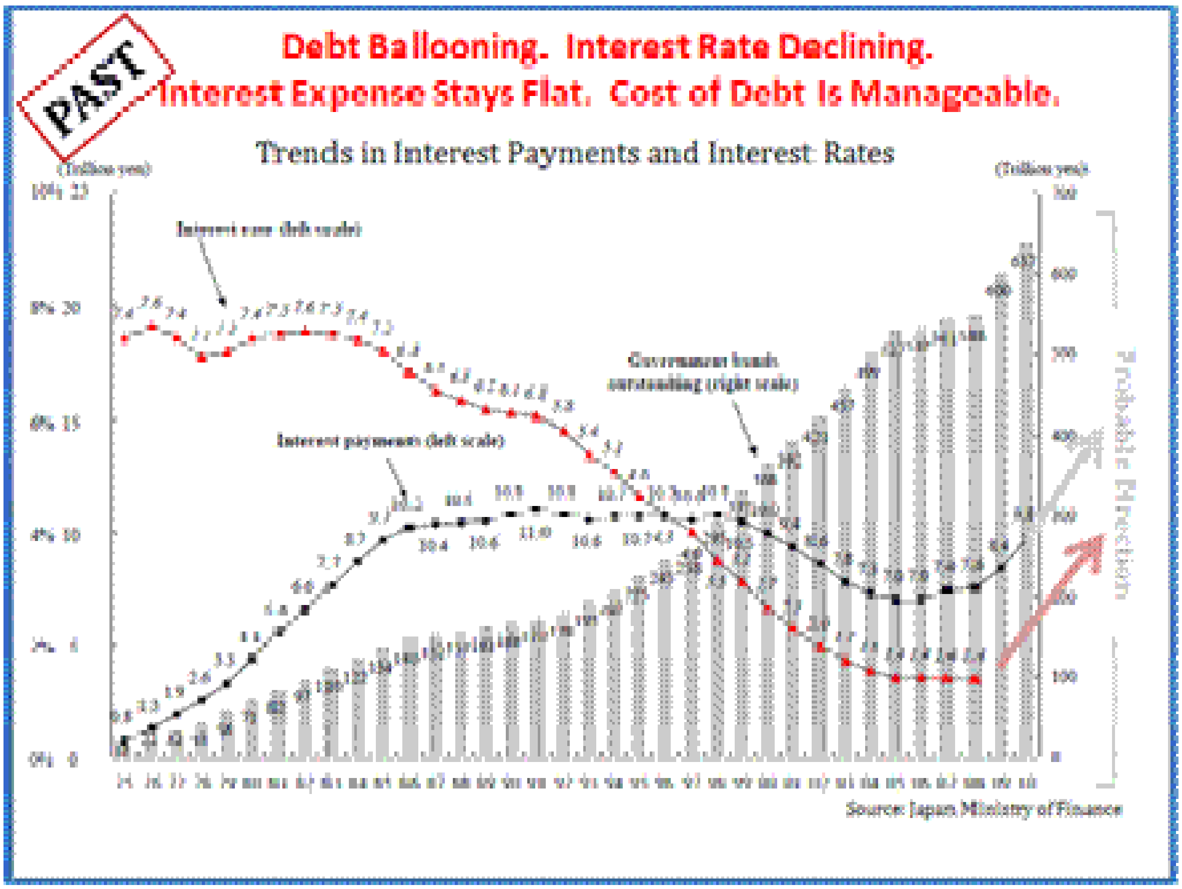




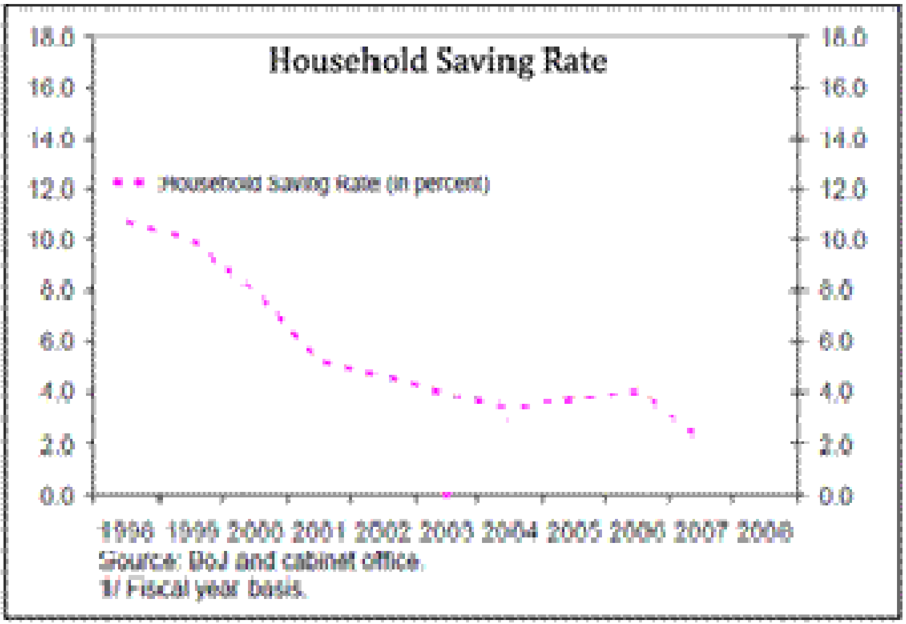
TCR: So there is less demand for Japanese government bonds.

VK: Yes, exactly. With the demand for Japanese bonds declining, they are going to have to start shopping their debt outside of Japan, and the second they do, they'll realize that no rational buyer would buy Japanese debt yielding 1.4% when they can buy U.S. debt or German debt with yields double that.

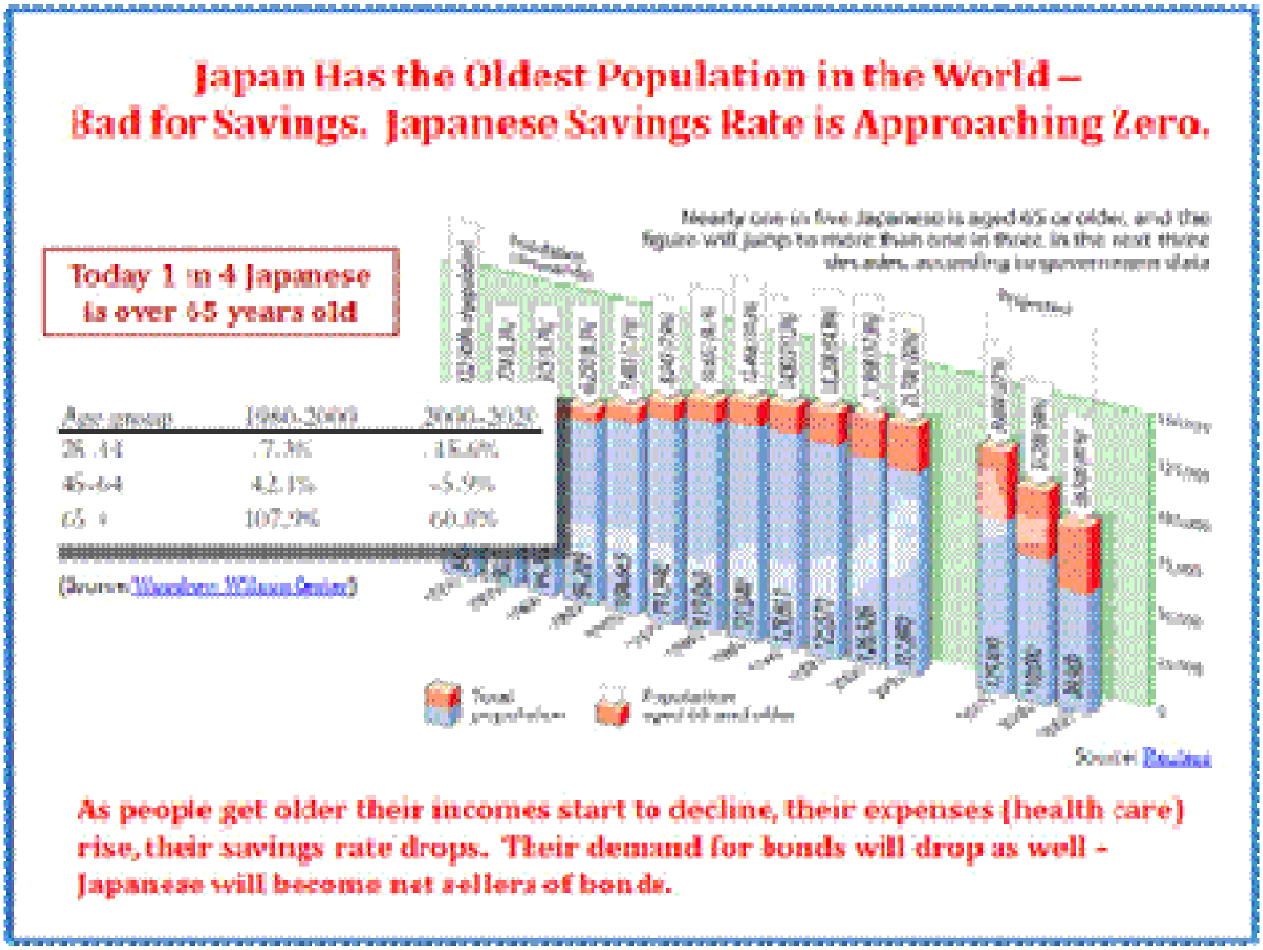
So the Japanese are going to have to start paying high interest rates, and they can't afford that, because one-quarter of the tax revenues already goes to servicing their debt. If their interest rates were to double to just 2.8%, it basically wipes out the funding for the country's Departments of Defense and Education. So this is a situation where they go from deflation to hyperinflation, because they're going to have to start printing money to be able to keep paying off their debt, so this is the case where they are going just from one extreme to another.



90% of Debt Financed Internally through Very High Household Savings Rate ... But Savings Rate is on Decline



Here is why...



TCR: Their economy has been hugely helped by their trade surplus, but their trade surplus has been going down steadily, in no small part because China has been stealing market share.

VK: Exactly. A lot of manufacturing went to China from Japan, so that hurt the economy too.

So when you ask me about what could trigger Chinese problems, well, you know, Japan is still a big trading partner for China, so Japan's decline would impact China as well, and vice versa.

TCR: We have heard a lot about Japanese demographics. That seems to be an intractable problem.

VK: Recently I heard that the Japanese were considering trying to solve their demographic problems by allowing immigration from China to Japan. I almost fell off my chair when I heard that, because there is a lot of animosity between the two countries. They love each other as much as Armenians love Turks, so it's very difficult for me to see that happening just because of the cultural issues going on.

TCR: And it seems that the tensions are actually getting much worse.

VK: Too true. But the key point is that Japan is past the point of no return. It’s like the Titanic has already hit the iceberg and you know it’s going to sink, you just don’t know just how long it will take to go down.

That's basically what is taking place in Japan.

TCR: Sticking with that metaphor, it seems like people need to begin donning life jackets and edging toward the nearest lifeboat.

So we've got some serious issues with Asia, which obviously will have some global implications. How does this tie back to the U.S.? Our take has been that – at least on a short-term basis – when things start to come unglued, it will benefit the U.S. as a purported “safe harbor,” but then people will begin to realize that if two out of three of the world’s biggest economies can fall, so can the U.S.

VK: In the short run, it may benefit the U.S. dollar because the value of currencies is relative, right? As my friend Barry Pasikov says – the U.S. dollar is valedictorian in summer school. So if people are afraid of Japan, afraid of China, they would be running towards the U.S. currency. By the way, the Japanese currency made a 15-year high recently suggesting what could be the trade of the decade.

I'm a value investor, so I generally don’t spend much time on currencies, but I think this is a case where shorting Japanese yen makes a lot of sense.

It may work against you for a while, but in the long run, I think it could turn out to be the trade of the decade.

Again, I think the U.S. dollar might benefit in the short run, but don’t overlook that China and Japan are the largest foreign holders of U.S. debt. If Japan becomes a net seller of U.S. debt and their debt starts competing with U.S. debt, then that's going to be negative for our economy because we are going to have high interest rates. If China also becomes a net seller of U.S. debt, again, it's negative for our economy.

The big question, once they start selling, is how fast will they sell their U.S. debt. If they sell it very fast, maybe because they have to, it's going to drive our interest rates higher. If it's something that develops over a long period of time, it may not drive our interest rates as much as you would think.

TCR: But ultimately, if they hit a real bump in the road, they’re going to have to start selling.

VK: Exactly. Plus, the Japanese government bonds will start competing with our bonds. In the past the Japanese people were able to consume the government debt internally, down the road the government is going to have to start selling its bonds to the same people who are buying our bonds, and instead of paying 1-2%, they’ll have to start paying 5, 6, 7%.

TCR: Which would be devastating for the Japanese economy, given the scale of their debt.

VK: Absolutely, At that point, they are going to have a very high inflation because they’ll be forced to print a lot of money.

TCR: Not a very positive outlook but I think very useful. You’ve written a book about managing a portfolio in sideways markets. What's your advice to investors at this point?

VK: I just finished a book titled *The Little Book of Sideways Markets*. It is a follow-up to *Active Value Investing* I wrote in 2007. My research leads me to believe that the U.S. markets will continue their sideways journey over the next decade, much as they did in the previous decade.

In such markets, the traditional buy-and-hold approach doesn't really work, so you need to modify your approach, starting with the idea that you want to become a buy-and-sell investor. You want to buy stocks when they're undervalued, but when they become fairly valued, you want to sell them.

Secondly, in the absence of good stocks to buy, you should be willing to hold more cash. I'm not an advocate of trying to time the market but rather saying that if you look at the market and you don't see stocks that meet your criteria, just hold more cash. The opportunity cost of holding cash is a lot lower in this environment than it would be in a cyclic bull market.

Third, you want to favor stocks with a high dividend yield. You don't want to buy stocks just because of the dividends, but if, everything else being equal, you can find stocks that have an above-average yield, that's going to become very important in this environment because in the past dividends accounted for 90% of the return during the sideways markets.

Fourth, you basically want to increase your margin of safety. If a value investor typically looks to buy a dollar for, let's say, 70 cents, I would recommend start looking for dollars selling for 50 or even 40 cents. That's point number four, and it's extremely important.

The book walks readers through the fundamentals of investing in sideways markets, and I think it will help most investors do well in what will be an otherwise challenging environment.

TCR: When is the book out?

VK: In mid-November.

TCR: We look forward to reading it – and maybe having a separate conversation on those concepts in a future edition of The Casey Report.

VK: That would be great.