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TRUTH & BEAUTY
[...AND RUSSIAN FINANCE]

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STRATEGY

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Of Blind Men & Elephants – Notes from China

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Having served as a sell-side emerging markets strategist for a decade or so – until our outspoken views (and a certain willingness to call journalistic whores "whores") led to our ostracism by the cowardly and consensual-minded sell-side, T&B acquired the ability to land in a new country, spend a few days chatting with whoever was available – from taxi-drivers to government ministers, central bankers, journalists, strategists, brokers and businessmen – before arriving at a reasonable overview of the lie of the land. On the other hand, after almost a month in China, we are frankly awed, cognizant of the fact that we have barely begun to scratch the surface.

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 <u>against</u> 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 <u>upgraded</u> – 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 19^{th} 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 19^{th} 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.
- T&B had 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.

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.
- **The shopping in Shanghai beats anyplace else on earth! T&B – a retail-phobe if there ever was one – arrived with 15 kg of baggage, leaving with 92 kg (*hurray for Aeroflot, the world's most understanding airline, and Russian airport customs, who apparently awaken late in the day*).**

- *Mea Culpa – on page 13 we discuss – probably not for the last time – our views on the European train-wreck, as well as our singularly infelicitous call on Greece*

Foreword

As a strategist one can no longer assemble a coherent world view without taking a view on China – not just the world's second largest economy, but the world's first-largest source of economic growth and commodity demand.

The secular rise of China has radically changed the rules of the game. Had it not been for China, the American crisis of 2008 would most likely have eventuated in a global economic depression; if the current, European, phase of the credit crisis does not lead to global economic collapse, the worst shall again be avoided largely thanks to rapid Chinese growth.

Were tales of the impending Chinese implosion to have any validity, investors would be well-advised to look at interplanetary opportunities – virtually no market on earth would be spared. Fortunately, like the reiterated warnings of a collapse in post-crisis Russia, these can be safely discounted.

For one used to the lies of the sleazy British financial press as regards Russia, the sheer volume of misconceptions regarding China seems oddly familiar. As a result of this disinformation, a number of our otherwise sane and reasonably well-informed correspondents have waxed lyrical about the "police state", the "slave workers" the "unsustainable income gaps", "the seething anger of the common people", and especially, the "thirst for democracy." Pure, and unadulterated fiction – fit only for those who believe uncritically what they read in The Economist/Financial Times*. Even those Chinese deeply critical of the State/Party were unanimous that the very concept of Western Democracy had been deeply discredited in China. One author told us that there had been a time – perhaps 15 years ago – when there were some aspirations towards the Washington model, but that time was now past, indeed, that absent the tight grip of the Communist Party, China would be far more radical and violently nationalistic than now.*

If "democracy" is taken to mean not simply the slavish adherence to the diktats of Washington or Brussels, but rather, a regime which personifies – by whatever political mechanism – ***the national spirit and desires of a nation,*** *China is more "democratic" than any major Western country (perhaps ex-Scandinavia). The Chinese are fiercely proud of their achievements of the past 30 years, accept that these have been made* *possible by the rule of the Party, and generally expect to overtake the West during the coming decade or so.*[1]

This sense of national greatness has been further fuelled by the anguished pleas for a Chinese solution to the Western financial crisis. As regards foreign policy, if the Chinese have one major complaint, it is that their State is far too cautious and conservative. Obviously, the collision of a rising China with a still triumphalist but declining Global Hegemon intent upon perpetuating past glories poses some real dangers of miscalculations.

*Even more so than for Russia, China offers a rich field for the study of the divergence between the fun-house mirror of the Western media and the underlying reality***.** *Anyone investing in Russia since 1998 will be cognizant of the fact that, as investors,* ***we make money trading against misinformation, bias, spin, and sheer pig-headedness****. Much of the China coverage in the British financial press – the* FT *and* The Economist *in particular – could have been written by their intellectually-corrupt Russia correspondents (Catherine Belton and Ed Lucas, both smart enough to realize that they are engaged not in journalism but in propaganda for pay, stand out here). From the investor's perspective, press coverage has been simply misleading, i.e. it would have led to seriously bad investment decisions; from the political standpoint, it is somewhat irrelevant given that the gradually shrinking sliver of the global mindspace now represented by the Western media. As the old economies of the West merrily discredit themselves and their political model by their extravagant mismanagement of over-indebted economies, with apparently-terminal political paralysis and balkanization, we shall at least enjoy the meagre consolation of their tame media reassuring us as to the unquestionable superiority of our model. Caveat Emptor!*

[1] *A view at least partially shared by a majority of Americans recently polled, who generally expected China to overtake America sometime during their lifetimes.*

Welcome In China

China is not a "country" and never has been. It is a civilization, a continent, a cultural empire. Perhaps the closest comparison is the Medieval "Christendom" of Charlemagne's era. While his Europe splintered into literally hundreds of states, city-states, electorates and kingdoms, despite repeated periods of fracture, China ultimately remained a unitary state thanks to the unique Confucian bureaucracy which survived dynasties and regimes, invasions and uprisings. This hyper-meritocratic civil service based upon three levels of examinations with a pass rate in the low single digits and which required literally a lifetime to master, proved extraordinarily durable, while creating a country of hyper-educated aspirants.

We are loath to toss about the usual shibboleths – but they are largely valid: Several regions of China are larger that any European country. The Chinese growth miracle has lifted more people out of poverty than any single transformation in man's history. While China retains a deeply conservative and isolationist mindset, accelerated change is being forced by rapidly shifting geopolitical and economic imperatives, compelling her to project power globally to protect markets and lines of supply – a role for which she is still largely unprepared. The pace of Chinese development leaves both Europe and America in the dust. Inequality is growing, endangering social stability (note, however, that China and the United States have nearly identical Gini indices of inequality, while income growth is far faster in former). China is indeed an authoritarian state, yet the State (or more correctly, the Communist Party - in reality no more "Communist" than T&B is High Anglican!) is overwhelmingly popular with its citizens, a unity which leads to a sense of purposefulness utterly unlike anything we have witnessed in the West. Indeed, China more resembles a multicellular organism than the individualistic and multi-facetted social model with which we are familiar; i.e. not at all an entity with which Western policy makers will find it easy to transact.

New Models – the Global Fashion Show

T&B has long taken a controversial stance, asserting that, at least in the Russian context, Western-style Democracy proved to be a distinctly mixed blessing, while the so-called "authoritarian" government of Vladimir Putin managed to tame not just the daemons of Russia's past – not dead but merely sleeping – but also the daemons of predatory and unrestrained capitalism (the Oligarchs) and regional centrifugal forces (the often corrupt and tyrannical local governors). Had the Western Consensus even the slightest feel for the Russian reality (or, frankly, any decency) some expression of gratitude should have been expected towards the man who preserved Russia as a unitary state.

As regards European democracy, T&B has never fully understood the relevance of the views of our cleaning lady as regards complex macroeconomic monetary/fiscal policy, nor frankly, why said views should be regularly solicited; these seem to us about as relevant as our own views on quantum mechanics.

It was, however, our recent travels around China which brought home to us just how mixed a blessing Western-style Democracy was. Ironically, our trip coincided with the terrifying acceleration of the Great Financial Crisis of the West, laying bare the fundamental dysfunctionality of the dominant political model – as practiced in America, Europe and Japan. The roots of the Debt Crisis of the West[2] are by now painfully obvious. The positivist economic dogma of the post-war period considered it to be self-evident that the development of the emerging economies would be a win-win phenomenon; the dominant Western powers thus encouraged transfer of technologies and capital to countries which, in a more mercantilist world view, would have been seen as dangerous competitors.

The explosion in Chinese manufacture was initially highly disinflationary, with the Chinese vendor finance model briefly providing a boon to US consumers, while also exerting deflationary pressures on wages and increasing competition for investment capital and natural resources. Given that the Western

[2] *Politically, if not geographically, i.e. considering Japan an honorary member of "the West".*

populace had come to consider the constant improvement in lifestyles enjoyed during the first forty years of the Post-War period as a given – a natural phenomenon not susceptible to reversal – to have openly called for a roll-back in living standards would have been political suicide; given the short electoral cycles, the obvious career move would have been to endeavour to keep the party going just a bit longer, hoping for the best – or at worst, that the inevitable unwind would occur on someone else's watch.

While in America, the widening of income inequalities back to levels associated with the Great Depression, with the attendant erosion of the middle classes, were addressed by promoting the use of leverage to finance consumption, in Europe, the State stepped in to support the incomes of its political clientele. Thus, while America created a real-estate and credit bubble of cosmic proportions, European banks leveraged themselves up 50-fold, financing "safe" government paper with cheap short-term borrowing. Meanwhile, Japan passed a never-ending series of supplemental budgets to support the economy, driving total borrowing to well over 200% of GDP.

The sovereign stimulus model is currently ending in tears – and, most threateningly, simultaneously in all three blocs. While China is exposed to a slowdown in Western imports, conservative fiscal policy, high savings rates and huge unmet domestic demand should allow a far less traumatic outcome than what we expect for the West.

Strikingly, as we travelled around China, our Bloomberg Anywhere carried incessant warnings of the impending China crisis, simultaneously warning about the dangers of Chinese overheating and of a Chinese slowdown – of restrictive monetary policy and of excessive stimulus – of the armies of angry unemployed peasants searching for work, and that China was running out of potential workers…some folk are just never happy!

What instead we encountered was rocketing growth and rapidly increasing prosperity, although with the attendant problems and dislocations. Meanwhile, both Europe and the US appear to be locked in a death spiral – with what needs to be done obvious to all, but with the political will to do so conspicuous for its absence. **As we go to press, S&P acknowledged the new global reality by downgrading 15 of the major Western financial institutions – from the Vampire Squid to BoA, while upgrading just two – the Agricultural and Construction Banks of China**.

Allocations and Misallocations

The real challenge in strategy is not in finding the data, nor even in its analysis; in the internet age, bucket-loads of data are readily available, while much econometric analysis is relatively straightforward; instead, the true challenge is to properly assess the functional relevance of the various phenomena. If one is looking at the wrong variables, one will of necessity predict the wrong outcomes; some problems may be both insoluble and ultimately irrelevant. This is particularly true in a country of the size and complexity of China.

Whilst the various financial imbalances threatening Chinese macroeconomic stability have been discussed in extenso *in the financial media, a considerable degree of scepticism is called for; many of those commenting on the impending crisis are short Chinese assets (and presumably hoping for an opportunity to cover their shorts) – while many of the others are infused with the ideological certainty (the mirror-image of much Marxist analysis) that since China does not cleave to the Washington Consensus it simply cannot work, and therefore does not work (and the data be damned!).*

None of the above is meant to suggest that there are not some very real problems in the Chinese financial sector. Using the only successful road map yet developed for the accelerated emergence from peasant agricultural economies to the post-industrial, i.e. the Asian developmental model applied first by Japan, then by the Asian Tigers (Singapore, Taiwan, Hong Kong), along with a mercantilist export policy, China has employed financial repression (non-convertible currency, restrictions on cross-border capital movements, directed banking, negative real rates) and directed capital allocation to favour industrialisation over current consumption. It is the very success of this model which has caused China to outgrow it – annual export growth in the middle-two digits cannot be long maintained before it exceeds the aggregate demand of the planet; rocketing GDP fuels increasing expectations for income growth which any government will ignore at its own peril. Although the proportion of GDP allocated to consumption has stagnated, this is due solely to the rapid increase in the denominator, i.e. GDP growth. Anyone travelling in China (including rural areas) will note that popular consumption is growing at an explosive pace.

Confirming some of the lurid stories in the press, T&B can confirm the existence of vast tracts of empty new skyscrapers (notably, in Hangzhou) and of equally empty motorways – yet we are told that five years ago some of the heavily congested highways we drove on in Shanghai were ghostly empty. The financial centre rising up across from Shanghai's Bund was initially thought to be a white elephant – five years later it now rivals London's Docklands or New York's midtown. Inevitably, some of the massive infrastructure investment will be misallocated, but what the doomsayers miss is the fact that the overwhelming majority of it has been effective, endowing China with an infrastructure which leaves its Western competitors – Europe and the US – looking distinctly African; anyone flying from Shanghai to Newark Intl. will feel that they have just changed centuries.

Of Elephants and Dragons

Rather than comparing the Chinese political system with those of the old democracies of Europe or North America, it is perhaps more instructive to compare it with India, also a developing country – hugely overpopulated and seeking to move out of agrarian poverty in the global mainstream.

Indian governance involves a European-style democratic system largely influenced by the British. This system is pluralistic, heavily populistic, and, at least in theory, seeks to uphold Western-style conceptions of human rights. There has been very substantial devolution of power at the regional level, meaning that recalcitrant local governments can block projects not to their own liking, frustrating the economic initiatives of the State. There is strong leftist influence in many of the regions (several of which are governed by the Communist Party) and both labour unions and the bureaucracy have inordinate political influence.

In the early 1960s, India had 420 million people – China 700 million. By the beginning of the 70s, the Chinese government, cognizant of the fact that if population were allowed to grow unchecked China would never be able to feed it nor to develop beyond third-world poverty, instituted a one-child policy, which was broadly criticised in the West. However "authoritarian" this might have seemed, it forestalled a demographic catastrophe of unimaginable proportions[3]; on the other hand, after a series of disjointed attempts at birth control, India essentially abandoned the struggle. As a result, while Chinese population nearly doubled since 1960 and is currently nearing a plateau, Indian population has nearly tripled, with no inflection of the exponential growth curve anywhere in sight.

Given the unsustainable demographics, hundreds of millions of Indians still live in sub-Sahara African poverty (i.e. on less than $2/day) – a phenomenon which ended in China a decade ago – many of these are the Untouchables, still born to a lifetime of humiliation and poverty for reason of caste, this despite reiterated promises to dismantle the caste system since Gandhi's day.

Indian growth has been extremely uneven – while some of the regions have been proactive and investor-friendly – stories of major investment plans becoming stuck in the sand after decades of fruitless negotiation are legion. Corruption is problematic in both countries, however while in China this tends to be concentrated in the regional administrations (if nothing else, the Chinese sanction for particularly egregious cases of corruption – "the 9 grammes" – eliminates any risk of recidivism) recent scandals in India show that it goes all the way to the top. The "license Raj" of India is largely a political phenomenon – the bureaucracy forms a major political constituency for the Congress party and is largely untouchable; many of the best initiatives of the central government expire in the application.

None of this is, of course, is meant to negate the reality of India's program of modernization and economic development; simply, we would argue that most India's great achievements have been attained despite the political system, not because of it. The comparison with China suggests that, whilst the Western liberal

3 When French President Valery Giscard d'Estaing criticized the one-child policy to Chou-En-Lai, the Chinese PM shot back – "if we did not do so, Mr. President, we would be shitting out a country the size of yours every year!"

political model has proved very successful in advanced industrial countries, it comes a poor second by comparison with the Asian model for the developing world. While the reader may argue that "authoritarian" models bear the risk of excessive personalization of power and of political stagnation, a quick look at the political paralysis in both Europe and the US suggests that the risks of deterioration of systems of governance are widely shared.

Environment – and other Luxury Products

Much ink has been spilled over the environmental depredations accompanying Chinese industrialization; these concerns are entirely justifiable. The architecture in Guangdong is quite spectacular… when one can actually see it through the smog. Air quality ranges from the merely bad (Shanghai) to the frankly atrocious (Beijing, Hong Kong). Water quality is worse – many of the Chinese rivers have been rendered unusable by chemical pollution, and environmental degradation is one of the main reasons cited by wealthy Chinese wishing to emigrate to Australia or Canada.

The point is that pollution is the price of rapid industrial development, and is common to all rapidly industrializing countries; vitally, (ex the global problems – rapid depletion of mineral resources and excessive CO2 production) these phenomena are temporary, not irreversible. The United States saw an analogous degree of environmental destruction in the 1950s; the Cuyahoga River, immortalized by the Randy Newman song, actually caught fire and burned for several days in the late 60s (*http://en.wikipedia.org/wiki/Cuyahoga_River*). Several decades later, the Cuyahoga, if still slightly toxic, is no longer flammable, while New York's Hudson River – once notorious for its deadly chemical slime – is now again home to schools of fish. The air of London, the city that once gave us the word "smog" is now almost pristine (at least compared to our beloved Moscow!) These improvements were not due to the "miracles of the free market", but, rather, to the creation of powerful federal bureaucracies tasked with protecting the environment (while these regulatory bodies are coming under fierce attack by the American far-right, if "democracy" has any meaning whatsoever, the middle-classes will manage to defend their demand for a non-toxic environment for their families).

While China is certainly not there yet, there is a powerful constituency of the new middle class who are demanding a better environment for their children. The Chinese press is replete with complaints about bad air, contaminated food, and toxic water (*http://english.caixin.cn/*) and at least the official discourse of the Communist Party now includes a very substantial commitment to environmental protection.

Between the desire and the realization, of course, falls the shadow. For economic reasons, China continues to burn its vast stocks of brown coal, with high sulphur levels and the worst CO2 output of any fossil fuel. Still, numerous steps are being taken to decrease environmental toxins – from shutting down the most polluting small-scale steel mills and mining operations, to fiscal measures aimed at encouraging the purchase of only the most fuel-efficient cars. Swarms of eerily silent electric motorcycles pose a hazard to life and limb in the Chinese cities, while armies of inspectors now comb the shelves for dangerous foodstuffs; hundreds have been jailed in Shanghai alone for producing bogus cooking oil.

The Internet is proving a powerful tool to focus popular attention on the environmental issues, with the Party taking up populist causes for political gain. While we would expect that economic growth will be the top priority for the next decade, as China still has some 150 million surplus agricultural workers to absorb into the modern economy, in a decade or two we would not be surprised to see it rival the "bicycle republics" of Northern Europe.

How to Trade it – The New Chinese Century

RM-Beware (…of what you ask for)

The anguished calls by Washington for a Chinese RMB revaluation may ultimately see some degree of satisfaction, but this will come at the price of an erosion in the global reserve status of the USD. The G7 debt crisis has greatly accelerated the rise of the Chinese Renminbi as a global currency for trade, a process we have long considered to be ineluctable. Although the bulk of RMB trade settlement still involves either Chinese domestic or China-HK flows, RMB settlement is being promoted across a broad swath of the emerging world – from Venezuela, Argentina and Brazil, to Belarus, Iran, Kazakhstan and of course Russia.

We would not be at all surprised to see increasing European use of the RMB as London CHN (offshore deliverable Chinese currency) trading gets underway. While the RMB is still not a significant component of global currency reserves, given the fundamental weaknesses of the USD, EUR, and Yen, it must be a very tempting option for sovereign wealth managers. We would note that the RMB bond market – the so-called dim sum bonds – has exploded to more than $100bn dollars market value over the past 18 months, and is set to become one of the largest emerging local currency markets.

Investment conclusions: Our main calls remain unchanged. We divide portfolios into trading and fundamental components – for the trading book, we have been short high-beta currencies, short European core debt, and cautious about most commodities ex-oil (which is being driven by its own dynamics, notably increasing Asian consumption, declining production from mature fields, and a spectacular increase in the cost of new production) but have taken off our European index shorts given the wild volatility; we currently shy away from short-term trading. For the longer time-horizon, we strongly reiterate our buy recommendation of Russian bank bonds, selected Ukrainian and Kazakh bonds, PdVSA, Argentina GDP warrants, Chinese RMB, and Russian high-dividend stocks (TNK-BP, BANEP). Given the uncertainty we would currently be hold zero Euro exposure and we remain chary of equities, both emerging and developed. Gold is probably a good long term inflation hedge, though our enthusiasm is contained, we would swap some dollar exposure forward into gold.

Beyond a two-year horizon, the great challenge will be investing in an inflationary/stagflationary environment. There is only one conceivable outcome of the global sovereign debt crisis – monetization. While the collapse in monetary velocity as banks horde capital buys time, when the current recession ultimately ends (the West is already in recession, and matters will get a lot worse as government expenditures are slashed) the monetary overhang will have a necessarily inflationary impact. For now, we are keeping our fixed income durations short – averaging about 30 months and not exceeding 5 years (alternately, investors can buy longer-dated assets, but should be ready to start shorting treasury as a hedge with the problem being one of timing; it is probably too early to start shorting what is fundamentally a wildly overpriced asset class, given market behaviour and reiterated “flights to quality” – but when the time comes, the treasury could tank quite violently and with little warning)

- Russian Markets – Emerging from the Emergings

Coverage of Russian financial markets during the 2008 crisis stressed the view that Russian financial assets were the ultimate high-beta asset-class, amplifying swings in global markets to a grotesque degree. How curious then that we are still awaiting the *FT* headlines pointing out the fact the Russian equity index has outperformed most of its European peers, and at least for a couple of hours last week, **Russian CDS actually traded inside that of France**.

In the fixed income space, while the market is correctly pricing the top Russian quasi-state banks – VTB and Sberbank – at a premium to their European and American peers, the top-tier Russian privately-held banks (RUSB, Promsvyaz, Alfa, etc.), which benefit from the same CBR implicit guarantee as do their top-line competitors, are once again offering yields only slightly below 10% - wildly generous given their negligible risk. For a slightly higher-risk play, we continue to like the Rencap 13s. As in 2008, we would strongly recommend readers fill their boots before everything gets expensive again; while there is a real risk of near-term mark-to-market pain the next time the crisis in the West suffers an exacerbation, we are more than comfortable with the ultimate credit risk.

As regards the equity markets, we are very cautious given the cross-correlation between all global markets – we would focus on cash flows, i.e. those few Russian assets yielding the highest dividend flows, especially the oil preferred shares.

- Fixed Income

While until about a year ago, T&B split our recommendations between a preponderance of Emerging corporate assets and European bank subordinated debt, we closed out our last position in non-EMEA debt almost 12 months ago, and are now entirely focused on the Emergings. Our top performing trade this year has been our "Axis of Evil Basket" – i.e. a mixture of Venezuelan (PdVSA), Cuban serviced (Staban), Belarusia[4] and Argentine bonds (Provincia BA, GDP warrants); we are not sure whether we can also allocate Russia/Ukraine/Kazakh to this portfolio – it depends upon the mood in Washington! Alas, we have failed to identify any investible Iranian assets. Besides a desire to be provocative, there is a certain logic to this trade: the market will generally apply a substantial discount to the assets of countries not viewed favourably by the dominant powers, leading to a mispricing of risk, and allowing us to acquire cheap cash flows.

Russian bank debt (including the Subs) continues to provide compelling yields, while Ukrainian and Kazakh assets provide higher yields, though with a meaningful increase in risk. While prices on the Ukrainian Privatbank and Metinvest have come off significantly, this is due to market dislocations as the market-markers withdraw from making markets – not to any deterioration in the underlying credits. On the other hand, the Kazakh banking sector remains stressed – while the fundamentals of both KKB and Centrecredit remain at least decent, we have concerns regarding Unicredito's ATF bank, given that the parent bank has been downgraded due to concerns with its domestic Italian market.

Our other top pick – PdVSA, continues to perform strongly, providing an absolutely compelling cash flow (occasionally cresting above 17% p.a.) with moderate volatility. While we would not expect strong price appreciation given the problem of new supply, we continue to hold large overweights in PdVSA, in particular the 2017s, as a carry trade.

The Argentina GDP warrants are, as expected, providing a 40% cash-on-cash yield this year, and have more than doubled since we first recommended them; cashflows next year will be similar, while we would guess that they will fall away in 2013/2014, before again recovering with the always-cyclical Argentine economy. At current prices, after payment of the 2011 coupon they should be held – if at all – as a long-term value play.

In our last issue, we capitulated on our Greek bond call - although expressing the forlorn hope that it might yet be saved. Thus far, prices have continued to slide, though hope dies last (see below).

- Currencies

During periods of extreme market turbulence, fundamentals become largely irrelevant as market microstructure becomes the dominant force. Traders are hard-wired to buy dollars in time of stress, so, like the treasury market, the short-term fluctuations in the USD Index will primarily serve as a gauge of risk-aversion[5]. This should not be confused with a purported "flight to quality"; NO ONE lends money to the US treasury for ten years at yields of 1.85%, expecting to hold their position to maturity. Instead, it is the greater fool theory of finance writ large – during times of stress, it works. Investors would be well advised to retain dollar exposure, however ready to buy the worst hit of the commodity currencies (AUD, NZD, RUB, BRL, and IDR – as well as SGD and KRW) whenever the crisis starts to abate and the market starts to refocus on the unsustainable US debt dynamics and dysfunctional political system. Currently, of course, obsessive attention is being focused on Europe, and all other problems are sleeping fitfully, awaiting their turn in the spotlight.

The one major currency positioning we would currently recommend is to swap dollar exposure into Chinese Renminbi, especially as this has now become highly efficient given the collapse in the erstwhile premium in the NDF (non-deliverable forwards) market. While it used to cost about 4% per annum to buy RMB forward, there are now times when the forward

[4] *the Belorusian bonds have fallen in price, in part due to the global risk-off trade, however total yield (i.e. including coupon) is positive.*

[5] *Those doubting this assertion should reflect upon the fact that the dollar falls on good US data, rises on bad data – while the T-bond surges on downgrades… This, of course, has nothing to do with perceived intrinsic value, and everything to do with market behaviour during times of stress.*

trades flat to the spot (for those in need of a bit more excitement, the deliverable, onshore HK market provides considerably more volatility – with the CHN actually trading at a discount to spot at periods of extreme market turbulence).

The European Train Wreck: A Greece-d Pole

Every so often T&B makes a spectacularly bad call; this year it was Greece. From a trading standpoint we were simply wrong – in terms of our fundamental analysis, perhaps both right and wrong. Learning from one's error involves backward-looking analysis of the logical process which led up to an erroneous call, with a willingness to shift one's working assumptions as a result of experience.

T&B has been forced to capitulate before the truly spectacular incompetence of the European political leadership. As the former Mexican finance minister put it (paraphrased):" You have transformed an expensive but eminently resolvable economic problem (Greece) into a totally insoluble political crisis."

Our unfortunate call on Greece involved two fundamental assumptions and a corollary: the first was that any failure of Greece to repay its admittedly unsustainable debt load would have catastrophic consequences on European and Global financial markets, leading to a generalized attack on first the peripheral countries, but ultimately, also on the Eurozone core, with knock-on effects around the globe. Our second assumption was that the European leadership could see the likely consequences of investor loss of confidence at least as well as could T&B, with the corollary that they would undertake any and all measures necessary – however unpopular or "morally dubious" – to forestall what could develop into a financial catastrophe of a magnitude visible from outer space.

Anyone with access to a trading screen will allow that we were proved right on the first point, i.e. the wheels are now coming off the European cart. As regards the second, we shall continue to assume that at least some of the European leadership has basic financial literacy, and thus could see it coming too, at least in its broader outlines. That leaves only the corollary: that all necessary steps would be taken before matters got out of hand – and here, alas, recent events have proved us totally wrong.

Rather than going into the arcana of European financial sustainability – an issue about which the reader has probably heard rather more than he wished to of late, we shall focus on what we see as one of the (very much neglected) fundamental drivers: Europe (and, more broadly, the G7) is faced with the disastrous internal contradiction of the Democratic Model; strikingly, those countries which, at least until present, have fared the best are the more "authoritarian" of the BRICs – notably China and Russia.

Against human folly, the Gods themselves struggle in vain. At the present time, the EU is on a highway to hell, in no small part due to Merkel's refusal to acknowledge the dictates of reality and accept the need for both monetization and joint-and-several liability. The alternative is chaos and collapse, with unfathomable socio-political consequences – for a politician to refuse to "bow down before the dictates of the markets" is akin to a farmer refusing to submit to the weather – deeply principled, with even a certain tragic grandeur, but nonetheless ultimately catastrophic.

Since it would appear that there is no longer the physical time to organize a mutualisation of European sovereign debt, the only conceivable solution would be monetization by the ECB – the same solution adopted by the US Fed. Had Germany capitulated and accepted the obvious need for a deeply unpopular Greek bail out six month ago, their obsessive concern with monetary orthodoxy and a strong Euro could both have been preserved. Instead, they shall have the worst of both worlds, i.e. both monetization and some form of transfer union in exchange for hard, supranational fiscal constraints – i.e. opting for the bad option, rather than for the catastrophic one.

Parting Shots – The Decline of the West (redox)

As we go to press, we are faced with meaningful uncertainties as regards the viability of the global financial system, the near-term survival of the Euro currency block, and ultimately, the value of the sovereign debt of the three main pillars of the old economy: US, Europe and Japan, all of whom are facing well-justified rating downgrades. While T&B has long warned of the unsustainability of the sovereign debt finance model (admittedly, giving more attention to Japan/US than to Europe, in that the blended debt metrics for Europe are far better than for the other two) financial markets have again demonstrated their ability to blissfully ignore growing imbalances until – suddenly and without warning – taking fright like flock of pigeons, becoming obsessed with what, until yesterday, they had glibly discounted.

Analysing the root causes of the crisis, we find that "democratic" values and the time horizon implicit in the electoral system are one prime culprit. As discussed above, neither the European nor the American political systems proved remotely prepared to accommodate the secular rise of China and the other Emergings via a compensatory decrease in their own cost structures, i.e. a relative decline of living standards, while engineering a fair allocation of the necessary sacrifices so as to preserve a sense of equity and national unity. The US persisted in supporting obviously-unsustainable consumption while covering up income inequalities rising towards levels associated with third-world economies (the US Gini index is several points higher than China's) via debt-financed consumption and a real estate bubble of epic proportions. On the other hand, the European states became themselves the principal finance vehicles supporting middle-class consumption; sovereign indebtedness was funded by banks leveraging up their holdings of European debt to grotesque multiples.[6]

The global unwind began with the American subprime crisis of 2008. Heretofore unimaginable amounts of Central Bank monetization and fiscal stimulus (recent revelations in the US show that the secret monetary stimulus dwarfed the already gargantuan fiscal boost – running into the low **trillions**), while in Europe, fiscal policy was largely left to take the burden as countries smashed through the fragile walls of the Maastricht criteria to run massive budget deficits.

The second phase of the crisis began when investors suddenly took fright at the magnitude of these deficits, and justifiably frightened by the grotesquely uncoordinated and self-contradictory response of whoever was seen to actually manage the European economy on a given week, withdrew their willingness to roll over sovereign debt. Meanwhile, Japan has been stuck on a highway to hell for as long as most market participants can remember; at well over 200% of GDP, it is only a question of time before the Japanese debt montage collapses too. Finally, as regards the US, any residual doubt about whether they would choose to monetize and inflate away the debt mountain was removed when the Fed began to officially consider the possibility of "twin-targeting," i.e. both price-stability and GDP-growth (this would likely resemble the legendary *horse-and-rabbit stew*, i.e. one horse, one rabbit).

What all of these countries have in common is the fact that they are old, comfortable, and accustomed to the better things in life; the notion of necessary sacrifice seems quaintly old-fashioned. In America rising levels of inequality have created a growing sense of outrage as the middle-class no longer can assume that their children will live better than themselves; in Europe, the idea of *toujours plus* – that the state will provide ever-increasing benefits – means that for any politician to promise a long period of painful austerity would be political suicide; given the electoral cycle, far better to kick the time-bomb down the road, hoping that it will explode on someone else's watch…(and explode it has!)

We might venture that the current crisis will be resolved when the ECB finally capitulates before the imperative of monetizing the debt. If properly conducted, this will provide another period of calm, itself eventuating in the third phase – the inflationary one – where investors lose confidence not in the debt securities, but rather, in the underlying currencies, at which time the desire to find alternative stores of value shall become rather pressing.

In both cases, it is clear that the ultimate outcome will be, at best, higher inflation, at worst hyperinflation or stagflation. Keep your durations short (and perhaps, start learning Mandarin…)

[6] *note that several European countries – notably Ireland and Spain – opted more for the American model, blowing huge real-estate bubbles, but these were the exceptions*

*Readers are **welcome to forward T&B** to any and all parties who might be interested. We write to be read!*

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