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STRATEGY

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Notes from China (*plus Two Handfuls of Dust*)

Uncertainty's Rainbow

T&B rides again!

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

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

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

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

The Eurocrisis has been analysed to death, and the outcome is simply not knowable – ask 15 experts and one will get at least as many opinions – we shall thus confine ourselves to a few general observations. It has become obvious to even the most obtuse Eurocrat that there is a choice between fiscal unification and an economic disruption of unimaginable magnitude. Alas, this does not signify that rational choices will come out of a dysfunctional political system. Whilst T&B ordinarily has a bias that, when matters becomes sufficiently dire, the political "leadership" will *in extremis* take the necessary steps to pull back from the brink, as regards Greece we were proved wrong; at present, an obdurate German hausfrau threatens to pitch the West into a vortex in many ways reminiscent of 1929, accelerating the fundamental theme of our century – the Decline of the West, and the Secular Rise of China. A rich source of misconception, misinformation, and bias – in actual fact, China provides virtually the sole reason for optimism in an increasingly parlous global context. We discuss our second journey to the Celestial Empire below.

But First – Meet our Sponsor: El Aleph, Cruising Yacht

T&B shall apparently remain an orphan. While several local financial institutions (the guilty will recognize themselves…) have pawed at the beast, mediocrity and political correctness apparently reign supreme in the brokerage business. While there are still some first-rate strategists out there (our friends at VTB, DB and Renaissance spring to mind), certain other institutions appear to favour safe, polite mediocrities over those who might occasionally offend a client's finer sensitivities or contradict their cherished political biases, apparently believing their clients better served by bland, pseudo-quantitative and rigorously consensual pap, consistently failing to spot the major inflection points or to dispute the egregious disinformation found in the Western media (much less to refer to wayward oligarchs as "bandits" or corrupt journalists as "prostitutes"). As a result, as a publication totally independent of our asset-management business, T&B enjoys an enviable degree of freedom – though no cash flows. The present newsletter shall thus remain a labour of love.

T&B has one faithful sponsor: a magnificent 40m teak and ironwood cruising schooner – El Aleph. Built from the ground up in South Surabaya and Bali from 2007 to 2009 by T&B's Eric Kraus – along with a largish (>100) team of highly-skilled Indonesian boat-builders, carpenters, cabinet-makers, engineers, seamstresses, sail-makers, naval electronics specialists, etc. – it was some 200,000 man-hours in the building, and is now available for charter to the fortunate few (when the Chief Strategist is not himself on board…). El Aleph comes complete with all the toys, as well as a 14-man crew, a Swedish cruise-director, two dive-masters, and, for the masochists among you, a satellite broadband system to power your Bloombergs and Blackberries.

Several of the prominent players in the Moscow finance community, both expat and Russian – including at least one hedge-fund manager and family, several well-respected bankers, the odd minigarch and a merry band of equity traders – have enjoyed wonderful times out sailing and diving in the Komodo national marine reserve, or for the most adventurous, exotic Raja Ampat, the magnificent constellation of islands off the Western tip of Papua – one of the most beautiful cruising grounds on Earth (and with the best diving in Asia).

While from the outside El Aleph is all tropical hardwoods and traditional construction – with nary an inch of fibreglass or plastic in sight – the interiors are as polished and comfortable as any mega-yacht on the ocean, with state-of-the art navigation and uncompromising safety; the guest experience is enhanced by great Asian food, remarkable stability (she's built for comfort, not for speed) as well as our cruise-director's decade-long experience of the Asian seas.

We can provide all manner of add-ons – from Balinese masseuses and nannies to erudite English ornithologists; while El Aleph is very family-friendly (and our Buginese crew loves children) those whom, like T&B, are not blessed with progeny will find no shortage of entertainment: world-class diving, magnificent snorkelling, fishing, water-skiing, kayaking, swimming with Great Mantas, exploring the mangrove forests, hiking up volcanoes, tracking the fierce Komodo dragons (Google it…), or just sipping a Margarita while soaking up the sunshine on our ample decks.

We would invite any of our readers who've recently been gratified with a generous, well-deserved bonus – and who are now looking for some rest and relaxation in the absolute lap of luxury – to enquire further. Groups of friends wishing to share an adventure will find that it works out not really any more expensive than a stay at a top-notch resort – but infinitely more exotic and enjoyable.

But don't take our word for it – start with our website: *www.elaleph.ru*

Then, if interested, drop a line to Eric Kraus at *eric@eastmonsoon.com*

And now, back to dry land…

The Eternal Russia – The Apotheosis of Vladimir Vladimirovich

To paraphrase Lev Tolstoy, every happy country is the same – each unhappy country is unhappy in its own way, and Russia is increasingly at least a moderately happy country. Despite the mendacious idiocy retailed in the Western press, Russian power politics remains almost boringly predictable. The new governmental line-up suggests general continuity, but with some surprisingly positive features.

Apparently convinced that Russia deserved not just one but two governments, President Putin has decided to split power between a traditional cabinet headed by Medvedev, with Dvorkovich playing a key role – as well as an inner cabinet around Putin himself, which will have an executive function, overseeing and controlling the work of Medvedev's team. The current assumption is that Medvedev has 12 months to demonstrate some concrete accomplishments, or shall find himself back in academia.

Putin's next goal will be to increase government revenues by decreasing the asset stripping and official corruption, which impoverishes the Russian State. Those tempted to scoff at this affirmation should reflect upon the huge changes he wrought early on in his first presidential term.

We are not asserting that the task will be easy, nor that success is certain, but preliminary indications are very encouraging. Given that Medvedev was never going to have Igor Sechin in his government, and Putin needs Sechin to continue the process of cleaning up the boards of state companies, a new government holding company – Rosneftegaz, the main assets of which are 75% of Rosneft and 11% of Gazprom, as well as assorted other state assets – was established specifically to allow Sechin to restructure state industrial holdings without interference by Medvedev's cabinet. Indeed, the new structure was created outside of ordinary procedures, during the handover period; Medvedev's team is said to have learned of it ex-post-facto.

Interestingly, while Rosneftegaz is expected also to invest in the utilities sector, its investment capital is to come solely from dividend payments by state companies – which we can safely assume will be further be prioritized. While we have no privileged information (*and would certainly not be writing about it if we did*…), we would be surprised were the recent newsflow surrounding TNK-BP to be entirely unrelated to this new policy.

While we expect the usual irrelevant anti-*siloviki* invective from the Kommentariat, we are quite encouraged by this development. Sechin has a background very similar to Putin's – he is a power guy, not out to line his own pockets, and one of the few men who can strike fear into the hearts of even the most corrupt *chinovniki* – like his boss, he is not someone to be toyed with. Putin needs Sechin to carry on with the job he began last autumn – cleaning up the boards of state companies.

In a situation somewhat analogous to that encountered by Mr. Putin at the beginning of his first term – when in order to fund even the minimal function of the Russian state, he was faced with the imperative of compelling the oligarchs to start paying their taxes – twelve years later popular expectations are far higher, and a way must be found to fund social expenditures without running American/ European-style deficits. For better or for worse, Russia is moving in the direction of the European-model welfare state, while the days when fiscal orthodoxy despite ultra-low taxation was rendered possible by policemen and teachers earning $100 per month are gone. Given the difficulty of increasing taxation (at least, until there has been a drastic improvement in the perceived quality of government services) in order to fund an increase in social expenditures[1] and military modernization (history has not – alas – ended), Putin needs to find a stable revenue source – with the state-owned companies the obvious choice.

We would note that the state companies have already been compelled to increase their dividend payouts, directors with the most egregious conflicts of interest have been squeezed out, and it is expected that, in collaboration with Shuvalov (the point man between the Government and the Kremlin), several company boards will likely be substantially revamped to decrease the diversion of revenues.

On the other hand, as regards privatization, we do not expect any acceleration; quite the opposite, Putin himself has stated that he sees no reason to sell valuable assets at knock-down prices (remember loans-for-shares?) and the main goal is to restructure and recapitalize the existing assets with prospect of medium-term privatization. A number of the main assets, including Rosneftegaz and the e-sector, have been designated as "strategic", i.e. cannot be sold without Putin's assent.

Despite some typically misguided warnings in the Western press regarding a future inflexion of the conservative fiscal stance, Putin is fiercely defensive of Russian sovereignty and will never risk a repeat of the humiliations of the 1998 defaults. Indeed, there is something quite funny about hearing the media of essentially bankrupt countries warn about the fiscal probity of a net-surplus nation. The new draft budget includes some spending cuts, and there is much to be gained from enhanced efficiency. Sustainability will remain the watchword.

Mr. Normal

In summary, the gradual restructuring of Russia continues – the politics are stable, predictable, indeed just a trifle boring. Progress has been and will remain stepwise – at times excruciatingly slow, but it has been reasonably successful over the past decade, and we see no prospect of either a sudden acceleration, nor of a retreat. Despite the mendacious pack of lies recently published by Bremmer[2] and Roubini in the FT, Russian economic growth is easily on a par with that of India and Brazil; the demographic collapse has halted, and Russian foreign policy has had an unaccustomed series of successes – *vide infra*.

Those wishing to understand Putin's real intentions would do well to listen to precisely what he says. T&B has heard him repeatedly intone "*postepenno*" i.e. stepwise – bit-by-bit – and that periods of sudden acceleration in Russia reliably lead to catastrophic outcomes. For those of us who remember the sheer wildness of the first phase of Russia's post-Soviet transformation, the current normality is a bit off-putting. Perhaps there is more in common between Francois Hollande and Vladimir Putin than first meets the eye…

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1 *Admittedly, motivated in part by the need to defuse the popular pressures manifest in the autumn political demonstrations and to purchase continued social stability*

2 *To hear Bremmer, a willing collaborator in Bush's criminal invasion of Iraq, in contravention to all principals of international law, speak about upholding international law is truly Orwellian…*

Through Western Eyes – Return of the Native

As T&B has repeated ad nauseum, the Facebook Revolution was an epiphenomenon led by a tiny fraction of bored, Internet-savvy middle-class youths with an almost comically misguided notion of what life is really like in the West. Their claims to represent the leading edge of an Orange-style revolution were always laughable. Putin's landslide victory in the last elections (where he outpolled the nearest contender by a factor of four), followed by the most recent "million-man march" (which missed its target by only a couple of zeros…) should have, logically, put an end to the discussion and the hysterical headlines – though, of course, did not. A large proportion of the Western journalists had happily swallowed the dissident line – indeed, not just the line but also the hook, and the sinker – and were predictably made fools of, left to explain away their wildly inaccurate warnings of riot, civil unrest and regime-change with increasingly wild and bitter invective (T&B won a couple of largish bets with otherwise sane Western investors who actually expected new Duma elections and an "Orange" scenario).

The recent slyly dishonest disinformation by Bloomberg's H. Meyer (quoting the wild and woolly speculations of an otherwise unknown think-tank predicting doom and gloom for Russia as if they were an authoritative forecast rather than some marginal rant), or Miriam Elder's moronic ramblings in the Guardian – a heart-rending story of how, having lost her laundry tickets, she held the Soviet system responsible for her struggle to recover her wash (*no, we are not making any of this up*…) constitute a furuncle on the face of their profession. We wish we had a dollar for every paper that begins with a litany of purported Russian ills before noting the recent weakness of the RTS or the Rouble – without bothering to mention the fact that entire global market has been suffering very much the same mindless volatility….

In fairness, there are a few journalists who still struggle to present a critical but balanced picture, making at least some effort to separate reporting from editorial commentary (a distinction the FT's Charles Clover apparently never learned). In the best of cases they have some insight into the Russian historical and political context: the likes of Fred Weir, on occasion the WSJ team, and a handful of the better BBC and Reuters journalists spring to mind.

Alas, the overall picture presented to Western audiences is at best misleading, at worst frankly dishonest. One need only compare the overtly hostile coverage during the Putin years with the fawning treatment of the deeply pro-Western but disastrously incompetent Yeltsin governments to realize that the mainstream press continues in its proud tradition of pandering to power – from the Opium Wars, to the Spanish-American, Vietnam, Iraq and South Ossetia, nothing fundamental has changed. With Russia now taking an increasingly assertive political line, one can expect ever-more pejorative coverage in the tame Western press.

Back to the Future

The Russian presidential elections came off very much as expected – Putin won by a landslide[3], with the anti-government demonstrations fading faster than even T&B would have expected.

Foreign policy will be firmly in VVP's hands – Russia has been uncharacteristically successful of late in her near-abroad, and is now serving notice that those powers failing to treat her with adequate respect should not expect Russian cooperation.

By snubbing the US' invitation to the G8 meeting (probably sparing Obama some unwanted photo opportunities) Putin expressed his frustration at hearing the Americans reiterate their inflexible stance on missile defence (purportedly not aimed at Russia, but to be built along Russia's borders, and with no willingness to share command; one wonders how the US would react to Russia's building a similar system in Mexico…).

President Putin is sending an unambiguous message that relations between the powers

[3] *As an amusing footnote, the European Commission representative complained that the election was flawed because of the complete lack of uncertainty about its outcome – according to him, the entire point of holding elections is for there to be some uncertainty… (Actually, that is not the point of having elections, but then who really bothers with these pygmies?)*

would be based upon pragmatic and tough-minded negotiations, and that Russia's acquiescence should no longer be taken for granted. Indeed, the G8 is no longer at the centre of Russian preoccupations, given that Putin sees Russia's place instead among the rising powers of the G20.

After some frustration at the slow pace of Russia's opening towards China during the last decade, T&B is deeply gratified to see this relationship now moving towards the centre of Russian diplomacy. China has become Russia's top trading partner (>$70bn and rising by ~15% per annum), as well as Putin's top priority, with increasing diplomatic, military and economic cooperation. Putin's recent high-profile trip to Beijing served to underline the great importance that both great powers now attach to their relationship – based not on any historic love, but rather, on a firmer basis of mutual interest and economic complementarity.

Very amusingly, T&B still has an e-mail sent ten years ago by Mr. McFaul, then a Stanford professor, that *"Russia was so afraid of China that they would be compelled to seek a military alliance with America under whatever terms the US chose to impose".* Failure has obviously gone to his head, and he has moved on to great things – as a singularly incompetent and provocative ambassador, he is now contributing to the growing rift between Moscow and Washington. Beijing should be grateful….

RTTV – The End of the Global Information Monopoly

T&B, once ubiquitous in the press, is now largely ostracized by media not wishing to risk confusing their readers by publishing views at odds with the party line. On the other hand, we are delighted by the rise of Russia Today (RTTV), now the second most widely watched foreign TV station in the United States (after the BBC, but well ahead of Al Jazeera) and especially, increasingly popular in more than one hundred countries around the world – having been on Peter Lavelle's Crosstalk in the run-up to the Russian elections, we were amazed to receive e-mails from friends who had chanced upon the show in countries as diverse as China, Brazil, Italy, Venezuela and Indonesia.

By giving a platform to Wikileaks founder, Julian Assange, RTTV has helped to do what Al Jazeera only claimed to wish – to redefine the global news agenda. Certainly, RTTV has no monopoly on the Truth – that is just the point – no one does (not even Truth and Beauty) but it is very positive that new media are increasingly available to provide the alternative view.

Notes from China – Part II

Begun on a second-class train carriage (the only form of transport available), lurching through the mountain passes of Hunan, from Zhaingjiajie to Hunan, ended on the steps leading up to Mao Zedong's former study, in the gardens of the very luxurious Lixu State Guest House on the banks of the sublimely beautiful West Lake, Hangzhou, China.

T&B has taken a second foray into the future – The People's Republic of China. The present paper is intended as a follow-on to Of Blind Men and Elephants (http://www.truthandbeauty.ru/global-macro/of-blind-men-elephants-notes-from-china), our first report.

After an initial junket in late 2011, confined to the major cities, during which we met mostly with bankers, academics, brokers and miscellaneous financial riff-raff, on this second trip we were accompanied by a Chinese friend, a post-doctoral student who was able to facilitate our communication with the locals without the imperative of our learning Chinese.[4] We have travelled to remote agricultural villages (from whence the famous migrant workers hail), "small" provincial cities (of several million inhabitants…), and a few of the spectacularly beautiful domestic tourist destinations, enjoying long discussions over endless cups of tea with students and intellectuals, and getting a slightly better feel for this amazing country.

Our conclusions very much confirm our previous observations, but with a bit more insight into how the Chinese see themselves, their country, and the world at large after several decades of unprecedented transformation. As in Russia, we note the systematic misrepresentation – almost a virtual reality – created by the Western press and

[4] *While T&B has begun the study of Mandarin – this is a uniquely long-term undertaking; if anyone thinks Russian difficult – they should try Chinese!*

Kommentariat, at a total variance from what one actually encounters on the ground. Since China is increasingly THE world's key economy, this is of vital interest to every investor, no matter what asset class he trades.

Bubble – WHAT bubble?

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

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

T&B believes we have discovered the secret to Chinese social stability: it is not, in fact, the rapid increase in wealth – that is only a derivative; it is, instead, the fact that the maniacal energy of the Chinese currently finds an outlet in the headlong pursuit of wealth. When Deng broke the taboo by stating, "it is also glorious to become rich", he was preaching to the choir. For as long as the opportunity to do so is available, there will be little energy left over for political agitation.

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

As the developed world teeters on the brink of outright recession, posing a challenge to some of the smaller emergings, global growth is becoming more, not less, dependent upon a single country – China. We find that there is considerable downside protection; as our friend John Anderson[5] puts it, *the bulls think China will grow at 8.5% – the bears, that it will be only 3%; both numbers would be the envy of most other countries…*

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

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

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

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

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

In 2008, unexpectedly confronted with a major economic slowdown with serious domestic consequences – notably the loss of some 20 million jobs, China engaged in the same sort of stimulus seen in the West. Fortunately, there were a couple of key differences:

-Chinese stimulus involved the spending of money saved during the good times – China and Russia being the only two truly "Keynesian" major economies, i.e. running truly contra-cyclical fiscal and monetary policies during the good times, and thus, in a position to employ retained savings – not debt – to stimulate their economies during a crisis. To speak of the "*parlous debt dynamics"* of a country holding $3 trillion in reserves should invite ridicule.

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

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

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

Through Western Eyes

For one accustomed to the nonsense regarding Russia retailed in the press, shifting one's attention to China can be instructive. Unlike in the 1990s when during a period of rapid transformation and enthusiastically pro-Western (mis-) governance, Moscow attracted the star journalists, it is now some of the most mediocre – the likes of Clover or Elder – who remain on the Moscow beat. As a general rule, mediocrities desperately crave someone to heap scorn upon, in order to build up their own (justifiably) low self-esteems; Russia is thus the recipient of much nastiness from inferior beings. China, on the other hand, poses a somewhat greater challenge – as it challenges some of our fundamental assumptions about ourselves and our societies, and unlike Russia, poses a very real threat to Western global dominance.

Few dominant cultures accept their own decline gladly – no doubt 19th-Century Chinese confronted with "Western barbarians", who, in fact, were possessed of far better weaponry, technology and military organization than was the degenerate Qing Empire, proved equally reticent to accept the reality of their own backwardness and decline, at least until that realization was forced upon them by events.

Cognitive Dissonance

Coverage of China in the financial press and analytical community displays a surprising tolerance for cognitive dissonance.

T&B encounters daily warnings of the non-sustainability of Chinese growth given that: a) China must continue to produce 10% annual GDP growth in order to absorb the massive influx of migrant workers into her cities, while at the same time b) the Chinese economic miracle is imperilled by the end of the "demographic dividend", i.e. by growing labour shortages.

Similarly, various authors impeach the quality of Chinese GDP statistics, which they claim massively overstate growth, while simultaneously warning that galloping Chinese GDP growth is creating unsustainable imbalances. Equally, we are warned that the fruits of growth are very unevenly distributed, with a large proportion of the Chinese population still living in substandard housing, but the building boom with tens of millions of dwellings going up in every Chinese city, town and village constitutes a dangerous misallocation of resources – "a bubble."

Chinese social stability is purportedly under threat from growing inequalities and poverty, while businesses are being handicapped by the explosive growth in real wages. *Apparently, one* ***can*** *have it both ways…*

In fact, the Chinese labour supply is indeed peaking; there is no need to create tens of millions of new jobs as there would be no one to fill them – there are simply no more able-bodied rural workers under the age of 35 willing to take factory jobs, and factory owners are making extraordinary efforts to retain and attract staff. Wages are indeed increasing at a formidable pace – the electronic giant Foxconn just announced a doubling of salaries – to a minimum 4400 RMB per month, about $700 at current exchange rates, but in PPP terms, and given differences in taxation and deductions, equivalent to between $1500 and $2000 in the West, an unimaginable sum for people who grew up as subsistence farmers.

In China, the New is Very New…the Old is much Newer!

Ex- the Great Wall and the (magnificent) Ming Tombs, at least outside of Shanghai, there appears to be precious little architectural heritage left in China. We assume that, until 30 years ago, not all Chinese lived in thatched huts – where did their dwelling go? Indeed, where did they live in 1900? Most likely, it was some combination of the sort of Marxist modernist urban planning which so blighted Russia, and the mad dash to rebuild China since the beginning of the post-Mao reforms, with every Chinese city aiming to become an identical clone of Buck Roger's City of the Future. *The traditional quarters of Beijing and Shanghai have long since given way to the tyranny of steel and glass.*

This has left a gaping hole – the need for places of historical interest to serve one of the great boom industries in China – domestic tourism, as the burgeoning middle-class sets out to discover its vast country.

Leave it to Chinese ingenuity – everywhere one now finds "ancient streets", indeed ancient quarters and occasionally small cities, springing up ex-nihilo, with classical Chinese architecture (built of concrete), Taoist temples, and endless store-fronts selling engraved chopsticks, tea, souvenir handicrafts (made in China, of course) and fast food (Chinese – dim sum, sticky rice, skewers of everything from chicken feet to pork balls and, yes, the occasional skewer of scorpions – but mercifully no McDonalds). For a taste of the genuine article, wander back into the lanes behind the Materials Market in Shanghai – but don't wait too long, the sky-scrappers grow like mushrooms.

A New China

What is most striking is what a "normal", middle class country China is becoming, more akin to Singapore or Los Angeles than Bangkok or Jakarta. The streets and restaurants are crowded with shoppers and dinners, the trains and airports bustling and busy, the traffic in the major cities gruelling (but with excellent metro systems and infrastructure). Flight delays make a havoc of planning – the trains are a better option – but the hotels are good, and everything works.

One could easily forget that this was one of the world's poorest countries within living memory. Not just in the wake of Mao's disastrous social experiments, but historically, over the last 150 years, China was poorer than India, poorer than Indonesia and Philippines, poorer indeed than almost anyplace outside of Sub-Saharan Africa.

French children were once admonished to finish their spinach in respect for the poor starving children in China. Grown up, they are now flocking here to open up restaurants and coffee-shops serving the Chinese residents of Shanghai and Canton, as they seek to escape the dismal lack of economic opportunities at home.

Friends abroad write us with lurid tales of ghost cities and empty highways; in a country with four times the population of the United States, there may indeed be such places – there may be many things, but the cities and highways which we saw suffered from no lack of inhabitants – quite the opposite, in China one is overwhelmed by the sheer mass of humanity. With >10% annual growth, bridges to nowhere rapidly became bridges to somewhere. New cities were built and have prospered; we saw bustling cities of over a million inhabitants which fifteen years ago were rural villages.

The pace of construction in China is indeed mind-boggling – the construction crane is apparently the national bird: more are to be seen in North-Western China alone than in the entire land-mass extending from the Urals to Ireland. One needs to experience it at first hand: driving down a brand new motorway towards Guangzhou, for 10 kilometres, as far as the eye can see on either side (albeit, given the pollution, not always very far) massive new housing complexes – some more than 40 stories high – were springing up like an endless array of terra-cotta warriors; it gives an entirely new meaning to the term "development".

When T&B noted to our Chinese friends that, ex- the Great Wall and the Ming tombs, no man-made structure in China outside of Shanghai appeared to be more than 30 years old, one of them corrected us – his parents' house in a small fishing village was nearly forty years old. When pressed on this point, he acknowledged that they were still living there while finishing up on a new, three-story dwelling, which they were building with his help.

China is one great construction site. Not just the cities – what struck us most of all was the activity in the countryside; in the mountainous rice villages of Hunan province (from whence many of the migrant workers hail) we saw new houses everywhere. When the paved road ended at a market town, we headed up the river on a rickety flat-boat, walked for 90 minutes following a peasant woman who had crossed on the same barge as us on her way back to her village where she was overseeing the construction of her new two-storey concrete dwelling – complete with plenty of chrome, exterior tiles, and great plate glass windows. When my Chinese friend – at least as perplexed as was I – queried her on how she could possibly afford the RMB 200,000 (~$30,000) that it cost, she explained that she had two children – a daughter who worked in a travel agency, and a son who was a factory mechanic; they brought home money at each Spring Festival, the government also provided a subsidy, and she was getting a good price for her rice crop (which she farmed using oxen, much as her ancestors had for 2,000 years…).

The houses in Hunan province would not inspire envy in Palo Alto or Moscow's Zhukovka, but then, they belong to people who a decade ago still often had not enough to eat, and the older of whom remember periods of outright starvation.

The wave of construction continues all the way to Beijing – anyone who has contended with the third-world misery of Heathrow airport, British rail, driven a Russian highway, or been crushed beneath a falling bridge in Detroit will be amazed by Chinese infrastructure. Even "small cities" (of several million people, i.e. larger than Lyons or Frankfurt) have shiny new airports, schools, hospitals and public buildings. The train system rivals the best of Europe – the highway network is far better. The entire housing stock for well over one billion people is being renewed. This is no bubble…

9 Myths and a Dragon

1. China is a bubble just waiting to burst

Of all the nonsense repeated in Western media and broker research, this one has a special place in our hearts. We first heard something similar asserted by Dr. Jim Walker and a host of others in 2004. While Jim is a recognized China expert, we were sceptical then, and rightfully so; since that time, Chinese GDP has more than doubled, China has become the world's second largest economy (and, at least in PPP terms, soon to be the first) as well as the source of most global GDP growth.

As noted above, there are substantial problems, yet none of these problems is new – over the past 20 years, China has already seen a couple of banking crises, inflationary bursts, and major corporate failures; and it will undoubtedly see a few more. None of this changes the simple fact that the Party is purposeful, highly professional, willing to experiment, and has both the willingness and ability to take necessary but unpopular decisions without being overly worried about its near-term popularity.

One of the great strengths of China is the ability of the government to deal with problems proactively, before they become overwhelming. Had the United States, Spain or Ireland mandated the sort of restrictive measures imposed by China 18 months ago to restrain real-estate speculation, they would have been spared the catastrophic implosions of their own bubbles. Unfortunately, free-market orthodoxy – and more to the point – the financial interests of the politicians' true constituencies (bankers, builders and speculators) precluded the sort of unpopular measures, which could have deflated an incipient bubble.

2. Chinese growth is an endangered species

Since the last time T&B wrote about China some of the characteristically self-serving hedge fund managers (e.g. Jonathan Chanis) are no longer quite as omnipresent on Bloomberg ranting about the coming Chinese implosion, with the "soft-landing" crew apparently taking the lead. We hear rather fewer warnings in the press of an incipient "hard landing", or of runaway inflation (now rampaging along at ~3.4%), though there are still claims of collapsing profit margins (in April, down a thumping 2.2% Y-O-Y, after rising 4% the month before), and bank lending (alternately reported as wildly excessive or seriously inadequate). While manufacturing is certainly slowing given the havoc in the West, the most recent non-manufacturing PMI slowed slightly to 55.1, i.e. still indicating rapid growth.

As China grows wealthier, of course, the first- and second- derivatives of Chinese growth will continue to slow, in large part due to the absolute-magnitude effect. As VTB Strategist Wiktor Bielski points out, 12.7% GDP growth in 2006 added some $350bn to GDP; in 2012, the government's predicted (and we think, too conservative) 7.5% growth estimate would add $500bn on the $6.5trn base (in fact, T&B expects modest stimulus leading to about 8.1% growth, i.e. a $575bn increase in absolute terms).

The slowdown in Chinese commodity demand is currently receiving a lot of airtime; we would be very cautious. Chinese traders are taking advantage of the fear factor to push down prices prior to restocking, and while the period of feverish acceleration in investment activity is probably past, the current levels of both investment and production remain extraordinarily high. Given the slowdown in global mining investment following serial financial crises, the depletion of existing deposits, deteriorating ore grades, and the simple fact that, like for oil, the easy minerals have already been dug while new projects are found in increasingly challenging environments, the commodity super-cycle has its best days before it[6].

3. The Chinese people are frustrated in their yearning for democracy

Despite the nonsense one reads in the FT, the vast majority of Chinese people do not give a tinker's damn for Democracy – or, for that matter, for any other political abstraction (not excluding Marxism). There is a widespread recognition that the Community Party has overseen a transformation of China from a famine-stricken wasteland – one of the poorest countries on earth – into a middle-income global superpower, on its way to becoming Number One. While we encountered people who freely expressed their dislike for the Party, arguing that the Nationalists could have done as well, this did not seem to be a major concern of theirs – they were living far better than even five years ago, and expected to live still better in the future… a state we once knew in the West, and apparently shall know no more.

The Chinese are remarkably energetic, and people's energy is engaged in a furious struggle to get rich; the cult of Mao has largely been replaced by the cult of money. Few countries offer as many opportunities for enrichment (for the locals) as does China – while not everyone succeeds, and there are great inequalities, rapid economic development provides a safety valve for energies, which might otherwise challenge the system.

In our earlier piece – Of Blind Men and Elephants – we wrote: "*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*

[6] *Note: this should not be interpreted as a Buy recommendation for GMKN – the timing, as always, can be tricky; at some point the market will reconverge with the fundamentals, but probably not this week…*

American rioting, and Russia's lost decade, seriously degraded the concept."

Now, having enjoyed the opportunity of chatting with some of the non-English-speaking majority, we can confirm our initial impressions.

4. China is governed with an iron fist by the Communist Party

Frankly, the Chinese Communist Party is "Communist" precisely as T&B is Hindu! Rather than speaking of the "Chinese Communist Party", we would simply refer to "The Party", a complex, self-perpetuating organization with at least as many Confucian elements as Marxist ones – deeply purposeful, highly competent, somewhat rigid in outlook, but characterized by a very long-term (there are not just 5, 10 and 20 year plans, but also a 100-year plan) outlook not readily recognizable by those of us accustomed to governments that live and die by the electoral cycle.

Faced with the need to open and reform the economic system, the great Deng Xiaoping came up with the brilliant theory of the *"Early and Late Stages of Socialism"*. While the "Late Stage" was precisely as Marx had predicted, the *"Early Phase*" looked suspiciously like what we would think of as capitalism; furthermore, this "preliminary phase" could last for decades, indeed, for centuries. Therefore, the Chinese were encouraged to pursue private accumulation of material wealth in order to ultimately build socialism – and they have done so with alacrity.

This is not to say that the Chinese Party does not have a strong social agenda. Huge efforts have been made to increase wages, to develop the countryside with subsidies, cheap loans and high agricultural prices, and major strides are finally being taken to strengthen the very inadequate social security net – basic medical insurance and old-age benefits; this remains very much a work-in-progress, with the family remaining the basis of social security.

The tragic error made by Gorbachev – his attempt to reform the political system before reforming the economy – has served as a warning to China's leaders. While the economy was gradually opened up to competition and private capital, with economic management decentralized and devolved to local party structures whose leaders engaged in tough competition with each other, strict and highly centralized political control was retained by the Party. Economic success could elevate a successful young regional leader to the central party structures in Beijing – failure would result in obscurity.

A fool and his money – one of our bank strategist friends remarked that during a recent road show, he met one client who indignantly rejected his constructive views on China, angrily retorting that "China was still Communist" so none of what our friend was saying could be true. Like for Russia, it is fools such as that who offer us such easy targets to trade against…

5. China maintains a draconian censorship regime with press, media and Internet censorship

In fact, this one's a half-truth – even a two-thirds truth. Censorship of the print media is fairly comprehensive; while some periodicals are seen as somewhat critical of the government, this is kept carefully within limits, with a lot of the criticism found between the lines. To publish unconstrained attacks on the Party would be foolhardy – career-shortening at best; unlike in Russia, there are no opposition newspapers or television.

On the other hand, the Internet has assumed a huge importance, with every educated young Chinese considering himself a "Netizen" and spending inordinate amounts of time on the net. The smart-phone browser has replaced the newspaper, and blogging is the national sport. Furthermore, while an attempt is made to censor the net with "The Great Firewall of China" anyone who wishes to do so can readily find software to evade the system, gaining free access to the global web (a second option to avoid censorship is to simply buy a Blackberry – to our amazement, not only could we open Facebook, but also, freely search for such forbidden terms as "Tiananmen Square" on our Blackberry without encountering any censorship).

Whilst our Chinese friends were happy to show off their anti-firewall software, most of their time is spent on Chinese domestic microblogs functioning along the lines of Twitter – they subscribe to feeds by popular bloggers, many of whom have millions of followers. The political bloggers are divided roughly into the "Running dogs of the Americans" (*their nomenclature – not ours*) and the "5 mau" (i.e.

five Yuan cents – the amount these bloggers were purportedly paid per each pro-government message they posted – though prices have certainly increased…).

Blogs are, of course, censored, however, given the huge number, as well as the ability of bloggers to post controversial messages while avoiding certain keywords, based upon the multiple possible meanings of Chinese characters, much of the content is critical. The great majority of the traffic is not overtly political, but, rather, deals with social issues and complaints. The general tone tends towards the fiercely nationalistic – e.g. demanding that the Philippines be "taught a lesson" as regards their claims to a share of the South China Sea, or that harsh measures be taken against foreign powers seen as lacking in respect for China (e.g. receiving the Dali Lama). Anyone imagining that the Chinese blogosphere is cuddly, pro-Western, caring-and-sharing, dolphin-friendly, politically correct place will be in for a bit of a shock.

By and large, we were very impressed by the knowledge of foreign affairs of young Chinese. They could discourse intelligently on French, European and Russian politics, with a good understanding at least of whom the major players were, and what policies they stood for. We were particularly struck with their relatively nuanced view of Russian politics, certainly far better than the crude caricatures we encounter in the West – Vladimir Putin is wildly popular. It goes without saying that their knowledge of Western politics greatly exceeds any Western understanding of China – or would the kind reader care to name the current members of the Politburo's Standing Committee?

6. Tiananmen has been forgotten/ censored out of existence – alternately, it lives on in the People's hearts

Neither – "the tragic events of 1989" are widely known to the educated, at least in their broad lines; they are no longer much discussed, and are almost completely absent from the official curriculum. The search term is censored on the Internet, and its summary coverage in the official textbooks is at a variance with the historical record.

To reiterate, the main driver for the occupation of Tiananmen by Beijing University students was not some "thirst for democracy"; the initial grievances were specifically students issues: the right to choose one's own job after graduation (rather than having one assigned by the Party) and the hated system of "political mentors" who lived amidst the students and exerted a major and unrestrained influence on their future careers. 1989 was a period of rampant inflation, and as the protests widened out to the general population, economic demands became more prominent. On the other hand, political demands for broader democracy were added only later, as the movement became radicalized.

Much like the Mexican student movement which ended with the massacres at Tlatelolco (between 300-1000 dead – with nary a peep of protest from the US) the focus of protests gradually widened from student complaints to more widespread popular grievances: corruption (at a time when China was still very poor a few state officials and private businessmen had begun to ostentatiously flaunt their newly-acquired wealth), inflation (then running as high as 30% per annum, creating real panic as most pensions and salaries were set at fixed levels) and, especially, growing insecurity as the "iron rice bowl" (jobs for life in state-owned companies) was smashed, while relatively few new jobs were yet available in the incipient private companies and village-level cooperatives.

After a failed attempt to end the occupation of Tiananmen square by sending in unarmed soldiers, and as hard-line protests appeared to be causing a split within the Party while spreading out from Beijing to the provinces, the decision was taken to crush resistance by an overwhelming force of arms. Tanks and armed soldiers fired upon unarmed protestors, with an estimated death toll ranging between some 250 and 700, as well as a larger number of wounded; in the wake of the crackdown, numerous student leaders were arrested (most but not all were released over the next two years); the student movement was crushed.

Putting the events in some perspective, we would note that the collapse of Soviet communism under Gorbachev was then underway, and Deng feared that events in Beijing could lead to a situation analogous to that of Romania. Though deeply committed to gradual economic reform, he felt compelled to protect the power of the Party.

We would note that 1989-1991 Russia had no equivalent of Tiananmen; the Communist system was overthrown without significant resistance. While the outcome in Eastern Europe proved quite beneficent, in Russia the resultant collapse of the state led to a decade of poverty with literally millions of premature deaths – due not to gunfire, but to extreme poverty, inadequate medical care, and social dislocation – alcoholism, violence, and despair.

The issue is again one of politics and of whose ox is getting gored. While the FT resurrects the ghost of Tiananmen on a regular basis, they appear to have conveniently forgotten the far larger massacres carried out by the force of Chiang Kai Chek – a staunch ally of the United States. During the occupation of Taiwan, the Nationalists arrested, tortured and murdered thousands – perhaps tens of thousands of native Taiwanese who could potentially have resisted domination by the mainlanders: first the "White Terror", then hard-line martial law with total suspension of all civil rights for a record 37 years – until 1987, with little complaint from Western powers who might appear more concerned with violations of human rights and democracy in countries whose policies are not otherwise favourable to Western interests.

Twenty-three years later, the conditions giving rise to the protests at Tiananmen have been largely remedied. Students are free to choose their jobs, travel abroad, or do pretty much whatever else they please; the corpus of political mentors was disbanded long ago. Inflation is well contained, salaries are far above the subsistence level, unemployment is low with inflation in the low single digits, and while corruption remains a serious problem and a source of frequent complaint, the more ambitious among the Chinese citizens do have the option of seeking to enrich themselves rather than stewing in their own envy.

The general response we got when speaking about what are now termed "*the tragic events of 1989*" is that yes, they happened, it was very unfortunate, but it was a long time ago. Of course, the infinitely greater horrors of the famines resulting from the Great Leap Forward, and later, the insane violence of the Cultural Revolution, are still within living memory. The 1989 events are now glossed over in the university curriculum, and students we spoke to did evince some curiosity about the events – T&B was travelling with a copy of Ezra Vogel's weighty (750 page) Deng biography – the relevant sections of which were photocopied by several of our Chinese friends.

7. The Chinese are genetically disinclined to consume

Anyone walking down the streets of any Chinese city – lined with everything from noodle shops to Louis Vuittons, all doing land-office business, and with shopping malls crammed with middle-class consumers on a spending spree, will realize what utter nonsense this is. While Chinese consumption **as a share of GDP** remains low by Western standards, this is due to the fact that nominal GDP has been exploding upwards, and consumption – while galloping – has struggled to grow any faster.

8. China is a cauldron of discontent, ready to explode

In fact, China is a remarkably apolitical place. Having spoken with students, intellectuals, writers and artists – and, via an interpreter, with taxi drivers, migrant workers, farmers and shopkeepers, we were struck – frankly almost disappointed – by their limited interest in politics. We did, with some difficulty, manage to dig up a single dissident – a web blogger who evinced great admiration, but strikingly little knowledge, about the West – he was subjected to a great deal of ribbing by his more nationalistic friends.

The Chinese are indeed a tough lot – highly motivated, acquisitive, and capable of outbursts of sudden verbal or even physical violence (of which we witnessed several instances in a little under one month). Chinese history saw numerous peasant uprisings of appalling violence – in the 19th Century, the Hangs, led by a man who had apparently gone mad, deciding that he was the brother of Jesus Christ following his repeated failure to pass the terribly difficult Confucian civil-service examinations, caused tens of millions of deaths before finally being suppressed, in part by British mercenaries in the pay of the Qing emperor. More recently, perceived corruption and bad medical care have led to a spate of violent attacks on hospital doctors and medical staff. There are numerous minor "mass incidents" each year, with the party quick to respond to the worst abuses that are now quickly broadcast via the Internet.

9. The one-child policy was inhuman

Cognizant of the fact that, absent extreme measures, China's development would be smothered under the sheer weight of its huge population, Deng availed himself of the full Party machinery in order to impose a frequently unpopular limitation of family size in what remained a profoundly traditional and family-oriented society. When challenged some years later by French President Valery Giscard d'Estaing, Deng shot back: "Mr. President, had I not done so, we would be shitting out a country the size of yours **every year**!"

It is instructive to compare the Chinese experience with that of India. Lacking the means to impose population control, India continued to grow its population exponentially. As a result, while one encounters enclaves of great prosperity, one also witnesses appalling scenes of desperate poverty. Large swathes of the countryside are still populated with peasants living on less than two dollars a day, where infant malnutrition is rife and medical care non-existent, i.e. conditions no Chinese has known since the 1990s.

10. Dragons are evil creatures – spit fire

Chinese dragons are beneficent, live in water, and do not smoke. St. George would be very unpopular here.

And a few Truths:

1. Don't drink water/don't breathe air

Even the Western press cannot get it all wrong all of the time, and the lurid accounts of pollution seem pretty much spot-on. When visiting Beijing, one is advised to take a deep breath before stepping off the plane; chatting with one Beijing-based friend, he laughed off our complaints about Moscow air, where the 2.5 mcg particulate level frequently rises above 80 in summer – in Beijing, he retorted, on a bad day we hit 550!

Air-quality in Beijing, Xi'an and the southern costal cities was indeed appalling. T&B has less first-hand experience with the water, but judging by the air quality, claims that the conditions of the rivers are equally dire seemed credible. Morbidity/mortality studies carried out in other countries would suggest that the Beijing air should result in tens of thousands of premature deaths each year.

While the Party now gives increasing attention to issues of environmental sustainability in formulating policy, results on the ground are not impressive. Perhaps it is simply a matter of time – we would note that in the United States, in the early 1960s, air pollution was seen as a welcome sign of industrial growth, and one river – the Cuyahoga, actually caught fire and burned; thirty years later, it now reportedly supports several species of fish. Clean air and water are luxury goods, and as China completes its first phase of industrial development, we would expect to see the next wave of Chinese investment including serious anti-pollution measures. It would be none-too-soon…

2. Corruption, land grabs, and abuse

Like in much of the developing world, corruption remains a serious complaint of the Chinese, although given the extraordinary economic growth, it must be agreed that its overall impact is somewhat limited (as opposed to, say, Indonesia or the Philippines which have been locked in a cycle of poverty largely attributable to rampant corruption[7]). Among the worst abuses has been the forcing of peasants off their land to make way for the endless building projects with land sales providing the main revenue stream for many regional governments. There have been numerous instances of civil unrest due to egregious land grabs, with several cases of peasants immolating themselves in protest.

These protests have been amplified by the blogosphere, leading to increasingly frequent intervention by the central government, which has become rather sensitive to public opinion. After some initial experimentation, village-level democracy is now being more widely introduced, and some attempts are being made to combat the most egregious abuses.

The Chinese system of justice is harsh, and, like the United States, China continues to execute common criminals including for cases of severe corruption.

[7] *In contrast with certain countries of the West, the Chinese have at least the decency to refer to corruption as "corruption", rather than as "lobbying and government relations".*

3. China is one great construction site

It simply must be seen to be believed. From the isolated mountain villages accessible only by river to the great cities of the Eastern seaboard, China has the builders in. Given the fact that the living conditions for a population of one-and-one half billion people were, until recently, quite appalling, this is as it should be. While the state attempts to squeeze out real estate speculation[8] via a limitation of bank financing as well as punitive taxation, they have also undertaken a massive programme of construction of affordable housing.

4. Nationalism and the South China Sea

With no history of colonialism, but a long tradition of receiving homage and tribute from its barbarian neighbours, the Chinese have a deep-seated sense of their own cultural superiority, and the government has, at times, encouraged nationalism as a safety valve, and to unify public opinion. This is very much a two-edged sword; having promoted popular anti-Japanese demonstrations, it was then compelled to crack down on the increasingly violent outbursts, for fear of creating diplomatic incidents beyond its control.

Official Chinese policy as regards the South China Sea (where "the 9-dashed line" map would have Philippinos needing a Chinese visa in order to go for a swim off of their own coast) has succeeded in frightening the Philippines, Japan, and Vietnam into the arms of the Americans, China's sole strategic competitor. Whereas Chinese policy as regards Taiwan has been patient and well-conducted, with growing economic links which will most likely result in a peaceful reunification over the next decades, on the other hand, Chinese policy in the South China Sea appears to us precipitous, ill-thought out, and self-destructive in the extreme.

5. Discontent amidst the students

There is growing malaise in the university dorms due to a combination of competitive pressure and less glorious opportunities for graduates. Many of the students are from poor, one-child families, their educations sponsored by the combined efforts of their parents and two sets of grandparents. There is thus huge pressure to succeed in the fiercely competitive preparatory examinations; now, even for those making it to university, the future no longer looks quite so rosy – especially for those graduating from the less-prestigious schools.

Like much of the West, China is seeing a surfeit of college graduates, especially in non-technical fields, along with a shortage of skilled industrial workers. The salary of an experienced construction worker in Chengu is 6000 RMB i.e. twice that of a recent college graduate. Perhaps China needs to emulate the West – establish a slew of investment banks, offering highly paid jobs to the best minds, consisting entirely in the transfer of money from one pocket to another…

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

In the near term, as was the case for Taiwan, Korea and Japan, Chinese growth will decelerate as it approaches Western income levels and encounters physical constraints. This however implies at least one (probably two) further doublings of GDP; given the sheer size of China, a profoundly disruptive event. Over the next decade China will become the world's largest economy – (indeed, in PPP terms, some have argued that it already is) and is already the world's largest automobile market, largest emitter of greenhouse gases, and the major determinant in most global commodity markets. China is the source of the majority of global economic growth, and increasingly, it is the news from China that moves global financial markets.

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

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[8] *Amusingly, while the press – rightly – warned of Chinese real-estate inflation, they have now switched to warning about the modest decline in apartment prices… you just can't please some folk!*

In Conclusion – The Dragon Rises

T&B hates to proclaim banalities – alas, it comes with the territory: ***the 18th Century was French, the 19th British, the 20th American… and as day follows night, the 21st will be Chinese.*** Laugh if you will – as an 18th-Century Frenchman would have laughed at the idea that a nation of shopkeepers would dominate the globe, or a Victorian gentleman would have ridiculed the notion that a bunch of semi-civilized colonials could prevail. Ten years ago when we argued for the ineluctable rise of China, the Old Believers retorted that 10% of almost nothing is still almost nothing. No longer. As in the 14th Century, when China was far more advanced, culturally, demographically and economically than was Western Europe, and accounted for a larger share of global GDP, it will likely resume its mantle as the predominant economic power in the decades to come. Of course, with rising economic power comes greater political weight, and the need to project power.

This does not mean we expect a mono-polar world or the rise of a single global superpower. As the centre of economic gravity shifts Eastward, the world will go from an ideological monoculture based upon 19th-Century British liberalism, toward a healthy competition of divergent ideologies with competing blocs jockeying for political influence. Do not underestimate the difficulty for the West of accommodating the rapid ascendency of the larger emerging economies. Historically, a peaceful, beneficent transition of power from the declining to the rising powers has been very much the exception, not the rule…

Post-Scriptum – When the Flame Flickers

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

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

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

How to Trade It – And is Athens Burning?

With no undue modesty, T&B is rather proud of our investment track record – punters following our advice over the years, as well as a few faithful clients, should be gratified by their performance. Inter alia, we were the first Western source crazy enough to recommend Russian sovereign bonds in 1998, Russian banks – repeatedly (including during the depths of the 2008 sell-off), Argentina GDP warrants, and more recently, Russian and Kazahk bank subs, as well as our Axis-of-evil trades (Belarus, Cuba-serviced, Venezuela PdVSA, and now, cautiously, Argentina). While we managed a few good trades in Russian small-caps, latterly, we have been increasingly chary of equities as an asset class, preferring emerging market debt – and have been well rewarded for this positioning.

None of this, of course, has prevented our making a few spectacularly bad calls – and, yes, our buy-recommendation on Greece was a real winner…

Having already issued several *mea culpas* regarding our Greece recommendation, we return to the subject neither out of masochism nor of false modesty, but simply because, while analysing one's successful calls is gratifying but fairly useless (maybe you were just lucky), when one's assumptions are falsified, it is vital to draw conclusions and to modify the analytical framework.

The issue of the Euro crisis has been sufficiently dissected in the media (W. Munchau has done a very competent job in his FT columns) so we can safely skip over the details. Suffice it to say that – as noted previously – T&B's basic assumption had been that a failure to provide sufficient financial support to prevent a Greek default would trigger a widespread loss of confidence, with financial contagion causing borrowing rates for any European sovereign seen to be potentially distressed to spiral out of control, causing a cascade eventuating in… exactly what we are seeing today.

It seemed so obvious. A few tens of billions of dollars spent early on in the crisis could have forestalled losses ranging into the trillions (though, of course, the opportunity would most likely have been wasted as governments continued their profligate ways). The outcome is still frighteningly uncertain, but we already draw three fundamental conclusions:

1. First, while some of the more clueless commentary has focused upon the "democratic deficit", the problem is precisely the opposite – a "democratic surfeit" if you will. Cutting wages, pensions and social benefits is a sure-fire vote loser; for politicians, to speak painful truths is often enough a career-ending move. Providing financial support to the profligate Greeks creates fury in the German heartland; removing long-cherished job protection and social benefits is deeply undemocratic; an economist or two will always be found to explain why pleasurable measures (ever-increasing stimulus) are to be preferred to unpleasurable ones (austerity). Finally, even the ability to comprehend the potential second- and third-order consequences of a disruptive sovereign event requires a fairly sophisticated understanding of financial markets, something totally lacking in most readers of the tabloid press – whose deeply held opinions are thus nothing more than ignorant prejudice.

2. As noted by Prosperity Capital's brilliant Liam Halligan (*yes, Liam, you were unarguably right about the Euro – and long before it was fashionable to be; but now, most you rant so*?) the broad Euro experiment was faulty – monetary union in the absence of hard fiscal convergence could not work. Alas, that was then, and now is now, and there is no way to unwind it without risking totally unforeseeable consequences. Personally, T&B much preferred the more diverse Europe we knew as a child – but that too is now history, the Rubicon has been crossed, with only two possible outcomes: either fiscal/political unification or severe economic/political disruption with potentially disastrous consequences.

Although we are reticent to make any further predictions regarding the efficacy of the European political process in dealing with financial crises, we would prefer to assume that the system is not fatally broken, and that the sole viable alternative – true fiscal/ economic union, is now ineluctable. Hope dies last!

3. While most commentary has focussed on the failure of the Euro project, the truth may be quite the opposite. It is not inconceivable that monetary unification was conceived in a secret attempt to force through a "United States of Europe" – in the knowledge that, sooner or later, a crisis would eventuate and, with no way back, Europe would be forced to adopt a federal model implying dilution of sovereignty of the component nation states. Perhaps linguistic unification comes next. *Ich bin ein Berliner.*

Beware the Bear…

The market currently offers a truly extraordinary opportunity!
There is only one problem – we have absolutely no idea whether it is a buying opportunity or a selling opportunity…

T&B

In our January issue (my, *how time flies!*), T&B predicted that the massive injection of liquidity from the ECB and Fed would lead to a powerful rally in risk assets, with however the underlying economic issues rearing their ugly heads by Spring[9] – and so it has transpired, in large part, thanks to the always imaginative and unpredictable Greek electorate.

[9] *There is just something about the month of May… perhaps we should switch over to an 11-month calendar.*

All considerations of fundamental risk and value currently pale before the fierce waves of disruption from the macros. With the financial world having shifted entirely to a risk-on/risk-off model, assets are now worth either a great deal more, or a great deal less, than current pricing.

Neither T&B nor any other sentient being is entirely sure what would happen were Greece to exit the Euro; the fact that the Lehmans debacle was not expected to create the degree of havoc that it ultimately did does not necessarily imply that a Grexit would do the same – much of the money that a Greek meltdown would "cost" has already been spent, and we would assume that markets have had time to prepare; that said, these are totally uncharted waters, and T&B would prefer not to see some of our hypotheses tested.

What does look fairly certain is that in the wake of a Greek default, we would see some truly extraordinary buying opportunities in a wide variety of financial instruments, as panicked investors dumped whatever they could for whatever price they can get, only then pausing to figure out what it was that they sold. It would be a wonderful time to have some free cash…

Our baseline scenario remains that some sanity ultimately prevails, and that Merkel abandons her hostility to desperately necessary Euro-wide measures – hopefully in return for the acceptance of some hard fiscal constraints by Germany's neighbours. In this case, current pricing would seem very attractive, including for some of our favourite debt assets which have traded off with the rest, although far less than would be expected given the violent decrease in risk tolerance elsewhere in financial markets.

Emerging Markets Debt (EMD) has greatly outperformed emerging markets equities – which have once again been hammered by a wave of risk-off. While this relative outperformance is gratifying, caution is called for. Were the situation to deteriorate further – and there is certainly no shortage of tinder – investors would likely be panicked out of their remaining winning positions *en masse*, leading to a short, sharp sell-off in bond markets.

Given the macro uncertainties, all trading calls should be considered as subject – beware of leverage and keep some powder dry!

Equities

Of the many valuable lessons that investors have learned from the great John Maynard Keynes, perhaps there is none so useful as the admonition that, in the short run, markets are voting machines – in the long run, weighing machines. Over a short time horizon (the only horizon remaining in modern casino markets) what is vital is the perception, which you ignore at your peril.

T&B remains suspicious of equity markets, given their ability to deviate from their fundamentals for a prolonged period, and their extreme dependence upon sentiment and mood. The recent sell-off in emerging equity markets was almost entirely unrelated to any fundamental economic factors (indeed, such drivers are usually invented ex-post-facto – to explain what has just happened). Therefore, if somehow, Greece and the EU find some temporary stability, a powerful rebound can be expected, at least until the next Eurocrisis strikes (apparently, it is unrealistic to hope that European policy makers actually take the proactive measures necessary to deal with the next phase of the crisis, before it eventuates).

Given the increasingly assertive foreign policy stance of the Russian government, T&B expects Western press coverage to remain unremittingly negative[10] (the *Pravda*-model of "independent journalism") and, thus, for Russian equity (but not debt) markets to continue to suffer from the disaffection of foreign investors. This is, of course, largely a self-inflected problem; the solution would be not a craven foreign policy, but rather, for Russia to develop her own pools of domestic long-term, institutional capital, as well as encouraging popular equity ownership, perhaps via another bout of pensions reform.

Whilst recent moves to unify the RTS and Micex exchanges, establishing a single custodian, and improving settlement procedures are all very helpful, further improvements in Russian corporate governance and an end to the constant stream of "surprises" (*inter alia*, the recent suspensions of Vimpelcom and TNK-BP dividend payments) would be most welcome. Investors in Russia must still expect the unexpected, and while, in almost all cases the

[10] *An excellent thing for fixed-income investors, put certainly not for equity players…*

story is ultimately resolved with limited or no real damage, event-fatigue ultimately sets in.

T&B remains underweight equities – both Russian and non-Russian, with zero exposure to the US and European markets. Of the Russian assets, we continue to have a strong preference for the remaining high-dividend resource stocks. We expect substantial volatility going forward and would prefer to capture cash flows, rather than rely upon hypothetical price appreciation.

Fixed Income

The recent volatility in the wake of the Greek electoral circus probably constitutes a good buying opportunity for unleveraged players. Our fixed income portfolio has again performed very strongly this year, and we reiterate our trading calls; that said, the timing is currently tricky and we would not be in any hurry to increase positioning, keeping leverage to moderate levels given the risk of a European implosion.

Our long-standing Axis-of-Evil trades – in particular PdVSA and Belarus – shot the lights out. Belarus was the best-performing EMD asset this year, with PdVSA a close runner up. At present, we are a bit more nuanced in our strategy; having taken some profits as PdVSA yields dropped towards 10% (reasonably close to fair value) we are cautious of general market sentiment, and the risk of a further short term sell-off in oil. We remain entirely comfortable with the mid-term credit fundamentals, and we would be looking to increase positions in the shorter end of the curve, once some sanity returns to global markets; for now, we see little reason to hurry.

The fundamental story remains unchanged – China is taking an increasingly important role in the Venezuelan economy, and those hoping for a right-wing government to replace Hugo Chavez are likely to be disappointed (if holding PdVSA bonds for the eventuality – best to hit the bid). That said, Chavez has severe, indeed potentially fatal health problems and the plans for a possible succession are by no means clear; there is a very high likelihood of continued Chavismo in one form or another, but with the potential for considerable disruption. We wish him good health and a long life!

-Belarus enjoyed a spectacular recovery as Lukashenko was forced to recognize economic reality – allowing a maxi-devaluation, briefly hiking interest rates as high as 70%, and negotiating a huge financial package from Russia, with sale of the Belarusian oil transmission infrastructure and commitment to further privatisations (by which only Russian buyers are likely to be tempted).

Russia's gains were facilitated by spectacularly incompetent European "diplomacy" that scored a marvellous own-goal, forcing Lukashenko to abandon his long-standing struggle to maintain equidistance between Russia and Europe. A charter member of the Eurasian Customs Union, Belarus should now be seen as a future province of the Russian Federation (indeed, the justification for the separation of Belarus from Russia was never self-evident). In the near term, the danger is that, with the noose loosened, rather than privatizing and maintaining credit restrictions Lukashenko resumes his previous economic mismanagement, throwing increasing quantities of credit at fundamentally non-viable government-owned entities. Even this worst-case scenario simply accelerates the process of economic unification with Russia; the current >11% yield on the bonds is an anomaly, largely attributable to the current risk-off mood in markets.

-Ukraine we would handle with great care. During our recent trip to Kiev, we were struck by a macroeconomic policy apparently based more upon hope than upon any rational analysis, with the government intent upon playing for time – although time was very clearly not on its side.

T&B somewhat provocatively put it to the Deputy Finance Minister that: "*If I have understood your presentation correctly, current policy involves collecting bottle caps and bits of string in order to survive until after the October elections – at which time you intend to do something, although no one knows quite what*". Our remark elicited nervous laughter, but no outright denial.

We have said so before, and will say so again – Ukraine is living on expedients, and needs to cut a deal with someone, either the European Union or Russia. Whilst the EU is very attractive to the Westernized denizens of Kiev – it is rather less so to the Russian half of the population. There is another slight problem –

while it can offer market access and much inspiring language, the EU currently has no money – for that, one needs to turn to Russia. The politics are particularly fraught, but our best guess is that typically incompetent European diplomacy drives Ukraine into the arms of Russia – much as it did Belarus, with the sale of the Ukrainian gas transmission system (a wasting asset, in any event) and, possibly, accession to the Eurasian Customs Union.

That said, Ukraine has performed better than expected in the recent sell-off, and for those wishing to play, we would strongly recommend taking the yield pick-up over the sovereign, owning City of Kiev, selected banks, or Metinvest. Our favourite Ukrainian trade – restructured AlfaUkraine bonds, has performed brilliantly – alas, their final amortization at par is coming up next month. Game over. *Those requiring further information on these assets, or indeed, wishing to hear an alternative view on the future of Ukraine, should contact our friends at Dragon Capital.*

-No issue of T&B would be complete without a recommendation for the USD Eurobonds of Russian private banks, in particular the subordinated debt of Alfa, Bank of Moscow and Promsvyaz, as well as the senior debt of Russian Standard Bank. To this litany, we would add the new issue of Nomos 2019. Although we generally shy away from such long duration, the 11% YTM appears quite compelling.

Given the relatively conservative positioning of Russian retail banks, and the unstinting support of the CBR, they are about the closest we can find to "free money" in this market. Spreads have drifted out in recent weeks due solely to the Greek fiasco, which, of course, has absolutely no fundamental impact upon Russian bank solvency. For those requiring a bit more yield (and excitement) we continue to like selected Kazakh assets – KKB subs, and for those willing to position for the long-term, and to accept illiquidity in return for high yields, the perpetual bonds of ATF, BCCRD and KKB.

-Finally, risk-tolerant investors might take advantage of the current market turmoil to position in Argentina, in particular Provincia de Buenos Aires which is yielding almost 25% – largely on the back of investor hysteria following the nationalization of YPF. We might also consider repositioning in the Argentina GDP warrants: currently pricing at about 9, a December 2012 payout of 6.5 cents based upon 2011 growth essentially means that patient investors can acquire a 20-year option on Argentine growth for 2.5 cents (after the coupon), with a theoretical potential payout some twenty times as large. No, markets are not always rational…

T&B has made a successful career of trading against the hysteria in the financial press – when the pundits start to gang up on any given company or country, one can usually assume that some serious mispricings are lurking about. Provincia de Buenos Aires is not for the faint-hearted or the over-leveraged, and considerable volatility can be expected; seen as a high-risk trade with a non-zero default risk, at a yield to mat of 25%, one is getting well paid to assume the risk.

Argentine macroeconomic policy is wildly unorthodox, with in particular the currency control regime becoming increasingly repressive and unmanageable. Like the previous attempts at a neoliberal model the current leftist model may well end badly, but that is almost certainly a problem for the medium term – at present, we see no immediate threat to debt sustainability, and despite all of the dire warnings, the Argentine economy has actually done quite well since its last financial crisis. Furthermore, nationalizing YPF may prove to be one of the several things that the Fernandez government has done right – the majority owner, Spain's Repsol, was using Argentina's main oil company as a cash-cow, milking it for very high dividends while underinvesting as oil production cratered.

Oddly enough, after acquiring YPF in a deal sanctioned by Kirchner, Repsol quickly sold 25% of the oil company to Petersen Co, owned by the billionaire Eskenazi family, in a deal in which the Eskenazi received one-quarter of a very valuable asset essentially for free; the entire purchase price was debt-financed, partly by Repsol itself, partly by a consortium of banks. The loans were guaranteed by the shares only, with interest and amortization serviced by the very high dividend flows (~90% of profits) generated by YPF itself… a wondrously attractive deal for the acquirer, though one which begs some fairly obvious questions regarding what was behind the deal.

Currencies

While from a fundamental standpoint, we continue to see the dollar as an accident going somewhere to happen, it is currently favoured by the risk-off trade. Given that we think it only a matter of time before the US either spirals back into recession or engages in further debt monetization, we are trimming our Euro/dollar and Euro/SGD shorts but certainly not going long the Euro. It has been a good trade.

On the other hand, our long-standing short-USD/long RMB is performing rather less well than expected. The Chinese currency is currently treading water; Beijing has shrugged off diplomatic pressure for a faster appreciation, and as the currency trades more freely, it is slightly affected by the same factors which have tanked emerging currencies in general – while the RMB is about 1% off its highs, the Brazilian Real and Rouble are off a good 10% - we would continue to own RMB as a store of value.

There are some great trades lining up as the risk-off pushes currencies away from their fundamental values. At some point, the AUD/NZD will once again become very fashionable as China plays – the BRL will come surging back, as will selected Asian assets. We would bide our time until there is some clarity as regards the European situation. While we think that the worry about China is misguided, certainly, Greece and the other PIIGS constitute a greater challenge.

Rates – When no Greater Fool is to be Found…

While noting that negative real rates for 10-Year US treasuries (much less paying to lend money to the Swiss or German governments…) were the mother of all bubbles, T&B was always hesitant to call a top. At below 1.5%, we must be getting near. We would NOT short the bonds outright – panicky markets make widows and orphans – but we think that out-of-the-money option strategies for a blow-out in yields 12-18 months down the road make a great deal of sense.

Happy Trading!

T&B

Readers are welcome to forward T&B to any party who might be interested. We write to be read! Comments should be directed to Eric Kraus, on eric@nikitskycapital.com

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