

Casey's Gold & Resource Summit

October 3, 2010

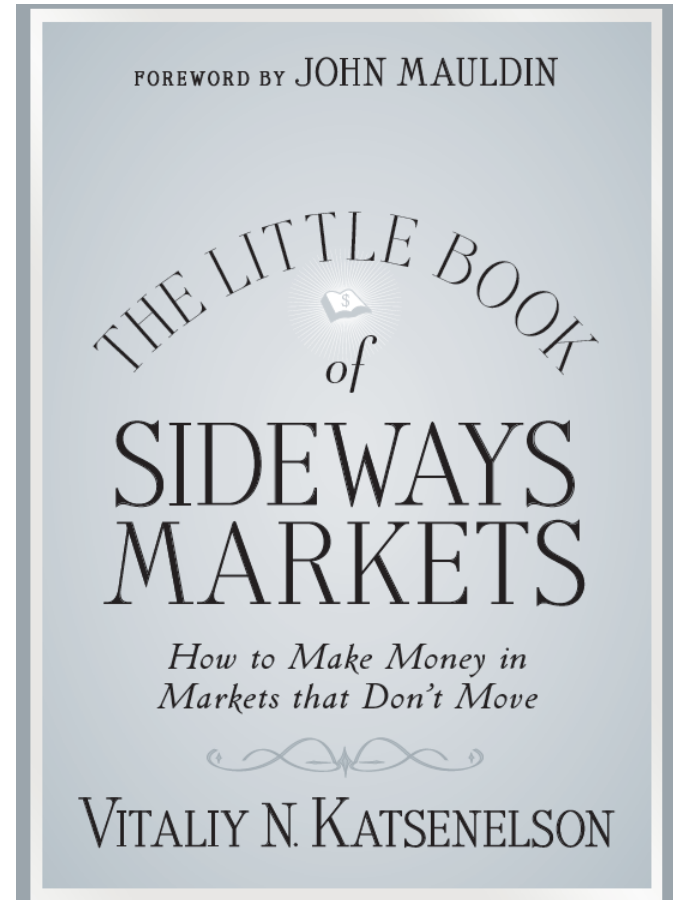
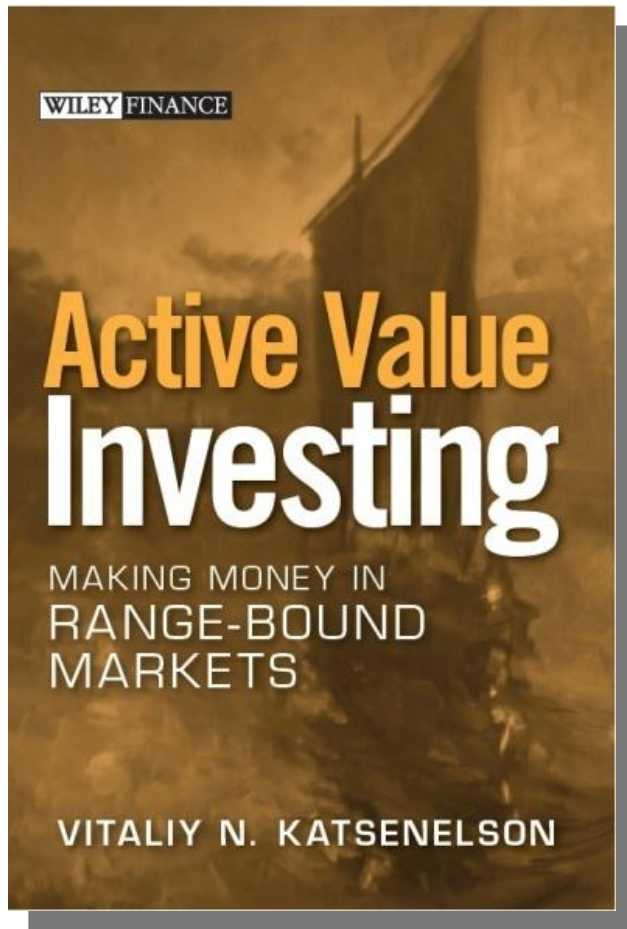
China – The Mother of All *Grey* Swans

Japan – Past the Point of No Return

Vitaliy N. Katsenelson, CFA
Chief Investment Officer

Investment Management Associates, Inc.

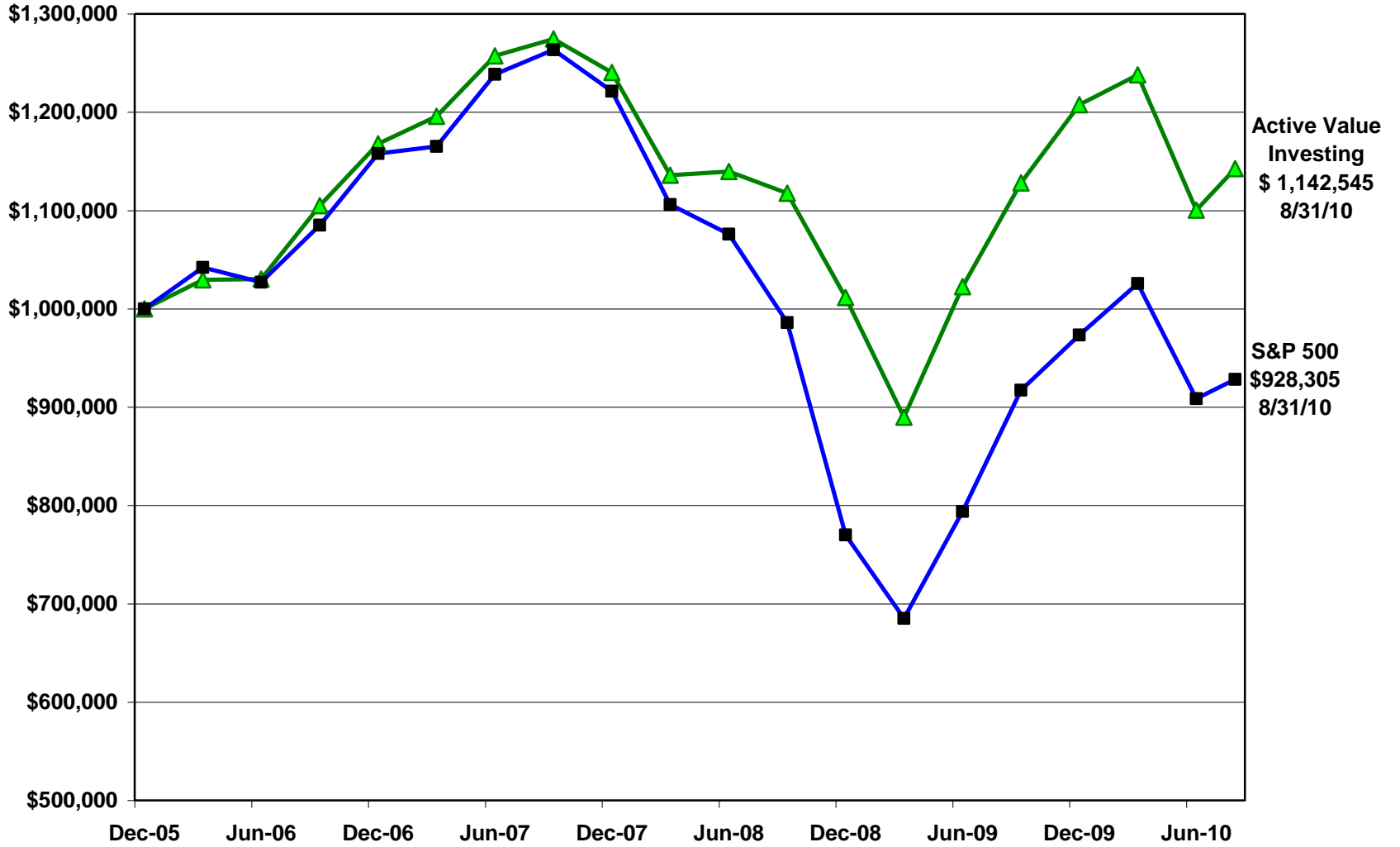
November 2010



Active Value Investing Performance

\$1,000,000 Invested on 12/31/05

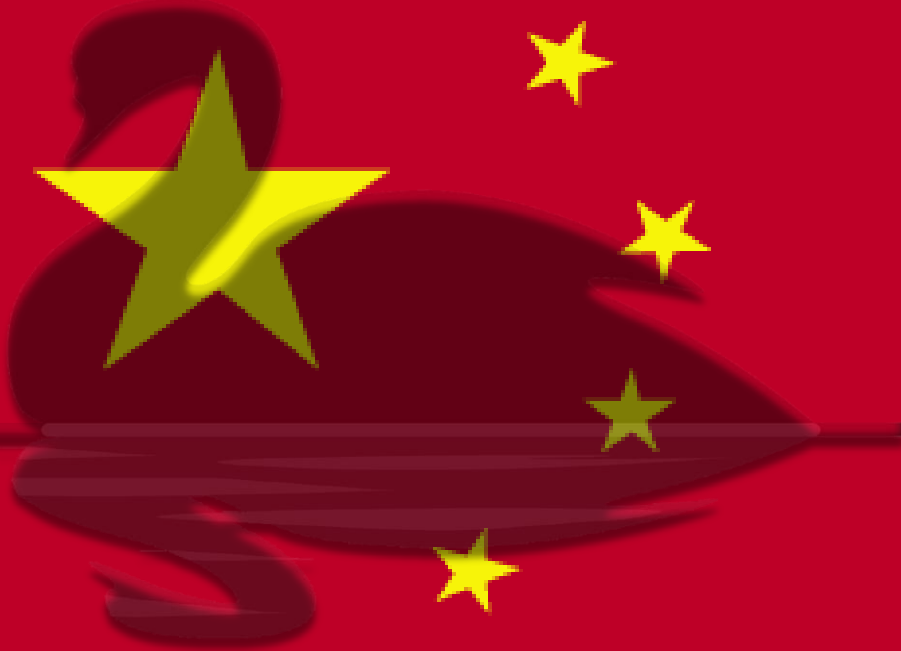
Net of Fees



Active Value Investing Net of Fees performance is after the deduction of management fees, after reinvestment of dividends, interest and other earnings (recorded on accrual basis), and after the deduction of broker fees and commissions.

S&P 500 market average includes reinvestment of dividends but are not adjusted for any transaction costs.

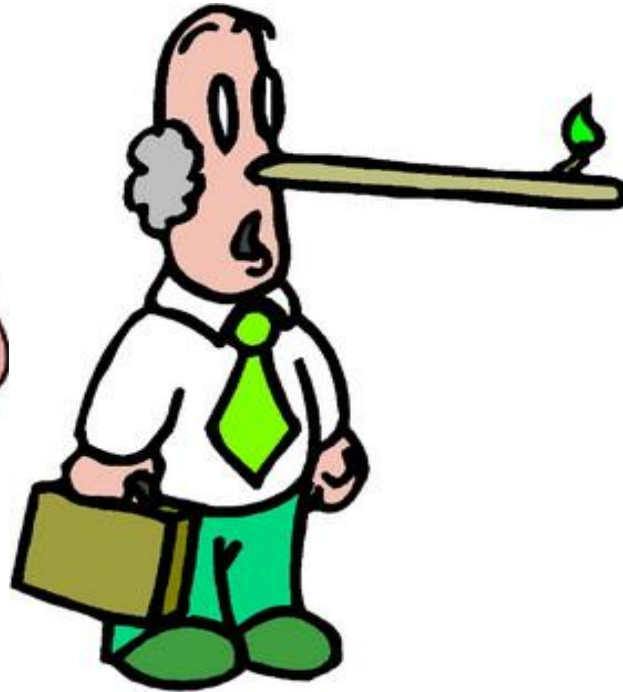
Past performance is not necessarily indicative of future results and is only one of several factors which should be used in evaluating a professional investment organization.



CHINA - THE MOTHER OF ALL GREY SWANS

THIS TIME IS NO DIFFERENT – THE OVER-INVESTMENT BUBBLE

Vitaliy N. Katsenelson, CFA
Chief Investment Officer
Investment Management Associates, Inc.



Overcapacity

+

Late-Stage Growth Obesity

You Lie!

Super Steroids-R-Us

1998

2008

2009

Today

Pre Great Recession: Significant Overcapacity

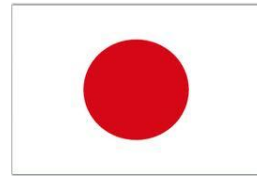
- ❑ 1998 – 2008, Economy grew at 10% (real growth) a year. When building new plants, made **assumption that past growth would continue into the future.**
- ❑ The **natural (unlevered) demand for its goods** from the developed world **was lower.** Actual demand was driven, in large part, by heavy borrowing by US and European consumers – China provided the financing. Similar to **Lucent in 1999 financing dotcoms** that were buying Lucent's equipment.
- ❑ **Future growth** will be significantly **lower** – China's customers (the US and Europe) are overleveraged and are deleveraging.
- ❑ Result: **overcapacity** (economy is geared for much higher global and internal growth)

Example:



**EXCESS
CAPACITY**

CONSUMPTION



source: [Pivot Capital](#)

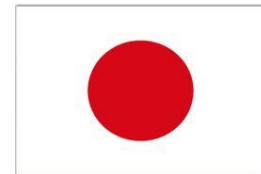
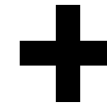
Example:



**IDLE
PRODUCTION**



PRODUCTION



source: [Pivot Capital](#)



Pre Great Recession: Late-Stage Growth Obesity

Growth is high, but its quality is low

Starbucks is a good example of Late-Stage Growth Obesity



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

Consequences for Starbucks

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

Starbucks Addressed these Issues

- **Closed stores**, terminated leases (took charges)
- **Slowed** store openings
- **Laid** off employees
- **Focused** on innovation
- Sales **stagnated** for 3 years

China: Quality of decisions was poor

Government intervention, corruption, political capital-allocation decisions **take things to a new level of financial insanity**. Provinces are given growth targets that they must meet.

❑ **Invisible** hand directs capital towards highest use.

❑ **Visible corrupted** hand of command economy directs capital towards **highest bribe**.

Example:

South China Mall, the second largest shopping mall in the world (second only to Dubai Mall). 1,500 store capacity, 7.1 million sq feet, opened in 2005. 99% of space **empty**.



Built a ghost town: **Ordos** in Inner Mongolia, for **1 million** residents on spec.

“The Kangbashi district began as a public-works project in Ordos, a wealthy coal-mining town in Inner Mongolia. The area is filled with office towers, administrative centers, government buildings, museums, theaters and sports fields—not to mention acre on acre of subdivisions overflowing with middle-class duplexes and bungalows. The only problem: the district was originally designed to house, support and entertain **1 million people, yet hardly anyone lives there.**”

[Time Magazine](#)

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1998 Q2 – 1999 Q1:
During Great Recession

Global economy is declining. You'd think the Chinese economy would be declining.

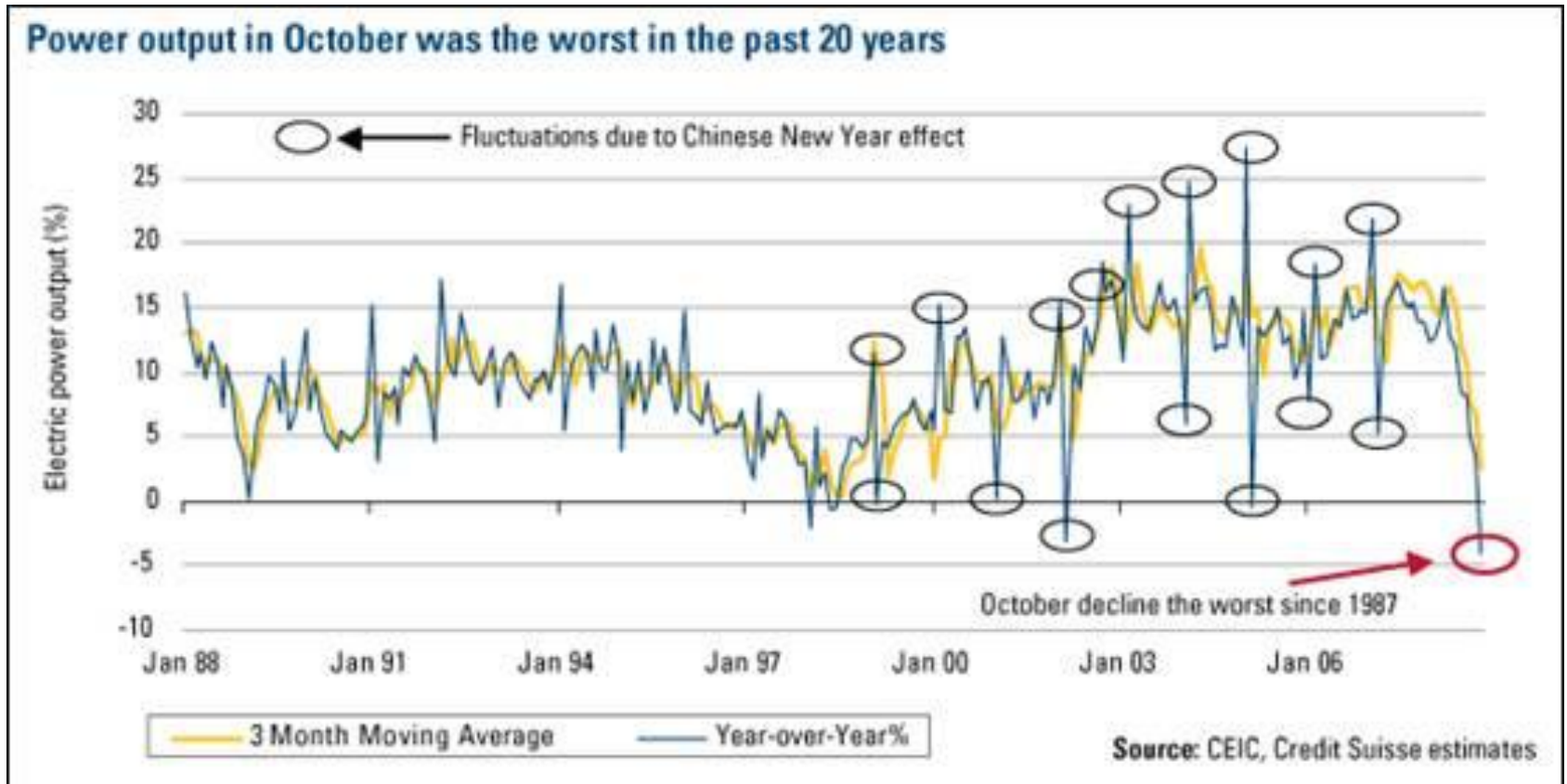
Wrong! China is still *showing* positive industrial production growth of 6-8%.

How does China achieve growth in this environment?

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

During Great Recession – You Lie!

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



Post-Great Recession – Super Steroids-R-Us



China will do anything to grow its economy – here is why:

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

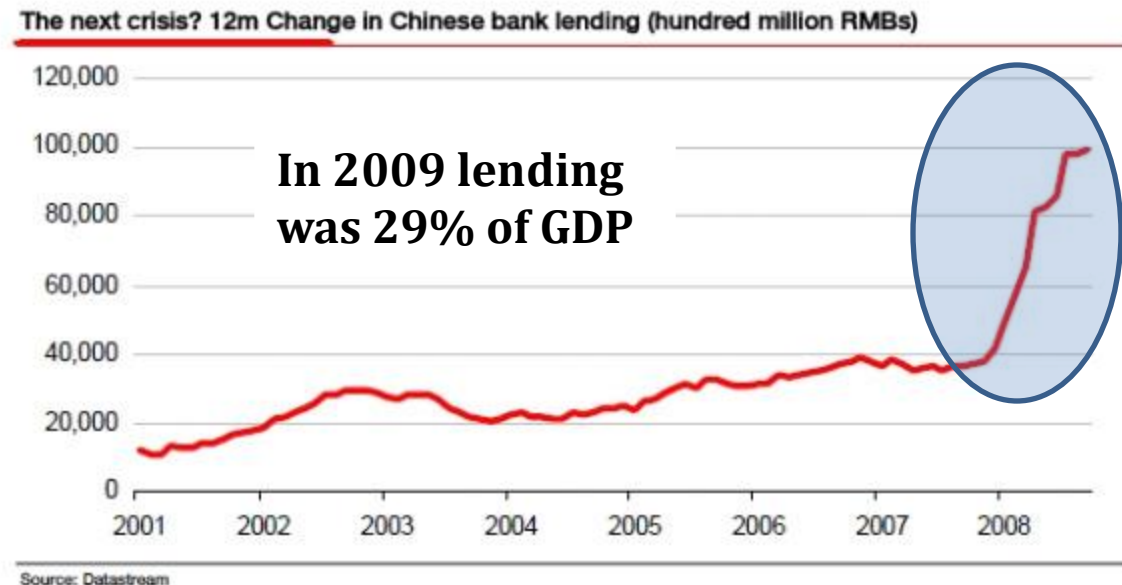
Hence comes the stimulus package

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

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

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

- **Lending goes vertical**



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

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

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

- Real estate projects are **funded** not based on expected cash flows but on **collateral**. Land is the primary collateral. If/when real estate/land prices decline collateral will not be sufficient to cover the loan. (Sounds very similar to what took place in Japan in late 1980s).
- Here is what Jamie Dimon, CEO of JP Morgan, thinks of Chinese banks and their lending:

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

National average property prices up 20% in 2009

As prices surge at their fastest pace in two years...

National average property prices, annualized percentage change



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

Floor space constructed is up 100% in 2009

New construction is booming at an unprecedented rate...

New floor space started, year-to-year percentage change

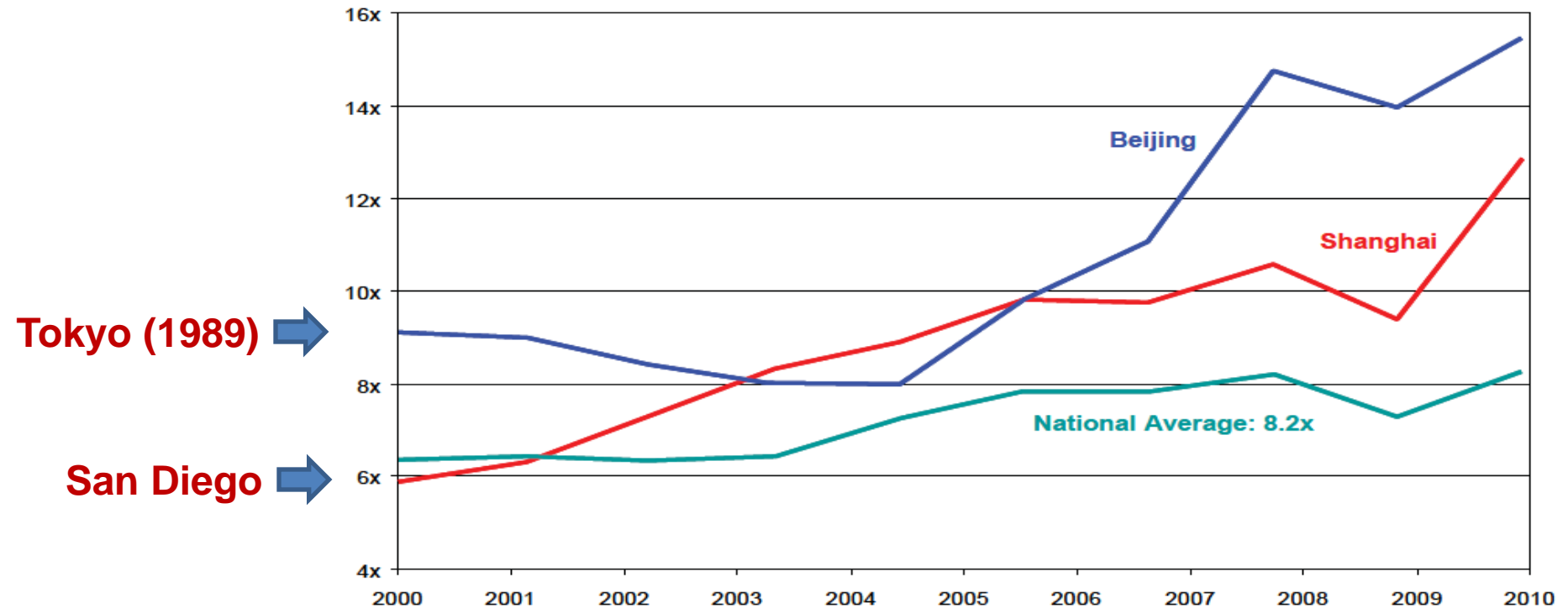


Source: [WSJ](#), January 19, 2010

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

Housing affordability is horrible

China nationwide property value/annual disposable income per urban household – cities



Source: CEIC, Morgan Stanley, GMO calculations As of 12/09

- ❑ Housing property value / annual disposable income **nationwide** is 8 times (source GMO)
- ❑ This ratio for Tokyo at the peak of the Japanese bubble was 9 (source GMO)

*“estimates from electricity meter readings that there are about **64.5 million empty apartments** and houses in urban areas of the country, many of them bought up by people wagering on a constantly rising property market.”*

[Yi Xianrong](#), an economist at the Chinese Academy of Social Sciences, a government think tank in Beijing

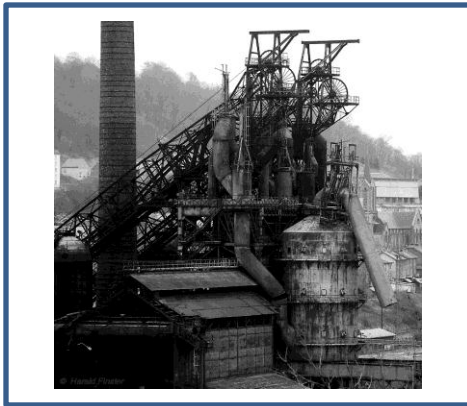
Property Investment % of GDP:

- ❑ Japan at the peak – about 9%
- ❑ The US at the peak – less than 6%
- ❑ China 2009 – **10%**

Source: [Citi](#)

Here is why command economy results in overcapacity in industrial sector, a *hypothetical* example:

1 Steel Mill



Required to
support
construction of



10 Bridges



Hypothetically 100 bridges needed to be built

- If 10 bridges *a year* built 1 steel mills required – **10 years** required to build all 100 bridges – no idle capacity
- If 100 bridges **commanded** to be built in **1 year**, 10 steel mills **are idle for 9 years**. Steel mills are very specialized thus idle capacity will be idle.

Beware of False Axioms

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

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

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

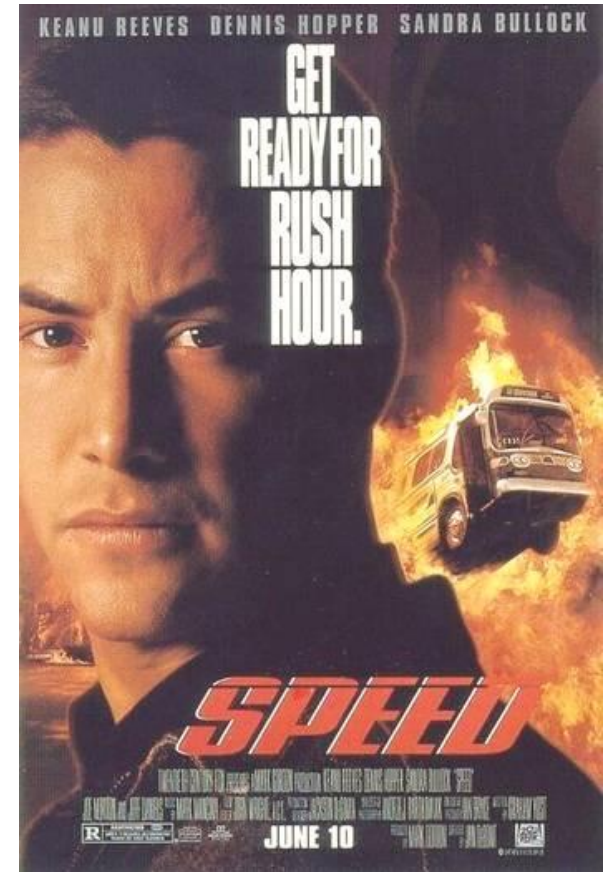
Chinese axiom: ***The economy will enjoy strong growth.***

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

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

What if the Chinese economy doesn't grow?

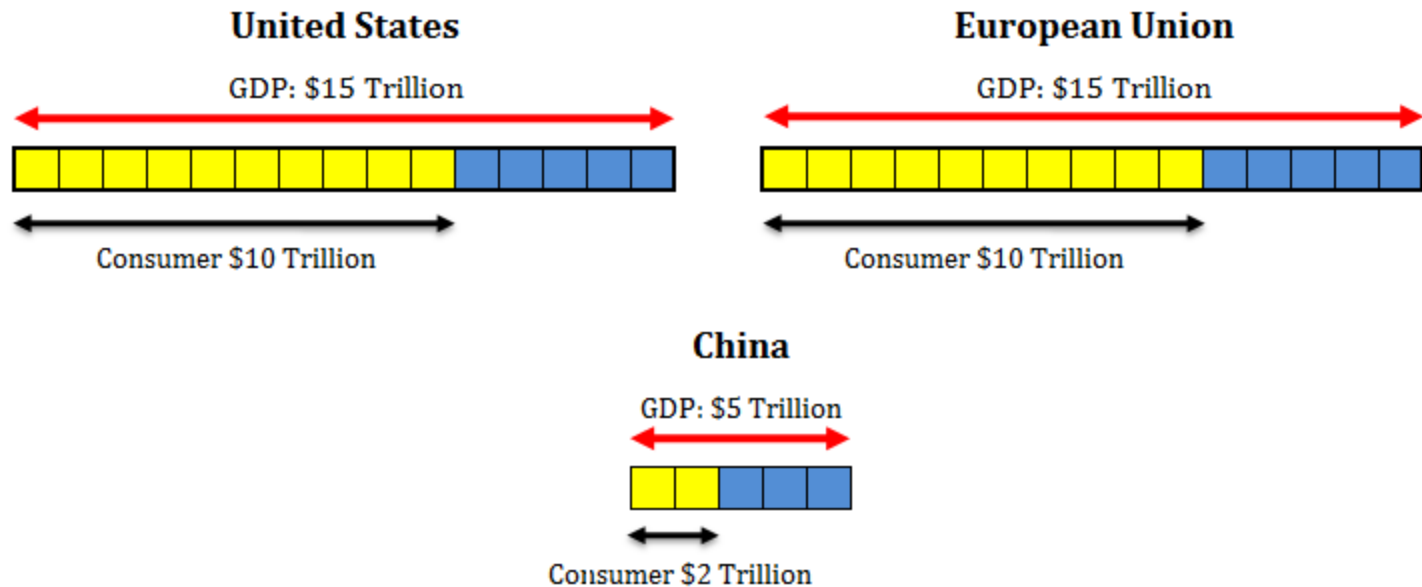
- ❑ **High operational leverage** – it is a manufacturer to the world. This is further exacerbated by excess capacity everywhere you look.
- ❑ **High financial leverage** – debt, easy loans are a choice of financing.
- ❑ High financial leverage + high operational leverage = **high total leverage**
-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



Additional points:

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

Will the Chinese **consumer pick up** the demand **slack** for the US and European consumers? This **may happen**, but it will **take decades**. US and European consumers are two-thirds of much larger economies. The Chinese consumer is only one-third of the Chinese economy.



Rounded numbers for simplicity: actual US GDP is \$14.2 trillion and EU GDP is \$14.5 trillion; Chinese consumer is about \$1.6 trillion (1/3 of Chinese \$5 trillion GDP)

Elephants in the Room



- 1. Low urbanization rate (migration from villages to cities)**
- 2. Low Government debt**

Migration from villages to cities has helped Chinese economy as peasants moved to a more productive economic activity (i.e. making toys or building skyscrapers vs. milking cows) and thus helped economy to grow. It is a common assumption that due to China's low (46%) urbanization rate over 300 million people will move to the cities by 2025. Here are some reasons why migration will not be as significant:

1. Not all cities are created equal.

- ❑ Chinese definition of a city **1,500** people / km²
- ❑ Western definition of a city **400** people / km²

American "Villages":

- Colorado Springs (767 people/sq km)
- San Antonio (1,084/km²)
- Dallas (1,427/ km²)
- Reno (1,008/ km²) are villages.

Urbanization rate is much higher in China than many expect. (See United Nations report [Demographic Yearbook](#))

- 1. Population in cities is understated.** Economic targets set by central governments for municipalities on per capita basis (i.e. GDP per person). Easiest way for local bureaucrats to game the system is to under-report local population.
- 2. One Child policy will have its toll.** Population will peak by 2015. Workforce participation **is** expected to peak in 2010. (source GMO).

Actual debt is not so low. The world focuses on Chinese financial strength of \$2.4 trillion of foreign reserves. Myopic way of analyzing a country (or a company) as it only focuses on the asset side of the balance sheet but ignores liabilities – government-backed loans which are in trillions of dollars as well. Also, foreign reserves are a testament to the lopsidedness of its economy.

❑ **\$1.5 Trillion** debt of local governments

❑ **\$1 Trillion debt** of “policy” banks guarantee

Source: [Victor Shih, Northwestern University](#)

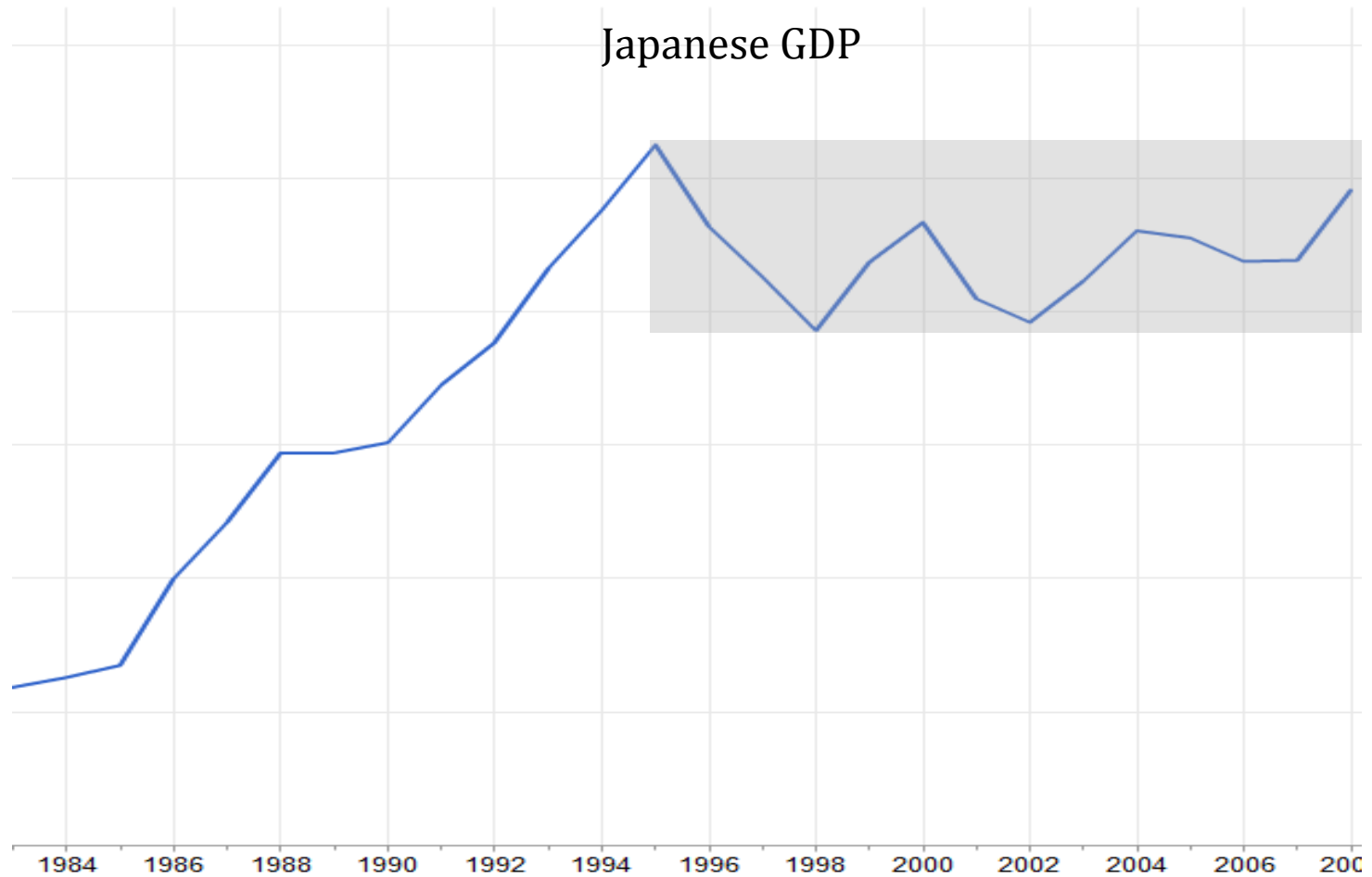
Consequences of the Bust of the Chinese Bubble

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

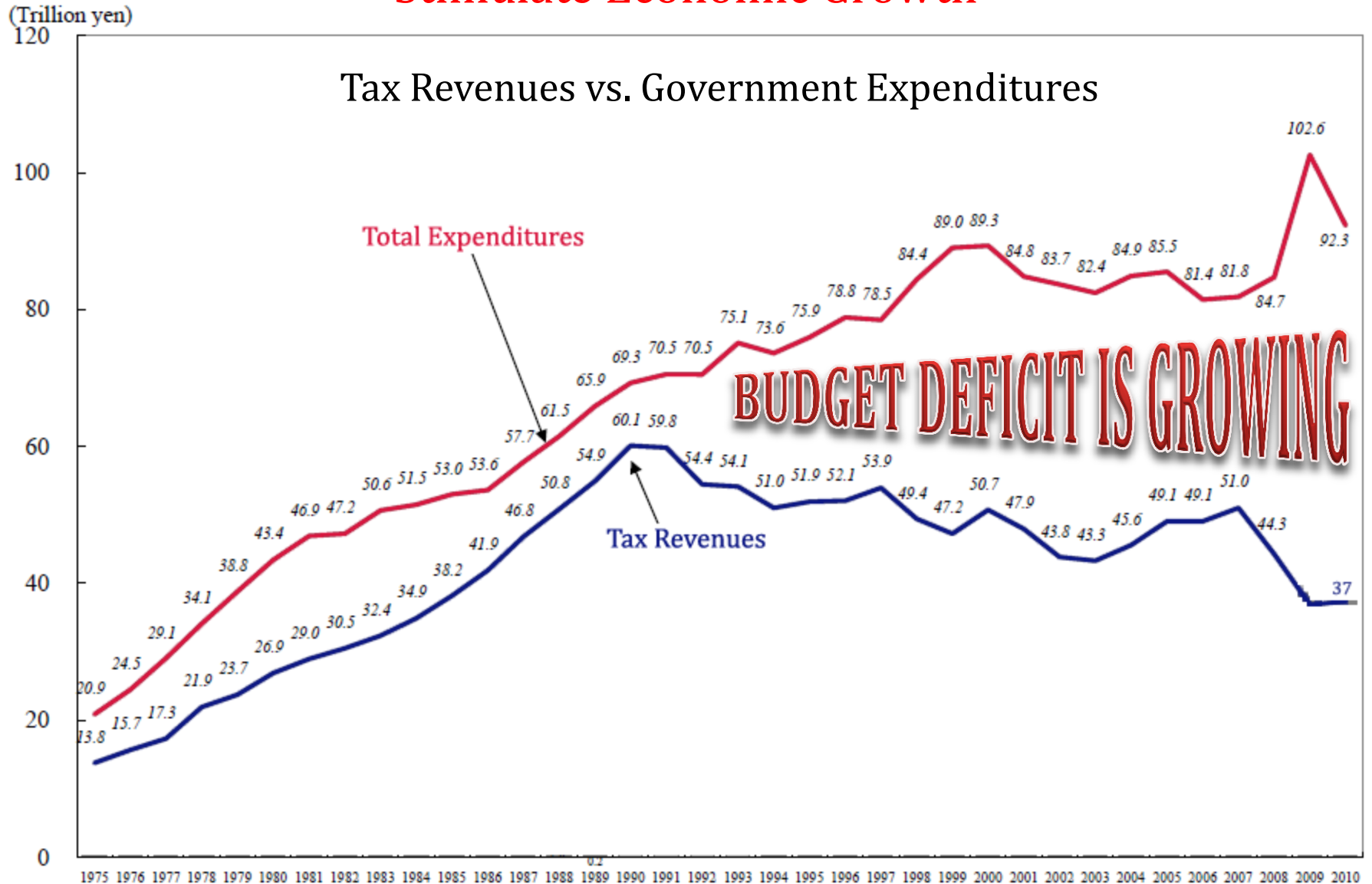
Japan – Past the Point of No Return



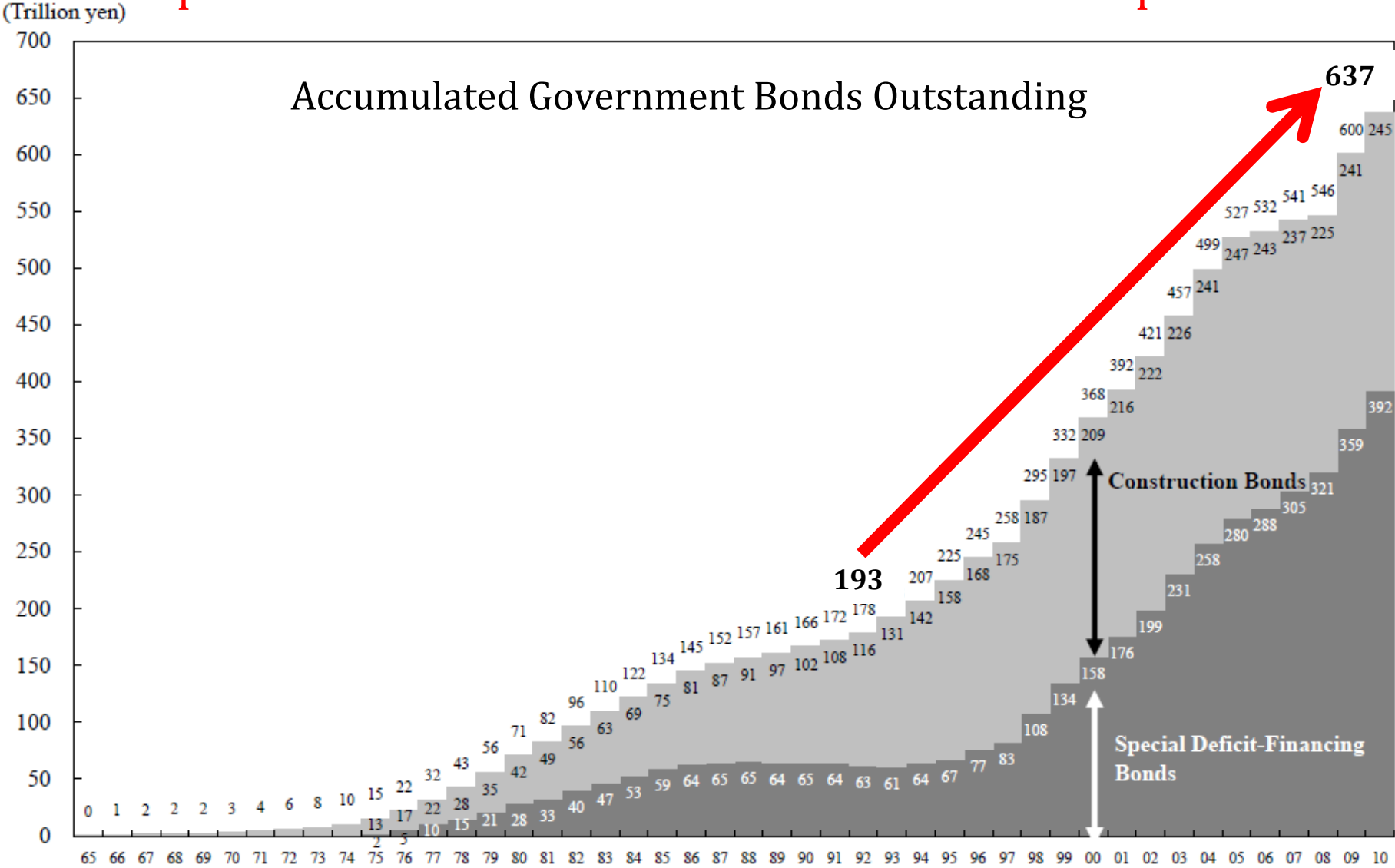
Japanese GDP Growth Comes to an End in the Early 1990s



Government Cuts Taxes and Increases Expenditures to Stimulate Economic Growth



Gross Government Debt Used to Fill in the Budget Gap. Debt Triples. This doesn't include debt of local municipalities.



Source: Japan Ministry of Finance

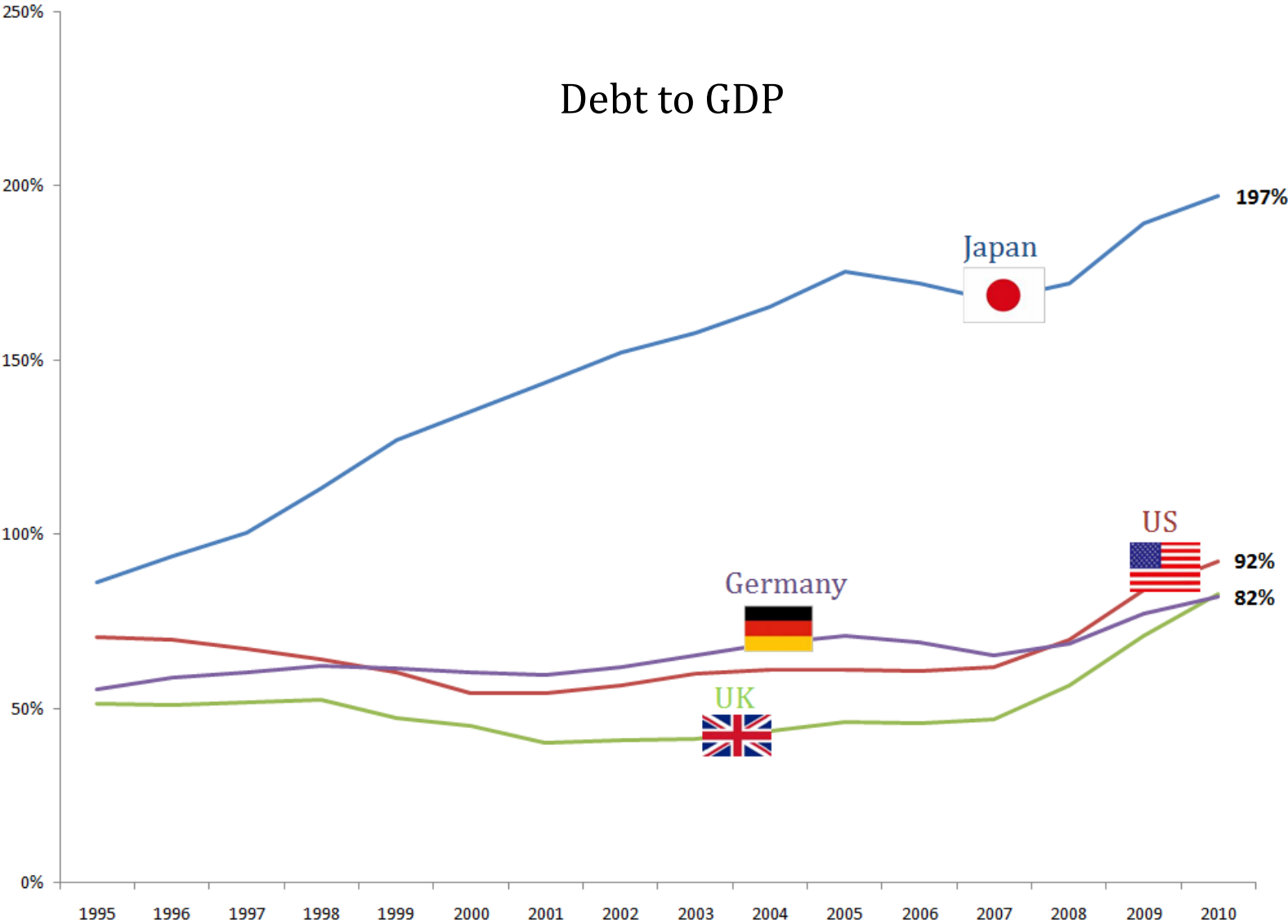
Here is the official explanation by the Japan Ministry of Finance of what took place from the early 1990s to 2000; the same story continues till today.

It all sounds like this: **Economy doesn't grow:**

1) cut taxes 2) increase government spending 3) raise debt

- ❑ **Early 1990s:** “Japan experienced a serious economic downturn. ... Government initiated various economic measures, including a series of large-scale public work programs these measures required further issuance of bonds...”
- ❑ **1994:** “A major tax reduction amounting to ... 1.3% of GDP was carried out, with the gap financed by the issuance of special deficit-financing bonds.”
- ❑ **1995:** “A major tax cut amounting to ¥5.5 trillion was carried out... Furthermore... the Government decided to initiate the largest ever economic stimulus package... As a result ... government bond issues ... reached ... 28.0% of total government expenditures.”
- ❑ **1996:** “A major tax cut on the same scale as that in 1994 and 1995 was continuously carried out. ... the amount of government bonds issued was ... 28.8% of total government expenditures.”
- ❑ **1997:** “the Government decided not to continue the temporary tax cut, and instead raised the consumption tax rate from 3% to 5%. ... However, due to the severe economic downturn ... decided to carry out a temporary tax cut ... government bond issues reached ¥18.5 trillion, or 23.5% of total government expenditures.”
- ❑ **1998:** “**Fiscal Structural Reform Act** ... given the still stagnant economic situation, the Government announced two more economic packages, one in April ... ¥16 trillion, and ... in November... of over ¥27 trillion... bonds issued totaled a record high of ¥34.0 trillion, and the ratio of bond issues to total expenditures reached an all-time high of 40.3%.”
- ❑ **1999:** “Budget was compiled with priority on promoting economic recovery ... the amount of government bonds to be issued was ... 6.3% of GDP... 37.9% of total government expenditures... Government took measures to deal with the continuous economic slump.... announced **Emergency Employment Measures** ... in light of weak private demand and a severe employment situation, the Government decided to use contingencies for public works amounting to ¥500 billion...
... Government announced **Policy Measures for Economic Rebirth** ... This package totaled over ¥17 trillion... government bond issues reached a record high 43.4% of total government expenditures ... amount of bonds to be issued soared up to ¥38.6 trillion.
- ❑ **2000:** “... providing utmost assurance to the Government's economic management in putting the economy back onto the track to a full-scale recovery... budget continued to be stimulative... bond issuances reaching ¥32.6 trillion, or 38.6% of total expenditures ... a policy package for **New Economic Development towards the Rebirth of Japan** was issued... As a result, government bond issuances for the year increased to be ¥33.0 trillion, or 36.9% of total expenditures... [Source: Japan Ministry of Finance. Emphasis added and text truncated for brevity.]

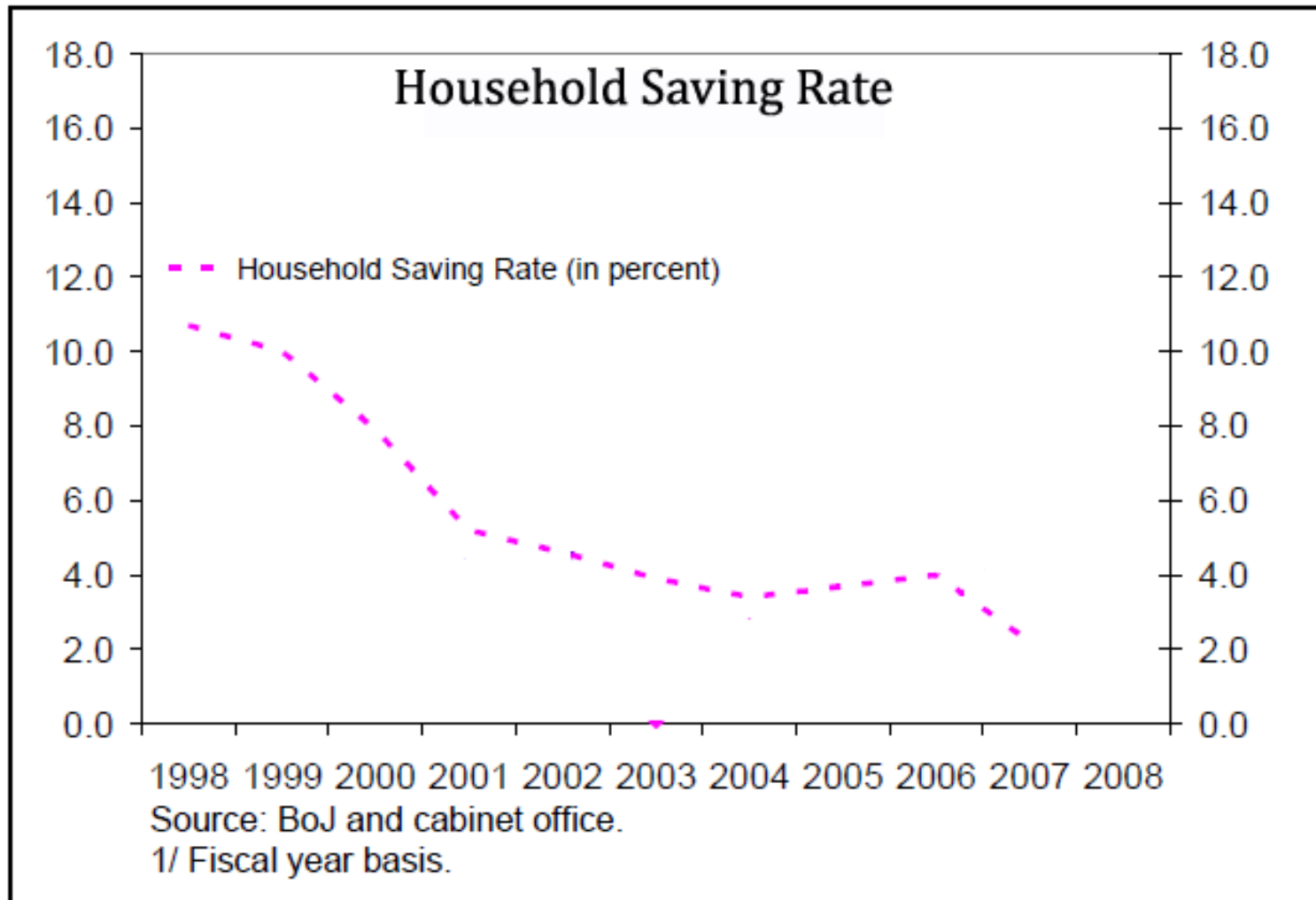
Japanese Debt to GDP by Far THE Highest in the Developed World *



* Second to Zimbabwe if you count developing countries

Source: Japan Ministry of Finance

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



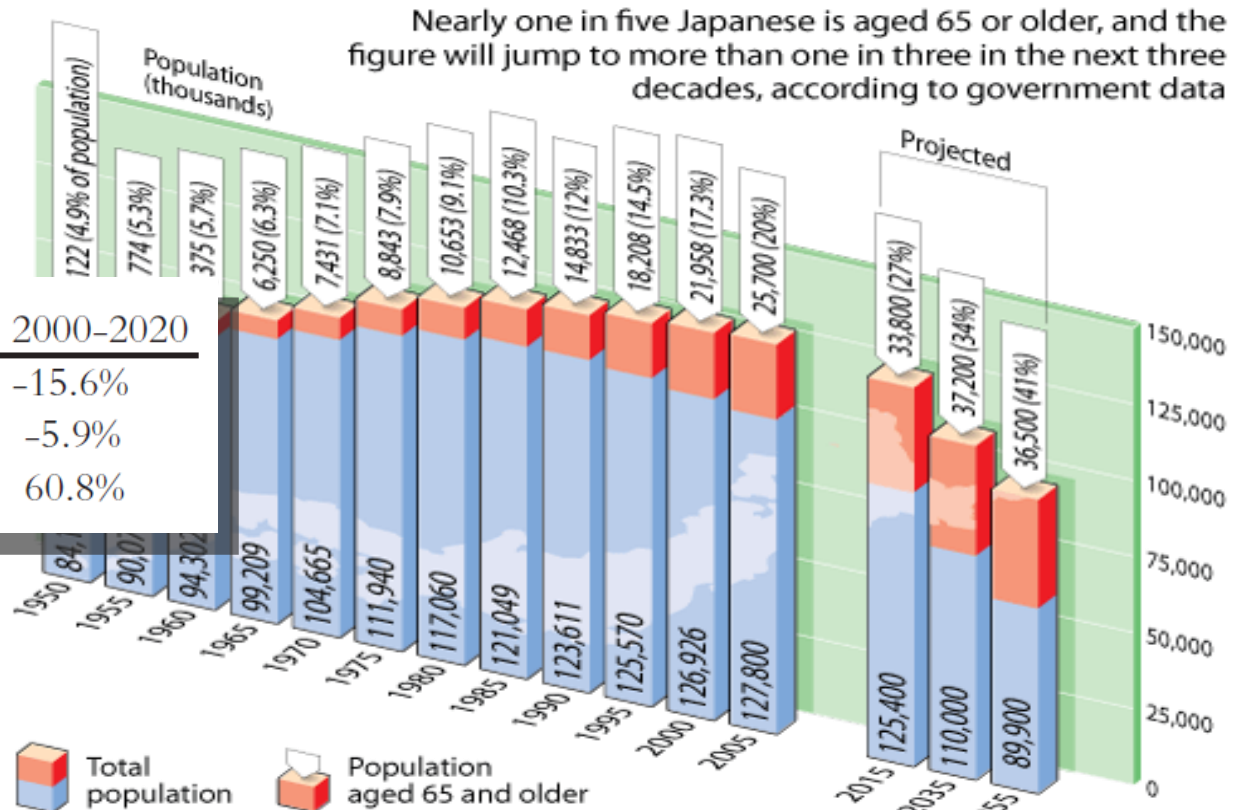
Here is why...

Japan Has the Oldest Population in the World – Bad for Savings. Japanese Savings Rate is Approaching Zero.

**Today 1 in 4 Japanese
is over 65 years old**

Age group	1980-2000	2000-2020
25-44	-7.3%	-15.6%
45-64	42.1%	-5.9%
65 +	107.9%	60.8%

(Source: [Woodrow Wilson Center](http://www.woodrowwilsoncenter.org))



Source: [Reuters](http://www.reuters.com)

As people get older their incomes start to decline, their expenses (health care) rise, their savings rate drops. Their demand for bonds will drop as well – Japanese will become net sellers of bonds.


Population is on Indefinite Decline – Horrible for the Economy and Savings

- One of the **lowest birth rates in the world**. Pay is based on seniority. Elders make too much money, young too little. Young don't want to start families. (Source: [Woodrow Wilson Center](#))
- Need to have 2.1 births per woman to maintain population size. 2009 birth rate: 1.21
- **There is no immigration** to soften very low birth rates (Japan is a closed society).

Fertility Rate is on Decline

Year	Total fertility rate	Rank
2003	1.38	202
2004	1.39	200
2005	1.39	198
2006	1.4	197
2007	1.23	212
2008	1.22	213
2009	1.21	216

Source: CIA World Book



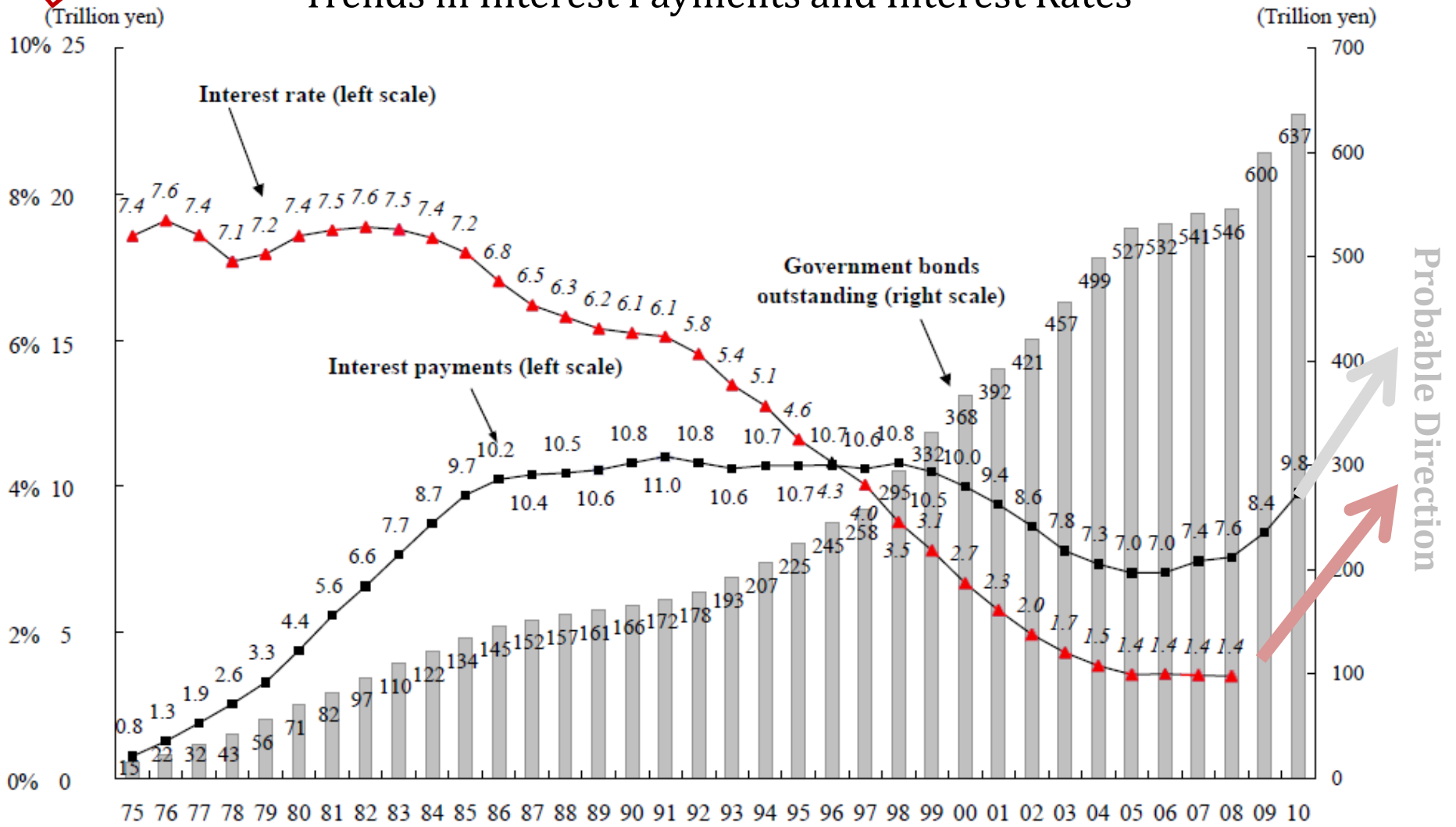
**One of the least
fertile countries**

Declining and aging population doesn't bode well for economic growth. Economic growth is paramount for the economy, whose debt obligations are increasing and interest expense soon will be rising (you'll see).

PAST

Debt Ballooning. Interest Rate Declining. Interest Expense Stays Flat. Cost of Debt Is Manageable.

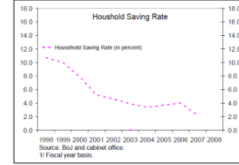
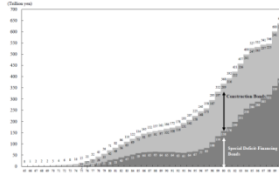
Trends in Interest Payments and Interest Rates



Source: Japan Ministry of Finance

FUTURE

High Supply of Debt + Low Demand for Debt



Higher Interest Rates

1.4%

????

Even Greater Budget Deficit

Tax Increases

Printing Money

Further Slows Economy

Torpedoes Yen

Higher Interest Rates

Vicious cycle

Japan is in a death trap: it cannot lower interest rates; they are already scratching zero. Higher interest rates will cripple the economy.

Additional thoughts:

- ❑ Current interest expense at 1.4% interest rate is 9.8 trillion yen; current expenditure of Education & Science, Public Works, and National Defense ministries is about 5 trillion yen each (source: [Japan Ministry of Finance](#)). If interest rates double (i.e. rise to 2.8%) interest costs increase by 9.8 trillion – Education & Science and National Defense both lose funding.
- ❑ Today, **interest expense is 26.4% of tax revenues** (using 2010 estimates). If rates double, interest-rate expense will be 52.8% of tax revenues.
- ❑ As Japan **starts looking for new** (external) **investors** for its bonds, it will be **competing with much higher global interest rates** and better sovereign credit profiles. This will lead to a higher cost of debt.
- ❑ **Population is aging** and shrinking, **taxes** will be going **up**, interest rates rising – this crashes the budget deficit, and a sovereign debt downgrade will follow – further increasing cost of borrowing – putting additional pressure on Japanese interest rates. Somewhere in between, government starts printing money – this torpedoes currency.
- ❑ As a consequence interest rates will rise globally. Japan is the largest holder of the US debt. Normally, yen should substantially depreciate against the dollar, but Japan is **the largest** holder of US Treasuries (\$768 billion). Japan will have to liquidate at least part of dollar reserves; this should mitigate some of the yen depreciation.

Beware of False Axioms

In Japan the false axiom is: **Japan will always be able to issue cheap debt.** Fifteen years of data support this false axiom. However, prolonged reliance on a *false axiom* will lead to its invalidation.

Thank You!

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