Y O S E M I T E C A P I T A L M A N A G E M E N T

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COMMENTARY

"The superior man understands what is right; the inferior man understands what will sell."— Confucius

SUMMARY

China faces questions about the longer term pace of productive growth and how to make that transition as smoothly as possible.

A reasonable guess is that China's real GDP might slow to a pace in the 4% to 5% range by sometime in the first half of the next decade.

The lower growth rates are not widely accepted and logically are not factored into future expectations by many market participants.

Unsustainable growth combined with a lack of market discipline has led China to have major problems that include excessive debt, industrial overcapacity, an overheated property market, a fragile banking system, an opaque interconnected financial system, and an impending demographic crisis.

Insufficient growth risks social upheaval and delays or prevents longer term goals, but unsustainably faster growth in the short term from delayed reforms could eventually lead to a more severe slowdown later.

When slower growth is manifested in China, other emerging markets are likely to be negatively impacted since these are often suppliers to China.

CHINA'S SITUATION WITH ECONOMIC GROWTH

Is China an economic accident waiting to happen?

While the country has made remarkable economic progress over the past several decades, the pace of growth was unsustainable. This is only natural as no country can maintain double digit growth indefinitely. China faces questions about ***the longer term pace of productive growth*** and ***how to make that transition as smoothly as possible***.

China's annual rate of real GDP increases had been in the 10% to 12% range in the years preceding the Great Recession of 2008. In more recent years the rate has been in the 6.5% to 8% range. (See Exhibit 1.) These are the official figures from the Chinese government, and though many economists have long questioned their validity we will put those arguments aside for now. Regardless, the future rates of growth are likely to be lower, though to what levels and when is subject to great debate. A reasonable guess is that ***China's real GDP might slow to a pace in the 4% to 5% range by sometime in the first half of the next decade***. But many still believe growth higher than 6% is pre-ordained for China and will be sustained for years to come. ***The lower growth rates are not widely accepted*** and logically are not factored into future expectations by many market participants.

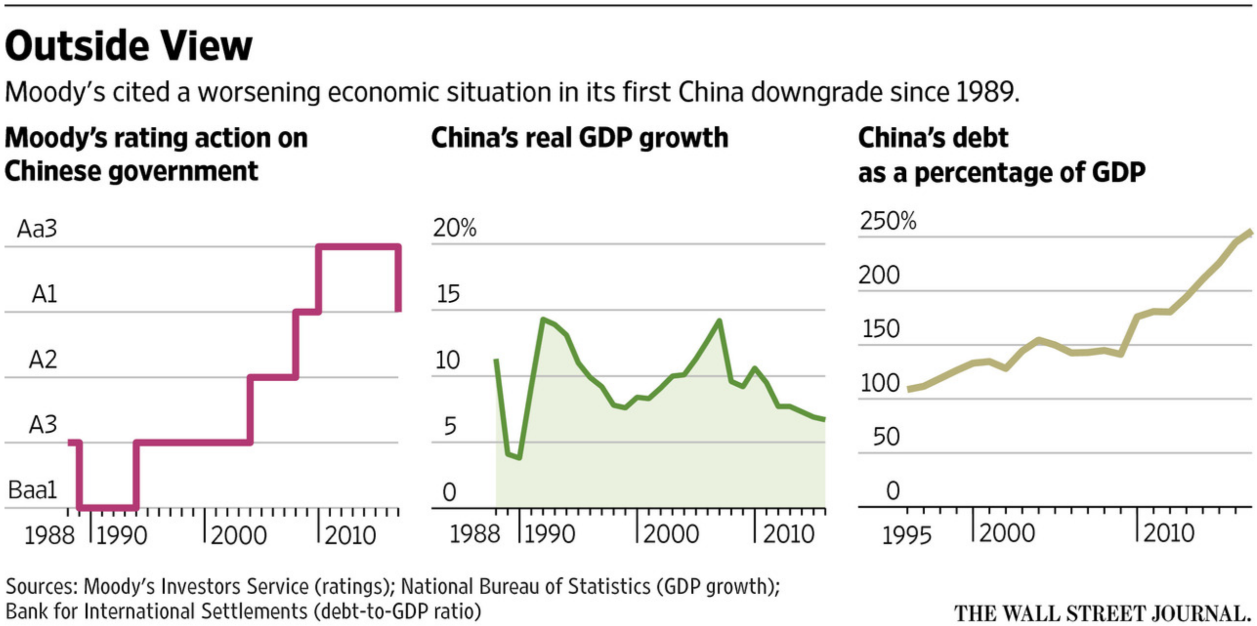
China slowing down is one thing, but additional problems could occur. ***When slower growth is manifested in China, other emerging markets are likely to be negatively impacted since these are often suppliers to China***. Thus their growth rates will decrease, and this will affect the financial markets in those areas if this scenario is not factored into prices beforehand.

BACKGROUND

China's explosive growth occurred because the country opened up its huge - and poor - population to the rest of the world to form a foundation of low-wage exports. Following Deng Xiaoping's exhortations in the 1980's that "it is glorious to become rich", China eventually minted many millionaires and a thriving middle class, at least in major cities in its coastal regions.

When the Great Recession hit the global economy in 2008, the authorities provided fiscal and monetary stimulus, noteworthy in the increase of debt to GDP, to mitigate the impact of declining demand from the rest of the world. This temporarily worked, but the long term trend of slower rates of growth reasserted itself a few years later. However, to prevent even slower growth, debt continued to rise to the point where ***China's debt to GDP is in the area of 250%***. (See Exhibit 1.) As Americans learned (or should have learned) from the Great Recession, no country can borrow itself to prosperity. China will not be an exception.

Exhibit 1, A Worsening Economic Situation in China
China's real GDP growth is slowing, in part due to a very high debt as a percentage of GDP



Source: Wall Street Journal

As a communist country, ***China has a command economy*** driven by the government. From the highest levels of the national government through the provincial governments, the central bank, the regulators, and local governments, the Communist Party controls the economy through its brand of state capitalism. State Owned Enterprises (SOEs) and private businesses are told how to conduct their affairs or are limited as to what they can do. This means, for examples, if the government wants more steel production from its SOEs, or the banks to lend to certain companies, or builders to construct more apartments, or the official exchange rate of the yuan to be within a tight range, or interest rates to be near specific values, or real GDP to be at certain rates, the authorities essentially say the word and they are done. And often their decisions are for political reasons and not economic reasons.

However, ***command economies don't work for very long*** for anything beyond a small size. History demonstrates they don't succeed in practice, and really don't even work in theory, most importantly because they ignore human nature. The complete lack of market discipline leads to imbalances, allowing excesses to build up without a natural avenue to eventually unwind.

Unsustainable growth combined with a lack of market discipline has led China to have major problems that include ***excessive debt, industrial overcapacity, an overheated property market, a fragile banking system, an opaque interconnected financial system, and an impending demographic crisis***. These problems are readily acknowledged by the authorities. They know the necessary structural reforms will be difficult to implement not only because the problems are entrenched and deep but also because of the tradeoffs they need to make.

In addition to economic concerns, there are social problems that may adversely impact the country. These include a huge and growing income disparity between urban versus rural and coastal versus inland citizens, with perhaps hundreds of millions still living in abject poverty.

Ultimately, the biggest tradeoff is about how far to slow the pace of economic growth. This is crucial because growth means a better life for ordinary Chinese, which is extremely important because the Communist Party fears above all else any social instability that would remove them from power (after all, the communists originally came to power through a peasant uprising). Prosperity via a larger middle class also provides the means for China to achieve its ambitious military goals, transition to growth from higher internal consumption and less investment-led growth, reduce its extremely wide income gaps, rectify an inadequate social safety net, and forestall environmental ruin. ***Insufficient growth risks social upheaval and delays or prevents longer term goals, but unsustainably faster growth in the short term from delayed reforms could eventually lead to a more severe slowdown later***. Neither of these outcomes is good for the politicians in power, so they have some tough choices to make as they direct their economy.

PROBLEMS THAT INHIBIT CHINA'S ECONOMIC GROWTH

Debt has primed recent economic success, so any clampdown to reduce excessive borrowing, perhaps by raising interest rates, by definition means slower growth. But higher interest rates could cause debt defaults which would further exacerbate the slowdown. Regardless of the path taken, financial deleveraging is a long-haul project for China.

Industrial overcapacity in basic industries (metal makers, coal mining, cement, etc.) is due in large part to state owned enterprises with falling revenues, a very inefficient workforce, and excessive debt on which they can barely make interest payments. The government has kept these zombie companies alive in order to maintain employment, often by directing banks to extend them even more credit, which is further complicated by the widespread belief that such debt has an implicit guarantee from the government. Simultaneously, efforts to cut excess capacity are often directed at private firms that are financially much healthier. Allowing state owned enterprises to continue in their present form puts a drag on growth. But allowing these bloated entities to restructure in order to be more efficient would increase unemployment and wipe out debt that would negatively impact debtholders, mainly banks.

The property market in China is directly and indirectly (through the construction industry, furniture sales, etc.) about 30% of the Chinese economy. Apartments continue to be built in coastal urban areas even though they cannot be sold on reasonable financing terms. Yet prices continue to rise due to financing incentives that include a minimum down payment (sound familiar?). Apartments were built in interior cities even though there was no demand for them which resulted in vacant ghost cities. But if real estate prices were allowed to fall, perhaps triggered by higher interest rates or restrictions on home speculations, this could spark a rise in nonperforming loans that would directly impact the financial system and cause ripple effects on leveraged developers, state owned enterprises, and local government tax revenues. Obviously these would be a large drag on economic growth.

The banking system is fragile. Four large banks control almost two-thirds of Chinese total banking assets. They have increasing amounts of nonperforming, substandard, and doubtful loans (as officially stated) due to unproductive projects as well as nonviable firms being artificially kept alive by the government. The banks may have insufficient capital to weather potential losses from mounting credit risks (as recently highlighted by the IMF). They also have large amounts of off-balance sheet liabilities.

An opaque interconnected financial system exists between bank and nonbank financial institutions (including trust companies, asset managers, insurers, and securities firms). These entities participate in the dubious practice of selling and buying off balance sheet "wealth management products" that through leverage offer rates of return that are higher than the underlying securities. As if that were not bad enough, the underlying securities are often obscured, though the products frequently consist of corporate loans and residential mortgages. Government crackdowns reduce non-interest income, a significant portion of financial system revenues.

An impending demographic crisis is facing China. Thanks to decades of "one child only" policy forcibly imposed on its citizens, the workforce is shrinking while the population of retirees is ballooning. This is potentially a huge weight on future economic growth. The cultural preference to have a son led to female infanticide with the result that many Chinese males will never marry, which could extend the demographics problem even longer.

OTHER ISSUES FOR CHINA

The authorities in China have declared they want markets "to play a decisive role" in their economy. And they want the yuan to be a major world currency. But it seems they only want the good part of the markets because they intervene heavily when those markets act contrary to their wishes. This happens in the stock market, the currency market, the residential housing market, the bond ratings system, etc. Trying to maintain control over market mechanisms, especially in a now large economy, never works well in the long run and something likely must give way.

In the near term of the next year or two, rising interest rates in the United States will directly affect the policies of China's central bank, the Peoples Bank of China (PBOC). Choices mitigate some problems but exacerbate other problems.

> If the PBOC keeps its interest rates steady, the relatively lower interest rates in China could encourage high levels of debt and therefore exacerbate excess capacity and additional speculation in the property market. If the PBOC raises its interest rates, higher borrowing costs could deflate real estate prices as well as trigger debt defaults that would in turn negatively impact the biggest holders of marginal debt which are the banks and some "wealth management product" holders and guarantors.
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> Concomitantly, relatively lower interest rates could cause the yuan to fall relative to the dollar. This would likely help exporters but could also encourage capital flight from China, another problem the government wants to curtail in order to keep resources in the country. Likewise,

relatively higher interest rates could cause the yuan to rise relative to the dollar, which could reduce capital flight but hurt exporters.

In any Fed tightening program, the Fed eventually runs the risk of overtightening and accidentally causing a recession in the United States. Should this occur, especially if Europe is weak at the same time, the diminished buying from China's largest customers could knock their economy into recession as well. But unlike 2008, Beijing will not have nearly as much fiscal stimulus available to them unless they make great strides in deleveraging in the next few years.

Of course, the United States and Europe could avoid recession for some time. The present situation of stronger global demand and rising commodity prices could last a while and buy China some valuable time to institute reforms, especially reduce debt.

Now that the five-year party conclave is over and President Xi Jinping is effectively a dictator (having amassed power by purging threats to his authority), the time is ripe for him to decisively address his country's economic ills. The question is whether or not he will seize the opportunity to make significant changes, even it means short term pain. Otherwise kicking the can down the road can last only so long before something implodes.

One way or another, China might see interesting times in the next few years.

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