WEDGE WATCH Q3

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Field of Dreams

"If you build it, he will come."
–The voice emanating from the cornfield in the film "Field of Dreams."

Third Quarter 2009 Financial Statistics

DJIA: 9712.28

S&P 500: 1057.08

90-Day T-Bill: 0.11%

30-Yr. T-Bond: 4.05%

In the uniquely nostalgic 1989 film Field of Dreams, novice farmer Ray Kinsella (played by Kevin Costner) stood in the backyard of his Iowa farm, just steps from his family's cornfield, mesmerized by a mysterious voice urging him to "build it and he will come." In time, Ray interprets this to mean that if he builds a baseball diamond in the cornfield, the legendary Shoeless Joe Jackson, controversially banned from major league baseball in 1921 for allegedly helping throw a World Series game, will magically emerge from the maize of cornstalks, along with his seven other banned Chicago Black Sox teammates, so he and they can finally play ball again. As some of you may recall, Ray did build it and he did come (along with the ghosts of a dozen or so other famous baseball players from Jackson's era). For those of us willing and able to suspend our disbelief, the film was an inspirational delight.

Needless to say, humankind is always in search of, and often in need of, inspiration. China, the world's most populous country, is no exception. In that regard, we'll probably never know if members of its Politburo saw Field of Dreams, though it would appear from their exceedingly bold and inspired actions in recent decades that they may have. As has become increasingly evident with the passage of time, China's "build it and they will come" approach to manufacturing has been a staggering success, a proverbial "grand slam" if you will. To help our readers gain insight into this remarkable transformation, and to consider its wide-ranging implications, let's delve into the story behind this still-evolving and historic saga.

Despite perceptions, China's capitalistic roots run deep. In a telling contrast, it was once said that "Japan is a profoundly socialist country where capitalism was imposed while China is a profoundly capitalist country on which socialism was imposed." Mindful of this, *the July 2003 issue of WEDGE Watch made a forceful case for China's emergence as a major economic power in the years ahead*. Since then, of course, the country's economic growth and dramatically elevated financial stature have more than exceeded expectations. Though a surprising development to some, knowledgeable students of Chinese history, especially economic history, were likely least surprised.

Jim Rogers, globe-trotting author, frequent commentator on global capital markets and prescient commodity investor, writing in his 2003 bestseller Adventure Capitalist, endeavored to put the history of China's capitalistic endeavors into proper perspective when he wrote that, "the Chinese are a people with a very long entrepreneurial history," and "are among the best capitalists in the world." In the paragraph that follows, with Rogers' permission, we synthesize a few key thoughts on China from his insightful book:

Before 1949, before the revolution and before the establishment of the People's Republic of China, the Shanghai stock market was the largest in Asia, exceeded only by those in New York and London. In fact, Shanghai was the center of commerce and the axis of everything in the Far East. Many centuries earlier, China had risen to the forefront of world commerce, industry, and technology. During the Song Dynasty, which lasted from A.D. 960 to A.D. 1279, China experienced a period of unprecedented economic activity during which coal, steel, and armaments industries flourished. Underscoring its economic prominence then, specifically during the late 11th century, market-regulated commerce in China led to a level of iron production that would peak at twice that of England's seven hundred years later. In fact, during the span of the Song Dynasty, the Chinese engaged in broad-reaching international commerce aboard sailing ships that are believed to have traveled as far as the east coast of Africa and the west coast of Latin America (long before the Spanish or Portuguese). However, following a period of political upheaval in the early fifteenth century, xenophobic mandarins turned the country decidedly inward, sadly destroying all its magnificent sailing ships and, in kind, the records of their explorations.

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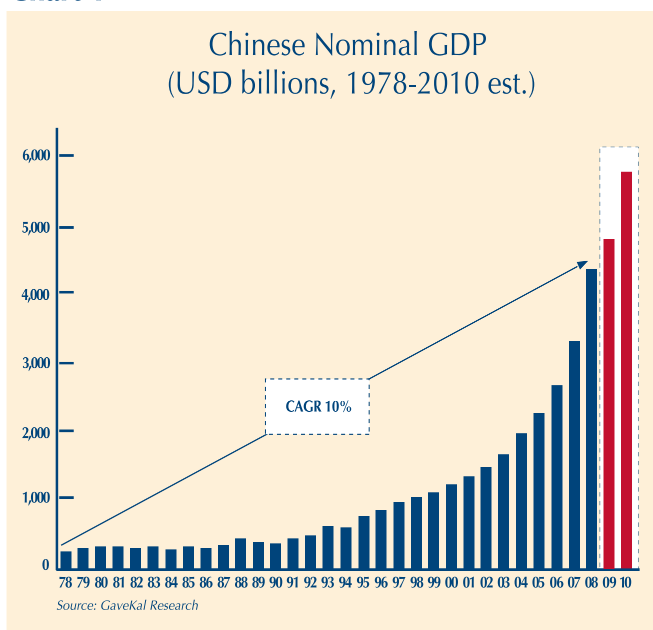
...Dreams

In the modern era, prior to China's economic resurgence and much enhanced global notoriety, many casual observers viewed the country largely through the singular prism of Communism and its infamous former dictator Mao Tse-tung. However, it's important to note, as Rogers points out in Adventure Capitalist, it was less than 100 years ago that Communist ideaolgy began to spread in China (1919) and for a mere thirty years (1949 to 1979) that China's strict communist economy prevailed. **Since Premier Deng Xiaoping sought to liberalize and open the Chinese economy to the rest of the world** (two years after the death of Mao in 1976), **China's economy has been expanding at a truly historic rate** – compounding at a world-leading 10 percent per annum (see **Chart 1**). Notably, *this unprecedented economic renaissance helped lift 600 million people out of poverty in a single generation.*

Chart 1



Source: GaveKal Research

Today, there seems little doubt that the Chinese economy has firmly embraced its entrepreneurial roots. In fact, at least throughout much of this year, *it appears to have been providing the lion's share of economic ballast underpinning the still nascent global recovery* (not to mention maintaining its all-important status as a primary funder of the ever-growing U.S. deficit). In fact, a solid case can be made that China has been pivotal in helping temper what was a uniquely vicious and abrupt economic contraction (of generational proportions). As a result of China's newfound prominence, **for the first time since the end of World War II, a global recovery (or stabilization) is being led by a country other than the U.S.**

In the paragraph that follows, with the help of Hong Kong-based GaveKal Research, a well-respected and long-tenured observer of the Chinese economy, we share compelling evidence on 21st-century China's stunning economic ascension:

China is now contributing more to global growth than all developed economies combined and is rapidly closing in on Japan as the second largest economy in the world. In addition, China is now a top-three trading partner for most countries of size. For example, China has become Brazil's largest trading partner, in contrast to its negligible relative position only a decade ago. Today, 15 percent of Brazil's exports go to China versus just 9 percent to the U.S. Further underscoring its growing stature, **China is now the first or second largest consumer of most of the world's key industrial commodities, with a market share that ranges between 25 percent and 45 percent**. (In addition, according to IMF estimates, since 2005 China has generated over 75 percent of the global growth in oil and coal consumption worldwide.) Adding heft to these eye-opening numbers, China's demand for heavy-industry imports dramatically outstrips that of commodities, at nearly two times the dollar amount of raw materials it buys from foreigners each year. Needless to say, as an end-market for such products, China's shadow grows larger by the day.

"It does not matter whether the cat is black or white, as long as it catches the mouse."
–Premier Deng Xiaoping (1904-1997), commenting on whether China should embrace capitalism to the exclusion of its Communist ideology

Notwithstanding the sustained positive glow emanating from "the land of enchantment" however, *the economic reality there may not be entirely what it seems.* History shows that proclamations of "new era" economic renaissance have often led to disappointment, wealth destruction and, ultimately, economic malaise (i.e., Japan following its economic heyday in the 1980's). As a result, we feel it's essential to remind investors that, despite China's increasingly robust capitalistic infrastructure, **the country remains, first and foremost, a "command-style" emerging economy where economic growth is often manufactured (dictated) by party rule**.

Earlier this year, a new book by George Friedman, founder and CEO of highly-regarded intelligence and forecasting firm Stratfor, examined the parallels between today's China and the Japanese experience of the 1980s. In his book, The Next 100 Years: A Forecast for the 21st Century, the author makes an emphatic case that economic history may once again prove prologue (we paraphrase in the two paragraphs that follow):

During the 1980s, Japan was widely seen as an economic superpower whose reach was boundless as it methodically rattled American businesses caught "flat-footed" in its wake. As evidence of its then-growing competitive clout, the emerging carnage was so widely-publicized, and believed so real and sustainable, that prominent business schools were teaching students to learn from the Japanese and to emulate their management practices. Magazine covers, both here and abroad, were rife with disturbing predictions trumpeting the inevitable demise of American business (against a backdrop of sustained global domination by Japan). At the same time, as this sobering and disconcerting story unfolded, Japanese investors were tripping over each other, almost literally, in a mad race to buy up trophy real estate properties across the lower forty-eight, such as the famed

Pebble Beach Golf Club in California (at stratospheric prices never before seen or imagined). To the Japanese, there seemed no limit to what they might conquer next. **Unbeknownst to most, however, its growth had much less to do with management than with its artificially propped up banking system**.

As Japan's economic prestige grew during the late 1970's and early 1980's, banks there, with the blessing of banking regulators, were lending money to Japanese businesses at heavily subsidized rates. In fact, those rates were a mere fraction of what American companies were paying at a time of rampant inflation and high interest rates. In addition, incestuous Japanese cross-ownership between banks and their industrial brethren was commonplace, if not the norm. This, in turn, led to capital allocation that was highly artificial (not economically-driven) and which gave recipients **a distinctly unnatural and unfair pricing advantage in the global marketplace**. Lacking sufficient domestic demand for its products due to very high forced savings rates (Japan lacked a robust social safety net), *the country's financial viability was largely dependent on its success exporting Japanese-built products to other countries,* much like China's is today.

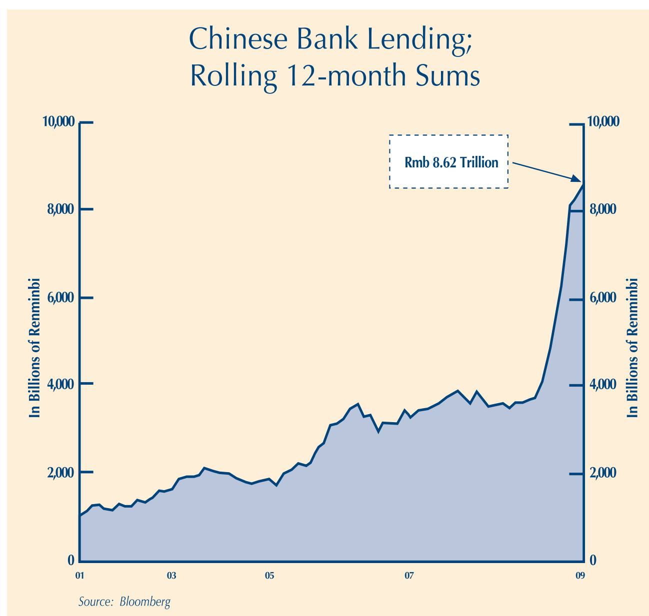
Needless to say, despite the apparent success of Japan's economy, and its mushrooming influence during that period, the rampant spread of cronyistic lending practices was seeding a banking crisis of historic proportions. As Friedman recalled in The Next 100 Years, "Japan was living off a legacy of cheap, government-controlled money, and low prices were a desperate attempt to keep the cash coming in so the banking system could hold together. In the end, however, the debt structure grew too massive and it became impossible to stay in front of it with exports. As a result, Japanese banks began to collapse, in time forcing widespread and extremely costly government bailouts. Unfortunately, instead of permitting a massive recession to impose discipline," Japan's leadership, in a culturally-driven and near-fatal miscalculation, "used various salvaging means to put off extreme pain in return for a long-term malaise" that, two long decades later, still endures. In the paragraph that follows, Friedman's illuminating and "no holds barred" commentary **postures the Japan experience as a proxy for today's Chinese economic miracle**:

> *"The most practical way to imagine the future is to question the expected."*
> –George Friedman

"China is Japan on steroids. It is not only an Asian state that values social relations above economic discipline but a communist state that allocates money politically and manipulates economic data" (more on this later). "It is also a state in which equity holders—demanding profits—are less important than bankers and government officials who demand cash." Like Japan during its glory days, China relies heavily on exports, has seen its economy grow at staggeringly high rates, and faces potential collapse when the growth rate appreciably slows (this, of course, is debatable). By Friedman's estimate, Japan's bad debt around 1990 was about 20 percent of GDP. Today, China's, under the most conservative estimate, is about 25 percent according to Friedman—and he argues the number is actually closer to 40 percent. **Disturbingly, much of this bad debt is carefully hidden (off-balance sheet), and not included in the official government estimates**. Alluding to this, in a moment of uncharacteristic candor, Chinese Premier Wen Jiabao recently told officials there that his country's fiscal situation "*is very grim*." Two and a half years earlier, in March 2007, a time when the Chinese economy appeared to be firing on all cylinders, he warned that its economy was "*unsteady, unbalanced, uncoordinated, and unsustainable*." This was very strong language and, from our perspective, a revelation not to be taken lightly.

In an attempt to make sense of the Premier's conspicuously cautionary language, we point to **China's decisive response to last fall's seizing up of the global financial system, which we believe speaks volumes about their need to maintain financial and social stability** (seemingly regardless of cost). Last November, China officials moved at lightning speed to bolster growth and stabilize employment by embarking on a massive stimulus program (targeting spending equal to roughly 15 percent of its GDP, an amount approximately 3x the stimulus approved here in the U.S.) while simultaneously cranking open the monetary spigots and flooding the system with cash. The Chinese banks (many of which are state-owned) have been pedal-to-the-metal as well (see **Chart 2**). First-half loan volumes surged nearly three times higher than last year's comparable level, *the strongest six-month lending spike on record*. All of this, ironically, transpired against a very tenuous backdrop where corporate profitability in China, under pressure from a sharp reversal in export volumes, was cratering.

Chart 2



Intended or not, this unprecedented outpouring of fiscal and monetary stimulus has proven to be a key psychological, if not real, factor driving this year's outsized rally in the Shanghai-index (which doubled from its November 2008 low to its peak on August 4th, a day when trading volume there exceeded that of New York, London and Tokyo combined). In addition, China's huge infrastructure-

dominated stimulus package helped dramatically drive up prices of key commodities (such as copper and iron ore) despite broad-based economic carnage and impaired commodity demand elsewhere around the globe. (Speculation by commodity investors has also been rampant while **a woefully resource-scarce China has voraciously stockpiled commodities** as well)

The Chinese monetary flood, despite its perceived potency, is not without risk however. Against a backdrop of precedent-setting loan volumes, bad loans are on the rise across China (although you wouldn't know it from the officially reported non-performing loan statistics). Case in point, in a sign of extreme imbalance (and potential stress), **the commercial real estate vacancy rate in Beijing has soared from just under 5 percent in March of 2004 to over 35 percent today** (with a large amount of new supply expected to come on-line in the quarters ahead). As many foreign visitors can attest, a casual stroll around Shanghai, Beijing or the industrial city of Guangzhou reveals "see-through" office buildings as far as the eye can see (a sober reminder for those who remember Texas in the aftermath of the oil bust in the early 1980s). Might this unhealthy and still growing structural imbalance be the proverbial *canary-in-the-coal mine?*

According to Ed Hyman's prominent and widely-followed economic forecasting firm ISI, for the past two decades the Chinese government has been pursuing an employment policy heavily reliant on growth in export-oriented industries to meet urbanization and social goals (it is believed that China needs to create at least 15 million new jobs each year to keep tens of millions of poor farmers from rising up in rebellion). Such a model of development largely depends on an undervalued currency, cheap labor and growth in external economies. As a byproduct of all this, *production capacity surged over the past decade, leading to today's rather daunting capacity imbalances across several key sectors of the Chinese economy* (following the crisis-driven collapse in export demand that surfaced late last year).

Stephen Roach, a long-tenured and influential Wall Street economist, and Chairman of Morgan Stanley Asia, elaborated on this theme earlier this year when he wrote: "Relative to all the Asian economic-development efforts since the end of World War II, **China stands alone in the massive bet it has made on externally-led growth**. According to Roach, citing statistics from the International Monetary Fund, *"China's share of world trade increased eightfold in the twenty-five years following its economic takeoff in the early 1980s. That is more than two-to-three times the gains experienced by other Asian economies over comparable phases of their development journeys."* Moreover, following its ascension to membership in the World Trade Organization, "China upped the ante on this export bet by taking the export share of its GDP from 20 percent in 2001 to 36 percent in 2007." In a more recent follow-up commentary, Roach described the financial crisis as a "real wake-up call for the entire Asian export-led growth model" adding that "**if the U.S. consumer is in the early stages of a long-term pullback, then Asia has big problems**."

Although it remains to be seen if China can thread the needle by successfully navigating and averting the severe dislocation which inevitably affects emerging economies, especially those heavily reliant on external demand (China's consumer economy remains much too small to serve as the primary engine of economic growth, as only 35 percent of GDP is driven by domestic consumers versus approximately 70 percent in the U.S.), it does seem obvious to us that officials there are striving mightily to maintain the illusion of unabated hyper-growth. Behind the scenes, however, we believe it's likely they are holding their breath, anxiously waiting for a tangible and sustained pickup in global export demand.

Economist John Makin, a visiting scholar at the American Enterprise Institute (AEI), recently highlighted the growing credibility problem with China's economic statistics. In a paper titled China: Bogus Boom?, Makin candidly apprises readers that "Chinese economic data are constructed very differently from the roughly comparable U.S. statistics, so that looking at Chinese data through a lens conditioned by U.S. data-building and reporting conventions can be misleading." According to Makin, "China's economic statistics are based on recorded production activity, rather than being a measure of expenditure growth—defined as the sum of consumption, investment, government spending, and net exports—as U.S. data are." The disbursement of funds from China's massive two-year stimulus program "is recorded as GDP growth," unlike here in the U.S. This allows the government to easily control the reported rate of GDP growth "by the pace at which it releases funds" from the stimulus plan (and would seem to explain why reported GDP growth in China often matches government projections). "Funds disbursed for fixed-asset investment by state-owned enterprises or provincial governments are counted as having been spent when they are disbursed" although they are often subsequently held back by the recipients for extended periods before actually being deployed.

Adding to the counterintuitive nature of China's accounting for GDP is the unusual methodology utilized to measure retail sales. Again, according to AEI's Makin, "Shipments to retailers are counted as retail sales on the apparent assumption that ultimately all goods shipped will be sold at some point." This is why some skeptical observers believe reported retail sales in China, during the first half of 2009, were highly suspect since the official government numbers showed nominal retail sales having grown 15 percent year-over-year (despite very severe global economic contraction elsewhere). Making things worse, in terms of transparency, Makin points out that progress on infrastructure projects in China can't be reliably monitored because "the information on inventories and the progress of outlays" on such projects "is not publicly available."

In addition to the accounting differentials just cited, Makin highlights anecdotal evidence as well. According to him, the growth of money and credit accelerated sharply in China during the second quarter, a possible indication "the public works projects and actual spending already recorded were falling behind schedule." As referenced earlier, the resulting flood of money into the Chinese economy has also found its way "into Shanghai-traded stocks, property markets, commodity stockpiles, and consumer durables" (with the help of special

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incentives for durable purchases and outright giveaways as well). Makin writes that there have even been reports of Chinese households acquiring washing machines (that were aggressively shipped and counted as retail sales) though many of the recipients "lack running water or electricity." Adding to his concern, state-owned enterprises, along with other recipients of stimulus funds, have apparently redirected portions of that money into equities, "rather than leaving them idle until they can be disbursed for actual projects," an undeniably speculative and high risk move. Interestingly, **much of this occurred against a backdrop where Chinese exports (the key cog to their economy) dropped at an estimated year-over-year rate exceeding 20 percent.**

"Massive injections of money and credit are always unsound. But for stocks, commodities and credit, they are bullish before they are bearish."
–Jim Grant, commenting on China's centrally-planned and centrally-orchestrated money printing and lending binge (*Grant's Interest Rate Observer*, July 10, 2009)

Despite the numerous and potentially valid concerns highlighted here, **China remains a country of vast potential** (a population of 1.3 billion highly motivated individuals, many long deprived, is nothing to sneeze at). Unlike the U.S., China fortuitously saved for a rainy day, evidenced by its immense storehouse of $2 trillion in foreign exchange reserves (the largest in the world). This financial arsenal has proved invaluable, especially over the past year. In addition, the country's urbanization potential appears far from tapped out. In fact, the government's current plan to dramatically expand the country's highway and public transit system should open up many relatively untouched parts of China to commerce over the next several decades (potentially helping propel many millions of dedicated and hard working rural Chinese up the ladder of success).

In addition, it would appear that the country's remarkably high savings rate (forced saving remains imperative given the government's very modest social safety net) puts it in a uniquely strong position to continue financing its massive infrastructure build-out, etc. China's exploding number of homegrown engineering graduates, 700,000 per annum, is also a competitive weapon not to be overlooked. (It's worth a reminder that for many years now, *underestimating China has been the quintessential "losers game."*) However, as pointed out earlier, **China's consumer economy remains far too small to drive the global growth needed to overcome still-lingering economic malaise in many parts of the world**. At least for the foreseeable future, the country remains a very large and unbalanced construction-based economy (an inherently risky underpinning, especially given China's inordinately high dependence on export demand for economic growth).

As always, only time will tell how this unprecedented emerging market story plays out. However, this year's stunningly robust rally in Chinese stocks (through early August), which, as noted earlier, began early last November before U.S. markets bottomed in early March, has proven a harbinger of much higher stock and bond prices around the globe. In fact, it seems plausible, at least for now, that China has become the world's economic indicator *du jour*.

As Mark LaPolla of Sixth Man Research recently declared in his often provocative newsletter, "**China is the psychological lynchpin for more investment sentiment than any other singular factor in the world**." In that regard, *it appears investors, consciously or not, are once again embracing risk and buying into the veracity of the positive economic data coming out of China*, despite the myriad concerns highlighted above. Equity investors, after all, are natural optimists, so their dreams often "die hard." This is especially true for investors intoxicated with visions of wealth and affluence (if not sugar plums) dancing in their heads. However, **if today's increasingly evident optimism proves misplaced, these same investors, both here and abroad, might be forced to reassess, hunker down and dig in their cleats as this ballgame could, in time, turn into a real nail biter**. Stay tuned.

Index	09/30/09 Price	3rd Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	9712.28	15.0%	10.7%
S&P 500	1057.08	15.0	17.0
Value Line Composite	298.87	22.1	32.3
American Exchange Comp.	1778.67	12.4	27.3
NASDAQ Composite	2122.42	15.7	34.6

*Does not include dividend income.

Fixed Income

A Question of Balance

Readers of a certain age may recognize our title, borrowed from the 1970 progressive rock album of the same name (artist: The Moody Blues). As the one-year anniversary of the Lehman Brothers bankruptcy passes (along with the earth-shaking financial fallout that resulted), **a question of balance** still pervades the financial markets. Unlike a year ago, however, the balance has shifted dramatically from one of *an abundance of fear* to, dare we say, **a virtual absence of fear**.

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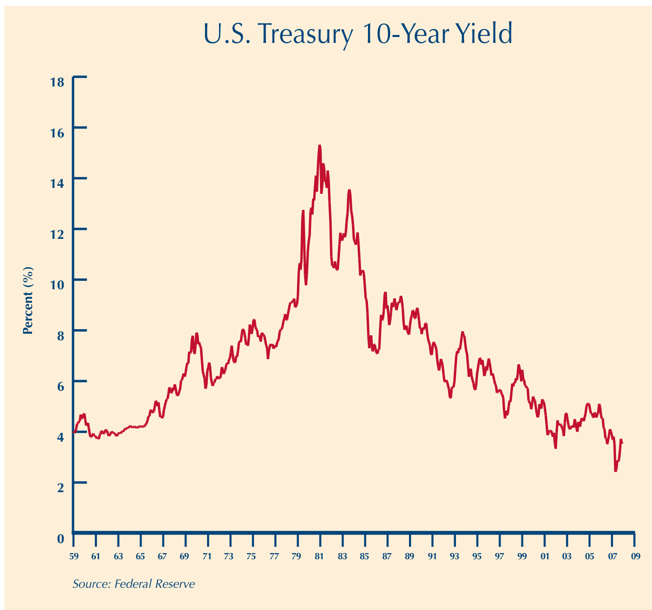
...Balance

As we survey the financial scene today, equity and credit markets (both investment grade and high-yield) have staged dramatic rallies from the March lows. Commodities (such as oil, gold and copper) have also rallied sharply. Helping to sustain these outsized moves, signs of economic recovery continue to emerge, increasing the confidence level of market participants that the worst is now behind us.

On the other hand, one market that appears to be out of balance with all others is the Treasury bond market. **Chart 3** shows the Treasury 10-year yield. (For simplicity, we refer to the 10-year Treasury as a proxy for the Treasury market.) Although the yield has retraced nearly 100 basis points from the December 2008 low of 2.42 percent, it nonetheless remains near 40-year lows! By now, **one might have expected the yield to have climbed considerably higher, given the exceptionally strong rallies in risky assets and commodities, increasing evidence of economic recovery, U.S. dollar weakness and the unprecedented size of the federal budget deficit.**

Chart 3



This begs the question: what's keeping the 10-year Treasury rate so low? A logical place to start is gauging Treasury obligation supply and demand. Supply is the easiest to discern, so we'll discuss that first. Given the incredible size of the current federal budget deficit, the supply of Treasurys appears limitless. It's estimated that the U.S. Treasury will borrow an incremental $1.6 ***trillion*** during the 2009 fiscal year, with large deficits projected "as far as the eye can see." Another obvious question to ask is: where has, and more importantly, where will, the demand for Treasury debt come from going forward? While it's difficult to give a precise answer, we can find clues from various sources. As the U.S. continues to run trade deficits, the accumulation of dollars overseas has primarily been recycled into Treasury securities here. According to recent Treasury Department reports, foreigners increased their holdings of Treasury securities by **$750 billion** from June 2008 to June 2009, bringing the total foreign holdings to ***$3.4 trillion***, or roughly 29 percent of Federal debt outstanding. Given the massive size of these holdings, one must ask whether or not foreign investors (i.e., China and Japan) will maintain such a voracious appetite for U.S. government debt (especially at today's historically depressed interest rates).

In terms of individual investors, they too appear to have dramatically increased their Treasury bond holdings in recent quarters. According to the Federal Reserve's flow of funds data, the household sector's holdings increased by **$238 billion** from June 2008 to June 2009. This is likely a result of the economic downturn and its dramatic impact on consumer psyches, given the far-below-normal consumer savings rates in the years leading up to last fall's banking collapse.

Of course, the Federal Reserve has also been a large and active buyer of Treasurys. The Fed, which publishes its balance sheet each week, has increased its Treasury holdings by **$280 billion** from the same year-ago period. This appears to be consistent with the Fed's commitment to take extraordinary measures to address the financial crisis. In March, the Fed announced it would buy up-to $300 billion in "longer-term Treasury securities over the next six months." As this program appears to be nearly done however, an unanswered question is how the Treasury market will respond in the absence of further Fed purchases.

To summarize, it appears, so far, that the majority of the onslaught of Treasury debt has been easily absorbed by demand primarily from three sectors: foreign buyers, individuals and the Fed. **This has helped keep Treasury rates relatively low even as risk assets and commodities have attracted enormous amounts of capital since the March lows**. Since the supply of Treasury debt appears nearly infinite going forward, a significant reduction in demand (from any major buyer) could very likely send rates higher (possibly significantly higher). **As we wait to see how all of this evolves, we can only hope that our "question of balance" is answered in a manner favorable to the markets and the economy.** Keep your fingers crossed.

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