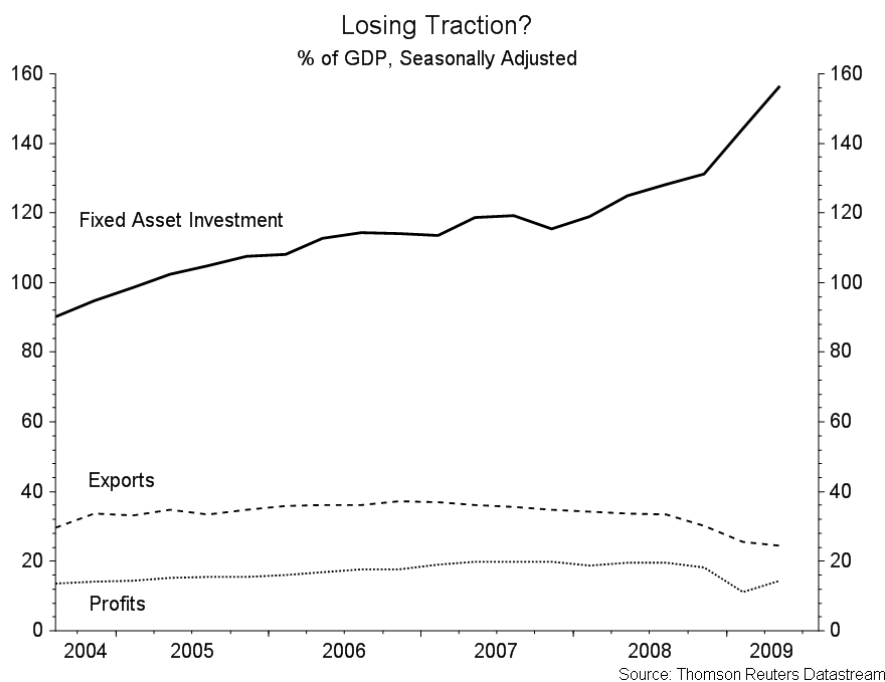


China's Reflation Experiment: Short Term Gain / Long Term Pain?

By all appearances, China's success in stimulating its way out of the global recession has been wildly successful. GDP growth was 8% annualized last quarter despite ongoing export weakness. The stimulus package, consisting mainly of a combination of infrastructure spending (U.S. \$590 b) and state-directed expansion of business lending (\$1,084 b), is by far the largest as a share of GDP of any nation. Tax rebates and other incentives have increased domestic consumption dramatically. For the first time, more cars were sold in China than in the U.S. in the first half of this year.

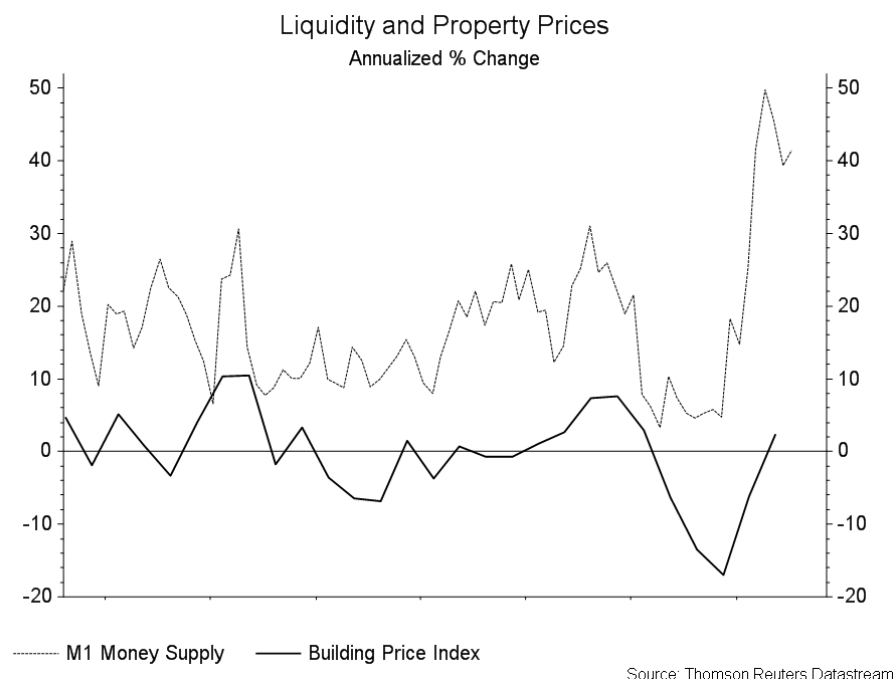
This success masks a growing set of imbalances. GDP growth has increasingly been driven by capital investment, as exports and profits have both declined over the last two years (Chart 1). At a time when most businesses outside of China are retrenching by reducing leverage and cost cutting, large Chinese corporations are doing just the opposite. Capacity expansion with weak exports will lead to a growing output gap that will further reduce profitability. Due to state control of the banking system a financial crisis is unlikely. However, investors should be concerned particularly given the high valuations of most Chinese equities (P/E ratio averages 38 for stocks in the Shanghai composite index).

CHART 1



Rapidly expanding excess capacity is likely to depress consumer prices and yet asset price inflation is thriving once again. The close relationship between money supply and property prices (Chart 2) indicates that prices are likely to move up substantially over the next 6 to 12 months. The stock market has surged 85% from the bottom last fall, although it is still off 45% from the peak in 2007. This past week, Chinese policy makers sounded the alarm over reckless domestic lending practices and emerging bubbles in asset prices, real estate in particular. Regulators have directed banks to ensure that new loans are channeled towards the real economy and not into speculative investments. This clearly signals that the authorities are taking the threat of another bubble seriously.

CHART 2



Domestic consumption has held up well despite the global downturn. Given that the sector is a relatively small portion of GDP, the Chinese economy continues to be dependent on the export market and will be for years to come. Exports remain depressed due to ongoing consumer retrenchment in the U.S. and Europe, China's biggest customers. Social unrest due to rising unemployment is considered the most immediate threat to the regime. If asset bubbles are the price of stimulating employment, the authorities will keep pumping up credit.

Capital flows into China in the first half of this year have been huge, driving the capital account surplus to U.S. \$178 billion in the last quarter. While there has been much concern over the unwillingness of the Chinese to continue accumulating treasuries, the fact is that they do not have any alternatives. The recent surplus has

been added to reserves, a clear indication that the China-U.S. “balance of financial terror” is still intact.

At present, the real problem for the Chinese is not concern over the debauchery of the dollar. It is sterilizing capital flows from further inflating stock and property markets. Since February, the money supply increased by 2.7 trillion RMB. Historically, China and emerging markets in general tend to perform well when U.S. interest rates are low. The dynamics of the current situation diverge from the past in that the U.S. will be forced to maintain easy money for an extended period. The U.S. recovery is fragile and it will take years for the deleveraging process to play out. Interest rate shocks to the U.S. property market will not be permitted, and consumer spending is not likely to become robust in the near future.

It is therefore probable that the authorities’ moral suasion will not be backed up by concrete action and the Chinese economy will remain awash in liquidity well into 2010. The property and stock markets will be beneficiaries of this easy money, but the risks of a major setback will grow as the excesses continue to mount. It is impossible to forecast exactly when a bubble will pop, but history shows that they usually run longer than expected.

Probably the most important lesson that can be derived from the financial crisis is that a steady diet of credit expansion can stimulate growth in the short run, but long term will lead to instability. In the West, this instability manifested as a series of stock and asset price bubbles, a build-up of excess private debt, and an increasingly vulnerable financial system. In China, it turns up as excess capital formation. Declining

profitability, deflation and possibly a spike in the RMB will be the catalyst that bursts the Chinese bubble, but not for a while.

Investment Conclusions

The charts showing key stock markets (p. 9) and copper (the bell-weather metal), oil and other commodity prices (p.10), remain supportive of our view that we are in the “sweet spot” of the cycle. The recovery has yet to use up much slack in the system as unemployment is still rising, unused capacity is large, price inflation is muted and debt is still being liquidated. The central bank is able to lean on the throttle, and now that collapse of the financial system has been averted, investors will benefit.

In general, liquidity is the main driver of financial markets. In the U.S. it continues to increase sharply and the money must go somewhere. True to form, it has been moving into equities, oil, commodities, high yield bonds and foreign currencies. Credit spreads continue to narrow (Charts p. 11). The U.S. dollar and treasuries have given back much of their post-Lehman panic gains but have not yet broken down to the point of creating concern for the stock market.

The bears are gradually capitulating. They tend to make the same mistake in every cycle, projecting where they think the economy is going and assuming that the market will follow their projections. The problem is that most economic data is a lagging indicator for the stock market. The market tends to look six to nine months ahead.

Waiting for the economy to give a clear buy signal would lead an investor to miss out on the powerful rally that typically follows a crash.

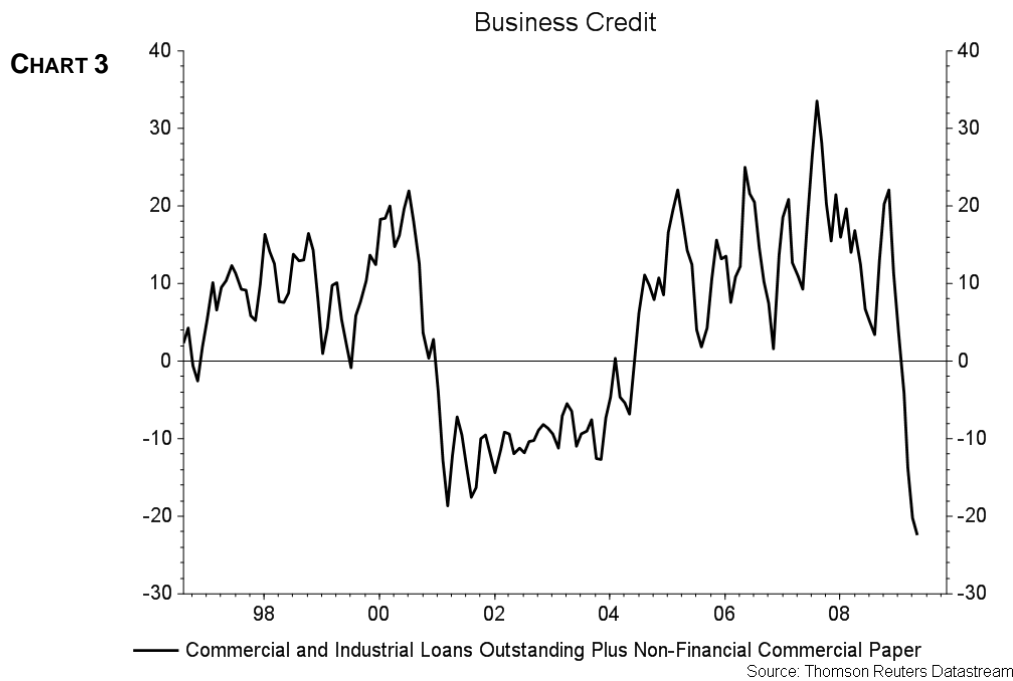
There are a number of encouraging signs from a short- to intermediate-term perspective. The stock market charts on page 9 consistently portray classic bottoms with a dramatic lift off the lows, followed by a rather anemic correction in May and June. Seasonally, and following a huge rally, one would have expected a sharper correction. It would appear that another major up-leg is underway. The wall of money created to bail out the financial system and economy continues to try to find a home. As more bears capitulate and as evidence of economic recovery is harder to dispute, investors' courage will strengthen. Financial healing, while far from complete, has moved much faster than most people thought possible.

The key question for investors is at what point should they start to have concerns for a much steeper correction. As pointed out in our most recent letters, the economy and financial system will remain fragile for some time, dependent on massive fiscal deficits, government bailouts and extreme monetary ease. We will hover on the edge of deflation for some years as the household sector delevers from untenable balance sheet positions. We must remember that the U.S. and world was staring down the black hole of incipient debt deflation less than six months ago.

The risk for financial markets will become much more acute after evidence of economic recovery and falling unemployment becomes convincing to policy makers. They are naturally vulnerable to accusations of being inflationists. We will hear increasing talk of exit plans as they become more confident that the recovery is solid.

We have experience of premature exit plans. In 1936-37 the Federal Reserve tightened and the economy and stock market plunged. Japan tried to consolidate its fiscal position twice in the 1990s and tightened monetary policy prematurely a few years ago. Each time the economy and stock market sank.

As we see it, the threat of premature tightening will create risks for investors as the debt structure and market confidence will remain fragile for some time. As a consequence of excess capacity, there will be no threat of rising price inflation for years. The Fed should only grow concerned about price or asset inflation, after credit starts growing rapidly. As Chart 3 shows, bank lending is still in contraction mode.



Gold (chart p.10) has been firm but remains in a wide trading range, boxed in by the bearish forces of weak jewelry demand, heavy scrap sales and relatively high price on the one hand and fears of U.S. monetary debauchery and a falling dollar on the other. We think that the balance of forces will be resolved on the bullish side but

investors may have to be patient before they see rising price inflation and a dollar collapse. One can never dispute the insurance value of gold but financial markets will probably prove to be a better place to make money for the time being.

We remain negative on U.S. treasury bonds and positive on credit spreads (charts p.11).

The U.S. dollar (chart p.11) has been very weak across the board but it is still well above its pre-Lehman level. It will have to be watched closely. The Canadian dollar (chart p. 11) has recovered sharply and will continue to do so if the global recovery remains on track. As a classic commodity currency, with sound public finances, it is a good hedge for Americans.

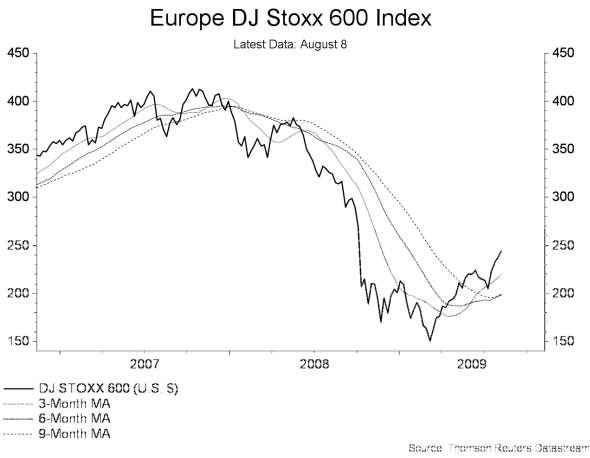
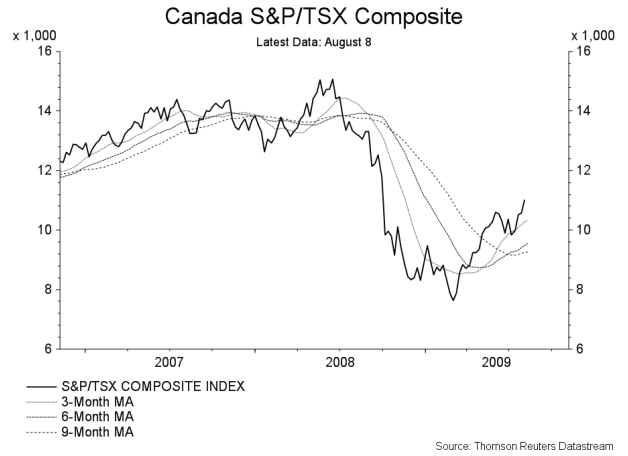
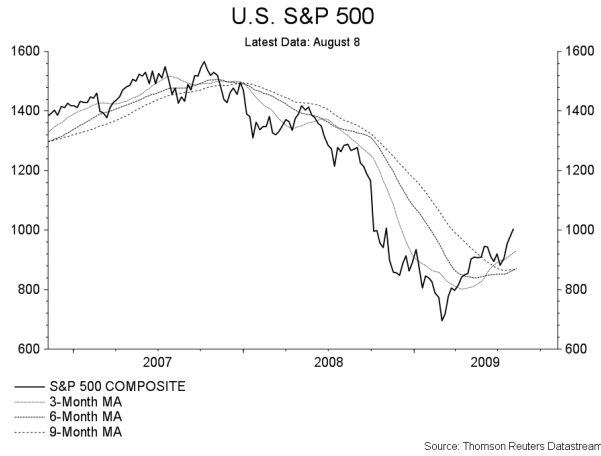
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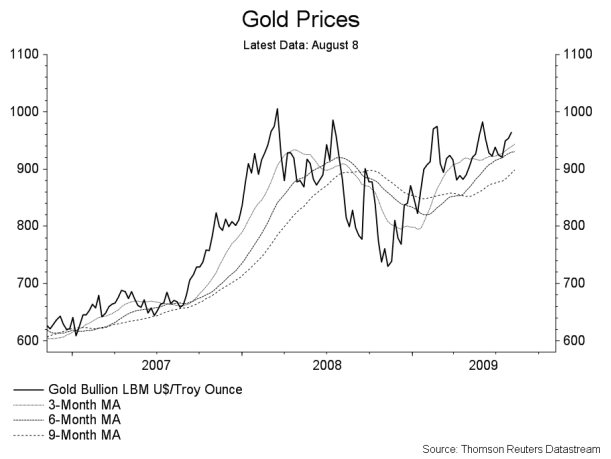
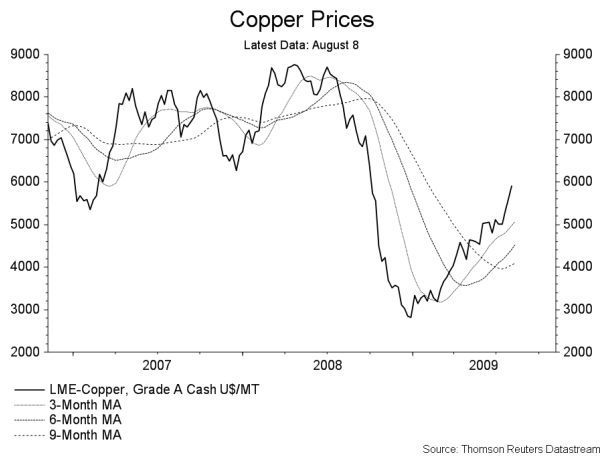
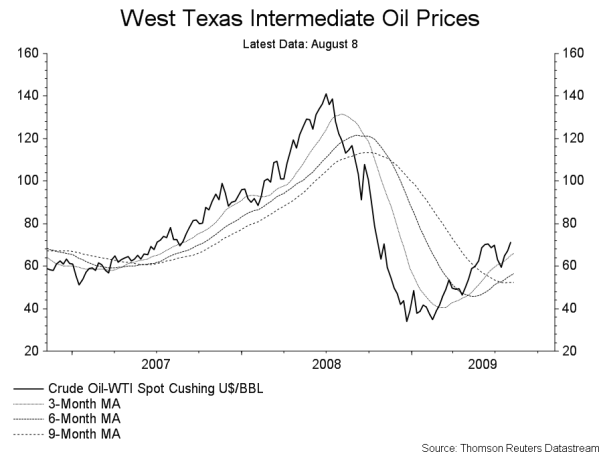
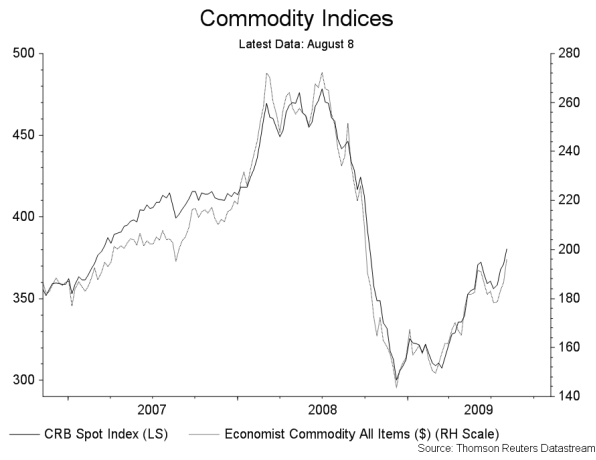
August 11, 2009

Rob Boeckh

STOCKS



COMMODITIES



CURRENCIES AND INTEREST RATES

