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China – The Mother of All Gray Swans

Japan – Past the Point of No Return

Notes:
1. Below are informal notes taken by a JHU/APL staff member at the Seminar.
2. Mr. Katsenelson used an extensive set of detailed viewgraphs, which are also available in the Video Archives.

Mr. Katsenelson began by noting that he was born in Murmansk, Russia. As a child he had been told that his aunt and cousins had moved to Siberia, which was too far away to visit. In 1987 he discovered that they had actually moved to New York. On hearing that, he immediately called her a traitor since he had been raised to hate America. But that soon changed. Around 1987-1989 American movies were beginning to be shown in basement informal “theaters” – several television sets hooked up to a VCR showing dubbed movies. Seeing American movies started to change how Russians felt about the US. Obviously, that change took place in Katsenelson, since he was now standing across from the Pentagon talking about capitalism.

China – The Mother of All Gray Swans

- Black swans: events of high improbability and great rarity, which occur randomly
- Gray swans: events of high improbability and great rarity, which are predictable although we may not be able to predict when they will occur
  - China is a Gray Swan

China has a predictable timeline of growth and problems
1. 1998-2008: Late-stage obesity and over-capacity
2. 2008-2009: You Lie!
3. 2009-Present: Super Steroids-R-Us

The Late-Stage Obesity and Over-Capacity
- During this stage China was growing its GDP at about 10% a year
- The assumption was that they would keep doing so
- US consumers borrowed against their houses to buy goods made in China
  - China’s economy was built on US buying
  - But US and European buying slowed down since buyers were over-leveraged
  - China was left with an enormous excess capacity in many manufacturing fields
    - Example: China has greater cement capacity than India, Japan, and the US combined (2008)
- Example 2: China has greater steel capacity than S. Korean and Japan combined (2008)
- Starbucks example of what can go wrong in Late-Stage Growth Obesity
  - In 1999 Starbucks was opening about 2,000 stores per year
  - By 2007 it was more like 10,000 per year
  - At something 5.5 opening a day, many poor decisions were made
    - Location of stores
    - Employee quality

China with its enormous growth has also been making low-quality decisions
- Complicated by the fact that the state owns/controls one-third of the economy
- Example 1: South China Mall – 2nd largest in the world – stands 99% empty
- Example 2: City built for 1 million people remains a ghost town
- More examples: See pictures in presentation

**The You Lie Period – 1998 Q2 to 1999 Q1 (the Great Recession)**
- Rest of world was suffering great losses but China still claimed 6-8% growth
- China lied about growth as can be seen by other indicators:
  - Exports down 25% in an economy based on exports
  - Electricity consumption fell sharply – need it to build the widgets that China builds for the world
- Why China lied
  - Government is a huge propaganda machine designed to support the government’s ideology using control tactics (censure of internet, jail for dissidents, etc.)
  - Local municipalities tend to over report their growth to their superiors since local bureaucrats don’t want to lose their jobs

**Super Steroids-R-Us Period: Post-Great Recession**
- China will do anything to keep its economy going
  - 14% of GDP was pushed back into the economy
- China is actually less socialist than the US
  - No unemployment insurance
  - Not much of a health system if not working
- Need to keep people employed to cut down on chances that they would riot
- Government could fire-hose 14% of GDP as a stimulus package to economy because of the control it has over it
  - US government can only ask banks to lend more
  - China can force them to lend more
  - China does not worry about property rights in order to get new projects going
- Mortgages are up 48% which makes it look like China is growing
  - Best way to keep people employed is to keep building
  - Chart shows the size of growth in Chinese building efforts
National average property prices up 20% in 2009

Floor space constructed is up 100% in 2009

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

Result of all of this building will be bad decisions
- Cannot see the indicators of bad debt in government reports
- Cannot see the problems in the balance sheets
- Projects are not funded based on projected cash flow
- Projects are funded only on collateral

House affordability (property value / annual disposable income) is another bad sign
- Nationally in China it is 8.2 times greater; in Beijing it is 16.2
- By comparison in Japan during the bubble it was 9.9
- The US national average was about 2.2 at the peak of the bubble

Result: millions of empty apartments owned by investors who expect that prices will go higher
- Investors bought apartments to flip them
- Apartments in China are bought bare bones – not livable
  - No money put into making livable since investors won’t get it back when sold
- Up to 64.5 million or 15% of dwellings are vacant – waiting to be flipped

Property investment as part of GDP in China is 10%
- At 9% at the peak in Japan
- Less than 6% in the US at its peak

Example of why a command economy results in overcapacity in the industrial sector
- Hypothetically, you need 1 steel mill to build 10 bridges
Situation: 100 bridges need to be built
  - If build 10 bridges, only need 1 steel mill that will keep active for 10 years
  - If government commands that 100 bridges be built in 1 year, then 10 specialized steel mills sit idle for 9 years

False Axioms
- Definition: proposition that is not proved but considered to be self-evident
- False axiom in the US: Real estate prices never decline nationwide
  - Everyone made investment decisions on this false axiom
  - Then things changed resulting in overcapacity
- China’s false axiom is that the economy will always grow
  - Vast amount of empty office space indicates differently
  - 30 years of observations do not make it a law
  - Complicated by bad debts and lower demands from US and Europe

What if China does not grow?
China is rather like the fictional bus that would explode if its speed dropped down below 50mph
- There is a fixed cost whether making one or 10 gadgets – high operational leverage with a great deal of excess capacity
- Complicated by high financial leverage
- While investors may make a great deal of money when the economy is growing, they are likely to lose lots of money rapidly when the economy declines

China’s economy is not superior to that of the US or the West
- But the Chinese government does have more control over its economy
- East and West Germany proved the point as almost a perfect experiment
  - Same people and culture
  - Only had different economic systems
  - We saw the result
- China is no better at managing its economy than East Germany was

Bubbles are good things taken too far – can be overbuilding railroads, plants, apartments, etc.
- No shortcut to greatness
- China has not had a recession in 10 years
  - Needs to work through some problems
  - Needs to work through some of its excess capacities
- Japan had the same sort of problem in the 1980s
- Laws of economics still apply
- Success in investing comes from being able to look around the corner before making decisions

Growth Quality
- When the Egyptians were building the Pyramids, their economy was doing great
  - But Pyramids provided no return on investment (until thousands of years later when they brought in tourists)
  - When the Egyptians stopped building Pyramids, the economy stopped growing
• Chinese apartments that stay empty are like the Pyramids – no return from investment

Another example of growing problems: Building of high speed rail lines in China
• China intends to build 8,100 miles of high speed rail
• China can produce only enough high-quality fly ash for 100km per year
  o But building 1,500 km per year
  o Result: trains soon will not be able to keep up the high speeds
• Hi-speed rail problem like all of command economy
  o Build so much over a long period but can’t maintain what is built
  o So problems set in

Chinese consumers won’t be able to pick up the slack left by US and European consumers
• US has a $15 trillion (T) economy – $10T from consumers
• European Union also about a $15T economy with about $10T from consumers
• China has a $5T economy with about $2T from its own consumers
• Small declines in US consumption must be balanced by a great deal of consumption by in China – not very likely to happen

Elephants in the Room
1. Low urbanization rate (migration from villages to cities)
2. Low government debt

Elephant #1: Migration is not as great as often claimed
• Migration to cities has a different definition in China
  o Urbanization there is considered 1,500 people / sq km
  o Urbanization here is considered 400 people / sq km
  o Colorado Springs (767 people/sq km) would be considered a village in China
  o Result: reported high rates of urbanization come from different definitions
• There are incentives for local bureaucrats to understate their populations
  o They are responsible for achieving a certain level of GDP per capita
  o If their GDP has not grown enough, they under report their populations
• China’s population will peak in 2015
  o Work force will start declining in 2012
• If people find that they cannot afford to live in cities, they will move back to their villages

Elephant #2: China’s actual debt is not as low as described
• Ireland had the lowest debt compared to GDP before the recent crisis (2007)
  o Ireland chose to nationalize its banks
  o China cannot do that since it already owns its banks
• China’s foreign reserves are a testament to the lopsidedness of its economy
• China doesn’t have choice of when the crisis will come
  o Government owns the banks that own the empty apartments
  o Result: China’s debt to GDP ratio will increase
China’s bank crisis on bad debts will grow
- Much debt was hidden in “special vehicles”
- If deposit interest rates are at 1%, but inflation is 5%, then savers lose 4% per year
- The 1998 crisis is being reflected in today’s situations – those who were losing money by simply saving money in a bank turned to real estate as a growing investment

Another source of problems: in China home buyers must put down 40-50% to get a mortgage
- To come up with that much, most people borrow from relatives
- When prices go down, people lose not only their money but their relatives’ money, too
- Result could be political unrest

Consequences of China’s debt crisis
- Problems won’t stay in China – economies to interconnected globally
- Problems will depress the commodities markets
  - Especially for Russia, Brazil, Australia (28% of exports go to China)
  - China imports 2/3’s of all iron ore but that will stop when they stop building
- China will stop being the biggest buyer of US currency
  - Can expect much higher interest rates for mortgages and other loans in the US

**Japan – Past the Point of No Return**

Japan has suffered from a big real estate bubble, which was followed by an era of stagnation
- Government tried to stimulate the economy
- Only created a huge budget deficit – tripled over last 10-15 years
- Also cut taxes to stimulate the economy
- Neither tactic worked so kept doing both year after year
- Bottomline: Things continue to get worse each year
- Government issued bonds raising the debt level
  - 90% held internally
  - Japanese had high savings rates but now dropping to near zero
    - Older people no longer save
    - Japan’s has the world’s oldest population

Japan’s demographics making it harder to get out of debt situation
- Fertility rate needs to be 2.1 per woman to replace the population
  - Japan’s rate now at 1.2 and has been dropping since 1990s
- The economic downturn has had an impact
  - In Japan the more senior you are, the more money you make
  - The young, who make much less money, are afraid to start families
- Japan also has no immigration
  - US generally has a low birthrate but it does have high immigration rate
- Only ways to grow the economy is to increase the population or increase productivity
  - Hard to increase productivity enough to offset the decline in population
Japan’s interest rates plummeted since the 1980s to bottom of world markets today (3/28/11)

- 10-year US bonds: 3.46%
- 10-year Greek bonds: 12.32%
- 10-year Japanese bonds: 1.24%

Japan now set for a death spiral

![Diagram showing the vicious cycle]

- High Supply of Debt + Low Demand for Debt
- Higher Interest Rates
- Even Greater Budget Deficit
- Tax Increases
- Printing Money
- Further Slows Economy
- Torpedoes Yen
- Higher Interest Rates

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

Expectations:

- Interest expenses are already over 25% of tax revenues – could double
- Personal savings rates will go negative as population ages
- World will demand higher rates of interest from Japan
- Result: funding for both defense and education in Japan will be wiped out
- There will be a need for more taxes, but that will slow down the economy

The only thing Japan has going for it is that so much of its debt is owned internally

- High interest rates lead to higher interest rates

Japan’s False Axiom: We will always be able to issue cheap debt

- Years of data may support this false axiom but that does not help
- Prolonged reliance on a false axiom will lead to its invalidation

More articles from Mr. Katsenelson can be found on his website: [www.ContrarianEdge.com](http://www.ContrarianEdge.com)
QUESTION & ANSWER SESSION

Signs of Collapse in China
- Bubbles are always a problem to predict
- China’s government might be able to push the situation along because it has so much control of the economy
- No way to know when the bubble will burst
- Expect to see house prices to decline
- Should stay away from investing in bubbles and commodities

Companies from outside China avoid using the latest technologies in China because they know that their technologies will be stolen
- In conference calls about China, it appears that companies don’t see the coming problems
- Example: Caterpillar sees continuing tremendous demand in China
  - They think it won’t end – but it will
- The Chinese government is not all that well prepared for what is coming

Excess capacity
- If have an excess capacity in steel, it would be possible to nationalize the steel mills
  - Someone would definitely lose money in that case
  - One problem is that the bubble is so large in China
- Nationalizing steel mills would probably hurt the economy
- Nationalizing might be good for US steel consumers because of likely lower prices

Japan and China – Interconnected
- In an investor’s view Japan’s and China’s situations are very interconnected
- Each will have an impact on the other
- There are differences between them
  - Japan’s collapse is just a matter of time
    - They have no control over the economy
    - Past the point of no return
  - China still has some control over its economy
    - Cannot tell what very small thing might set off collapse
- Japan is likely to fail first

When China does collapse, it is unlikely to do anything as drastic as attacking Russia to distract its people from their internal problems

China – Weimar Republic or Gorbachev’s Soviet Union?
- Can’t say whether China will implode or not
- Political unrest is what worries the Chinese government the most
- Japan has just had a series of major shocks but it is staying relatively calm
  - Can’t say that China would have the same sort of calm response
- Must worry about unrest when people start to lose a great deal of money
  - No way to guess when that will be
  - No way to tell if the government will crackdown or take a great leap forward
Size of China’s Collapse

- Bubble in China’s economy is so much bigger than that in the US
  - Government driven to a whole new level
- May wind up with a situation like Ireland’s
- All about confidence
- Big difference when compared to the US dot.com bubble – much bigger

There is some excess capacity worldwide since growth is not continuing all over the world

Cannot really advise where to invest

- Can see a lower demand for commodities
- Can see lower demand for companies that help get commodities out of the ground and transported – equipment manufacturers
- Countries that once got a lot of help from China might be good (Australia, Canada)
  - Look for those with little debt
- Always want to own high quality companies that aren’t cyclical in nature
  - Not a recommendation but an example: Johnson & Johnson
  - Used to pay high premiums to invest in high quality companies
  - Now high quality companies may be less expensive

US consumer benefitted from the economic system of China

- Chinese consumers are the losers in this because their wages are so low
- It would be hard for China to move to a more consumer society
  - Consumers only make up 1/3 of GDP because their wages are so low
  - Any transition would be hard and long – assuming that the Chinese government could control it

Japan is the number two owner of US debt

Turn over of debt is about the same as in the US

- Interest rates will go up a great deal when they do increase

Recommendations for the US economy:

- Cut the deficit
- Increase taxes – that will help but will also slow the economy

Uncertainties in Japan may be best explained with a Russian drinking joke

- Man wakes up drunk on the sidewalk
- He tells his friends he had:
  - 5 bottles of vodka and felt fine
  - Then had 5 bottles of wine and felt fine
  - Then had 2 cases of beer and felt fine
  - Then had 1 shot of whiskey and fell on his face – blamed the whiskey
- Tsunami and its aftermath may be Japan’s one shot of whiskey
  - Could be what pushes them over the top
  - Could bring the timeline for collapse forward