

Popular Delusions

China's looming financial crisis will provide the next buying opportunity

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There's plenty of long-term upside in China. I think it'll one day eclipse even the 1980s boom in Japan. But chasing upside can be a dangerous game, especially if it leads one to ignore the downside, and there is plenty of that in China too. Real buying opportunities occur when upside potential is disregarded, usually during a crisis. A newly published NBER paper suggests one is brewing in China right now ...

■ That the tectonic plates of the geopolitical landscape are shifting in China's direction is widely acknowledged. Less well known is the coincidence of asset bubbles with such shifts (see table below). Similarly, while it's well known that bubbles are fuelled by rampant liquidity creation, less well known is that financial deregulation usually primes the pump. The recent credit bust was partly caused by the implementation of Basle risk weights. But the 1920s stock market boom, the 1980s Japan boom, and the tech boom of the 1990s can all be similarly traced to earlier financial deregulation.¹

■ China, with one of the most heavily regulated financial systems in the world, has barely started down this path. But with the stated objective of having Shanghai as a world financial centre by 2020, and the motivation behind the Chinese government's bond issue in Hong Kong (to foster the "international status" of the Renminbi), the writing is on the wall.

■ So with financial deregulation, when it comes, likely to stoke China's already heady bid to become the next global superpower, shouldn't we be filling our boots with all things Chinese now, in anticipation? Probably not. Two NBER economists recently found credit growth to be the best predictor of financial crisis: more rampant credit growth equals more elevated macro risk. As we know, China's credit growth has *exploded* this year ...

Historic manias and geopolitical swings

| Year of bust | Country | Mania | Geopolitical Swing |
|--------------|---------------|------------------------|--|
| 1636 | Netherlands | Tulips | Peak of Dutch hegemony |
| 1696 | England | Joint Stock Companies | Glorious Revolution |
| 1825 | England | Emerging Market Issues | British hegemony following victory at Waterloo |
| 1873 | Germany | Railroad Stocks | Newly unified Germany as continental superpower following victory in Franco-Prussian war of 1871 |
| 1929 | United States | Stocks | US dominance emerging; 'Great Powers' in disarray following WW1 |
| 1989 | Japan | Real Estate, Stocks | Economic overtaking of US |
| 2000, 2008 | United States | Stocks, Real Estate | Undisputed hegemony following Soviet collapse |
| 201X? | China? | ?? | Overtaking US economy? |

Source: SG Cross Asset Research

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¹ See "Does financial liberalization increase the likelihood of a systemic banking crisis? Evidence from the past three decades and the Great Depression" by Arthur E. Wilmarth, Jr.

“The best investors do not target return; they focus first on risk, and only then decide whether the projected return justifies taking each particular risk”

Seth Klarman

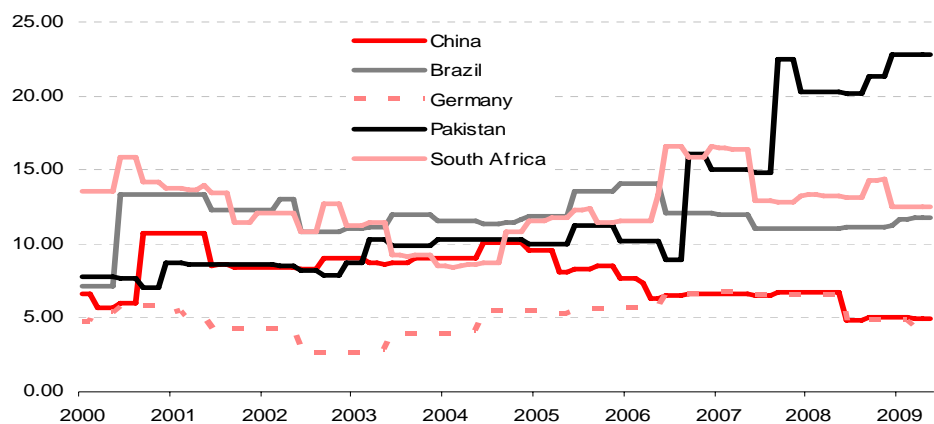
The upside potential in China is vast. But what about the downside? I was mulling this during a recent trip to Paris where Albert and I saw some clients and presented at the SG Premium Review, an annual event run by SG enabling companies and investors to get together.

One of the companies presenting was Lloyds, the UK bank rescued by the government but now recapitalised and apparently clean. I'd have thought there would have been some interest at least in hearing what they had to say. They are after all one of the UK's biggest banks and have had an 'eventful' few years which they are now trying to put behind them. Yet only a handful of people attended the presentation (interesting in itself). Trading on a lowly 0.5x book value, Lloyds is clearly unloved, presumably because prospective investors aren't sure how safe its loan book is and are understandably concerned that an increasingly unpredictable UK government owns a 43% stake. Who, after all, wants to own an asset which the government reserves the right to commandeer for its own ends and which has an opaque loan book?

Well, quite a few people it seems, judging by the situation on the other side of the Eurasian plate. Industrial and Commercial Bank of China, for example, is sitting pretty on around 3.5x book value and a forward PE of 14.7x. Yet as far as I can see, it's 74% owned by the Chinese government and, so far at least, has been subject to far more political interference than anything seen at the semi-nationalised UK banks. If it wasn't bad enough for shareholders that Chinese banks ramped up this year's lending because they were so ordered by the government, they have now been [told to submit capital raising](#) plans to preempt the consequent increase in bad loans! Shareholders are essentially paying dearly for the Chinese government's policy objectives.

And as for the quality of the loan book, the deflationary danger of over-investment is evident in the low returns Chinese firms are making. Believe it or not, RoAs are closer to Germany's than the more thriving emerging markets (see chart). Bear in mind that those [empty cities](#), unoccupied hotels and vacant shopping malls will be collateral on Chinese banks' books ...

Chinese RoA is closer to Germany's than other industrialising economies



Source: SG Cross Asset Research, Factset

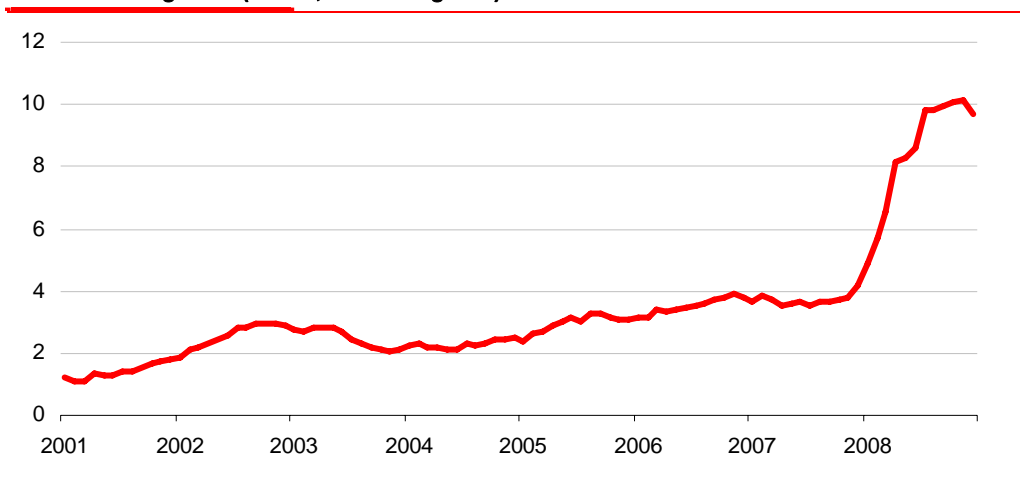
I'm not picking on ICBC here. I know almost nothing about it, or Lloyds for that matter. I'm just trying to illustrate the point that China is forgiven sins others are punished for. This tendency to view China with rose-colored spectacles is visible in aggregate valuations too. According to FTSE All World data, the Chinese market has a RoE of 17%. And if I set a hurdle rate on the return I want on capital at 10%, then in very simple (probably simplistic) terms, fair value would be around 1.7x book (and ideally, we'd buy a discount to that). But the market currently trades at 3.3x book.

In a very important respect, the deflationary infrastructure boom currently under way in China is a perfectly normal part of the industrialisation process. In the UK, we had an infrastructure overbuild in the form of a railway mania in the 1840s; the US had one in the 1850s and the 1860s; Germany had one in the 1860s too. So although it's often said that "bubbles don't re-inflate" financial history says otherwise. The 19th century was dominated by one theme – rail – which investors fell for over and over again. I see China as the 21st century equivalent.

So when should we look to buy? We know that distressed macro valuations only really occur during a crisis. And financial history shows that deflationary booms tend to become deflationary busts. So it was with great interest that I read a fascinating paper recently published by the NBER analysing 60 financial crises going back to the year 1870 and asking what the best *pre-crisis* predictors were.² Their answer? Credit growth.

Not the broad money supply, not debt to GDP, not the stock market and not the real estate market; just credit growth. If they're right, the following chart suggests such a crisis (or opportunity, as I prefer to think of it) is brewing in China right now ...

China's credit growth (RMBtr, 12m rolling sum)



Source: Datastream, SG Cross Asset Research

As a closing thought, it is often said that China's infrastructure overbuild isn't something which should be of any concern because the money is being spent *productively*. But Messrs Schularick and Taylor caution against such a rosy view. They conclude that "crises are no less likely when they have been funding investment booms as opposed to other activity."

² See "Credit Booms Gone Bust: Monetary Policy, Leverage Cycles and Financial Crises, 1870-2008" by Moritz Schularick and Alan M. Taylor. National Bureaux of Economic Research

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