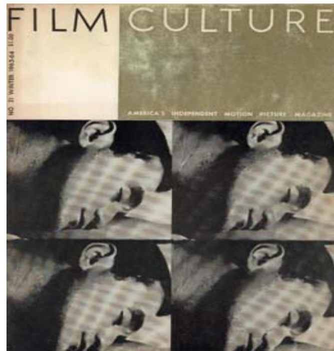
find this & many more hedge fund letters at marketfolly.com

Manager Commentary, May 2010

'People are not able to take the consequences of their own curiosity'

-Anonymous California theatre owner



Andy Warhol's five hour movie, *Sleep*, attracted several hundred fervent cinephiles to one of its first Californian screenings in 1964. Only fifty stayed to the very end. At best, Warhol's soporific cinema verité of his close friend John Giorno can be thought of as an examination of the German philosopher Heidegger's concept of time, that it is simply a medium in which events take place, boring or otherwise.

Investment letters typically run roughshod over this principle, substituting dramatic time for real time. They compress and sometimes even replace time's ponderous qualities with great drama, jumping relentlessly back and forth from the excitement of rare moments in the capital market's past to projections of a climactic and spectacular resolution; stuff happens. Reality, of course, is more prosaic. For despite the many months that have passed since I last wrote to you in any great length, back in October of the previous year, I am somewhat relieved to report that very little of real substance has changed. Accordingly, and much to the hedge fund's advantage, short term interest rate expectations are unaltered. For instance, since last September the British one-year swap rate has continued to bob around 90 basis points.

Having deliberately positioned your cautious Fund to exclude the potentially damaging arena of equity and commodity shorts, we find ourselves somewhat at ease with the credit market's slumber at a time of ebullience elsewhere. Like our German philosopher friend, we continue to argue that the future is perhaps not yet now. The past is certainly no longer now and the present is simply the now that flows from the past to the future. Put differently, we believe that central banks in the UK and Europe are likely to keep their monetary tightening powder dry for some time yet. Accordingly, it seems likely that conjecture will remain our preoccupation at least until we receive some resolution to the great speculation of this year. By this we mean an answer to the question of whether we are in the midst of a vigorous yet typical economic recovery, or near the end of an inventory-led and rather short business cycle bearing testimony to an ongoing debt deflation.

As much as I sympathise with Warhol's torpid cinematic tendencies, I nevertheless accept that something has to give. Allow me to suggest that instead of us witnessing nothing of importance, the last few months may have demonstrated more price evidence of the US dollar having finally formed a bottom with the last low at the end of 2009 exceeding the previous low in March 2008. If true, this would conclude a chapter of historic dollar depreciation that began way back in 2001. This could presage an under-appreciated but potentially troublesome tightening of monetary policy in China, that in turn may be a portent of difficulties that lie ahead. I ask you to heed the warning given by China's Vice Commerce Minister Zhong Shan, as cited by the *Wall Street Journal*. Worried that many Chinese exports have a profit margin of less than 2%, he noted that, "water doesn't boil if it is heated to 99 degrees Celsius. But it will boil if it is heated by one more degree."[1] In other words, "a further rise in the yuan by a very small magnitude might cause fundamental changes." We should consider ourselves forewarned.

[1] http://online.wsj.com/article/SB10001424052748703523204575129463922409480.html

'History can repeat itself with a vengeance'

-Henry Kaufman

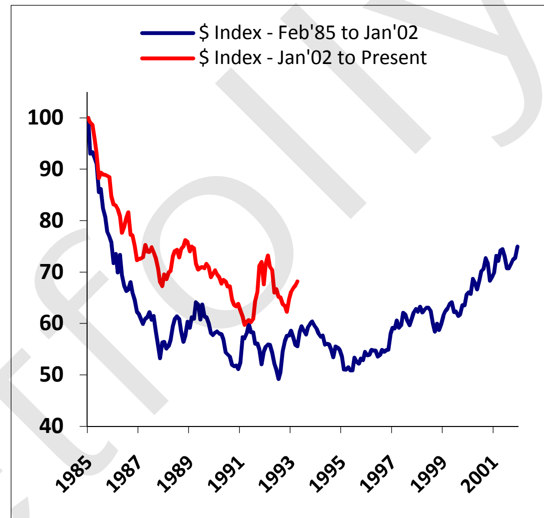
As you may be aware, I have a keen interest in the economic parallels of today and the policy mistakes of the past. Perhaps like the Italian lawyer in Arthur Miller's *A View from the Bridge*, "I am inclined to notice the ruins in things." So let us consider the period 1992 to 1997 to see the damage wrought by a change in the dollar's direction. Back then, the dollar succeeded in finally arresting another precipitous fall this time initiated by the 1985 Plaza Accord, an aggressive trade intervention aimed at preventing the loss of more American manufacturing jobs to the Japanese. Over these years, the dollar lost 15% of its value applying the Fed's broad trade-weighted series and dropped 45% using the major trade-weighted index. That is to say, the dollar, just as it has been since 2001, was very weak and Asia's fixed currency regimes benefited from inappropriately low interest rates in the US as investors adopted a fawning admiration for the Far East. Does this sound familiar?

'The great enemy of the truth is often not the lie – deliberate, contrived and dishonest – but the myth – persistent, persuasive, and unrealistic.'

-John F. Kennedy, Commencement Address, Yale University, New Haven, Connecticut, 11th June 1962

With their currencies pegged to the weak dollar, South Korea, Taiwan, Hong Kong and Singapore, the group of countries dubbed The Asian Tigers by an overconfident financial community, all witnessed a dramatic transfer of income from the household to the corporate sector. And again starting in 1985, and mirroring in reverse the dollar's decline, their stock markets all rose nearly sevenfold.

But by 1995 the dollar was largely unchanged versus its low of three years earlier and proved ultra-competitive against the rest of the world's floating currencies. From its nadir in 1987, the US trade deficit contracted from $151bn to just $31bn four years later as exports jumped 65%. With its rate of price descent having abated, the dollar eventually reversed course; between the summers of 1995 and 1997 it would appreciate 12% per annum vs. European currencies. Scary things were about to happen.



Source: Bloomberg

By 1997, as a consequence of the currency appreciation, monetary policy was tightening across the Far East. Yet, according to the thought process responsible for setting Asian asset prices, such a threat was barely perceptible (it rarely is). By this point, the Tigers' economic achievements had taken on almost mythical proportions. Credit growth, when allied with the super-competitive dollar peg, had proven a further powerful economic stimulant and hot money flowed in from overseas investors eager to share in the domestic prosperity.

The private sector in Asia lapped it up, fatefully adopting a pro-cyclical debt load denominated almost exclusively in dollars. Between 1993 and 1996 in the four largest ASEAN economies, foreign debt-to-GDP ratios rose from 100% to 167% (see Bismarck's warning to nineteenth century Japan, below). Monetary inflation was in full effect and, using South Korea as an example, broad money supply (M3) surged, consistently registering year-on-year growth rates of between 20% and 35% during the boom. The Tiger economies, in the words of Adam Smith, were enjoying one of those moments when, "the greater many demand capital for foolish ventures such as property speculation and banks act as if honour bound to supply them with all the capital they demand."[2]

[2] P.J. O'Rourke, *On the Wealth of Nations* (London: Atlantic Books, 2007).

marketfolly

As we all found out, this wicked brew had to end. By 1998 the IMF had been called in, Asian currencies were devalued and foreign debts restructured. In other words, drastic remedies were sought to escape the vice-like grip of the now much stronger dollar.

'...little is ever really new in the world of finance. The public has a euphoric desire to forget...'

-John Kenneth Galbraith, *The 1929 Parallel, Atlantic Journal*

Forty years ago, just prior to a performance at Amsterdam's renowned Concertgebouw, a group of radical young musicians began making noises with their nutcrackers and bicycle horns. Their "nutcracker action" denounced the orchestra as a status symbol of the ruling elite, claiming that it was guilty of "maintaining an undemocratic artistic environment." Persuaded by the immediate dangers of deflation, I feel much the same antagonism towards most investment matters today, especially the Asian business model and the investment community's bullishness regarding China.

From the phenomenon that was Japan in the 1970s/80s to the aforementioned Asian Tiger movement in the 1990s to our present obsession with China's economic might and its future prospects, Asia has won the hearts and minds of the financial world's most demanding investors. Witness Fidelity's legendary British fund manager Anthony Bolton's explanation for his decision to come out of retirement and launch a new career at the helm of a China fund, "...only a remarkable opportunity could have tempted me...this may be the biggest economic and investment story of our generation..."

In the spirit of the nutcracker revolutionaries, I would like to warn you that I think the Asian business development model is flawed. I think our elites have it wrong. It is my contention that China produces GDP growth without per capita wealth creation. It is analogous to a cocktail party without the cocktails; what is the point?

Furthermore, I fear that should China suffer an economic reversal, it might have especially ominous implications for Japan. I am concerned about the lopsided nature of Japan's finances, with its domestic liabilities (pension and insurance schemes) being supported by the country's substantial overseas dollar hoard. To my mind this trillion dollar reserve of foreign exchange has parallels with America's sub-prime debt. This may be contentious but I believe that both assets are dubious and dangerous in nature. For the Japanese and other sovereign Asian currency reserves are only of use so long as they are not deployed domestically; just like Napoleon's bayonet. Let me explain.

Japan is effectively short its own currency and, to aggravate matters further, so is the international hedge fund community. Think about it, do you know of any wealthy acquaintance that has yen-denominated cash deposits? Dollars, euros, pounds, Swiss francs, even Singapore dollars, yes, but no one holds the currency of the world's second largest economy. This arrangement is not viable in the longer term. To quote Galbraith once more, "The enemy of the conventional wisdom is not ideas but the march of events." Sure, the yen is not cheap on a purchasing power parity basis and its domestic exporters struggle to remain competitive with a yen-denominated cost base. But an unforeseen event, such as a slump in Chinese economic growth, has the potential for torschlusspanik in the currency markets, which could in turn precipitate a much higher value of the yen.

It's coming up
It's coming up
It's coming up
It's coming up
It's coming up
It's coming up
It's coming up
It's DARE

-Gorillaz, *DARE,* 2005

We worked this out when Lehman failed. In a world dominated by hugely leveraged financial institutions' portfolios, if a yen asset, say a corporate loan note financed in yen, falls substantially (20% or more) it adds to the demand for the yen as the borrower now has to borrow even more yen (or sell more of its foreign denominated assets to buy yen) to cover the loss. I am willing to wager this action would invoke a vicious cycle as the country's export base would be jeopardised further by the appreciating currency. Already jittery stock markets would unravel, initiating even more selling of dollar assets to buy more yen to make good the losses or shortfall vis-à-vis domestic institutions' yen liabilities.

It is perhaps interesting that when I visited Tokyo in March the local businessmen pronounced the notion of negative Chinese GDP growth as a near impossibility. Maybe such confidence explains their asset-liability mismatch. I really do like their use of the world impossible. I remember how it was used so often by Wall Street banking analysts to describe the plausibility of a nationwide housing slump in America; yes, impossible indeed!

As Liaquat Ahamed's excellent study of the policy follies of the 1920s reveals, moments of historical change are marked by a clustering of debilitating events and "part of the reason for the extent of the world economic collapse of 1929 to 1933 was that it was not just one crisis but a sequence of crises, ricocheting from one side of the Atlantic to the other..."[3] Just look around the world at all the revealing headlines: American sub-prime losses, the Greek bond panic, Portugal and Spain's spiraling government bond yields, the IMF in Europe and prophecies of a Chinese property crash. Such headlines recall the journalist Christopher Morley's observation that, "sometimes there is so much writing on the wall that the wall falls down." You will not find us short the yen anytime soon!

The Blind Leading the Blind?

I like to think that modern China's economic transformation has a shared heritage with that of Japan, cemented by Deng Xiaoping's visit in 1978. This was the first ever by the head of a Chinese government. I am sure that the then Prime Minister, Fukuda Takeo, warned China's "little bottle"[4] of Bismarck's precautionary advice to his nineteenth century predecessor Iwakura that national independence can be compromised by an excessive reliance on foreign creditors. Superior investment prospects are one thing, but not when they entail persistent current account deficits and a dependency on the fickleness of foreign capital. You better believe Bismarck's lesson was rudely brought home to the Asian Tigers one hundred years later.

Power not Profit

Japan, however, heeded the instruction. From then on it chose to subordinate everything else in its domestic economy to the success of its export sector. Only by such sacrifices, it believed, could it hope to independently acquire the necessary foreign exchange required to pay for imported capital equipment and the industrialisation of its economy. This was when the 'P' for sovereign power came to supplant the dominance of the Anglo-Saxon demand that capital be allocated according to the 'P' for profit.

[3]Liaquat Ahamed, *Lords of Finance: 1929, the Great Depression, and the Bankers Who Broke the World* (London: Windmill Books).
[4]Akio Mikuni and R. Taggart Murphy, *Japan's Policy Trap* (Brookings Institution Press, 2002).

Every creditor nation needs a transformational event. For Japan it was the First World War, which displaced the warring European nations as competitors during a time of huge Allied military demand. The opportunity produced a boom for Japanese products. From 1915 to 1918, Japan went on to accumulate a current account surplus that eventually represented over half of its GDP at the onset of war. Buoyed by such financial success, it was able to complete a rapid upgrading of its manufacturing base without the need for overseas debt.

China's transformational event arguably came with its admittance to the World Trade Organisation (WTO) in 2001 and the coincidence of yet another overseas conflict, the Federal Reserve's monetary battle to stem the economic fallout from the TMT crash. The spur to Chinese demand from low American interest rates and the willingness of Western society to take on more financial leverage was even more startling than the absence of European competition in the Pacific in the early part of the twentieth century. From 2001 to its peak in 2007, China accumulated a current account surplus of $1.7 trn, a sum equivalent to one and a quarter times the size of its economy back when it entered the WTO.

One must wonder whether Chinese policy makers have considered what happened to Japan after World War I. We all know that world demand sagged after the conflict. Europe bounced back and began producing competitive, non-military products once more. Eager to earn precious foreign currency to repay war debts, European manufacturers proved surprisingly price competitive in an attempt to recapture their lost market share. The environment should have prompted caution. However, perhaps imbued by the hubris of their startling and unprecedented expansion, the Japanese bureaucrats saw things differently. They could not accept the obvious and immediate dangers arising from the fall-off in demand. Neither were they afraid of the commercial implications from a resumption of international competition. Instead they pressed on, raising the stakes further, by directing the private sector to borrow and invest in yet more excess production capacity and to build and store more inventories.

Not only was Japan operationally leveraged to global growth, it was simultaneously becoming financially leveraged as well, as its banks financed the post-war expansion. The nation had also become internationally contentious; the industrial capacity built during the run up to the war was far greater than the sum of the domestic and foreign markets' ability to absorb it. As would happen again sixty years later, Japan was deemed to be predatory in stealing jobs from the West as trade tension was fanned by high unemployment in the austerity bedraggled economies of Europe. But ultimately it was its domestic financial vulnerability that led to Japan's undoing. The excess capacities never produced the cash flows necessary to service or retire the debt, and with unsold inventory piling up, companies began to default on their loans. A bank run ensued in 1920 and the rest of the decade was mired in low and disappointing economic growth.

Wise Man Not Invest in Overcapacity

'When a country has an investment rate over 50 percent of GDP and rising, you say this country is not suffering from over-capacity...are you serious!?'

-Yu Yonding, Institute of World Economic and Politics, Chinese Academy of Social Sciences

Of course that was a long time ago, but have things really changed? As I wrote in a piece in *The Sunday Telegraph*, the ancient ethical system of Confucius has nothing to say on the subject of modernisation.[5] There is no aphorism counseling wise men not to invest in overcapacity, but perhaps one day there will be since the Chinese seem hell-bent on a similar course of action. Investment spending has tripled since 2001 and the consequences are staggering.

marketfolly

[5] http://www.telegraph.co.uk/finance/personalfinance/7219178/China-Hugh-Hendry-warns-investors-infatution-is-misguided.html

A country that represents just 7% of global GDP is now responsible for 30% of global aluminum consumption, 47% of global steel consumption and 40% of global copper consumption. Similar to what happened during the Japanese capacity build, I doubt the ability of foreign markets to absorb such slack without some hostility arising.

At one level of abstraction I accept that China should be congratulated on its efforts to repel the 1920s-style deflationary trap in which surplus countries reign in their monetary and fiscal policies, thereby exacerbating the difficulties of the weaker debtor countries. It is just that I suspect the Politburo may have gone too far by embarking on a policy to match the US fiscal surge nearly dollar-for-dollar despite having an economy one-third that of its American counterpart. Surely, Chinese officials must regret the explicit state blessing for a frenzied doubling in domestic bank lending last year. Exuberant credit creation and its associated, although officially unrecognised partner, hot money, have strengthened the twin problems of commodity hoarding and property speculation. This fiscal surge has many Australian and Brazilian commodity producers, as well as Japanese manufacturers, brimming with financial gratitude, but it will have the hapless Chinese household paying the bill should the rest of the world fail to sustain a vigorous economic recovery.

Where is the value in shuttling Chinese peasants, typically earning less than $1,000 per annum, back and forth at over 200 km/hour from the country's poverty-stricken interior to its prosperous coastal regions? Will the expected productivity enhancements succeed in generating sufficient profits to service the state's gargantuan investment spending? This is not to mention the railway ministry's proposed high-speed rail link between Shanghai and London, penciled in for no later than 2025 (see *The Economist* April 10th edition)![6] It is behaviour of this kind that brings to mind Buffett's witty dictum that, "to a man with a hammer everything looks like a nail."

Many optimistic investors will assail my argument and ask where the harm is in these policies. The harm is that such spending probably guarantees the continued impoverishment of the Chinese household sector at a time when there is much international enthusiasm for autonomous and consumption-led Asian growth. The fashion of our investment age is to upbraid economies like America's that have high levels of consumption and to instead look approvingly at the high saving contemporaries, the Asians. I think, though, we have it the wrong way round; one new hot dog vendor may be better for a nation than any number of state financed projects that fail to pay their economic rent.[7] Let me explain.

The goal of economic policy should be to maximise the household sector's well-being with a high re-occurring level of household income evidenced by high levels of consumption to GDP. As someone accurately noted, "we're not producing just for the fun of it." Consumption is the prize and its dislocation in Asia is the principle cause of my concern. According to The Economist, consumption's share of GDP in emerging Asian economies has fallen from 65% in 1980 to 47% by 2008. In China it is just 35%; something is broken in their wealth creation process. I know this stands in rude contrast to China's booming retail sales last year. China's unit car sales of 13.6m even dwarfed the 10.4m units sold in America. However, one swallow does not make a summer. Let us consider the long term record of this transformative period of Chinese growth. The ten year CAGR until 2008 is 13.5% for GDP and 10.7% for household consumption. The share of consumption fell from 45% to 35% over this period. We await the figure for 2009 with much interest.

It is popular to argue that China and its satellites regularly redistribute income from the State Owned Enterprises to households via their awe-inspiring building projects and the associated job creation. Unfortunately, it too can be argued that the reverse is the real truth, as much of the money is actually captured by the bank accounts of political fixers, locally connected construction executives and the property speculators whose land is expropriated. A revealing Japanese government study found that construction costs in 1990 Japan were roughly Y200,000 per square meter for both public and private sector projects. But within a decade the private sector cost had fallen to Y130,000 whereas the public sector saw cost inflation to Y220,000.

marketfolly

[6] http://www.economist.com/business-finance/economics-focus/displaystory.cfm?story_id=E1_TVPNRRSV
[7] P.J. O'Rourke, *On the Wealth of Nations* (London: Atlantic Books, 2007).

So I would not be surprised if the Chinese government (read the people) find in due course that in order for their nation to continue to service the interest costs not covered by their trophy assets, they may have to borrow more money, raise taxes, and of course be subjected to the penury that comes with a cheap currency and miniscule savings returns.

If in Doubt, Blame the Banks?

So why has the ratio of consumption to GDP fallen so precipitously? One reason is that China did not escape the 1998 Asian crisis unharmed; it suffered a traumatic recession that exposed the folly of previous bad bank lending. Others will disagree, but as Kindelberger noted, financial crises are like pretty girls: they are difficult to describe in abstraction but are instantly recognisable when seen. The problem with China's contemporary economic history is that so much of it has been concealed by subsidies, or what I call subterfuge, that one commentator's pretty girl can just as likely be construed as another's haggardly wench.

'Heaven is a place where nothing ever happens'

-Talking Heads, *Heaven*

China's economic reversal was not remedied by a violent currency upheaval or corporate and bank failure. Instead, the recovery happened after an enormous and still ongoing subsidy from the household sector to both the banks and the manufacturing sector. It is as if nothing really bad happens in a Chinese recession: problematic debts are rolled over and restructured (that is to say, forgiven), and the banking sector accepts low credit and capital costs. It is a Hobson's choice.

If I promised to make you rich but insisted on just one condition, that you had to spend the rest of your life in New York, could you accept it? This, I think, is the essence of Chinese munificence. A wealthy household can only own stocks, bonds, real estate and commodities if they are denominated in renminbi. Now, New York is my favorite city in the world, but would I want to be imprisoned there? Some estimate that the overall socialisation of the credit process may have involved a transfer of as much as 5% of GDP from the household to the corporate sector each year.[8] Maybe this was feasible when we had an unprecedented synchronised period of global growth, but in more straitened times it might not feel like the heaven I think of.

Conclusion and Investment Review

'All you do with your talent is wear dressing gowns and make witty remarks when you might be really helping people, making them think!'

-Noel Coward, *Present Laughter*

It is now commonly accepted that the magnitude of the financial problems confronting the world economy are so great that in all likelihood we will be confronted by a hyperinflation allowing sovereign debts to be paid off in worthless fiat currency. Just like the Bolsheviks in 1918 and 1919, the machine-gun of the Commissariat of Finance will pour fire into the rear of the bourgeois system.[9] We do not dispute this outcome.

However, it remains our contention that policy makers can only gain the political legitimacy for such extreme behaviour if the world is once more confronted by a profound and debilitating deflationary event. We therefore find it a more profitable exercise to envisage what such a catastrophic event might look like.

[8] http://mpettis.com/2010/04/who-will-pay-for-chinas-bad-loans/
[9] http://books.google.co.uk/books?id=LUhXZD2BPeQC&pg=PA244&lpg=PA244&dq=that+machine+gun+of+the+commissariat+of+finance&source=bl&ots=-vqt9xGF0l&sig=lplqSKTdSPcBbZLT9N2Z9mhXSW8&hl=en&ei=wYvtS8KVA4bw0gSD6JDfBw&sa=X&oi=book_result&ct=result&resnum=4&ved=0CCUQ6#v=onepage&q=that%20machine%20gun%20of%20the%20commissariat%20of%20finance&f=false

marketfolly

Above, we have outlined two game changers: a slump in China's rate of economic growth and a sudden and dramatic appreciation in the yen that would bankrupt its domestic export base.

But opinions are cheap and plentiful. I believe it is more instructive to consider what people do with their opinions. So let me tell you what I have done with mine. The investment team and I have carefully constructed a short credit portfolio made up of over twenty single-name industrial, cyclical businesses which have the dubious distinction of suffering from gigantic financial leverage and Asian/commodity overdependence. Without a doubt, some of these businesses will not survive; others will have to be radically overhauled and restructured and we will make money.

The Sky Doesn't Have to Fall Down for Us to Make Money

I suspect we will succeed with or without an economic slow down in mainland China. For if it continues with its linear GDP growth of 8 to 10% per annum, we can be assured that it will have made further investments in adding to its considerable industrial capacity. Much like the Japanese at the end of WW1, China finds itself on a collision course with the rest of the world. Its future economic success could lead to increasing skepticism as to the viability of many industrial businesses located both in Japan, Europe and the US as going concerns.

Mikuni's Passing

Remarkably, given the stakes are so high, investors seem acquiescent in this area. Last December saw the closure of Japan's only truly independent and rational (at least to me) credit rating agency. The following is an excerpt from an actual e-mail I received:

Re: Termination of Mikuni's Credit Ratings services

Please be noted that we will terminate Mikuni's Credit Ratings services on December 31, 2009.

Thank you very much for your support to our services.

We have provided with Mikuni's Credit Ratings on Japanese banks and companies since July 1983. When we started this service, it was widely recognised that banks and large companies basically had never failed in Japan and credit ratings had not been necessary for the investors.

However, in July 1984, Riccar's convertible bonds were defaulted and the final investors lost money for the first time since the World War II. Thereafter, we have experienced 46 cases of failures of bond issuers. Among them were large bank failures. We understand that credit risks on Japanese large corporations have been less "socialized" in recent years and are likely to be "privatized" more completely in near future.

Thank you again for your support and ask for your understanding.

Mikuni & Co., Ltd

The closure of course coincided with Japan's first ISDA recognised credit default event, the restructuring of the consumer finance company Aiful, and preceded by a mere month the bankruptcy of JAL. It is as though the truth is so unpalatable that investors would rather not hear it, certainly not pay Mikuni $5,000 per quarter to confirm the near certainty that they own over-valued corporate credits. A country with a debt burden that is unprecedented in the modern age and whose companies typically pay less than 2% per annum for ten year money has decided that it has no need for tales of possible woe. To quote Hillary Clinton, it's, "Unf***ingbelievable!"[10]

[10] John Heilemann and Mark Halperin, *Game Change: Obama and the Clintons, McCain and Palin, and the Race of a Lifetime.*

marketfolly

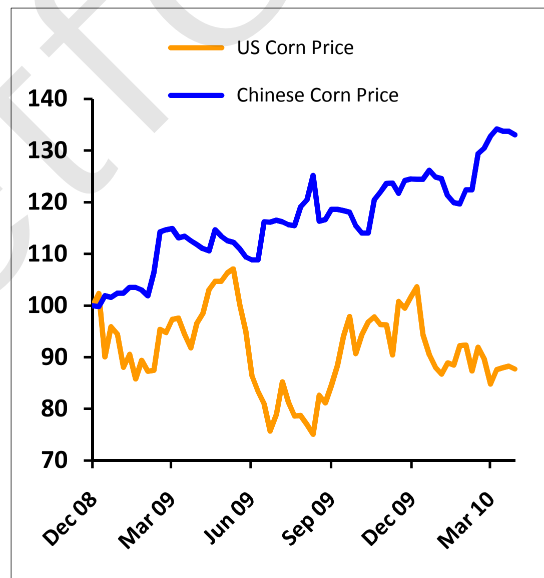
The Fund has been buoyed by the performance of our Sterling, Australian and Kiwi interest rate swaptions this year as well as gains from European sovereign CDS and successful speculations in currency and corporate debt. These profits have allowed us to lean into the sell off in risk-averse markets in February/March. We have therefore been able to double notional exposure to our Asian bear portfolio. Today we are 3.5x short the Fund's NAV. We have a maximum loss of 8.5% and a maximum potential gain of 250% should our names go bankrupt and creditors recover 25% of their assets. We are ready…

However, so dramatic are the pricing anomalies prevailing in today's market that we intend to launch a single strategy version of this trade in June 2010. As a single strategy product, we anticipate the new Fund will offer investors much more gearing to the upside potential inherent in this asymmetric trade. More detailed information about the investment parameters and structure of this Fund is available upon request.

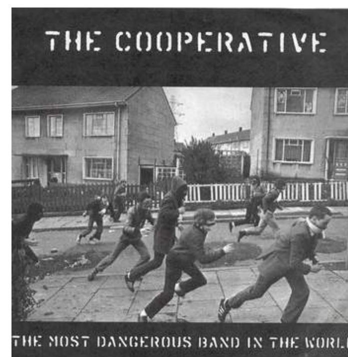
Chairman Mao's Great Leap Forward

China accounts for one-fifth of world corn production, and a similar proportion of demand. Its net exports over the last five years have been negligible. And, according to the statistics, China holds 34% of global inventories, well above the world average. In fact, its stocks-to-use ratio is 31%, which compares with a global average of 18% and an average ex-China of a rather paltry 14%. In short, China is long. So can someone please explain to me why the price of corn in Dalian, a port city to the east of Beijing, trades for $7.50 per bushel, more than double the Chicago price?

The issue with Chinese data is that which has afflicted all communist governments over the years. Key economic indicators, whether they are in GDP, credit growth or grain production, stipulate a desired (and not always realistic) level of output, rather than the sum of individual achievement. When things go wrong, local officials prefer to secure their jobs by presenting results in-line with the state target rather than telling the truth. This means the centrally-compiled data can often end up wildly misrepresenting the real situation, particularly when events on the ground deviate substantially from the official target.



Source: Bloomberg



There is some history to this. During the period of Chairman Mao's Great Leap Forward, government policy relied upon absurdly high projections of grain output in order to fund the rapid industrialisation of the country.

marketfolly

China was selling grain to Russia in exchange for military and industrial hardware. But it could only afford its Russian arsenal owing to its fourfold increase in grain confiscations from a population which had already been struggling to feed itself since the forced collectivisation of the mid 1950s.

The Politburo announced that farmers could meet this demand by massively increasing output, and set improbable targets for grain production. In order to 'prove' that these targets were possible, Mao arranged for farmers in so-called 'Sputnik Co-operatives' to transplant ripe crops from a number of fields into a single artificial plot in order to impress local stooges, who duly reported their findings back to the masses. And the People's Daily newspaper duly reported the highly improbable yields of over 20 tons of wheat per hectare (about twice what the best land globally could hope to achieve today) and even, in one case, 400 tons of rice per acre (which was divorced from reality by a factor of about a hundred).

Encouraged by this apparent great leap forward in productivity, the government increased its grain requisitions to secure and pay their foreign exchange commitments; and the population, hindered by having to face the harsh reality of yields which weren't improving at all, reluctantly handed over their food to the Russians and promptly starved. Household subsidies without global growth are just more unpleasant.

Returning to the present, the agricultural data (like the economic data) suggest that 2009 was another successful year for Chinese farmers and the outlook for 2010 is similar. But the sham of the 'Sputnik Co-operatives' cautions us to be careful with all statistics emerging from totalitarian states. Instead my team looks for anomalies in real economic activity, whether in terms of price action or trade flows. And the Dalian corn price highlighted above constitutes a striking anomaly.

What Might Have Happened in the Last Year to Cause Such a Price Aberration?

Early 2009 saw a drought in northern China so bad that Beijing ordered rockets to be fired into the skies to make it rain, and sent out divisions of the People's Liberation Army to water the fields by hand, armed with little more than buckets and spades. Aggravating matters further, the start of 2010 has revealed a very severe drought in the south-west of the country, bad enough to curtail industrial production in a region heavily reliant on hydroelectric power. Furthermore, fertiliser consumption in China was down sharply compared with previous years, and the impact of lower fertiliser usage on yield tends to be magnified by poor weather. This conjunction of events is normally considered prejudicial to good grain harvests.

If there has been a problem with the domestic harvest, the government will have to intervene. Politics in China have moved on somewhat since the heartless policies of Chairman Mao, and the last thing the current regime needs is an outbreak of civil unrest caused by hunger or, worse, starvation. Any domestic shortfall must be made up in the world market. We now have relatively good data regarding global trade in grains. And this is the crucial fact: China has re-appeared in the global grain markets, buying wheat from Australia and, most significantly, buying cargoes of corn from the US for the first time in a decade.

How significant could this prove to be? The example of other commodities suggests that China could have a major impact.

marketfolly

For example, they formerly played a very insignificant role in the global soybean market, but within the last fifteen years they have moved to a situation where they import over 70% of their soybean requirement and account for over half of world trade. Soybean prices have doubled since China began to be a major world player in the late 1990s.

It is perhaps too early to tell whether these purchases are a response to one bad harvest or the start of a structural trend where China begins to import corn. Nevertheless, trading at $3.60 per bushel, the global corn price looks far too cheap as China moves into the market, and we have recently begun building a small position for the Fund.

marketfolly

www.eclectica-am.com / info@eclectica-am.com / +44 (0)20 7792 6400

This document is being issued by Eclectica Asset Management LLP ("EAM"), which is authorised and regulated by the Financial Services Authority. The information contained in this document relates to the promotion of shares in one or more unrecognised collective investment schemes managed by EAM (the "Funds"). The promotion of the Funds and the distribution of this document in the United Kingdom is restricted by law. This document is being issued by EAM to and/or is directed at persons who are both (a) professional clients or eligible counterparties for the purposes of the Financial Services Authority's Conduct of Business Sourcebook ("COBS") and (b) of a kind to whom the Funds may lawfully be promoted by a person authorised under the Act (an "authorised person") by virtue of Section 238(5) of the Financial Services and Markets Act 2000 (the "Act") Chapter 4.12 of COBS. No recipient of this document may distribute it to any other person. No representation, warranty or undertaking, express or implied, is given as to the accuracy or completeness of, and no liability is accepted for, the information or opinions contained in this document by any of EAM, any of the funds managed by EAM or their respective directors. This does not exclude or restrict any duty or liability that EAM has to its customers under the UK regulatory system. This document does not constitute or form part of any offer to issue or sell, or any solicitation of any offer to subscribe or purchase, any securities mentioned herein nor shall it or the fact of its distribution form the basis of, or be relied on in connection with, any contract therefor. Recipients of this document who intend to apply for securities are reminded that any such application may be made solely on the basis of the information and opinions contained in the relevant prospectus which may be different from the information and opinions contained in this document. The value of all investments and the income derived therefrom can decrease as well as increase. This may be partly due to exchange rate fluctuations in investments that have an exposure to currencies other than the base currency of the relevant fund. Historic performance is not a guide to future performance. All charts are sourced from Eclectica Asset Management LLP. Side letters: Some hedge fund investors with significant interests in the fund receive periodic updates on the portfolio holdings. © 2005-10 Eclectica Asset Management LLP; Registration No. OC312442; registered office at 6 Salem Road, London, W2 4BU.