MONEY MACRO AND MARKETS

Unconventional Wisdom. Original Thinking.

September 2015
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The Great Mirror of Folly

Exactly 300 years ago, on September 1st 1715, the reign of one of history's great destroyers—the vainglorious, self-indulgent monomaniac and inveterate warmonger, Louis XIV, finally came to an end, leaving in its wake a defeated and demoralised country, wracked with debts and with its commercial and industrial sectors in a state of complete disarray.

As the dissipated if intelligent Duc d'Orléans took over as Regent to the deceased Sun King's infant grandchild, the initial advice he received would be familiar to any incoming government finding itself in similar straits today: to raise taxes; claw back the gains made by the '1%' - firstly through the fiscal institution of the Visa and later by criminalizing them in the inaptly named Chamber of Justice, largely for the sin of being rich; to 'restructure' by reducing the interest rate payable on and extending the maturity of the outstanding debt; and to devalue the currency in order both to lower the real value of the debt burden and to apply a monetary 'stimulus' to the populace at large.

But Orléans, like so many of his successors, felt too uneasy in his office to wish to preside for too long over such an unpopular and initially ineffective programme. Soon he turned to a man who had a far bolder and seemingly far less painful proposal to offer, a man the Duc had met at the gaming tables; a great thinker and financial innovator, the notorious monetary wizard, father of modern central banking, tutelary deity of all the Draghis, Bernankes, and Kurodas ever since - Scotsman John Law of Lauriston.

The real parallel we wish to draw here though, is not that which could be made with the sham battle being currently waged between the unanaesthetized amputative surgery of 'austerity' and the narcoleptic seductions of QE. Rather, we have long been struck by the similarities between Law's *Compagnie des Indes*—a body preserved in folklore as the Mississippi Company—and the disastrous attempt by the Chinese to rejuvenate their faltering economy by inveigling young and old alike into trusting their savings to a rising stock market.

From cautious beginnings, with the note issue of his new *Banque Générale* both strictly limited and convertible upon demand into coin of equal metallic value to that deposited, Law and his sponsor soon expanded their horizons to encompass a total overhaul of the state finances and of the very economic structure which underpinned them.

In essence, this was to be achieved by persuading people to surrender their debt claims and to spend their cash balances on acquiring shares in a grandiose state-controlled company which would not only revolutionise business at home, but would make fortunes in modernising the undeveloped regions of the world—in Law's case a vast tract of territory in the heartland of the contemporary United States; in China's case the 'Belt and Road' project of ports, highways and railways with which it proposes to engirdle the globe. Mercilessly spun as THE great financial opportunity of a lifetime, and aided by the loose money operations of what was now the *Banque Royale* it did not take long before Law's vast debt-for-equity swap became an exercise instead in debt-upon-debt pyramiding as a wild, speculative mania was unleashed with leverage being ever more eagerly piled upon leverage.

[continued over]

Sean Corrigan

The Great Mirror of Folly (continued)

So, too, in China where the original intent was jointly to put the nation's unsteady overhang of bank balances to more productive work than in financing bubbles in real estate or gold and to speed the process of industrial renewal. This would take both tangible form - by turning them into long-term equity capital and so sanitizing old, as well as constituting the basis of new, balance sheets – and would also operate through the more insubstantial method of re-enthusing the masses at the prospect of the bright, new Tomorrow they were each now helping to map out.

Here, too, matters quickly got out of hand with just the *official* total of margin debt (and hence the tip of a very large iceberg) soaring 120% in under six months – growing, as it did, by a sum equal to the entire disposable income of more than 130 million average citizens.

The problem with all such manias, as three centuries and more of history can testify, is that they can go ever up while they *are* going up but once the skyward momentum is lost, the inexorable pull of gravity regains its mastery to the ruin not just of those on board, but to the many innocent bystanders who had come to rely on the passengers' custom or who had lent them the fare to board.

It is not just what happened leading up to the peak which resonates with the events in 18th century France, but also what took place afterwards as, slowly, Law's schemes started to unravel. As the spill-over from the share market gains and the inflation of the currency necessary to sustain these began to affect the price of goods and property, and with hard money beginning to leave the country by whatever avenues it could discover, Law was forced to resort to ever more desperate and draconian measures in the attempt to keep the wax from melting beneath his wings.

Among these, he effected several changes in the value of money. He forbade the export of gold and silver, then banned not just their financial, but even their ornamental use (along with that of precious stones) and soon forbade their very possession above a certain strict maximum. Partly this was to try to force people to carry out their transactions using his depreciating paper and partly it was a crude form of capital control aimed at denying people the simplest, most fungible means by which to transfer their wealth outside the country. He then merged the Bank with the Company, closing the latter's offices before reversing course and reopening them a few days later with an offer to buy back its shares at a high fixed price in his banknotes. Far from restoring the now shattered illusions of their holders, the queues which quickly formed to take advantage of this escape clause signalled the effective end of his System, though its death agonies would endure further months of anguished twisting and turning before they were to run their full course.

So, too, in China where the authorities at first condoned (if not actually promoted) the boom, then tried to slow it, before rushing back to try to sustain it amid its inevitable collapse with a welter of diktats and directions, confusing public with private, and rights with obligations as they did. Ultimately, much like Law after his forced merger, large parts of the whole have been re-nationalizing at one remove by using state-owned entities, such as the CSFC, and state-owned banks, to take over the bulk of the unwanted shares and to substitute their credit for much of the unsupportable margin debt which sprang up along the way.

As Richard Dale attests in his impressive 2004 study of Law and his English South Sea Bubble counterpart, Blunt, a work entitled '*The First Crash*':-

'His regime was characterised by almost daily changes in the rules governing the pricing, convertibility, and permissible use of financial assets embracing specie, banknotes, and shares. The frequency, complexity, and inconsistency of these edicts… made it impossible even for sophisticated observers… let alone ordinary citizens to understand what was going on or how best to manage their financial affairs. The inevitable consequence was a generalized collapse of confidence.'

Given what is presently afoot in China - much of which we attempt to discuss below - one wonders whether one ought to send a copy for Li Keqiang to read.

As his difficulties mounted, Law summoned his one-time collaborator and rival financial genius, Irishman Richard Cantillon, to his presence after the latter – not just a penetrating economist but a remarkably astute trader - had been speculating so successfully against the French currency that he had begun, single-handedly, to depress its value and so put further pressure on Law's design. [Contd.]

The Great Mirror of Folly (continued)

Back in England, said Law, they would simply have had to negotiate a settlement to their differences but *'… in France, as you know, I can tell you that you will be in the Bastille this evening if you do not give me your word to leave the country in forty-eight hours.'*

The hedge fund managers, stock brokers, and investment banking chiefs who, in a yet another echo of that earlier time, have lately attracted the ire of the Chinese authorities must hope that they, too, will be given such a generous stay of sentence.

Mario Draghi may well have written himself in the European history books with his famous 2012 boast that he would do 'whatever it takes' – even if it did take him the best part of three years to begin to do it (by which time his doing was certainly redundant and even potentially harmful). But even that hardly retiring soul must be feeling a touch overshadowed by his Chinese counterparts' unremitting determination to 'do' whatever springs to mind in the attempt to shore up their flagging equity market and, by extension, to take the pressure off their badly faltering economy.

Just trying to keep up with the blizzard of pronouncements and policy changes issuing forth from Beijing is becoming a full time job in itself, these days. So rapidly are little Dutch boy fingers now being poked into the crumbling walls of the dyke that it has proven a struggle to stick to the writing deadline this month by reason of the multiple distractions caused by each new act of desperate 'Whateverism'.

As part of the urge to throw everything and anything at the problem, there has been much movement in both the fiscal and the regulatory fields. We have, for example, seen the Provident Fund announce that those wishing to tap its wellspring of cheap money in order to buy a *second* home will henceforth only be required to put up 20% rather than 30% of the purchase price as a deposit - only fair, perhaps, since the would-be property tycoons may well have their nest eggs locked into the impossible-to-sell stock market.

Further, Premier Li Keqiang – above whose head the sword of Damocles may be dangling if some reaches of the media are to be believed – has been trumpeting further tax concessions to small business and has chaired an emergency session of the State Council at which the intent to undertake 'targeted' and 'flexible' stimulus measures was proposed (as opposed to 'untargeted 'and 'inflexible' ones, perchance?). Fin Min Lou Jiwei however has been the man hogging the headlines by unveiling a further round of authorisation for those debt swaps for local governments which are perhaps the *dernier cri* in the practice of 'extend and pretend'.

Having started only in April with a CNY1 trillion package - quickly doubled to CNY2 trillion a bare month or two later - Lou has, this week, again upped the ante with a third tranche of CNY1.2 trillion, this one to incorporate scope for those serial misallocators of capital in the lower echelons of government to raise a freshly spendable CNY600 billion as well as to complete the subsidized rate rescheduling of all the debt thought to fall due up to the end of next year.

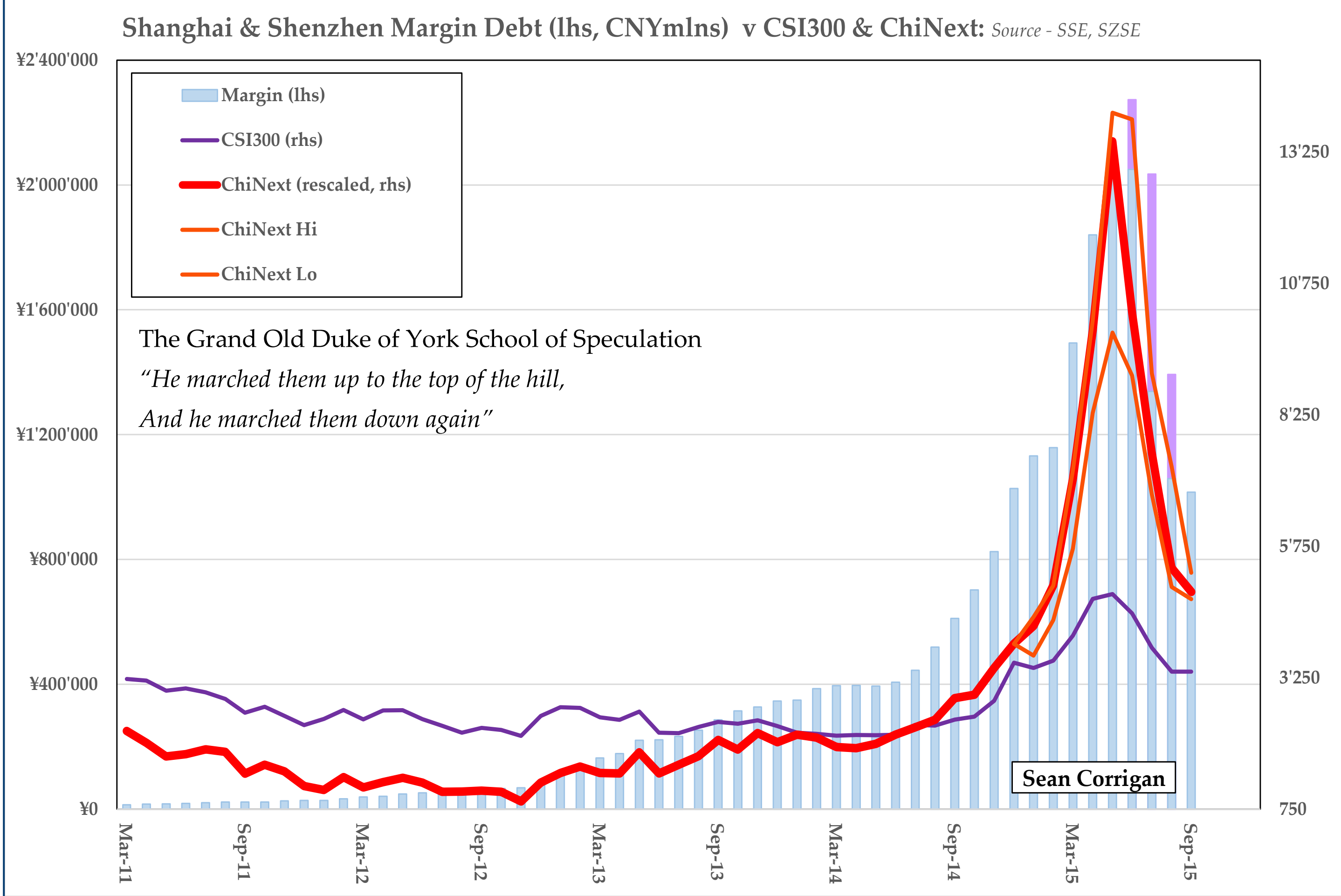
As part of these pronouncements, it was of note that the Ministry actually released some hard(ish) numbers regarding the true enormity of the problem being addressed. Five short years ago, we are now told, local governments owed CNY6.7 trillion directly and were on the hook for a further CN4tln in various guarantees and pledges. By the middle of 2013, cut-off point for a much-trumpeted audit of their finances, that already sizeable sum had swollen to just under CNY11tln in own-name obligations and a further CNY7bln in indirect liabilities (a 23% CAR of joint increase over the period).

Next we learn that the end of 2014 had pushed those already gargantuan totals up to CNY15.4tln plus CNY8.6tln for a grand total of CNY24tln, an increment of CNY6.1tln in just 18 months! Jaws figuratively dropped all over China at this revelation until some of the consternation was relieved by the cynical, if all too plausible, observation that some of this addition was probably *not* new borrowing at all, but simply debt no longer being hidden from oversight once the incentives to a realistic reckoning had swung 180° from the 2013 audit's climate of implicit criticism to this year's career-saving chance to stuff the banks with as large a forced roll-over of IOUs as possible.

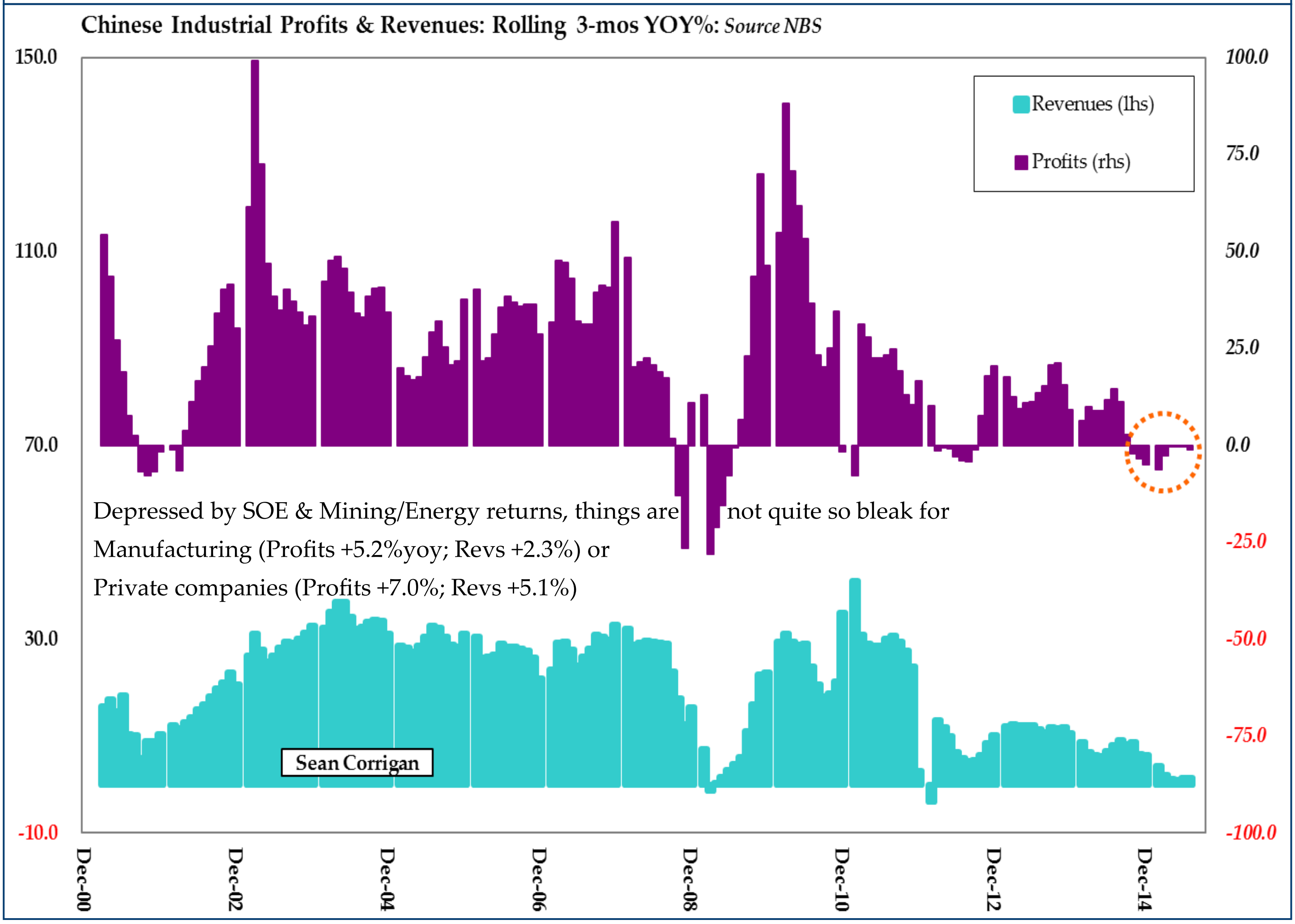
Forgive us if we do not find that explanation – rich as it is with a mixture of fraudulence and opportunism - entirely reassuring.

Various estimates are to be had as to how much of this conversion has already taken place: Minsheng is touting a figure of CNY1.82tln while Wind prefers CNY1.47tln – either total being readily accommodable in the CNY2.7tln in securities that banks have added to their balance sheets so far in 2015.

In terms of the effort at stimulus, we can only point out the wonder that the provision of new funds is even being countenanced when many in Beijing rightly suspect that LG activity has been at the heart of many of today's most



Shanghai & Shenzhen Margin Debt (lhs, CNYmlns) v CSI300 & ChiNext: Source - SSE, SZSE
Margin (lhs)
CSI300 (rhs)
ChiNext (rescaled, rhs)
ChiNext Hi
ChiNext Lo
The Grand Old Duke of York School of Speculation
"He marched them up to the top of the hill,
And he marched them down again"
Sean Corrigan
¥2'400'000
¥2'000'000
¥1'600'000
¥1'200'000
¥800'000
¥400'000
¥0
13'250
10'750
8'250
5'750
3'250
750
Mar-11
Sep-11
Mar-12
Sep-12
Mar-13
Sep-13
Mar-14
Sep-14
Mar-15
Sep-15



Chinese Industrial Profits & Revenues: Rolling 3-mos YOY%: Source NBS
Revenues (lhs)
Profits (rhs)
Depressed by SOE & Mining/Energy returns, things are not quite so bleak for
Manufacturing (Profits +5.2%yoy; Revs +2.3%) or
Private companies (Profits +7.0%; Revs +5.1%)
Sean Corrigan
150.0
110.0
70.0
30.0
-10.0
100.0
75.0
50.0
25.0
0.0
-25.0
-50.0
-75.0
-100.0
Dec-00
Dec-02
Dec-04
Dec-06
Dec-08
Dec-10
Dec-12
Dec-14

pressing difficulties. As Reuters illustrated in a recent report, the mindless reduplication of projects undertaken by the cadres is already beginning to infect precisely those shiny new industries of tomorrow that Li Keqiang is relying on to take up the baton from the ailing sunset industries of the rust-belt. For instance, as Gongxue Pei of Shanghai's Electrical & Mechanical Co. told the agency, the overseas market for robotics is dominated by four major brands but Gongxue himself has more than 1,000 competitors vying with him for business at home, most of them soft-budget, local government-funded start-ups.

And not just robotics. With no binding restraint on the allocation of means and often all too little emphasis on the rigorous accounting by which their subsequent use should be guided, such profligacy is said to be eroding returns in solar and other areas of the sexy-sounding 'clean-tech' field which is a vogue industry of the reformers.

At one remove we also have the plant and machinery companies, each heavily dependent on both LG white elephant expansionism and the credit-fuelled excesses of the bureaucrats' developer cronies. Among such firms, Liugong has just posted half-year profits fully 46% below those of a year ago. In accompanying comments, the firm noted that demand was presently where it first was way back in 2006, a pretty pass made much worse by the fact that considerably more capacity was on stream today from which to chase that shrunken market. The firm talked of the large excavator segment being in surplus to the tune of 1.5 million units a year. Peak loader demand, it said, had been 230k annually; today that stood at less than 50k. Excavators told a similar tale of woe: a 200k peak demand had dwindled to just over 40k.

Things were not much more cheery for Liugong's better known competitors, Sany Heavy and Zoomlion. The former's net profit plunged 72.9% YOY on a 30.5% drop in sales. Tellingly, the figures generated by its overseas department, which effects 40% of the company's sales of construction machinery, were roughly unchanged, meaning the domestic market - undergoing a slump of 40% - was the source of most of the woes.

As for Zoomlion, it reported a net loss of CNY300mln compared to a profit of CNY900mln in the like period in 2014. Revenues were off by a quarter. An economy under *'severe downward pressure'* in a business *'saddled with a capacity glut'* were the usual suspects cited by the firm's spokesman in trying to excuse the poor performance.

What's that old adage about what you should do when first you find you're in a hole?

In light of all this, in a wide-ranging interview on the causes of the business cycle, eminent PBoC advisor Fan Gang told *Phoenix* that China's particular curse when it came to the attempt to impose macro-control was the classic Public Choice dilemma of dissociated rewards and responsibilities which characterises the behaviour of the lower tiers of the state. This, he said, added an extra twist of 'complication' to the forces at work in the West. He pointed out that the LGs' pivotal role in the inflationary disaster of the early '90s was the reason they had been forbidden to borrow, a proscription which had largely held good until the exigencies of 2008/9 drove a CNY6tln hole through both the letter of that law and the wider requirements of good sense.

So, here we are again, five years on from that particular orgy of blind GDP worship, working out novel ways to liberate these serial murderers of capital return and striking new Faustian bargains to achieve a degree of short-term 'boosterism' (to use Raghuram Rajan's trenchant phrase) in despite of the avowed purpose of genuine, structural reform. Just to make sure the message sank home, the NDRC issued a directive to the banking industry telling it to get on with the setting up of securitisation programmes through which to fund all manner of new infrastructure expenditure. So vexed has the situation become for those at the top that there appears to be little chance of them taking the advice of the country's richest man, Dalian Wanda's Wang Jianlin who cautioned his masters that they needed to *'…drop the fantasy of a high growth rate…'* as soon as possible.

PKOs go WFO

Meanwhile, the battle for the soul of the stock market continues. The authorities have tried sizeable, outright 'price-keeping operations' *à la* Japan. They have raised futures margins to 40%. They have permitted sustained stock suspensions lest banking covenants be breached by tumbling collateral values; they have strong-armed companies into pledging not to sell shares and bullied first 21, now 50, brokerage firms into 'investing' 20% of their capital in the market (and then had the gall to insist that said firms increase that same quantum of capital by a matching CNY100bln).

As Vice Fin Min Wei Yu Ping announced, rules have been changed to allow the social security fund to invest what will probably be a standard 30% of its estimated CNY2tln war-chest in the equity market though this, for the present, remains a matter of intent – and hence of sentiment – rather than of hard reality. Further, the three major regulators and the finance ministry have declared their resolution to make listed, state-controlled companies (itself an oxymoron that only China could achieve) suddenly lead the way to becoming all shareholder friendly (not least, friendly to that cash-strapped prime shareholder, the government) by paying out hefty dividends, undertaking buybacks, launching ESOP plans, and engaging in M&A more actively.

As a sign of the act first, think later mentality currently on display in Beijing, this is a programme which begs the question as to where these ailing giants will get the money to comply with this wish-list when profits (at least for the industrial members of this happy band) were down 19.2% YOY in the past three months on 8% fewer revenues. Moreover, it makes the classic planners' mistake of confusing ends with means and maps with territories in that it hopes, by forcing an essentially non-market animal to mimic one, that the market itself will be reinforced in its turn.

Going around the houses one more time, the Crash Support & Firefighting Corps known as the CSFC (actually the China Securities Financing Corporation) will be soliciting a handy little one-year advance of CNY1.4 trillion from the ever-tractable banks, the better to hold onto all those underwater positions that nobody else really wants to hold.

Far from being the bottomless pit of largesse that the authorities seem to regard them, those same banks have been having more than a few woes of their own. Consider that net profits at the Big 4 – ICBC, BOCOMM, BOC, and ABC – were up just 1.5% in H1'15 despite an increase in the asset base of around 7-10%. Margin compression was probably a contributory factor but principally this anaemia was due to a sharp rise in provisioning (up 74% in the case of ICBC) on an acknowledged upswing in NPLs (31% for that same institution). Given that (a) Chinese banks are nowhere near as rigorous as they should be in recognising souring loans; (b) that these are now widespread not only in heavy industry and in wholesale and retail trade but also, said CCB, in IT; and (c) that none of this incorporated the share market disaster which began to unfold only in the latter half of July – and hence fell several weeks after the relevant reporting date – we can presumably look forward to much more of the same in future.

Notwithstanding such Herculean efforts, official levels of margin debt on the two principal exchanges have erased all of their steepling climb of the first, heady seven months of the year largely taking stock prices back with them. What a Red Queen race to nowhere that $400bln roundtrip has involved – not least in that it embroiled China in four months of frantic overtrading to the tune of $20tln – almost half the worldwide total, 4.2 times the churn in the whole of the rest of Asia, and 2.2 times that on New York's hardly quiescent two main bourses!

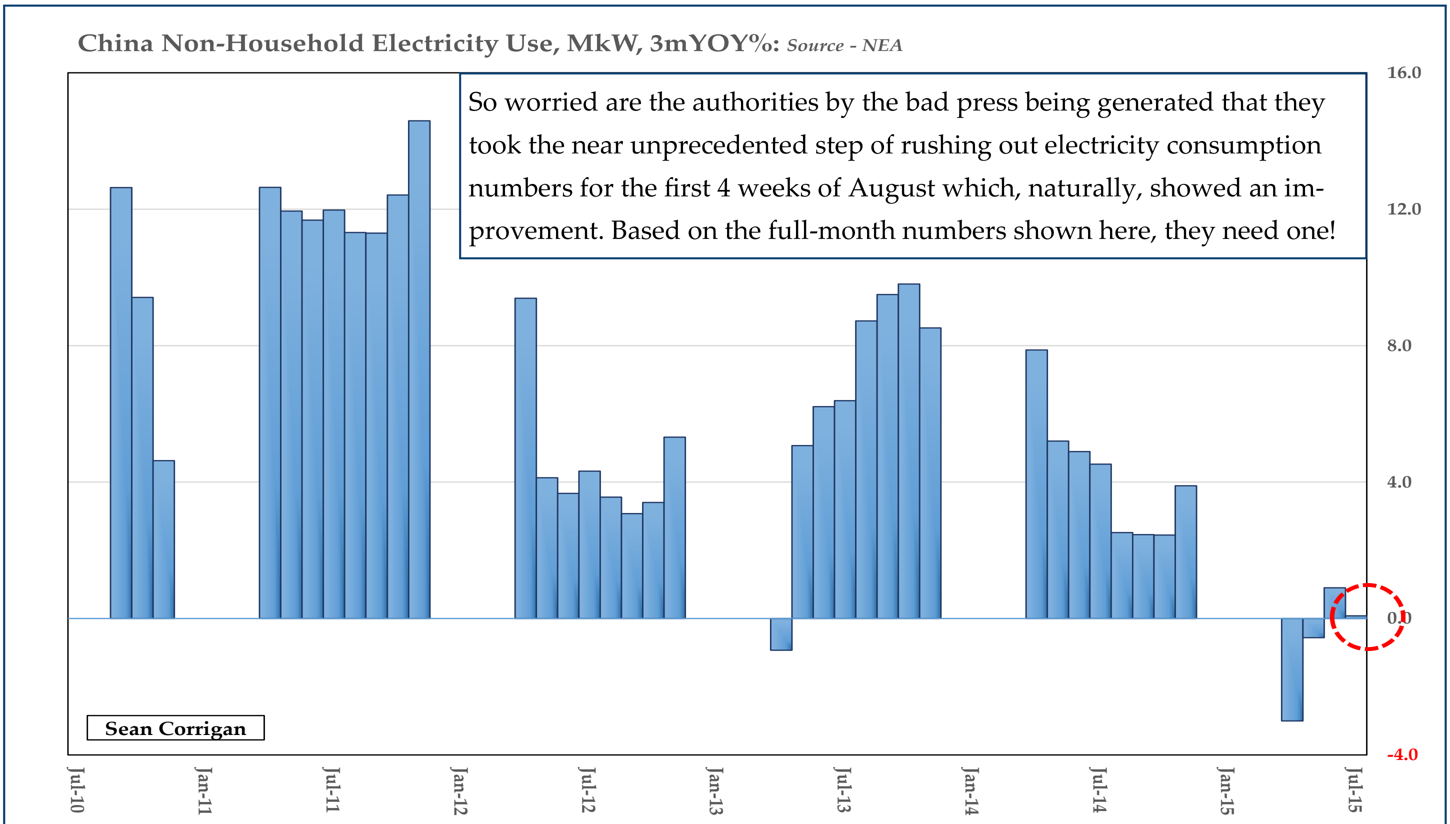
And for my Next Trick...

On the monetary side, meanwhile, we have recently seen several of the long-established pillars of the system swept away in rapid succession, leaving one clinging to the hope that those in power who are removing them are not being entirely eyeless in Gaza as they do so.

We have had two headline RRR cuts in swift succession – though these have been, in part, an inescapable consequence of what seems to be a haemorrhage of hot money out of the country (more on that below). On top of this, there has been further recourse to the technique of varying the reductions according to the prevalent business of the lending institution – an extra 50bps here for an agricultural co-op; a whole 350bps there to help the nation's petrified auto manufacturers and importers mobilize their own creditworthiness in order to finance the acquisitions of their suddenly reluctant clientele—not to mention to prop up the 90% of their dealers whom their own National Federation reckons made a first half loss.

To see why this has been deemed necessary, consider that car sales have slumped from double digit rates of growth to YTD declines while those for commercial vehicle sales have utterly collapsed. Things in this sector are so bad that Suzuki admitted its sales took up just 50% of capacity, rendering one of its two mainland factories – *the one brought into service only 18 months ago* – surplus to requirements. Talk about a credit-led failure of entrepreneurial vision!

Official rate cuts we have also had though, as ever, it is hard to know whether these will be meaningful in a land where so much of the architecture of lending is shadowy –


China Non-Household Electricity Use, MkW, 3mYOY%: Source - NEA
So worried are the authorities by the bad press being generated that they took the near unprecedented step of rushing out electricity consumption numbers for the first 4 weeks of August which, naturally, showed an improvement. Based on the full-month numbers shown here, they need one!
Sean Corrigan
16.0
12.0
8.0
4.0
0.0
-4.0
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Jan-12
Jul-12
Jan-13
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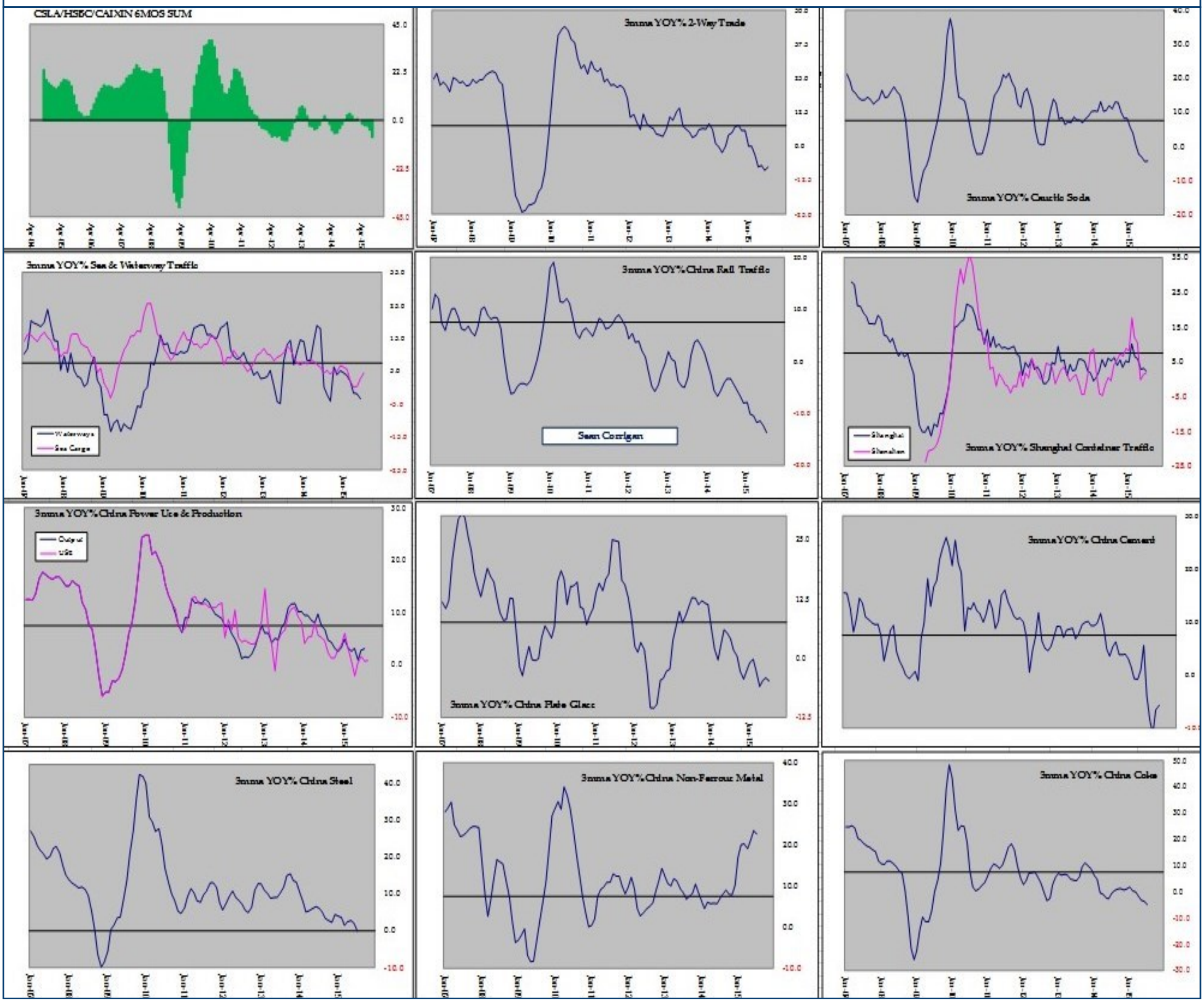

CSLA/HSBC/CAIXIN 6MOS SUM
3mma YOY% 2-Way Trade
3mma YOY% Caustic Soda
3mma YOY% Sea & Waterway Traffic
Waterways
Sea Cargo
3mma YOY% China Rail Traffic
Sean Corrigan
3mma YOY% Shanghai Container Traffic
Shanghai
Shenzhen
3mma YOY% China Power Use & Production
Output
Use
3mma YOY% China Plate Glass
3mma YOY% China Cement
3mma YOY% China Steel
3mma YOY% China Non-Ferrous Metal
3mma YOY% China Coke

if not actually *sub rosa* – and where each transaction thus routinely incorporates a hefty premium as compensation for both the liquidity risk and the legal uncertainties being incurred by the funds' intrepid lenders.

The central bank has also deployed the thick end of $100 billion in a recapitalization of two of the nation's so-called 'policy banks', China Development Bank and the Export-Import Bank of China, while another $16 billion has been supplied to the Agricultural Development Bank of China by the Ministry of Finance itself.

Next, the two-decade old stipulation that banks cannot lend more than 75% of their deposit base has been rescinded, meaning that a check upon over-extension imposed in the aftermath of the inflationary debt boom of the early 90s has at last succumbed to the urgent need to try to shore up a different kind of debt bubble in the 2010s.

After months of relative quietude, we have also witnessed a barrage of 11- and 12-figure lending operations, both long and short. Some of this has been aimed at restoring the liquidity lost to the drain taking place across the country's borders: some is undeniably intended to add some much-needed buoyancy to a commercial banking system which, as we have seen above, is now being charged with keeping all and sundry afloat beside them.

Finally, we have enjoyed the upheaval unleashed by the partial unpegging of the yuan – a seismic event not entirely unheralded, as the preternaturally compressed price action of the currency in the weeks leading up to the release was a clear sign of building stress and a tell-tale sign of a heavy, yet ineffective programme of intervention.

Making a virtue out a necessity, the official spin was that the move introduced an 'improved' fixing procedure, allowing greater market influence and hence was a step towards satisfying the IMF's laundry list of conditions for SDR inclusion. The horrible truth soon emerged as the renminbi's less reputable offshore relatives – the spot CNH and the NDF family – started soaring, rates on the latter peaking at a level 47 big figures - some 7.6% - above its starting point and only subsiding therefrom because the PBoC itself first sat on the offer in an attempt to try to cover its embarrassment and then peremptorily imposed a draconian 20% margin requirement on banks' gross (not net, you will note) forward purchases of dollars.

Despite this, the spill-over has even stirred the HKMA into action. At one point last week, as CNH short positions climbed, driving interest rates to 10% and more, it had to lend yuan into the market, presumably acquiring it by means of its swap line with the PBoC. Then, as the new month dawned, the pressure mounted again, this time on the local unit – a demand perhaps emanating from those mainland property developers whom JP Morgan estimates have two-fifths of their debts denominated in US and HK dollars. Swiftly, the HKMA was back in to defend the upper bound of its peg, conducting several rounds of intervention for a total of US$3.6 billion bought. In all, this cross-strait chicanery amounted to a very inefficient way of transferring a pile of 'Benjamins' from the PBoC's virtual vaults to those of its smaller counterpart.

So far, Pandora is sitting firmly on the lid of her box, having let only a few of the demons it incarcerated loose in the world. But whether she can contain them indefinitely is a problem of a different order especially as, to change the metaphor to one employed in the 1960s by Fritz Machlup, the lending operations which are being conducted to prevent the forex reserve depletion from being too contractionary are acting like a magician who forgets that it is he who keeps putting the rabbit back into the hat out of which he then pulls it to his audience's amazement

Not 'Going Out'

Uncertain as to this will all eventually pan out, it is clear that Beijing is becoming more than a little alarmed. As a symptom of this, Ming Qingfeng, Vice Minister at the ominous sounding Ministry of Public Security announced a clamp-down on underground banks which, he said with only a trace of hyperbole, were: *'…severely disturbing financial market order and endangering the country's financial safety.'*

You will agree that such strictures represent something of a *volte face* from the fanfare which only four weeks was sounded to laud a new arrangement *allowing* firms in the trading company hub of Xiamen to borrow overseas from Taiwan at rates said to be up to 20% (sic) lower than they could before the facility was put in place. As *China Daily* reported at the time:

'Li Weiping, manager of the People's Bank of China's Xiamen central sub-branch, said: "The service will expand financing channels overseas and reduce costs. It will not only give strong

support to the real economy in Xiamen but also encourage the flow of yuan from Taiwan to the Chinese mainland and the development of the offshore yuan market in Taiwan."'

Then again, this is the place where *Caijing* quoted a local logistics owner as saying that Customs are unable to gauge just how weak trade really is because he and his colleagues systematically over-report exports in order to earn the associated tax subsidies. That gentleman's weary pessimism was echoed in *Economic Information Daily* by TLC Group manager Liang Qichun who told the paper that the devaluation of EM currencies, plus the imposition of exchange controls in the likes of Argentina, were hitting his firm's overseas sales of white and brown electrical goods hard and that accounts receivable were mounting alarmingly on their books as a consequence. Faced with all that, is it any wonder that the temptation to turn a quick buck by providing – how shall we put it – i*nformal* financial services is seemingly becoming irresistible?

Death to the Speculators!

But if the powers-that-be could largely turn a blind eye to such shenanigans when money was pouring *in* to the country, it has become a wholly different matter now that it is beginning to drain back *out*. That this phenomenon is being taken very seriously could have been divined some time back in reports that several trading companies – among them the local branch of Blackhawk Ben Bernanke's *amakudari* sponsors, Citadel - had been the subject of official scrutiny and that some had even had their accounts suspended, pending further investigation. Then the purge intensified with local titans CITIC having eight senior employees 'taken away' for a friendly little chat with the regulators; an invitation which quickly became rather less exclusive as news broke that Li Yifei, local boss of the mighty Man Group, had been likewise honoured.

Next, the privilege was extended to members of the Fourth Estate. Liao Hong – editor-in-chief of the online edition of the regime's house-paper, the *People's Daily* - got his call to attend, as did *Caijing* journalist Wang Xiaolu, this last poor soul appearing in the media a short while later to make a ritual public 'confession' of his malfeasance in sowing *'panic and disorder'* in his columns. All in all, the propaganda machine was careful to let us know, some 63 firms have now been the subject of an SEC *razzia* and 197 individuals have thus far been 'punished' for that crime against the Great Bull Market which goes by the name of '*malicious manipulation*'.

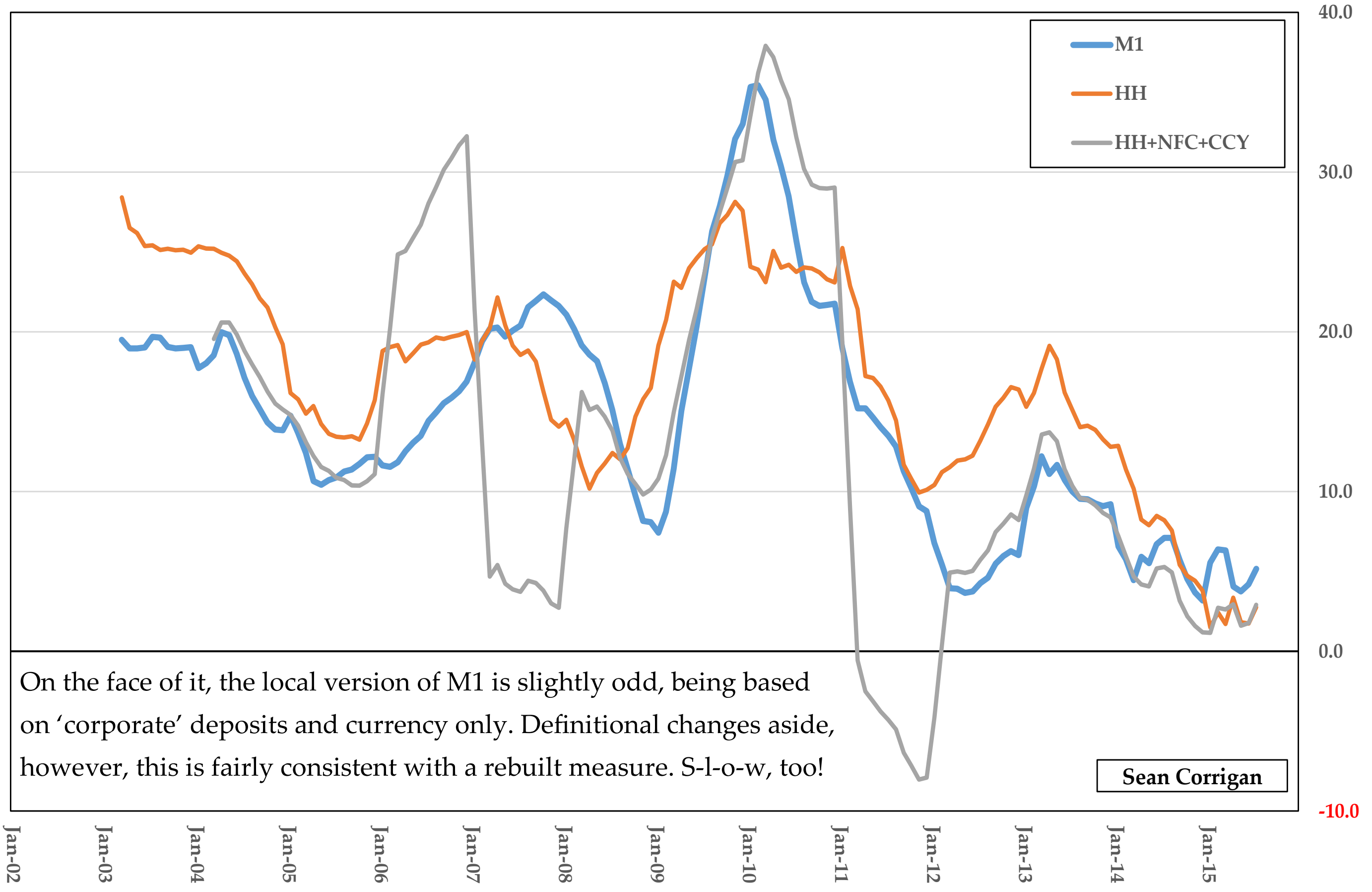
Meanwhile, in Macau, police staged a series of high-profile raids on several of the island's pawn shops which, along with its sprawling casinos, are known to be regular conduits for people wishing to get a greater than sanctioned portion of their money out of China. In fact, if we believe Tam Chi Keong, assistant professor at the Macau University of Science and Technology, flows out through this clandestine channel can amount to $200 billion a year – enough to buy an awful lot of *dim sum* in foreign climes.

Moving money the other way seems to be the speciality of the Yiwu City, world champion vendor of cheap merchandise – Christmas lights, party hats, 'novelty' gifts and the like. An in-depth report conducted in Yiwu by *Time Weekly* magazine a fortnight ago elicited some fairly candid admissions of the ruses routinely practiced by the local entrepreneurs. Suffice it to say that, in a country where expressions of concern about the currently depressed state of foreign business are commonplace, Yiwu supposedly enjoyed a *43.5%* increase in two-way trade, taking it to over $15 billion, in the first six months of 2015!

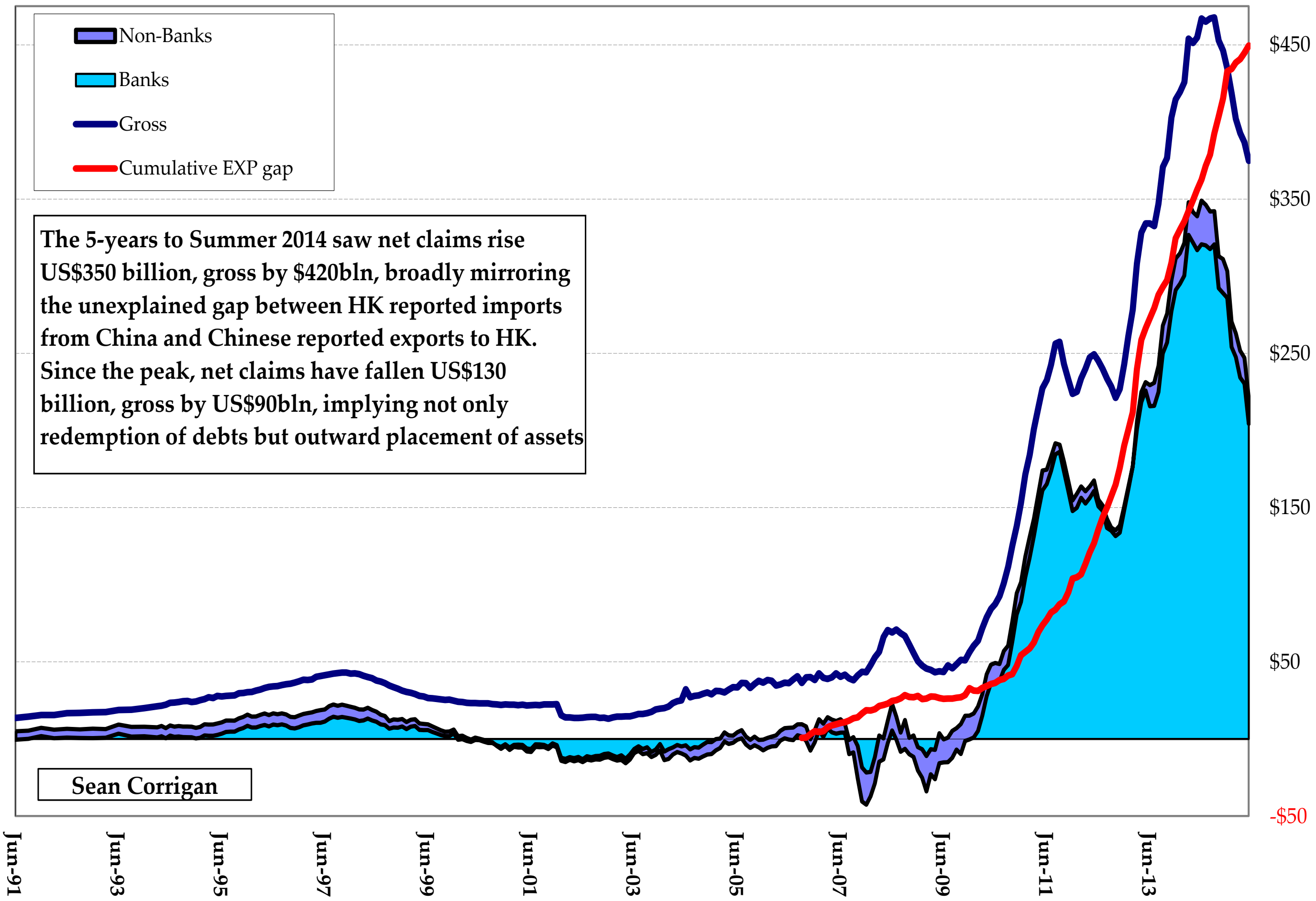
In the face of all this it may be that the regime has manoeuvred itself into fighting yet another unwinnable battle. Certainly, the scale of oppression it would have to visit upon the very people whose support it is otherwise trying to enlist in its struggle to re-orient a badly misaligned economy would be shocking indeed to modern sensibilities if it were serious about sealing off such outlets. Here we must be frank about the chance of success: if even the most draconian penalties currently exert no more than a modicum of friction upon the trade in, say, proscribed narcotics or sensitive technology, are we to be supposed to think that even the spectacle of public executions in the town square would really put a halt to the flow of all other monies across the borders if it seemed that their extraction made sound, economic sense?

In fact, it might even be supposed that the very threat of the noose being tightened in the coming days might be enough to persuade the hitherto undecided to put their heads in it now, before it is pulled any closer about them. Rather than being deterred, they might feel it was now or never to get their funds out and away from the grasp of a regime perceived to be turning more dangerous to their

Chinese Money Supply: M1, Household & NFC (shifting definition) depos: *Source - PBOC*



HK Net Forex Claims on China v Reported Trade Discrepancy, US$blns: *Source - HKMA, Bloomberg*



material well-being.

A further important consideration—one which is given far too little attention by the army of China pundits which occupies our airwaves—is that relating to just what effect this flurry of ill-considered initiatives and knee-jerk responses will itself have on decision makers - whether political, corporate, or individual. If your author cannot find even a few days' peace to put this commentary together without having constantly to update and revise it, how are people whose entire livelihoods and careers directly at stake meant to react to such a constantly shifting landscape?

There is however one even more alarming possibility, if not one that we should yet allow to weigh too heavily in our counsels, for fear of being counted among the despised band of rumour mongers ourselves. This is the idea that, as some have indeed begin to speculate, the factions in the Communist Party which Xi has been so implacable in bringing to heel are the ones he is really trying to subdue with these otherwise inexplicable actions.

Let us not be misunderstood: we are not suggesting that, say, Jiang Zemin's crew are *actively* conspiring to crash the stock market and drain the nation's foreign reserves as part of a Machiavellian scheme to topple a hostile President, but rather that such cliques cannot be entirely unhappy to see that some of the aura of invulnerability and infallibility in which Xi has taken care to bath since his inauguration in office is at last beginning to pall.

It would not be wholly unnatural to suppose that, were things to turn out worse than Xi anticipated in any particular area, a judicious nudge on the margin loan account, a heavy liquidation trade here, a planted (even a *true* but previously spiked) story there might be engineered to maximise his discomfiture Nor, once these came to light, could the leadership's response be expected to be anything other than forthright in rooting out the agents of dissent and disruption, wherever these could be identified. Is this then what lies behind the otherwise bewilderingly Maoist attempt to suppress all opposing opinion?

Recall that, just before the renminbi change was announced, the *People's Daily* carried a cryptic admonition that one should *'let the tea go cold once the guest has gone'* – a metaphor widely interpreted as Xi warning Jiang to cease and desist from all further interference. This was followed, some ten days later, with a pseudonymous article in a relatively obscure journal in which Xi himself decried the *'unimaginably fierce resistance'* which was being offered to his programme of reform. Given that this unusually explicit tirade was issued in the aftermath of the annual conclave of the good and great of the Party at Beidaihe, one might be forgiven for surmising that Xi did not meet with a unanimous endorsement of his policies at that august gathering.

It has been argued – if largely by either linear, 6"rule economists or inveterate, grow-to-the-sky Sinophiles – that the stock market's current travails represent absolutely no fundamental treat to the Chinese economy as a whole and that we should all therefore take a deep breath and raise or gaze beyond it.

What this does overlook, however, is not just the possibility that such a financial tremblor might trigger a wider avalanche out in the real world, but that it might just pose an existential peril to Xi's term in office—hence the seemingly limitless series of counter-measures being undertaken to mitigate its effect on both the perceptions and the pocketbooks of the ordinary folk.

Whatever the underlying motive, one cannot help admitting that one is not entirely sure that the present strategy can succeed and so, while Xi maintains this hyperactive response of stick and carrot, of stimulus and constraint, the words of Sun Tzu play continually at the back of one's mind:

'Too frequent rewards indicate that the general is at the end of his resources; too frequent punishments that he is in acute distress.'

To recap, as part of the mechanism by which China manages both its currency and its domestic supply of base money, all foreign receipts were—until a partial liberalisaztio took place in recent moths—theoretically to be surrendered to the central bank against the creation of new reserve balances or issues of specie. If unhindered, this would mean that every dollar of external surplus (which, all you neo-mercantilists should note represents a net *sacrifice* of labour and resources) should give rise to the equivalent number of newly-issued yuan. With no increased supply of domestically-purchasable goods or services, no further division of labour, and no enhanced appetite for holding money *necessarily* involved in the process, this *should* initiate a steady rise in prices such that, eventually, the terms of trade between exports and imports will shift so as to slow - and possibly even reverse - the positive external balance.

Of course, this application of the classic price:specie principle would be doubly effective if the nation to which China is exporting such a surplus were, *ipso facto*, losing reserves, shrinking its money supply, and hence deflating its way back to competitiveness concurrent with China's inflation away from said competiveness. Alas, on a fiat money, floating standard rather than a fixed, bullionist one, that is never the case, though it could be that the trade imbalance itself – if unchecked by the offsetting voluntary acquisition of financial claims beyond the otherwise unavoidable, but possibly unwanted, accumulation of pass-the-parcel bank balances - is enough to alter the relative valuation of the currencies and so to exert an equilibrating push by this means instead.

Since China does *not* wish such an adjustment to occur and since, also, it does not wish to allow free rein to the associated inflationary impetus, the PBoC buys the foreign currency, relends it to the outside world, and then partly 'sterilizes' the influx by forcing the holders of its own liabilities to immobilize them in the form of reserves. Note that this does not completely eradicate the increase in domestic money, it merely limits the exporters' correspondent banks from multiplying their reserve balances up to more than a closely prescribed extent.

Now, on top of the legitimate monetary gains from trade, China has also typically attracted other financial inflows, both licit and illicit, thus building up a body of external, foreign currency obligations alongside its assets. The most obvious example of these comprised the peak US$450 billion in gross claims which were held against it last summer by entities resident in Hong Kong.

Now, if people want to get money back out of China – whether to repay (or hedge) their naked exposure to foreign loans, or to acquire offshore assets as protection against an ongoing decline in the yuan, all of this goes in reverse. The PboC receives yuan at home and cancels the reserve balance, handing over dollars and euros in exchange, having first sold the instruments in which these were being kept.

If nothing else were to be done, this efflux would therefore tend to be as *de*flationary for China as the original influx was *in*flationary. For the rest of the world, the position is a little more subtle. Existing borrowers from China's reserve hoard find their loans being called or their securities being offered on the secondary market, something which might be expected to push up the yield which they bear. Conversely, however, the private sector recipients of dollars and yen are either repaying their own debts (and thereby freeing up their lenders' balance sheets) or they are looking for foreign-denominated assets to buy. Hence, while there may be *relative* pricing effects – or changes in spread, if you will – and while existing borrower A now has the bother of seeking access to new lender B, the overall effects of the shift should largely cancel out.

Not so at home, however, for unless China takes other steps to replace the extinguished reserves, domestic base money will shrink. It has two tools at its disposal with which to compensate for this drain. Firstly, it may add reserves by means of a domestic open market operation (buying or repoing a bond or other asset, such as gold) and it may relax the reserve requirement. The PBoC has done both, as we have mentioned.

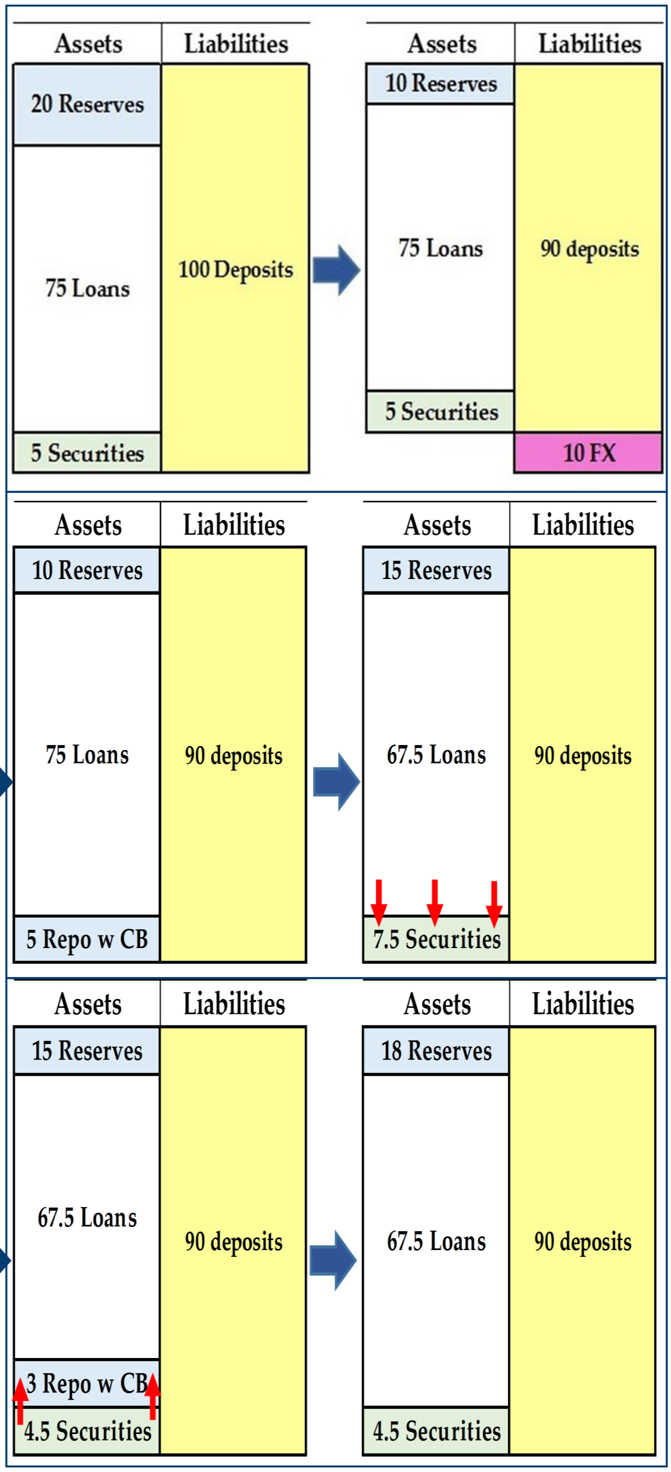
At some point, if the transfer of monies out persists another step becomes necessary. To see this, suppose we initially have a bank, Bank A, which has CNY deposits of 100, 10 of which were placed by a customer who raised the funds offshore in the Eurodollar market before selling the proceeds to the bank and hence on to the PBoC. Being anxious to maximise his earning assets, the Banker A holds no more than the statutory 20 in reserves with the central bank, lends out the full 75 he is allowed against his deposits, and buys 5 bonds with the remainder. 100 matches 100 and all regulations have been complied with.

Now suppose the customer wishes to pay back his USD loan. He therefore sells 10 yuan to Bank A from his deposit account and the bank draws upon its reserve balance at the CB in order to acquire the dollars. Being aware of the ramifications of this action, the central bank immediately offers to buy Bank A's full quota of 5 bonds, writing a cheque on itself and so boosting the other's reserve quota as it does.

At this point, the bank's balance sheet shows deposit liabilities of a reduced 90, an unchanged 75 in loans and 15 in reserves at the PBoC. The books balance once more, but the ratios are now both out of kilter. Bank A only boasts a reserve ratio of 15/90 = 16.7%, not the 20% it needs, and, furthermore, its loan:deposit ratio has swollen to 75/90 = 83.3% in place of the permitted 75%.

Thus, in order to restore the innocent banker to legitimacy – and without adding a single *fen* to the system – the easiest course for the 'Big Mother' is for her to cut the RRR and to ease (or abolish) the LTD stipulation. What she might alternatively do is persuade Bank A to commute 7.5 of his (LGFV) loans to bonds and then offer a reverse repo of 3 against them. Bank A now ranges 18 in reserves, 67.5 in loans, and 4.5 in securities against its 90 deposits and harmony is once again restored. [In reality, bank A will also hold perhaps 10 units of equity. Against this we would find both tangible assets and some mix of securities but this would only complicate the arithmetic without altering the substance of the scheme so here we have ignored it]

The conclusion we must draw from the foregoing is that, or all the talk of 'freeing up' this or that impressive sounding sum by its actions, until we see the next set of money numbers and we can gauge the scale of the external drain, we do not know that the PBoC has managed to do any more so far than try to mitigate the impact of the loss.



INSIDE THE MAGIC CIRCLE: The Central Bankers Speak

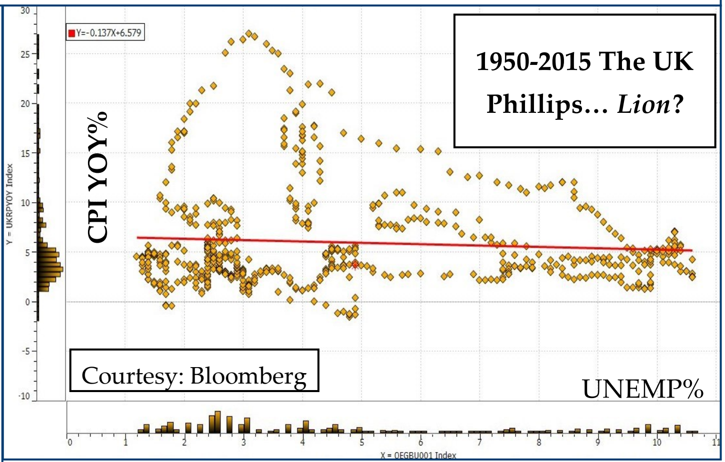
There are all manner of proverbs in the circulation to the effect that it is always possible to appear wise by not saying anything at all and vice versa. There is also the old adage that familiarity breeds contempt. Your author cannot help feeling that both of these are given a solid dose of confirmation whenever we hear from a member of the sprawling tribe of central bankers—a community split into the three main castes of cracker-barrel philosophers, reality-divorced technocrats, and sly political timeservers.

Though it is always hard to pick the winning entry from such a rich field, this week our contenders for the award for aphorism verification include Vitor Constancio of the ECB who declared, with what was presumably a straight face that it is too, too unfair to criticise central banks such as his since they are *'simply reacting to and trying to correct a situation that they did not create '!*

Clearly, Vitor! Now, when you finish washing your hands and you have given Pontius Pilate back his fingerbowl, perhaps you would like to run us through how it was that the world's largest and arguably most economically damaging credit bubble happened to erupt on your watch, and yours alone, if you had nothing whatever to do with it.

Moreover, since you also seem wedded to that truly dismal cult of 'secular stagnation'—you know, the one where, as you went on to explain in your apologia, we suffer a '*continuous* [sic] *deceleration of total productivity growth and an increase in planned savings accompanied by less buoyant investment prospects'*—we manage to indulge in so many successive asset bubbles, run up so much debt, and not have enough left in the kitty to see us through our dotage.

Given that the first signifies a repeated willingness to *over*-invest (at least, in financial assets and such typical target durables as houses, art, and baubles); the second shows our societal penchant for reckless *dis*-saving; and the third is testimony to that failing's worrisome long-term effects, I think you might put the horse of artificially-lowered interest rates back ahead of the cart of increasingly tardy growth rates and admit that your asymmetrical policy bias, together with your irrational phobia about letting the full fruits of enhanced productivity translate naturally into lower purchasing prices, are very much the things culpable of 'creating' our current situation!



Giving Vitor a run for his money was the head of the BOE Circus himself, Mark Karney. In a Jackson Hole address which was built around the thoroughly vitiated concept of the alleged inflation-unemployment trade-off known as the Philips Curve, Team GB's expensive Canadian import managed to come up with the following jaw-dropper:-

'In order to counterbalance the scale and persistence of exchange rate movements, UK monetary policy needs to support a continued firming in the growth of wages and unit labour costs. The stronger the drag from foreign cost pressures, the more domestic costs will have to run above past averages. '

In other words, because what was once simply a stratagem to help deflect political demands for too much monetary accommodation—namely, a CPI target—has been elevated by today's crop of *économistes savants* into an idol of Baal and Moloch and has the thus become the goal, not the guidepost or the guardrail, of policy, Karney wants us to know that, if the Brits are ever in any danger of seeing their cash go a little further in the supermarket than it used to, his Circus will endeavour to make it even more expensive for businesses—some of whom will be facing tougher competition as a result of that same price change—to keep those same happy consumers gainfully employed and spending. Simply marvellous!

A collective entry from the crew at Riksbank is not to be overlooked in this race, either. These worthies have decided that the chimera of 'inflation expectations' is the beast that must be fed up in the land of flat-pack and pickled fish. Already acting to try to deny their countrymen the full benefit of a lower oil price, they have now painted themselves right into the corner of the padded cell they each occupy, the latest wheeze being to try to persuade the unions to ask for—and employers to cede—*higher* (yes, you read that right) wage rises than they are otherwise likely to agree upon.

As Deputy Governor Per Jansson warned in the Bank's last minutes, *'there is now a risk of the inflation target not forming the basis of next year's wage negotiations….this would of course be deeply regrettable.'* What would be truly regrettable, Herr Jansson, is that businesses are forced to find other ways to minimize labour costs, or else that they go under in the attempt, thanks to your mindless macro-meddling.

Though he did not appear to commit any such obvious enormities, the acknowledged doyen of Anglo-American central banking Stanley Fischer hardly covered himself in glory at Jackson Hole when he volunteered that he was still undecided about a US rate hike, but dearly wanted to see two whole weeks more low signal:noise ratio and a few more closes on the Shanghai Comp data before making the momentous—and eternally delayed—decision to inch short-term rates up by the merest iota. So the model upon which the MIT Council of Monetary Elders is now relying is the Weather Vane model? How very reassuring!

Perhaps, dear Stanley should quit his procrastination and take a leaf out of Charles Goodhart's book. Speaking at a recent conference, this other grand old man of British central banking rightly declared that:-

'One of the great errors of policymaking is the view that "There are a lot of things we don't know and many of these will become apparent over the next three months, so why not wait three months until you are more certain?"'

'The reason why that is an error is because there are lots more things that become uncertain over the next three months, and so the degree of uncertainty is pretty well constant at all times. But no-one sees it in that way… It won't become more obvious. You are just as likely to make mistakes if you wait.'

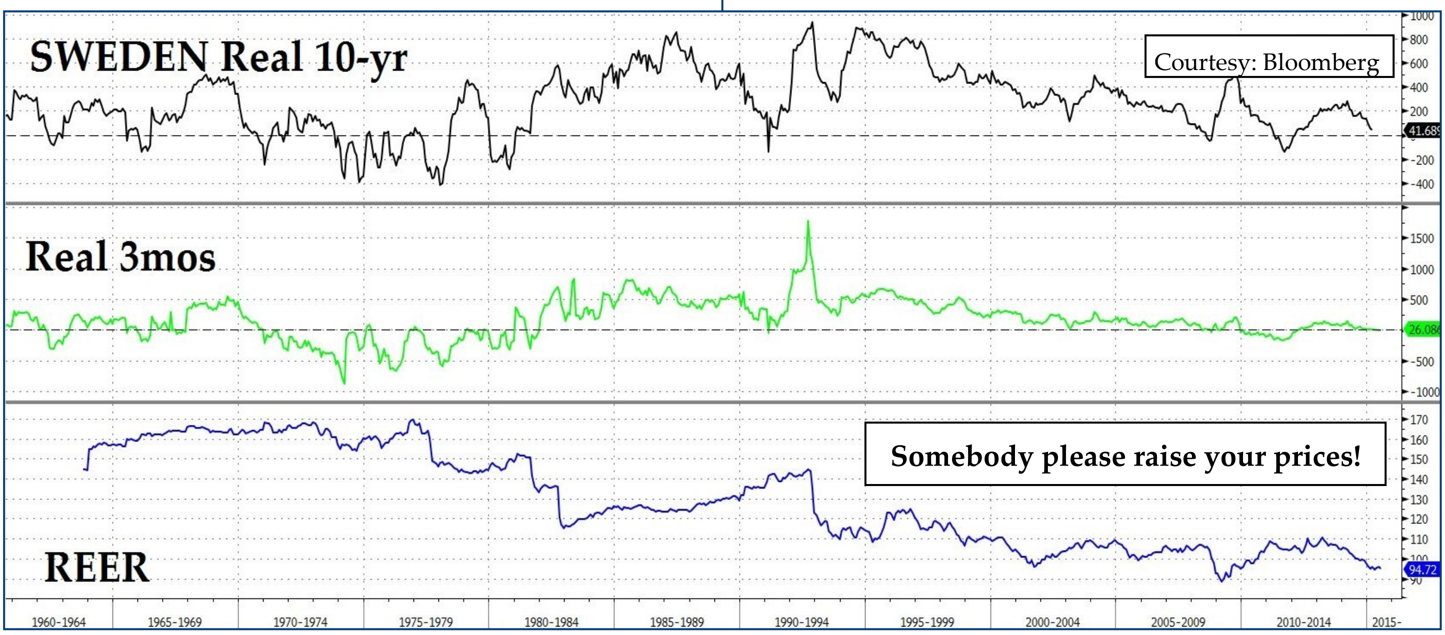
And just to show we are not entirely biased against the species, another man who propounded a view which made eminent good sense and which is therefore likely to fall mainly upon deaf ears in the circles in which he moves, was SNB head Thomas Jordan.

Though not entirely immune to the virus of *'well-anchored inflation expectations'*, Jordan did hammer home the point that central bankers must not be distracted by those very short-term developments which seem to have Stanley Fischer in their thrall. Do not be tempted to fine-tune, was Jordan's repeated mantra.

He also had this to say:-

'When adverse spill-overs occur, firms must adjust quickly and flexibly to changing conditions both at home and abroad. The Swiss economy has proved on several occasions in the past that it can master significant challenges. Institutional arrangements and good labour-management relations allow relatively high price and wage flexibility. Ongoing innovation drives also play a key role in ensuring that firms in Switzerland remain internationally competitive.'

As Jordan says, sound institutions and entrepreneurial adaptation: these are the answers to most economic problems, not Man Behind the Curtain conjuring tricks from the likes of Jordan's regrettably less circumspect peers.



There has lately been a good deal of breaking of Bastiat's windows when it comes to the vexed question of EM current account declines. The line being bandied about is that as the commodity slump takes its toll on the resource producers, they will no longer be acquiring (principally) Treasuries and may even end up selling them.

As they do, we are warned, not only will this push up interest rates directly, but it will deprive the world of a good deal of much-needed 'liquidity'. To dispel any unease which this may be causing you, dear reader, let us try to lay out the fallacy of this as simply as possible.

Suppose that you have found yourself on your uppers in recent months to the point where your income no longer fully covers the requirements of your regular grocery bill. Rather than starve, you have instead been making use of the credit facilities thoughtfully provided by your favourite supermarket and you have taken to charging half of the cost—some $50 a week—to your storecard, rolling over the vast bulk of the balance with interest each month for want of any other means by which to pay off more than the statutory minimum.

After several months of this, you are fast approaching your credit limit and so are beginning to wonder how you will cope when, suddenly, you receive the first piece of good news to come your way in a long-time. Under pressure from a new chain of discounters, the store you frequent has been moved to slash its prices in order to stay competitive, reducing your typical outlay by that very same $50 you were previously having to borrow from it.

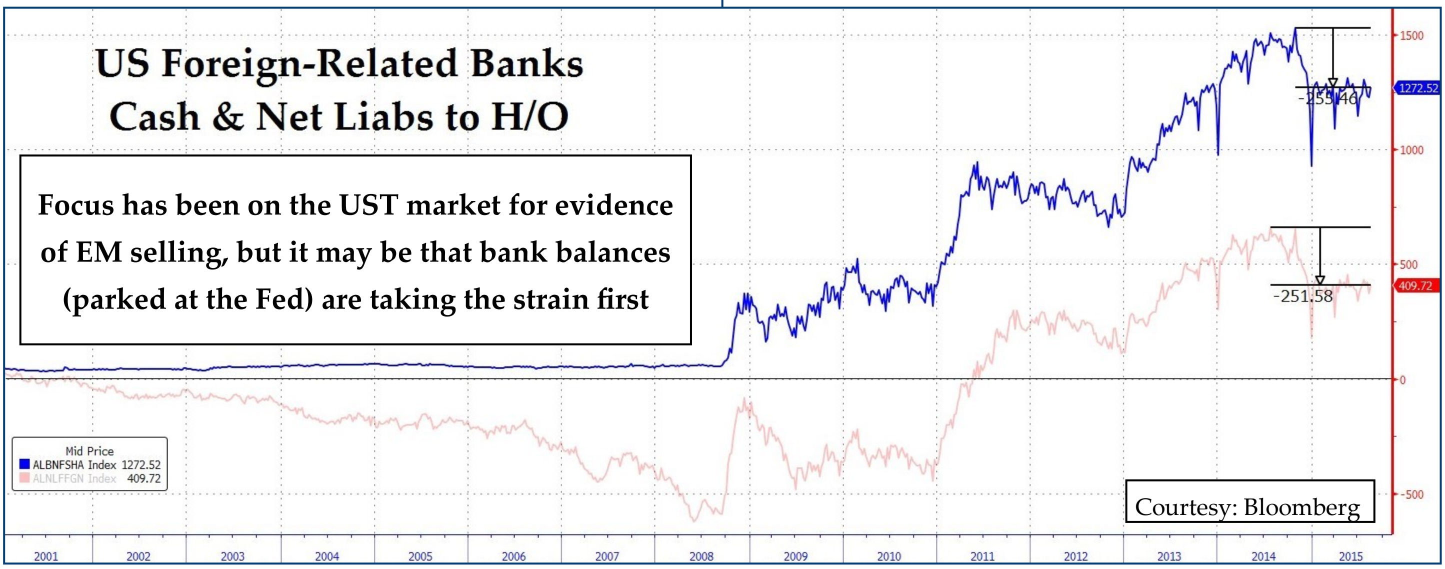
Do you feel aggrieved at such a development? Do you fret that since you are no longer having to run up more debt that the world is now short of 'liquidity'? Somehow, I doubt it.

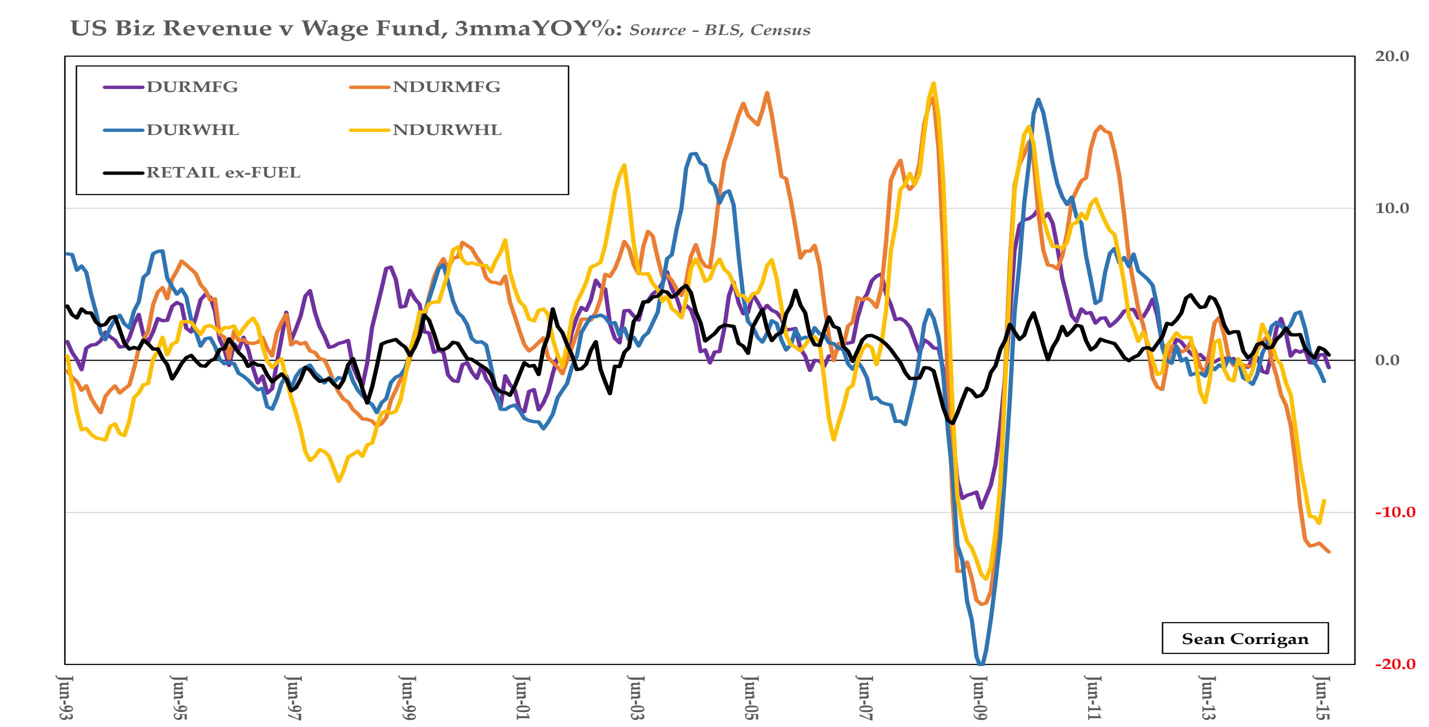
Following on from this, the store finds itself in need of some extra services and advertises a part-time job whose hours do not clash with those you are already working elsewhere. You apply and are duly accepted. At the end of a long week's work, you are delighted to receive a pay cheque for fifty well-earned dollars to add to the $50 you have all the while been making in your other job.

You promptly spend half of your greater combined income on another consignment of groceries and, being the prudent type, you devote the other $50 in its entirety to reducing your by now substantial arrears. Again, we ask: are you unhappy at the turn of events, or are you more content than ever? Answers on a postcard, please.

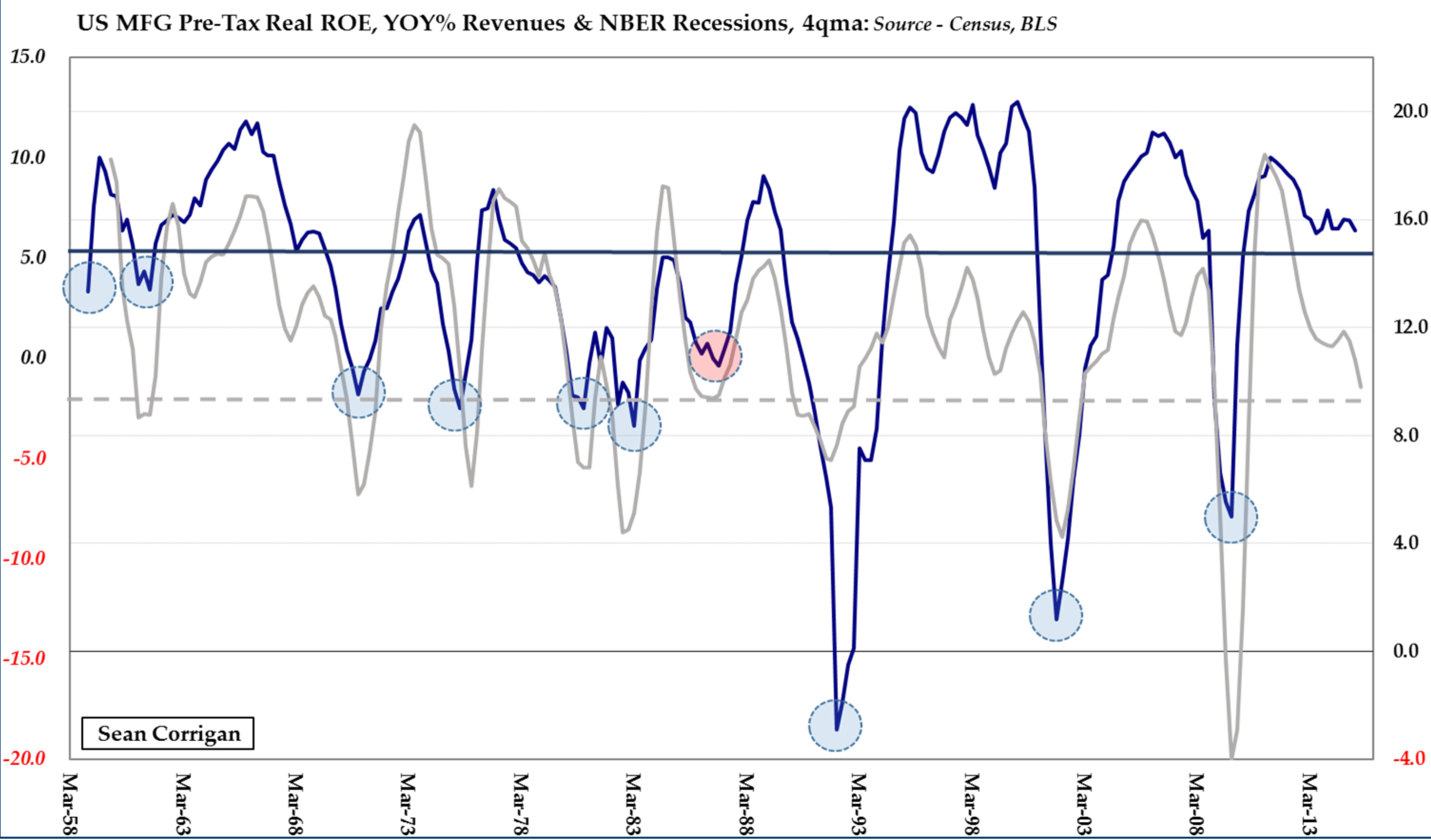
So now substitute, say, Saudi for the supermarket and bump the $50 up to $500 million, 'work' for it by exporting to Riyadh the equipment by means of which the regime there hopes to diversify away from raw energy sales, and reduce your arrears by redeeming your bonds directly (or by paying off the IOU when presented with it by whoever bought it from a cash-hungry SAMA in the secondary market).

In this entirely analogous case, you are unequivocally better off and the only people who have to worry are the Sauds. But then, why have reserves in the first place if you're never going to use them when you need to?





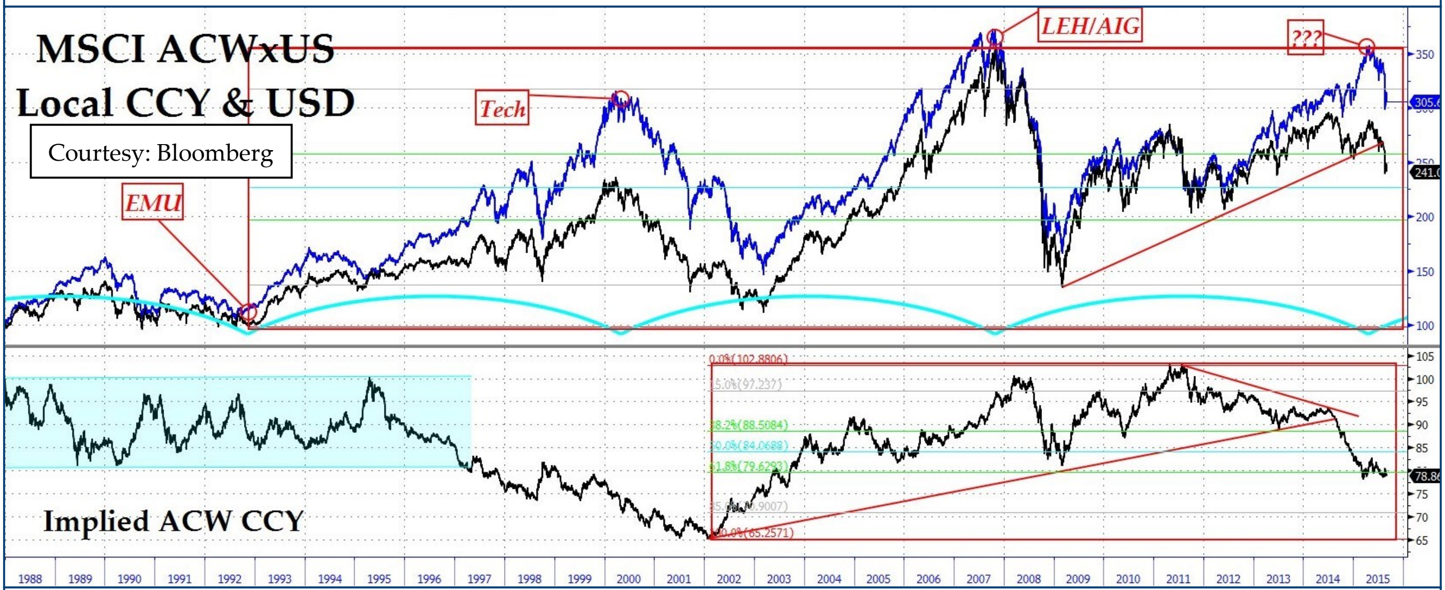
Though the usual interest-rate sensitive consumer sectors such as housing and autos are doing well and though there is survey evidence of tightening in the ex-shale patch labour markets, being Austrians we tend to focus on whether things are conducive for businesses profitably to produce and, more especially, whether they are so for 'higher-order' goods makers. One such gauge is the proportion of the wage-bill to the vigour with which the cash register is ringing, i.e., to business revenues. Here, with the exception of the construction industry, things range from dire in the non-durable department (think: commodity crash) to sickly for the rest. Combining a look at those revenues *per se* with a glance at a standard measure of profitability, we can also see that every time real returns on manufacturing equity fall much below 15% and real sales shrink by 2%, a recession ensues (note the head fake in the 1986 oil price collapse when profits just failed to confirm). Today, though we stand above both of these thresholds, the trajectory is not overly promising.



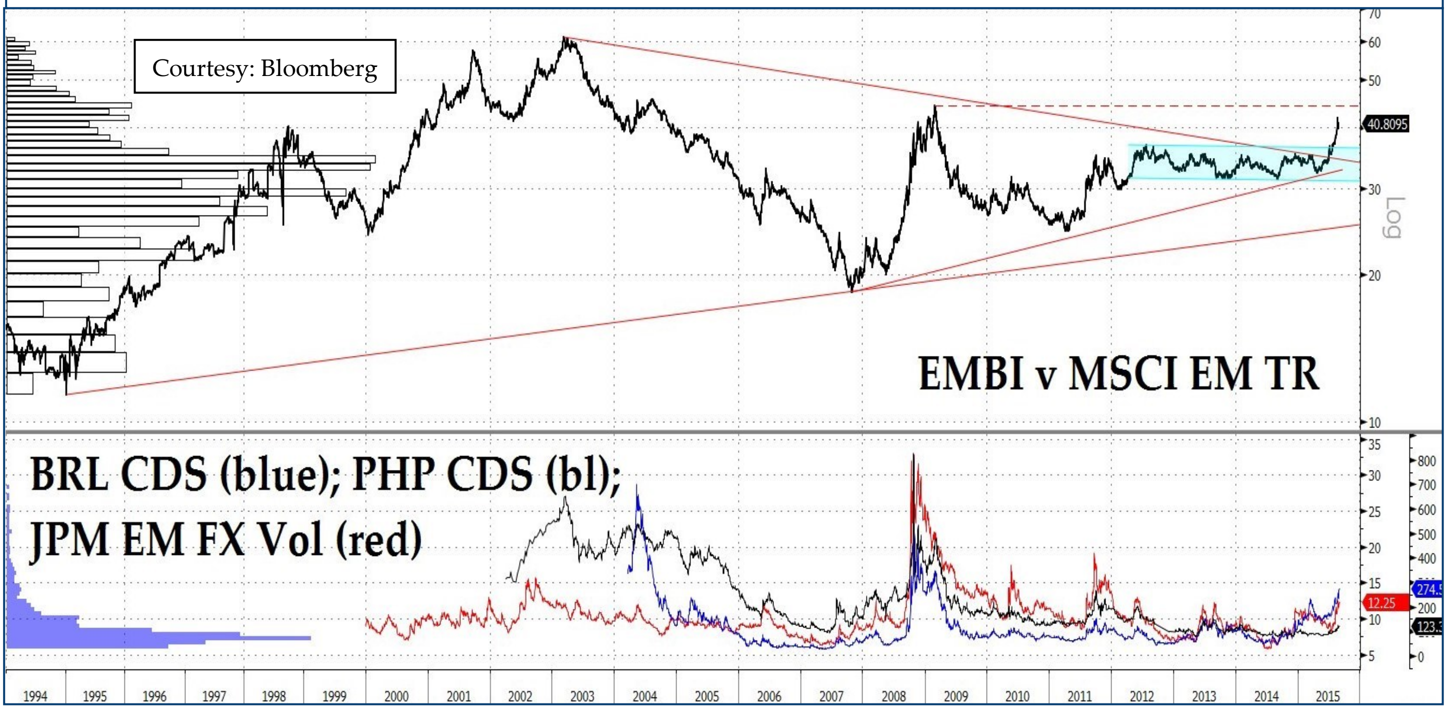
Those declining revenues come when price/sales for non-financials are already at Tech Bubble extremes. Caution!

Lose the trend & 2007 highs and we mean revert v. bonds. Late inning v commodities but room to run, nevertheless

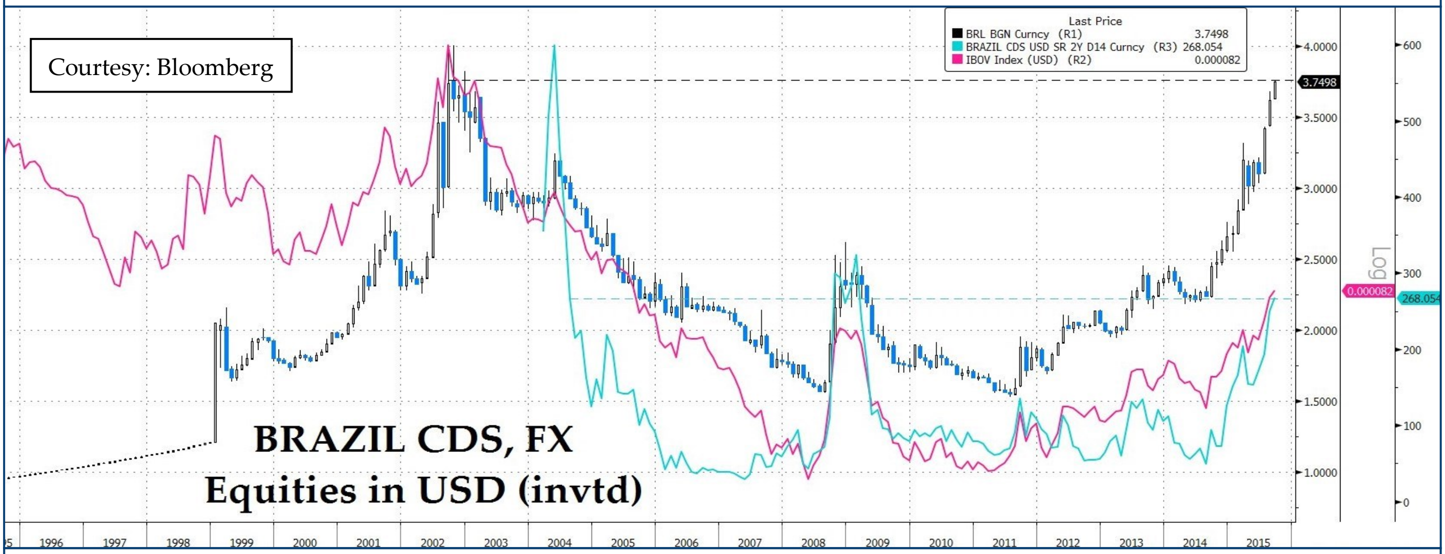
As with most other measures, US equities are back to peak value; this time relative to all other equities

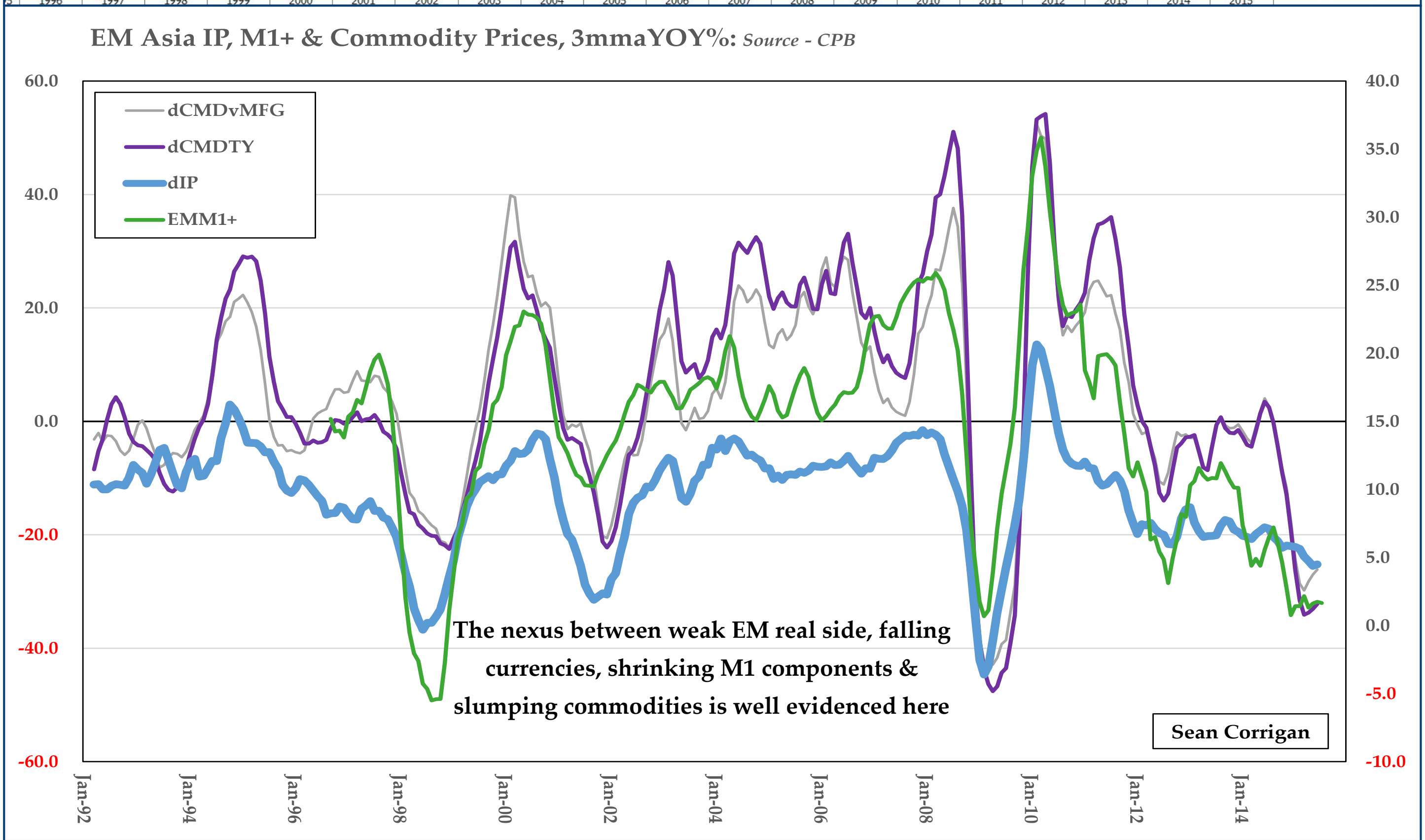


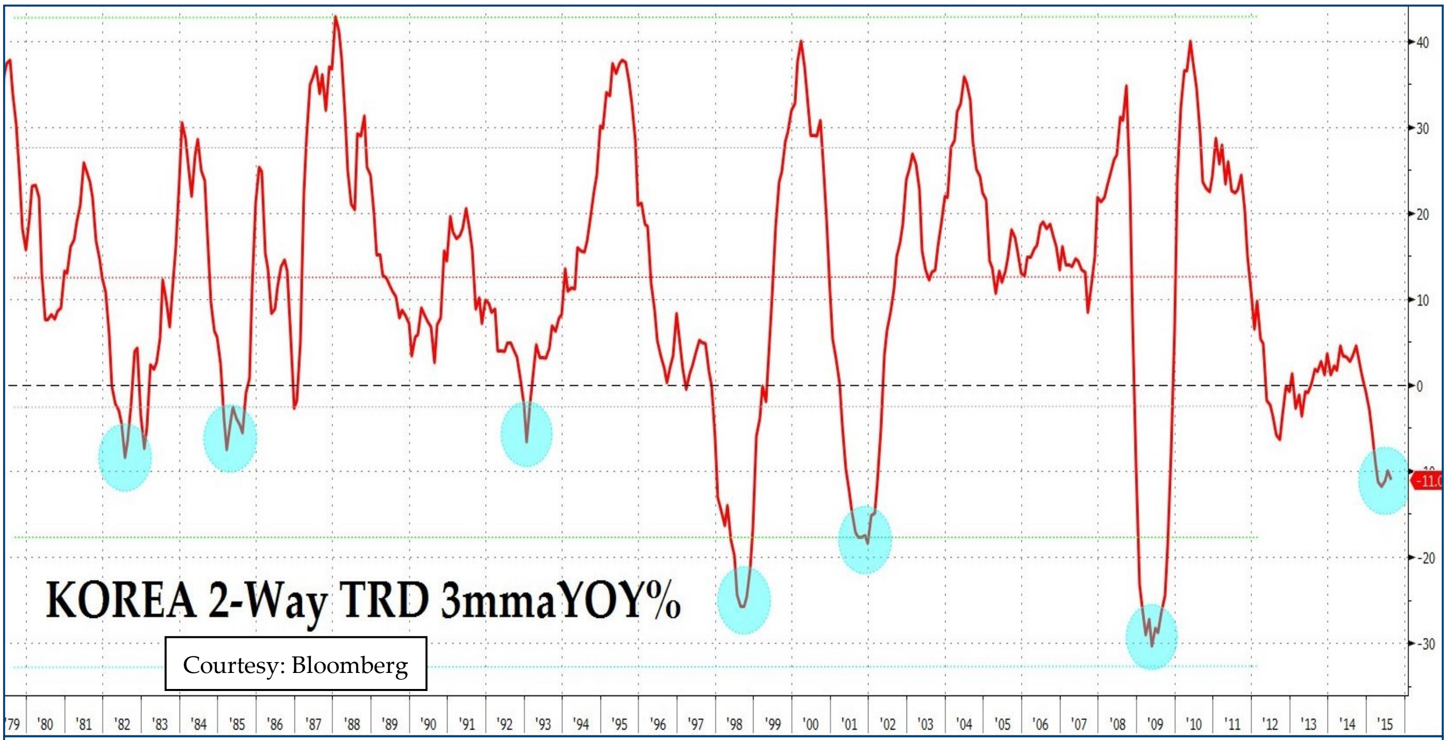
That basket of 'All other equities' may be about to hit the 7.6-yr crisis point & EM stresses have broken out



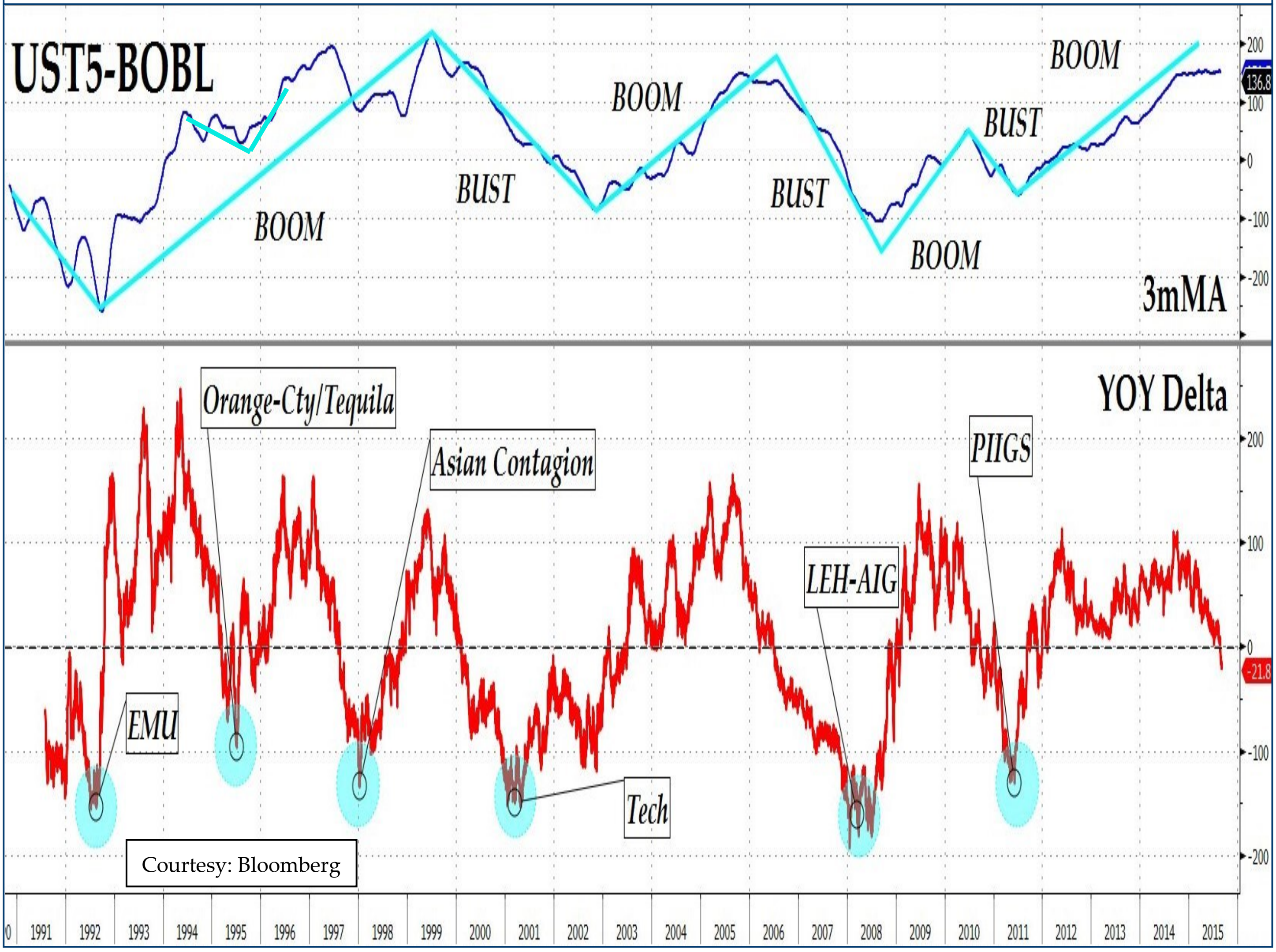
For all the support efforts, do not rule out the possibility of a full China unwind. Brazil looks doomed

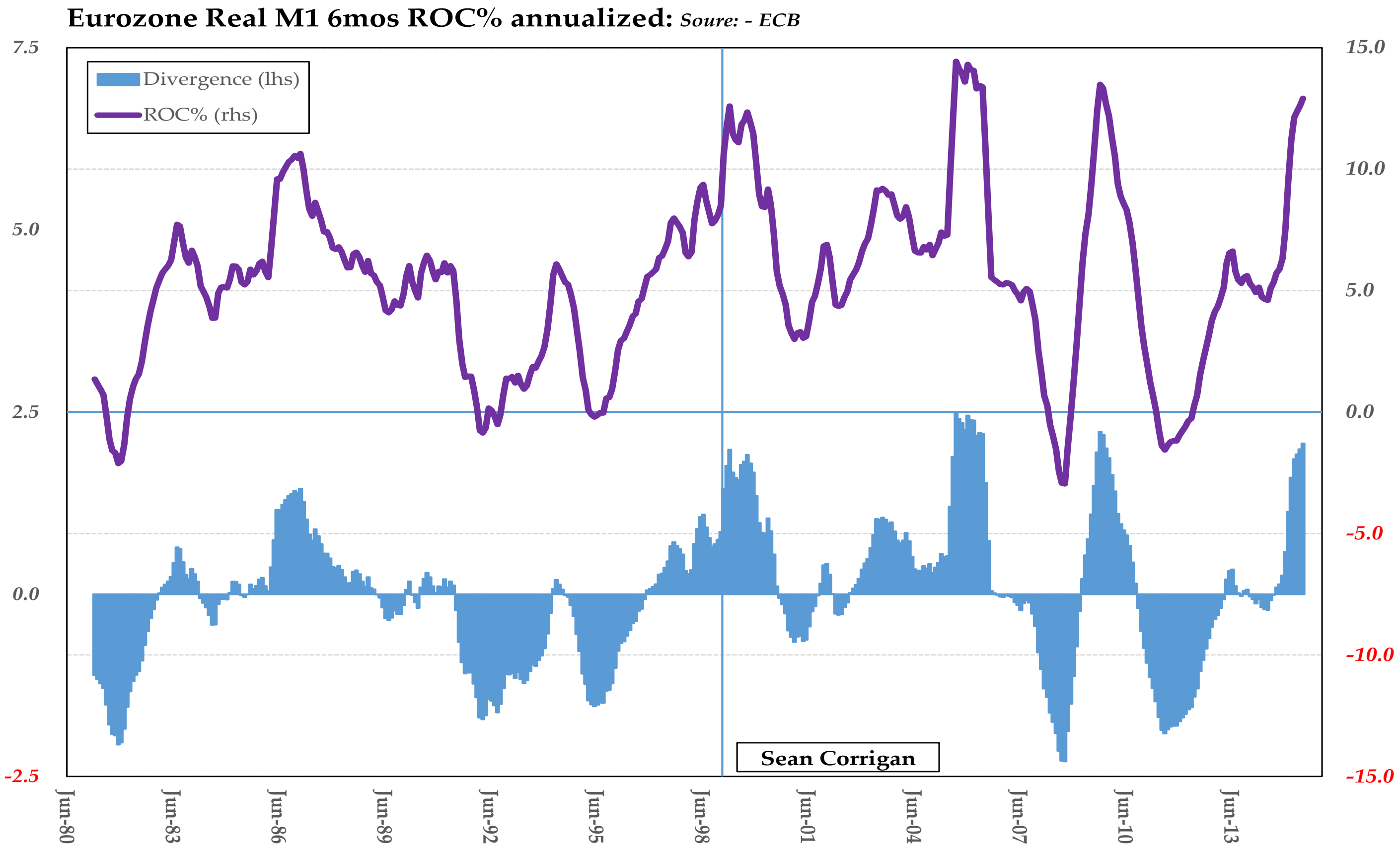




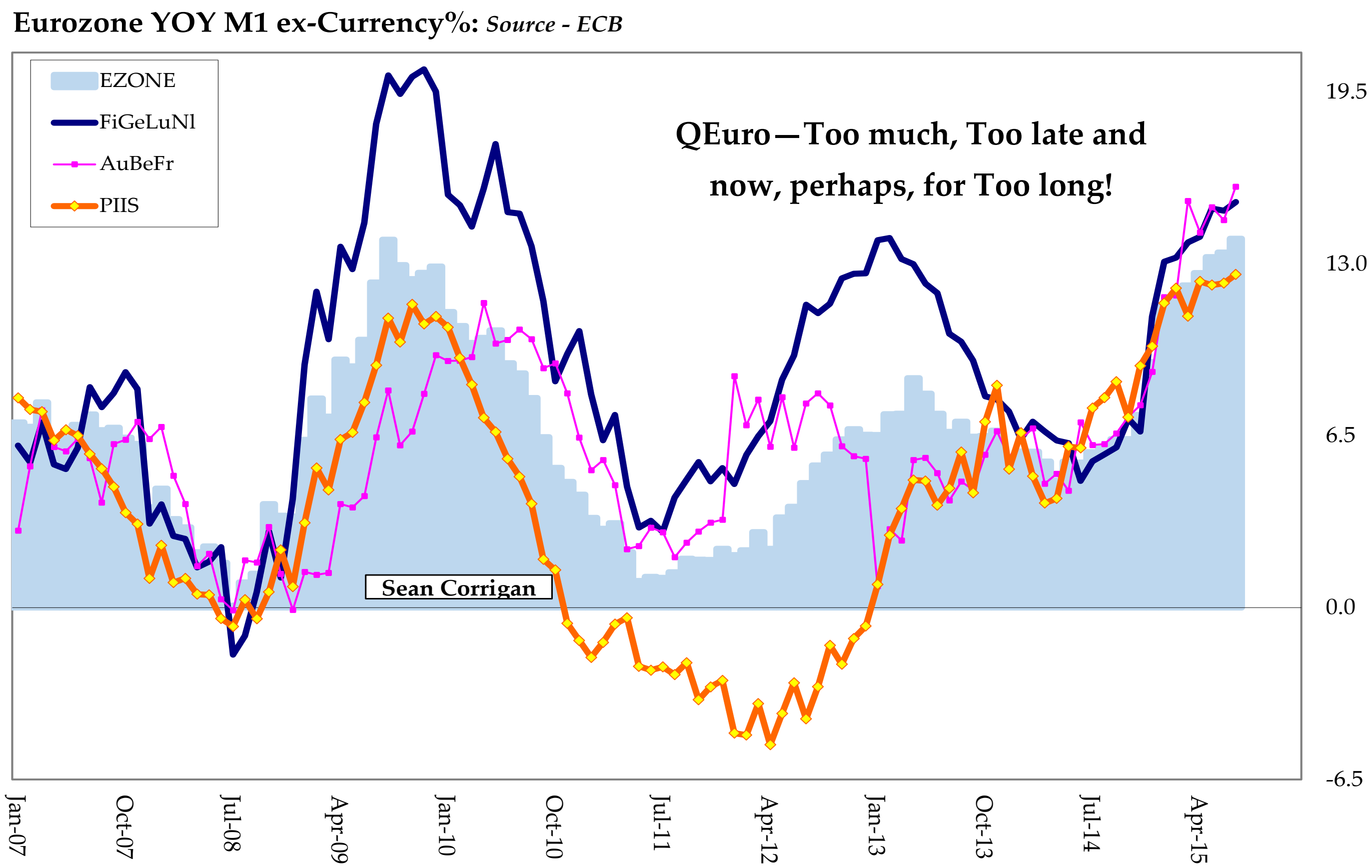


Korea acting in classic style as a storm beacon. The US-Europe yield differential which seems to wax and wane with the global cycle is also just showing signs of rolling over, adding to the foreboding aroused by the other indicators we have enlisted here. Recent swings may only be the start of something worse. Never underestimate the 2nd-leg millstone effect of trapped longs who see dead cat rallies fade before they can exit at a regained in-price

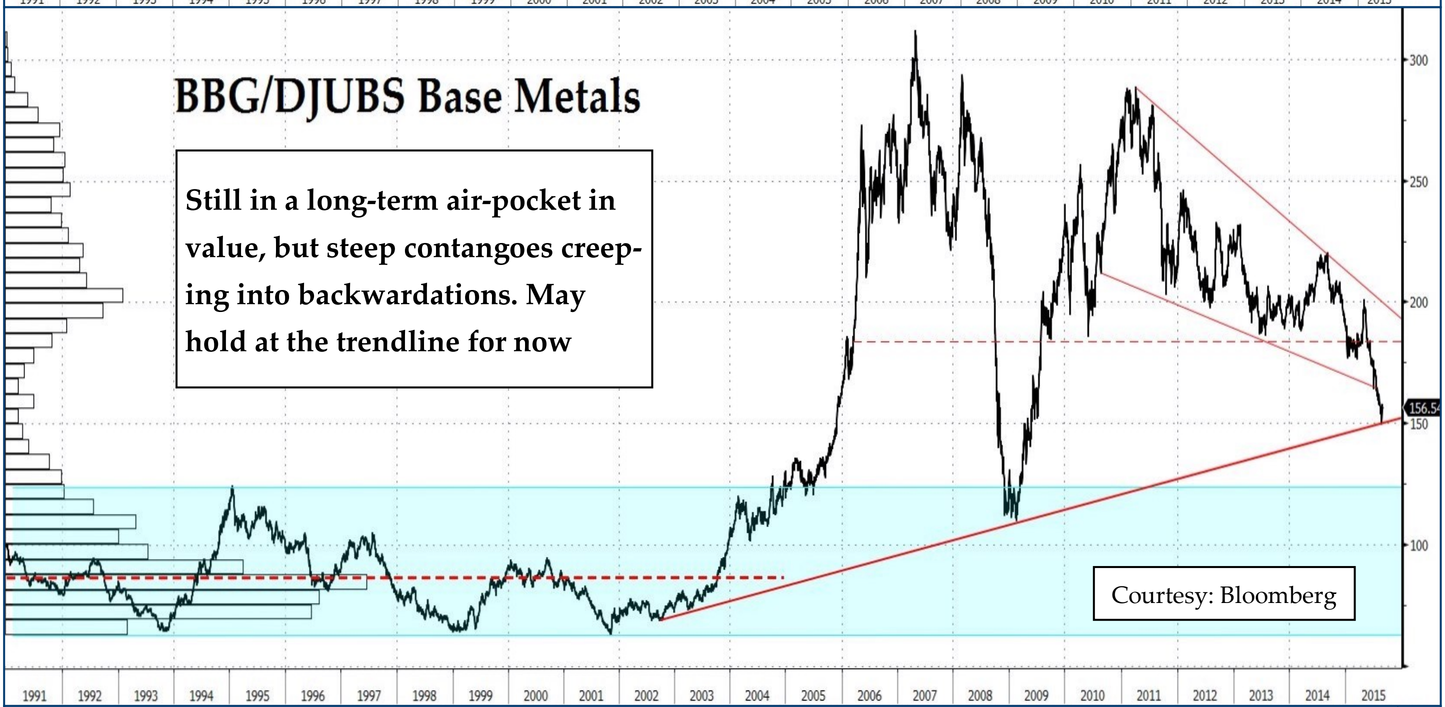


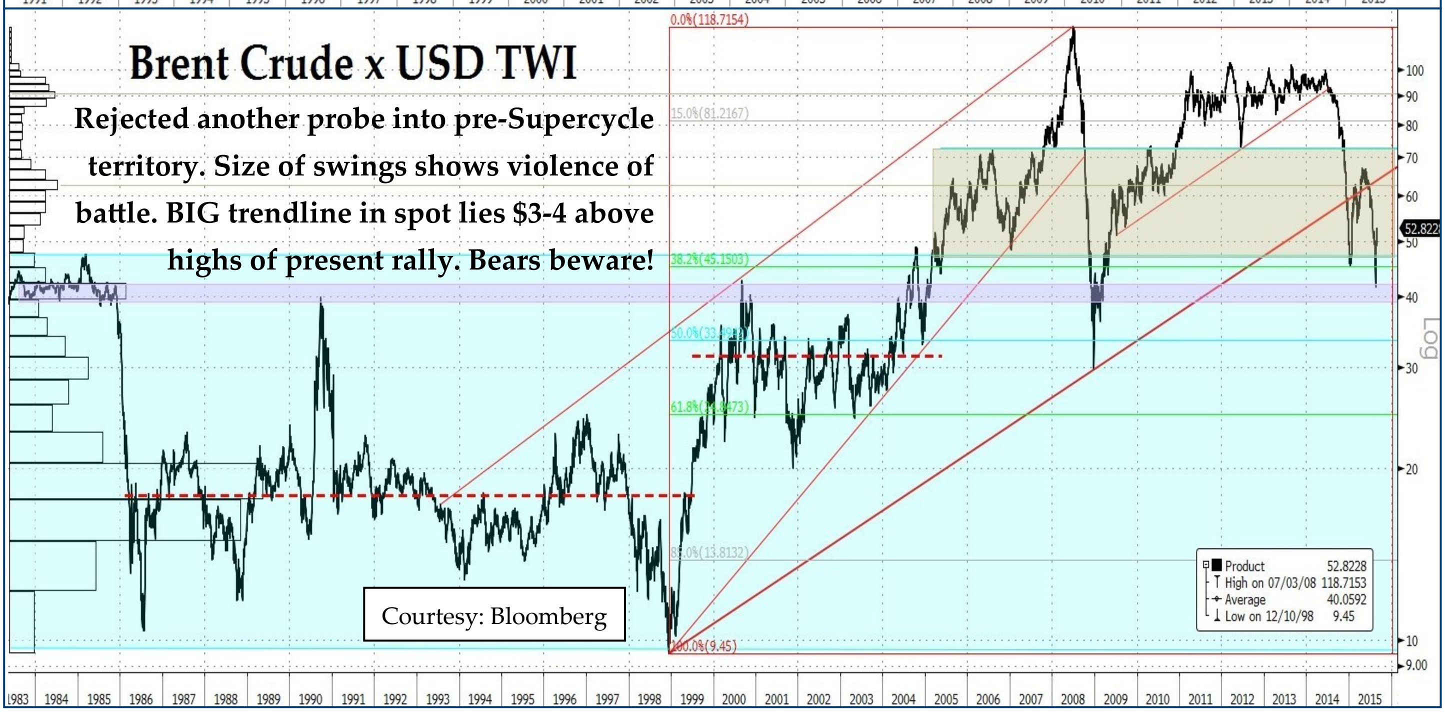


Anyone had enough yet? Private sector balance sheets in Italy, Spain & Portugal are much restored. Money supply there is growing as rapidly as in the core. Yet Draghi wants to do more and for longer. Politics, not economics are at work as the 'Project' is threatened by emerging parties, regionalism, and the social and financial stresses associated with the *Volkseinwanderung* fall-out from the Atlanticist Great Game.




BBG/DJUBS Agri
Bumper harvests, a strong dollar, energy weighing on the Biofuel boondoggle (and falling lease/royalty payments for shale) Who would be a John Deere dealer? Note the Fib/trendline, though...
-48.04%
Courtesy: Bloomberg
Last Price 233.7248
High on 03/03/11 449.2135
Average 189.7520
Low on 10/22/01 92.8188


BBG/DJUBS Base Metals
Still in a long-term air-pocket in value, but steep contangoes creeping into backwardations. May hold at the trendline for now
Courtesy: Bloomberg


Brent Crude x USD TWI
Rejected another probe into pre-Supercycle territory. Size of swings shows violence of battle. BIG trendline in spot lies $3-4 above highs of present rally. Bears beware!
Courtesy: Bloomberg
Product 52.8228
High on 07/03/08 118.7153
Average 40.0592
Low on 12/10/98 9.45

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