China's Dangerous Game

February 2012

SUMMARY

China has transformed from a productivity-driven boom to a credit-fueled investment bubble

Whether the inevitable adjustment is orderly or disorderly will largely be determined by the actions of China's policymakers

- In the past two decades, China has made a quantum leap in terms of economic significance
- China now accounts for 20% of global manufacturing and has a material influence on commodity demand, liquidity and risk appetite across the world
- Because of its importance in manufacturing and trade, understanding China's economy is critical to resolving the "Inflation or Deflation" debate, arguably the most important question to investors, business owners and real estate investors
- The consensus view remains that China will continue to develop at high rates, allow the nominal exchange rate of the RMB to rise, and transition relatively painlessly to a consumption-oriented economy
- We believe all aspects of this view are likely to prove false. China's productivity-driven expansion has morphed into a credit-fueled investment bubble. As other countries have demonstrated, transitioning from a command-style economy to a market-oriented system can be very difficult
- Most recently, China's chief competitive advantage has been it's artificially-suppressed exchange rate, requiring it to print enormous amounts of RMB. And while it has allowed China to become the world's 2nd largest economy, the exchange rate regime has been a major destabilizing force in the global economy
- China has been the chief contributor to the global imbalances that afflict the global economy today. Because these imbalances are fundamental, we believe they will inevitably adjust
- An orderly adjustment would require accepting significantly lower near-term growth and a rebalancing towards consumption. The disorderly route would be an attempt at more investment-led growth, likely re-igniting inflation and leading to an eventual bust

GLOBAL MACRO BACKDROP

Global Imbalances

"Invert, always invert."

- Carl Gustav Jacob Jacobi, German mathematician

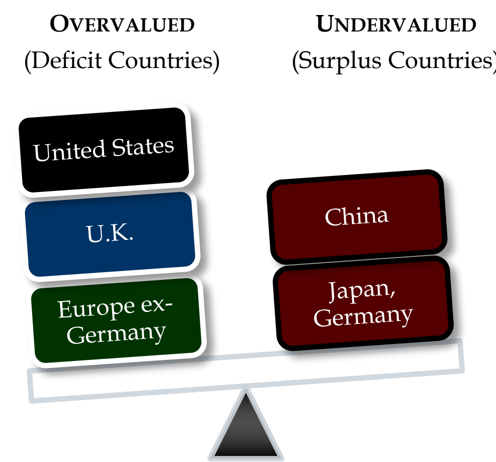
GLOBAL IMBALANCES

The financial crisis marked the end of the surplus nation's export-led development

The developed, debtor nations no longer had the balance sheet capacity to continue playing the game

- The global economy remains deeply unbalanced
- The world can be divided into "deficit" and "surplus" countries. High-savings surplus nations intent on export-led growth have kept their wages and/or currencies' artificially low
- For every surplus there is a deficit. Therefore, every country cannot be a net saver. The developed world was the source of demand driving these surpluses
- In 2007, the combined current account surpluses for China, Japan and Germany, the world's 2nd, 3rd and 4th largest economies, was nearly $1.0 trillion. These savings could not be prudently invested at home so they were "lent" to the West, driving down interest rates (i.e., Greenspan's "conundrum"), in return for consumption

RELATIVE COMPETITIVENESS



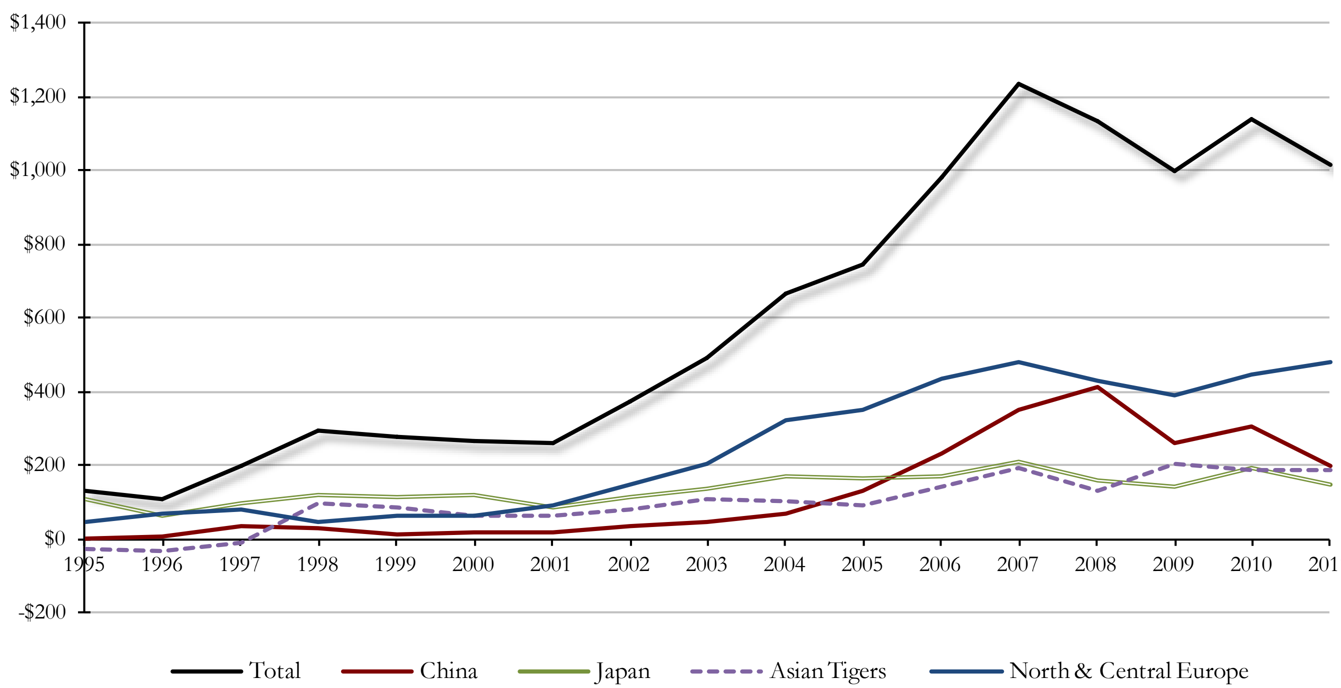
- The justification for saving is to invest for consumption and export growth. Saving more to simply invest more without an increase in consumption is a dead end
- With Europe in recession and the U.S. headed towards austerity, export-dependent economies will continue to experience a demand shock
- Demographics in Germany and Japan ensure high savings. Other Asian countries' policymakers believe export-led growth is the path to development. Similar to "decoupling," these policies will soon be invalidated

Global Imbalances

By 2007, the collective surpluses of China, the Asian Tigers, Japan and North-Central Europe amounted to nearly $1.25 trillion. These surpluses represent deficient domestic demand (i.e., savings over consumption and investment).

- For every surplus there must be a deficit because the world as a whole is a closed system. Therefore, the Eurasian surpluses appeared as deficits in much of the West

"Eurasian Savings Glut"
Current Account Surpluses (in USD)



Source: IMF; LSR; Bienville Capital Management, LLC

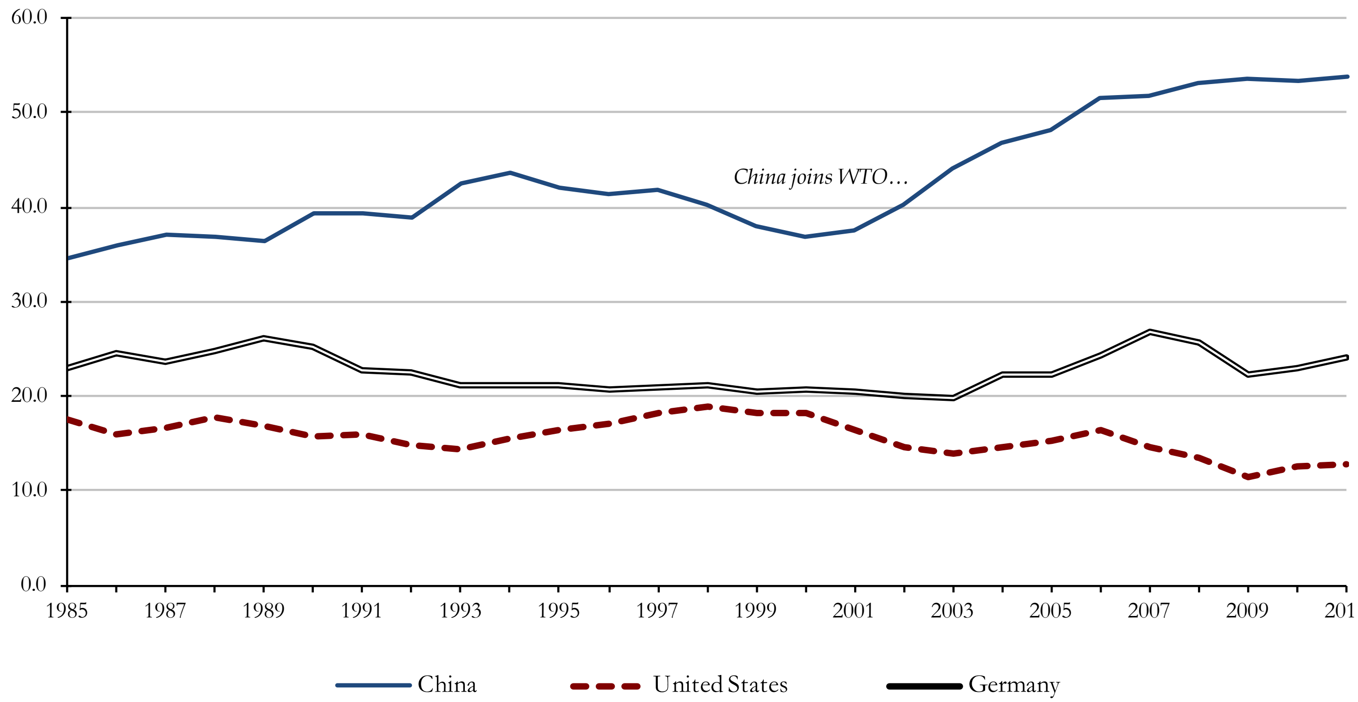
Global Imbalances

China's savings rate has always been high. However, since joining the WTO it has turned malignant.

- After building out China's productive capacity in the mid-90s, these savings couldn't be invested profitably at home. Therefore, they were both wasted on unviable projects and channeled to the U.S. and other deficit countries in return for consumption

The ultimate justification for savings is investment for consumption and export. Saving to invest more without an increase in the propensity for consumption is a dead end

National Savings Rate
(% of GDP)



Source: IMF; Bienville Capital Management, LLC

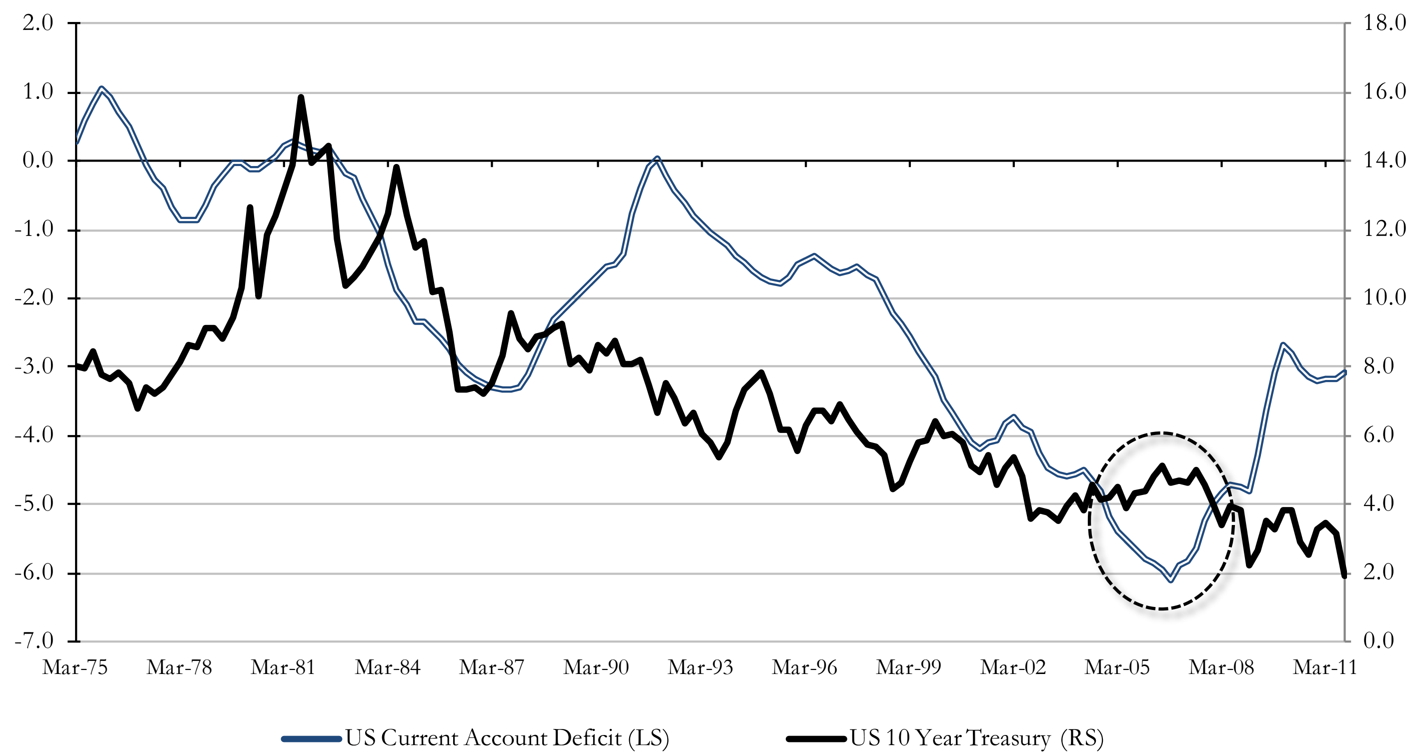
Global Imbalances

Greenspan's "conundrum"

The surplus nation's savings were impervious to the price of money – they were structural and not dependent on the returns earned for loaning their capital

Economic theory would suggest as the U.S. borrowed more, increasing its current account deficit, interest rates would rise. However, the opposite occurred, suggesting the direction of causality should be reversed (i.e., the excess savings were being pushed upon borrowers).

US Current Account Deficit vs. 10-Year Treasury Yield



Source: Bloomberg; Bienville Capital Management, LLC

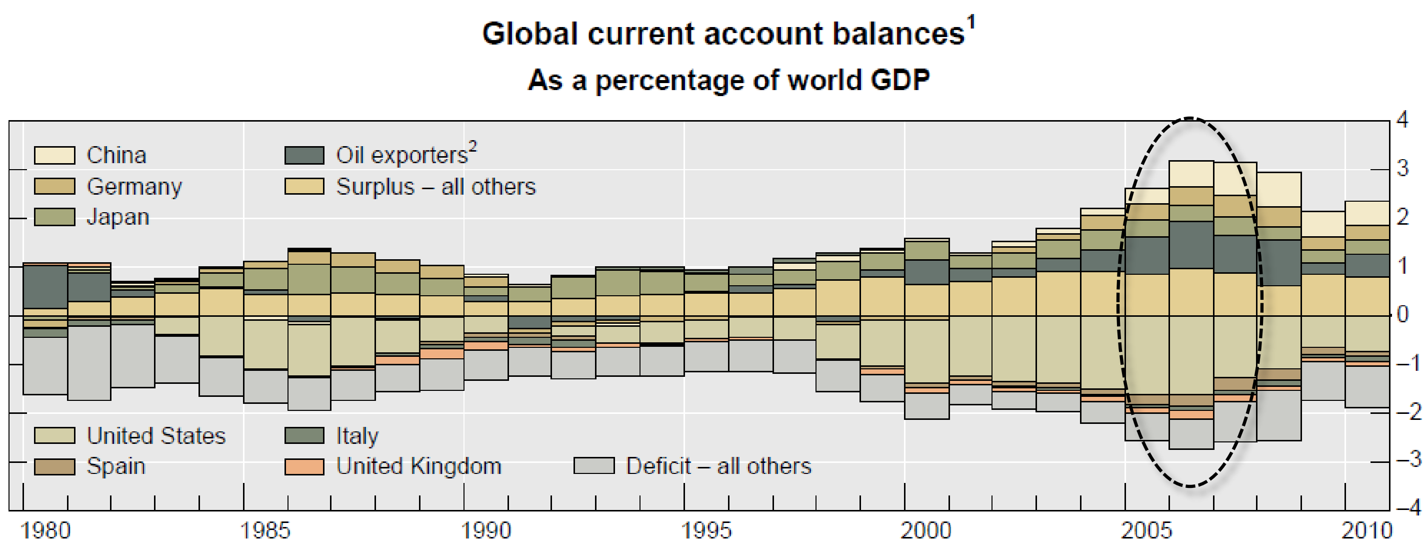
Global Imbalances

In the mid-1990s, most countries had floating exchange rates

Today, countries accounting for nearly two-thirds of world GDP are part of two quasi-fixed currency blocks: the Eurozone (20%) and the 'New Dollar Area' (45%)

Throughout the 1990s, the world economy was relatively balanced. However, after China entered the WTO, aggregate surpluses and deficits explode.

- It's no coincidence that the financial crisis began at the largest aggregate point—the imbalances were no longer sustainable as borrowers exhausted their ability to borrow and spend



Source: Bank of International Settlements

GLOBAL IMBALANCES

"I would argue that, given the size of international (and domestic) balance sheets, monetary stability is more important than ever."

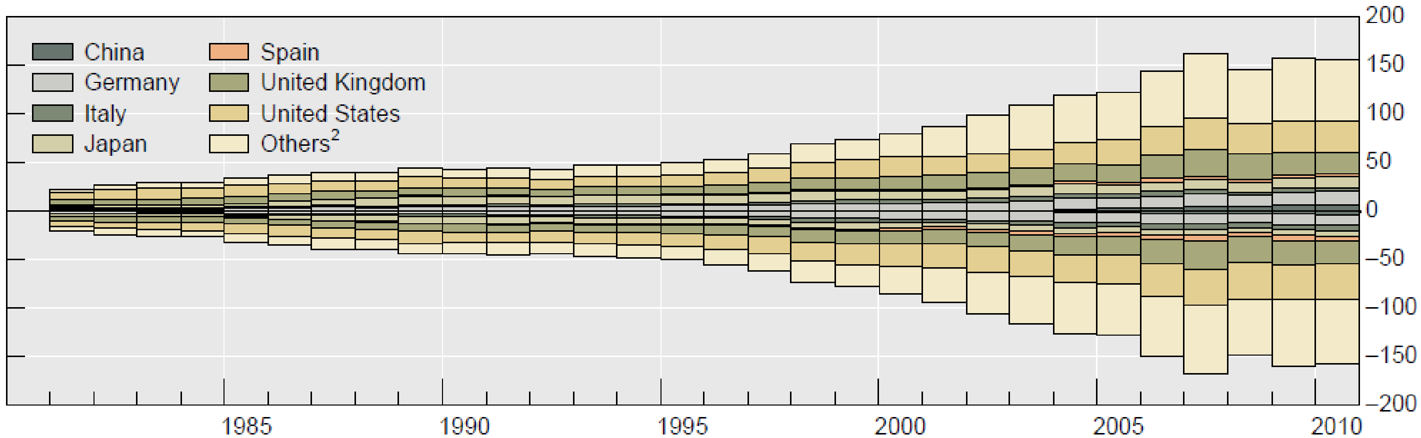
– Stephen G. Cecchetti, Bank of International Settlements, September 2011

Accompanying trade flows are corresponding financial flows. In absolute dollar terms, the increase in assets and liabilities from 50% to 150% represents a rise from over $15 trillion to $100 trillion.

- Management of these assets and liabilities is based on "price signals." Monetary instability distorts these price signals, creating the potential for disorderly liquidations
- Because the fundamental imbalances of the global economy are unsustainable, a reversal of these flows could be highly destabilizing to the financial system

International investment positions of all countries[1]

As a percentage of world GDP



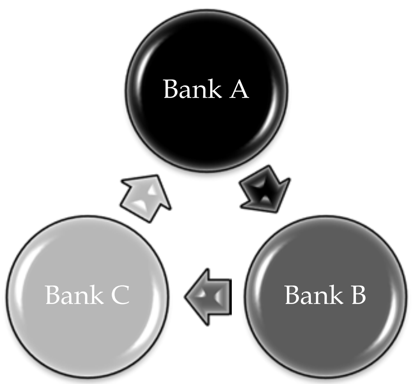
[1] Latest available data. [2] Sum of 114 economies.

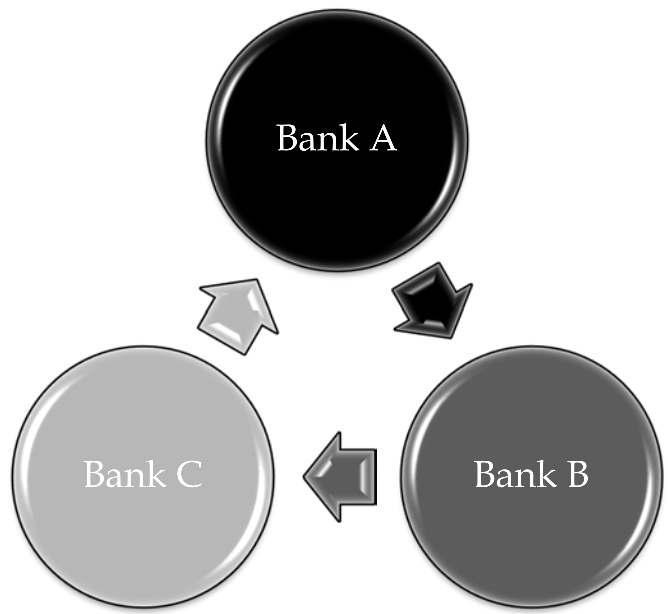
Source: Bank of International Settlements

GLOBAL IMBALANCES

Financial globalization has been far more profound than trade globalization, meaning international balance sheet growth has far outpaced economic growth.

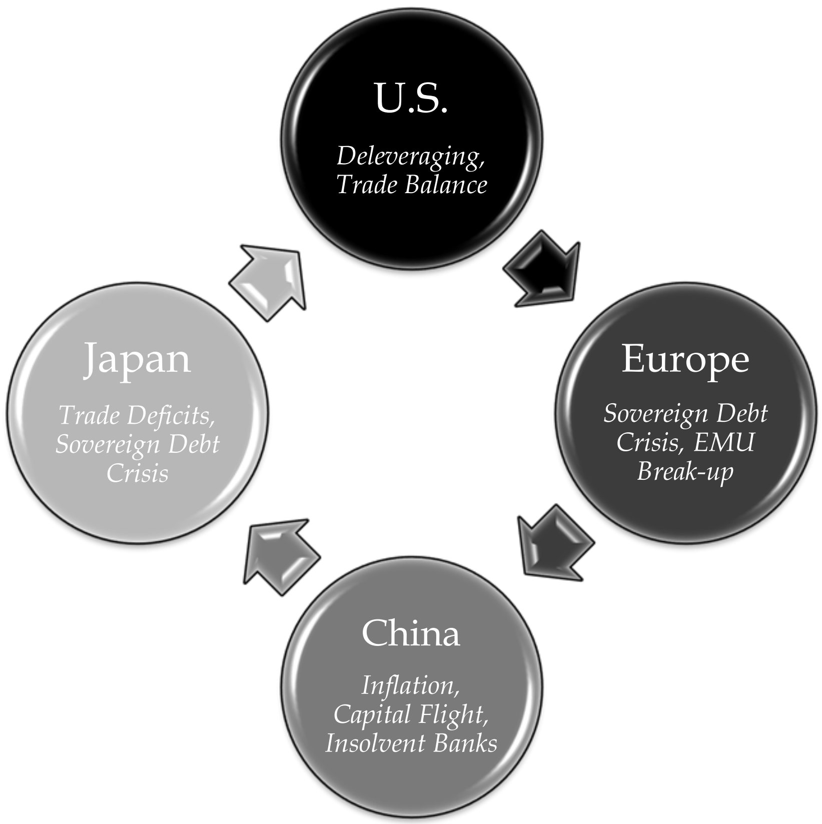
- Gross cross-border flows result in the accumulation of assets and liabilities and are more important than net flows. For example, consider a scenario where:
  - Bank A lends to Bank B, which lends to Bank C. Bank C then lends back to Bank A. Net flows are zero;
  - Initially, these flows are small, but ultimately the banks do more business, expanding their balance sheets. Again, although the gross flows become large, the net flows sum to zero





GLOBAL IMBALANCES

But if problems occur in one country, they are quickly transmitted to another. Therefore, it is gross financial flows, rather than net flows, that matter when assessing the interconnectedness of the financial system.



Global Imbalances

Leading up to the crisis, household borrowing significantly outpaced nominal GDP growth

Over 4 years after the onset of the crisis and nothing has changed: the surplus countries are still over-saving, and in order to prevent a global demand collapse, the U.S. is still over borrowing. This time, however, it's the public sector doing the leveraging.

- However, unless the U.S. is to continue running 10% budget deficits, this dynamic will soon change

Growth of Domestic Nonfinancial Debt
Percentage Changes; quarterly data are seasonally adjusted annual rates

	Total	Households	Business	State & Local	Federal
2001	6.3	9.6	5.7	8.8	-0.2
2002	7.4	10.8	2.8	11.1	7.6
2003	8.1	11.8	2.3	8.3	10.9
2004	8.8	11.0	6.2	7.3	9.0
2005	9.5	11.1	8.6	10.2	7.0
2006	9.0	10.1	10.5	8.3	3.9
2007	8.6	6.8	13.0	9.5	4.9
2008	6.0	-0.1	5.8	2.3	24.2
2009	3.0	-1.7	-2.7	4.8	22.7
2010	4.6	-1.8	1.5	4.4	20.2

GLOBAL IMBALANCES

Today's global monetary regime links developed countries undergoing deleveraging with poor, developing economies

Today, all of the world's top central banks are engaged in expansionary monetary policies, yet for disparate reasons with vastly different inflation outlooks.

- Global coordination is needed to manage today's imbalances and outsized cross-border exposures. However, in a global economy deficient of demand, the impetus is for "beggar-thy-neighbor" policies, including competitive currency devaluation

Country (Region)	Action	Currency	Rationale
United States	"Printing Money" (QE)	Dollar	Ameliorate deleveraging
China	"Printing Money"	Yuan	Quasi-peg to US Dollar
Europe	"Printing Money" (LTRO)	Euro	Ameliorate deleveraging
United Kingdom	"Printing Money" (QE)	Pound	Ameliorate deleveraging
Switzerland	"Printing Money"	Franc	Stem currency appreciation
Japan	"Printing Money" (QE)	Yen	Stem yen appreciation, deflation

GLOBAL IMBALANCES

Large global imbalances leave the financial system in a precarious and fragile state:

- If financial flows from the surplus nations funding the deficit nations reverse, we could potentially experience a:
  - U.S. dollar crisis (i.e., monetary instability);
  - Sovereign debt crisis in the U.S. and other deficit nations (U.K., Spain, France, etc.);
  - Demand collapse in surplus nations, including Germany, Japan and particularly China (i.e., hard landing);
  - Potential inflationary shocks in deficit nations (resulting from higher import prices)

- If borrowing for consumption by deficit countries from the surplus nations reverses, we could witness:
  - Demand collapse in surplus nations, including Germany, Japan, and particularly China (i.e., hard landing);
  - Industrial commodity demand collapse (lower prices to benefit deficit nations);
  - Significant deflationary shock, more QE

China's Economic Impact

CHINA'S ECONOMIC IMPACT

Over the past few decades, China has made a quantum leap in terms of economic significance…

Real GDP (as a % of World GDP)							
	1950	1960	1970	1980	1990	2000	2010
North America	**44%**	**38%**	**3%**	**32%**	**31%**	**29%**	**26%**
United States	41%	35%	32%	29%	28%	27%	24%
Canada	3.1%	2.8%	2.7%	2.9%	2.8%	2.4%	2.2%
Europe	**36%**	**37%**	**34%**	**32%**	**28%**	**25%**	**22%**
Euroland	24%	27%	26%	25%	22%	19%	17%
UK	10.0%	7.0%	6.0%	5.1%	4.6%	4.0%	3.6%
Sweden	1.3%	1.1%	1.0%	0.8%	0.7%	0.6%	0.6%
Asia	**14.0%**	**16.0%**	**18.0%**	**20.0%**	**25.0%**	**28.0%**	**34.0%**
Japan	3.6%	6.5%	9.0%	10.0%	10.0%	9.0%	7.0%
China	-	2.3%	1.6%	2.2%	4.0%	6.9%	14.0%
Korea	0.7%	0.7%	0.8%	1.2%	1.8%	2.3%	2.3%
India	4.6%	4.1%	3.5%	3.1%	3.9%	5.3%	5.7%
Malaysia	0.2%	0.2%	0.2%	0.4%	0.4%	0.6%	0.6%
Thailand	-	-	0.4%	0.5%	0.8%	0.9%	0.9%
Indonesia	-	-	0.8%	1.2%	1.5%	1.7%	1.5%
Taiwan	-	0.4%	0.6%	1.1%	1.7%	1.4%	1.2%
Latin America	**4.6%**	**5.7%**	**8.8%**	**10.7%**	**9.5%**	**9.0%**	**8.5%**
Brazil	-	-	2.9%	4.3%	4.1%	3.6%	3.3%
Mexico	2.1%	2.1%	2.5%	3.1%	2.8%	2.7%	2.6%
Argentina	2.0%	1.5%	1.4%	1.2%	0.8%	0.9%	1.0%
EEMEA	**-**	**-**	**10.8%**	**10.8%**	**10.5%**	**7.0%**	**7.8%**
Russia	-	-	-	-	-	2.7%	3.5%
Turkey	-	-	1.4%	1.5%	1.6%	1.7%	1.7%
Poland	-	-	1.5%	1.5%	1.2%	1.1%	1.1%
South Africa	-	-	1.4%	1.3%	1.1%	0.9%	0.8%
Oceania	**2.0%**	**2.0%**	**1.8%**	**1.6%**	**1.6%**	**1.5%**	**1.6%**
Australia	1.5%	1.6%	1.5%	1.4%	1.3%	1.3%	1.4%
New Zealand	0.5%	0.4%	0.3%	0.0%	0.2%	0.2%	0.2%

Source: Bridgewater Associates

CHINA'S ECONOMIC IMPACT

However, when accounting for size and volatility of its growth, China's relative impact is far greater…

Relative Impact on Global Growth

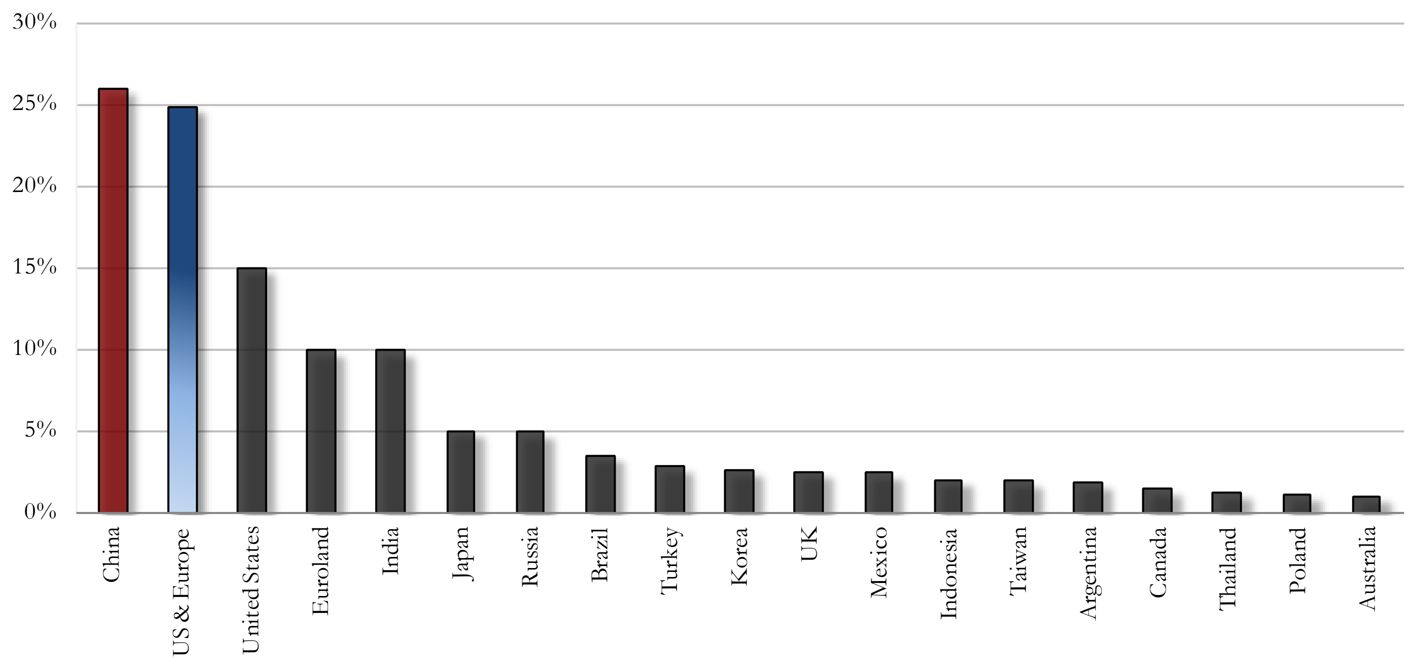
	1950	1960	1970	1980	1990	2000	2010
North America	**38%**	**29%**	**26%**	**26%**	**28%**	**23%**	**16%**
United States	35%	26%	24%	23%	25%	21%	15%
Canada	3.3%	2.6%	2.4%	2.8%	2.5%	1.7%	1.4%
Europe	**39%**	**36%**	**29%**	**25%**	**18%**	**14%**	**13%**
Euroland	32%	31%	24%	21%	13%	11%	10%
UK	5.0%	3.0%	3.5%	3.3%	3.5%	2.5%	2.5%
Sweden	0.9%	0.6%	0.7%	0.6%	0.4%	0.4%	0.5%
Asia	**9.4%**	**25.0%**	**27.0%**	**28.0%**	**37.0%**	**42.0%**	**50.0%**
Japan	9.4%	15%	16%	12%	10%	5%	5%
China	-	5.6%	4.1%	4.4%	9.7%	16%	26%
Korea	-	0.5%	1.1%	2.1%	3.5%	4.2%	2.6%
India	-	2.9%	2.9%	3.0%	5.6%	9.8%	9.9%
Malaysia	-	0.2%	0.4%	0.8%	0.9%	1.3%	0.8%
Thailand	-	-	0.5%	0.8%	1.4%	1.7%	1.2%
Indonesia	-	-	0.6%	1.9%	2.1%	2.7%	2.0%
Taiwan	-	0.6%	0.9%	2.4%	3.4%	0.7%	1.9%
Latin America	**5.5%**	**6.8%**	**12.0%**	**15.0%**	**11.0%**	**9.0%**	**10.0%**
Brazil	-	-	5.2%	7.3%	5.1%	2.6%	3.5%
Mexico	2.4%	2.2%	2.9%	4.1%	2.9%	3.0%	2.4%
Argentina	1.9%	1.3%	1.4%	1.1%	0.9%	1.7%	1.8%
EEMEA	**0.0%**	**0.0%**	**4.5%**	**4.8%**	**5.0%**	**10.1%**	**10.3%**
Russia	-	-	-	-	-	4.9%	4.9%
Turkey	-	-	1.4%	1.7%	1.9%	2.5%	2.8%
Poland	-	-	1.3%	1.5%	1.5%	1.6%	1.1%
South Africa	-	-	1.3%	0.9%	0.9%	0.5%	0.8%
Oceania	**3.0%**	**2.6%**	**1.5%**	**1.2%**	**1.4%**	**1.3%**	**1.2%**
Australia	2.6%	2.3%	1.2%	1.0%	1.2%	1.1%	1.0%
New Zealand	0.4%	0.3%	0.2%	0.2%	0.1%	0.2%	0.2%

Source: Bridgewater Associates

CHINA'S ECONOMIC IMPACT

Today, China is more impactful to the global economy than the U.S. and Europe combined…

Relative Impact on Global Growth
(Size x Volatility of Growth, 2010)



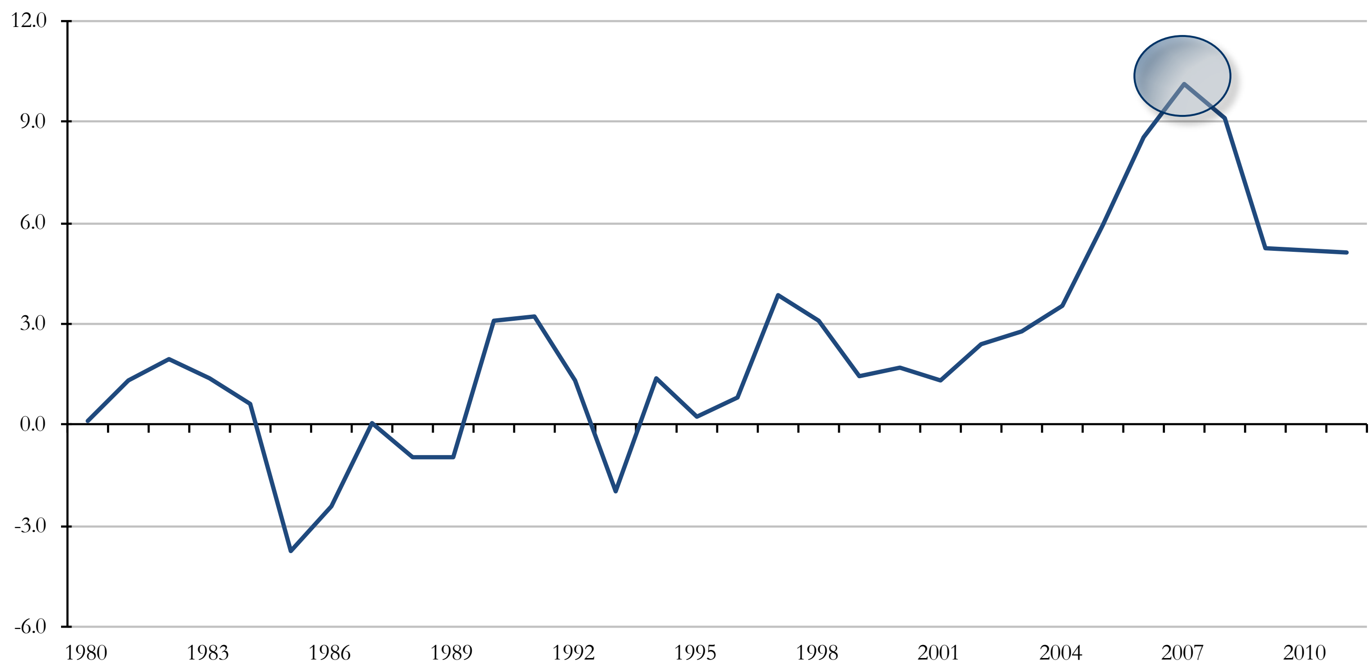
Source: Bridgewater Associates

CHINA'S ECONOMIC IMPACT

In 2002, China should have begun letting its currency float higher

Following entry into the WTO, China's current account surplus exploded to 10% of GDP. China now accounts for 20% of global manufacturing…

China Current Account
(% of GDP)



Source: Bloomberg; Bienville Capital Management, LLC

CHINA'S ECONOMIC IMPACT

China's impact on both commodity prices and commodity-rich countries has been extraordinary…

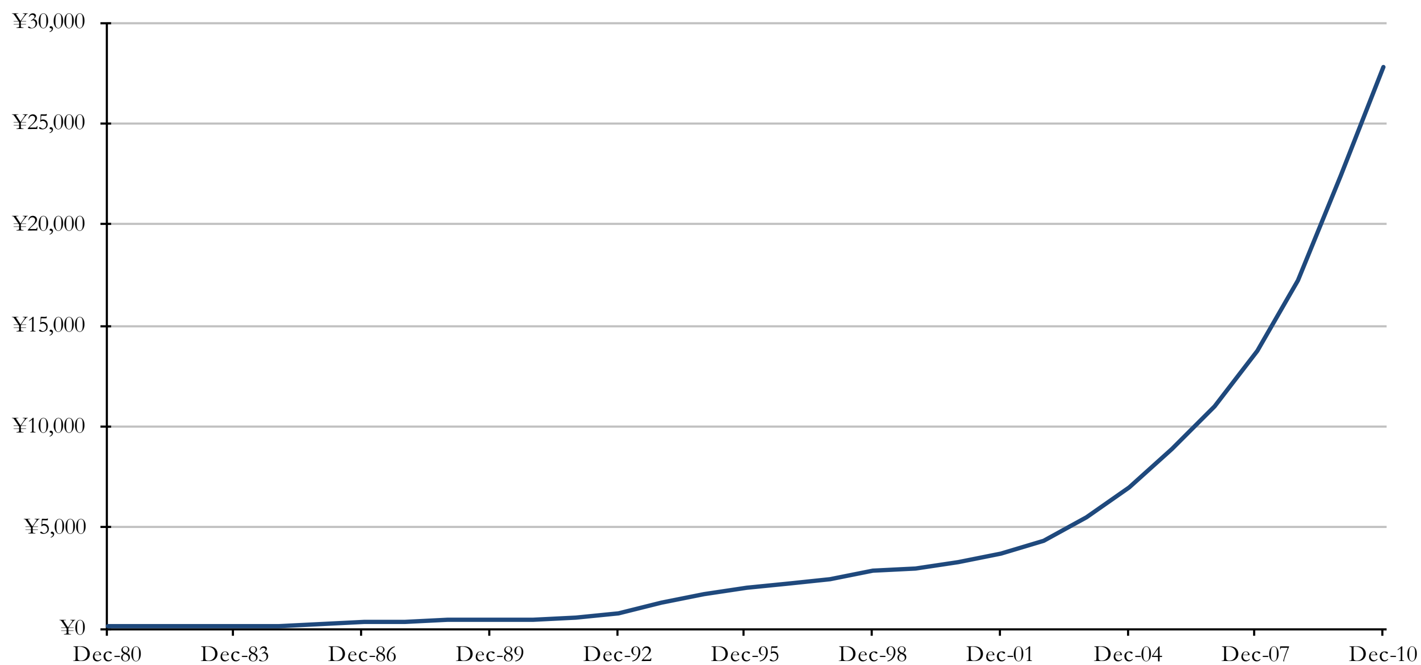
Commodity	China's Consumption as % of World
Cement	53%
Iron Ore	48%
Coal	47%
Steel	45%
Lead	45%
Aluminum	41%
Copper	39%
Oil	10%

Source: GMO April 2011

China's Economic Impact

The impact on commodity prices is not surprising given China's nearly 10-fold increase in Fixed Asset Investment (FAI) over the past decade…

China Fixed Asset Investment
(in RMB)

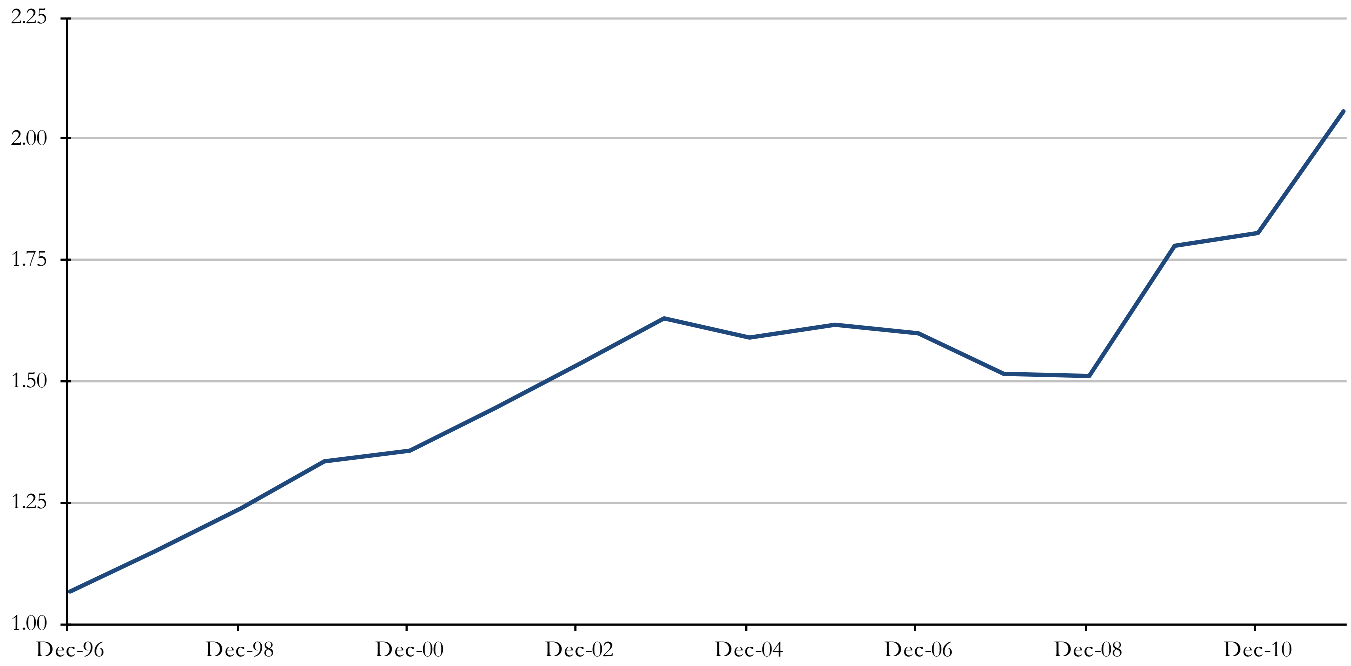


Source: Bloomberg; Bienville Capital Management, LLC

China's Economic Impact

However, China's investment-heavy model requires an increasing amount of money and credit expansion in order to generate the same unit of GDP. This dynamic is indicative of credit-driven bubbles and has global implications…

China M2 / GDP

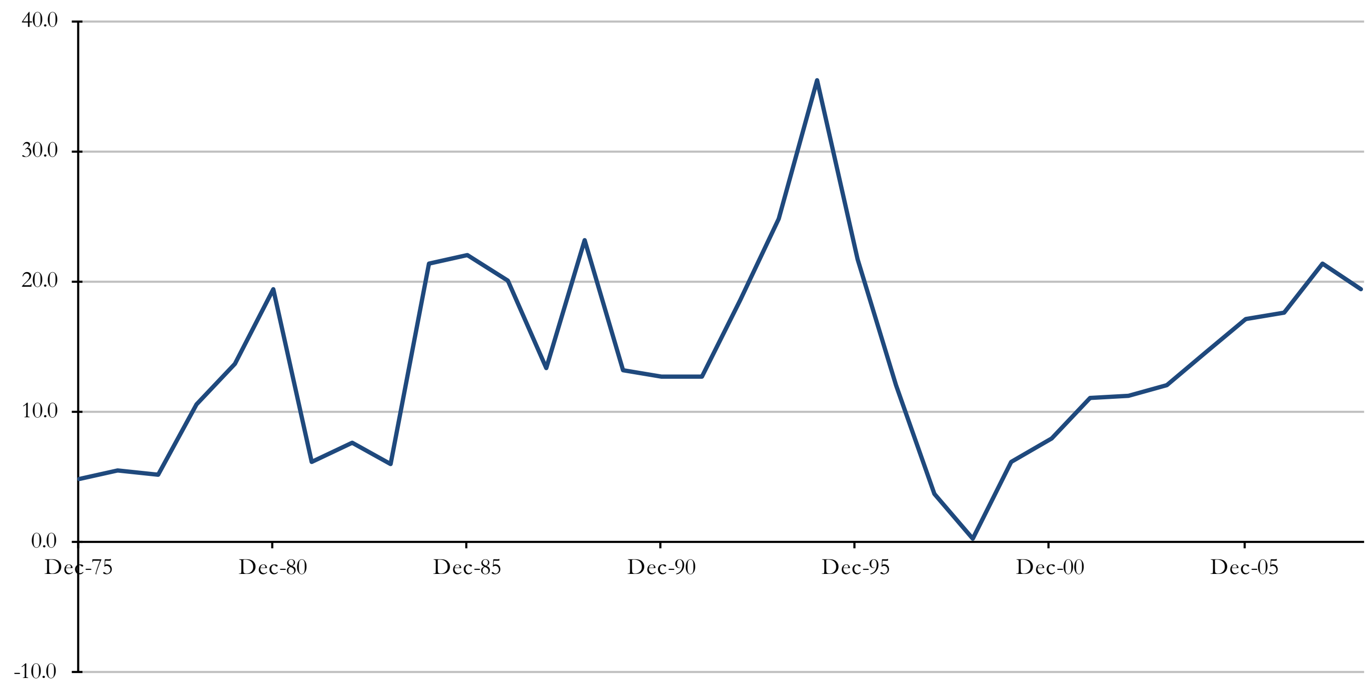


Source: Bloomberg; Bienville Capital Management, LLC

CHINA'S ECONOMIC IMPACT

As a result of excessive money and credit expansion, inflationary pressures are mounting. As wages rise, global competiveness deteriorates…

China Wages
(%, YoY)



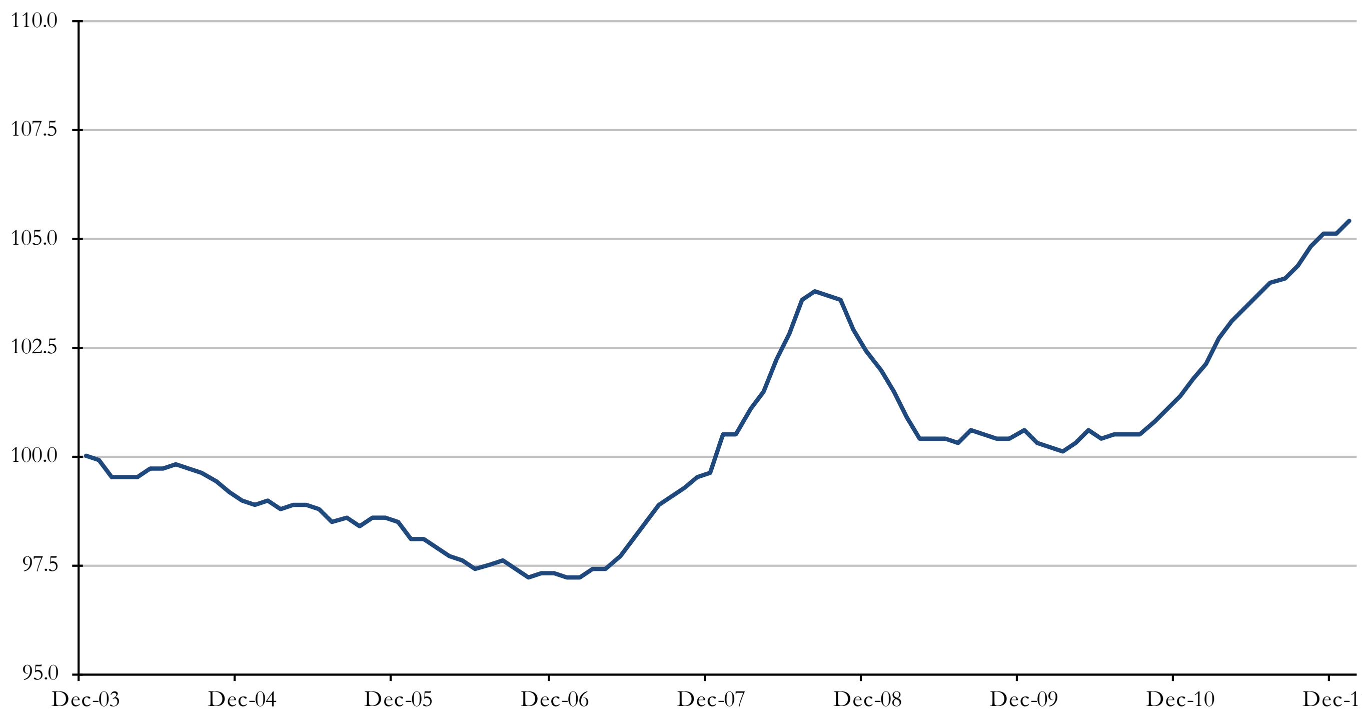
Source: Bloomberg; Bienville Capital Management, LLC

CHINA'S ECONOMIC IMPACT

China's exports will become uncompetitive either by a large nominal FX appreciation, inflation of wagers or protectionism

Higher wages translates into higher import prices. After years of exporting deflation, import prices from China are at all-time highs…

US Import Prices from China
(All Goods)



Source: Bloomberg; Bienville Capital Management, LLC

CHINA'S CURRENCY REGIME

"China, by maintaining its exchange rate policy, has been an important island of stability in a turbulent region."

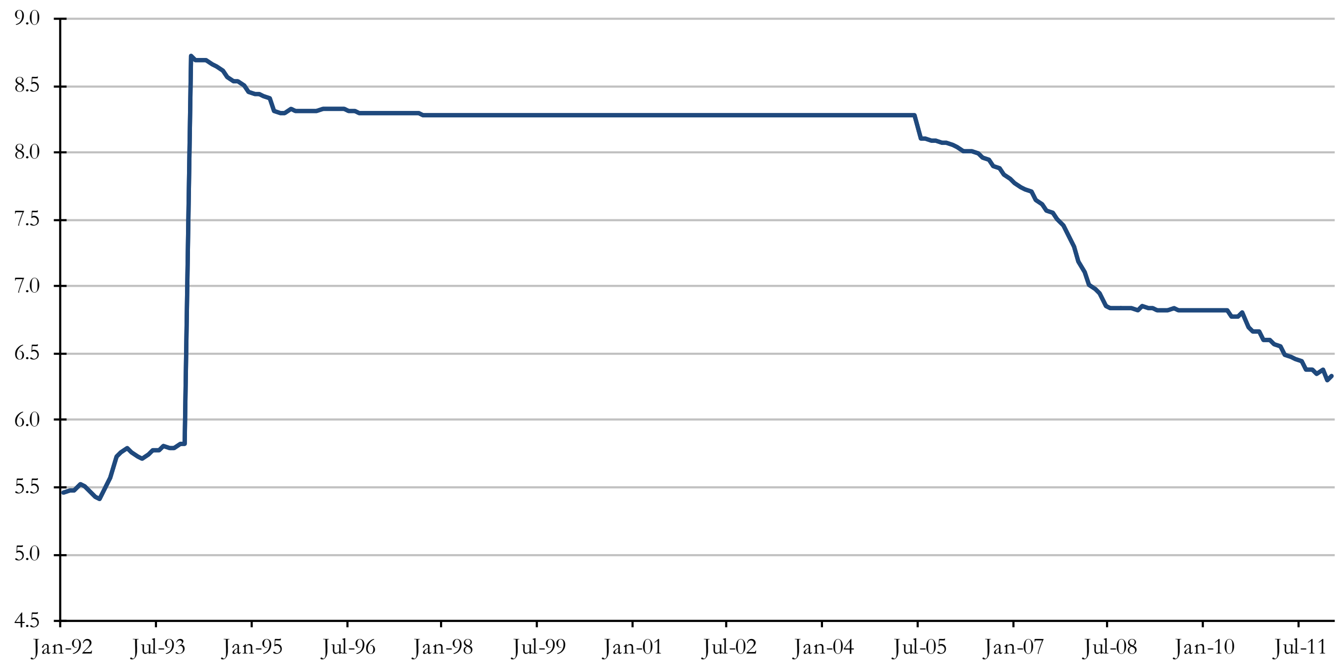
- Robert E. Rubin, Secretary of the Treasury, May 1998

CHINA'S CURRENCY REGIME

In 1993, there was no equity or property market for the excess liquidity in the financial system to spill over to. Therefore, consumer inflation surged

In 1994, following inflation of 30%, China devalued and pegged its currency to the USD. At the time the linkage made sense: China's economy was highly correlated to the U.S. business cycle. Today it is a highly destabilizing force in the global economy…

China RMB Spot
(in USD)



Source: Bloomberg; Bienville Capital Management, LLC

China's Currency Regime

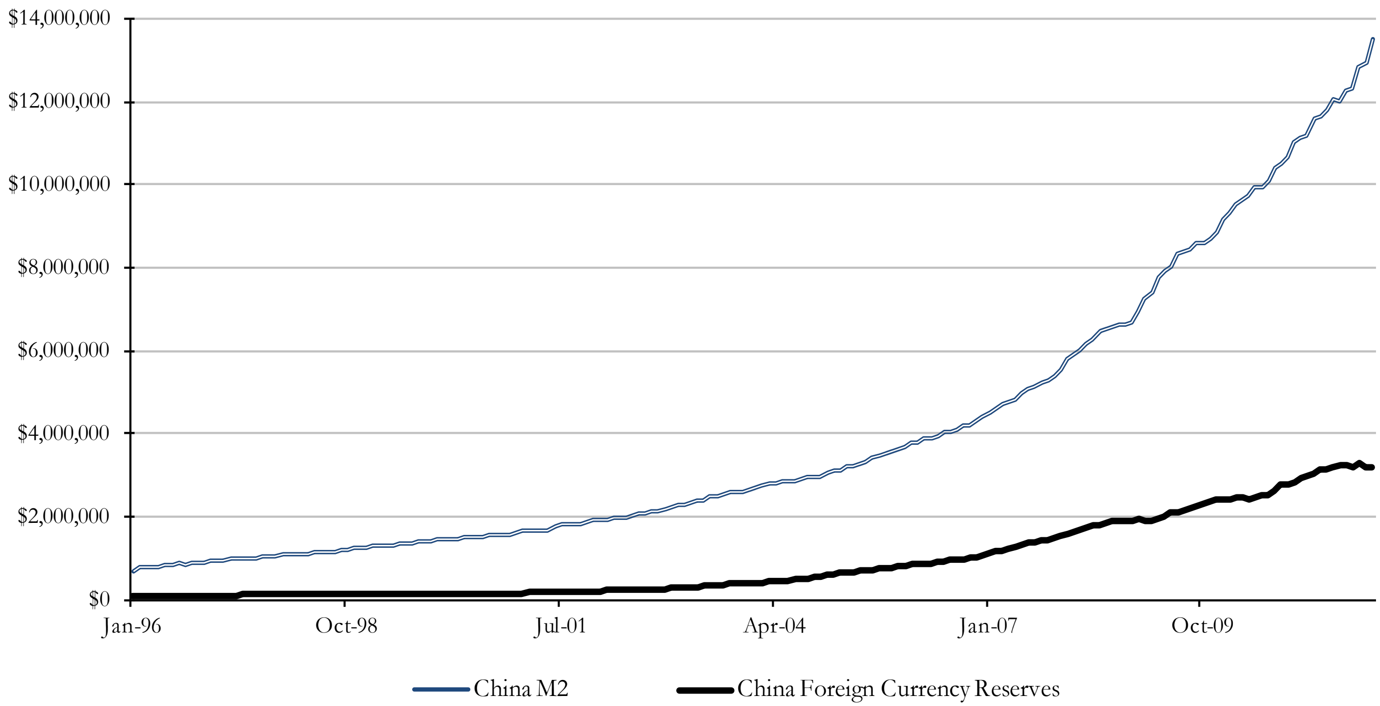
In reaction to the global recession, Beijing engineered the most spectacular monetary expansion in history. Since 2008, M2 has risen 100%

China now has 40% more money outstanding than the U.S., yet its economy is barely more than a third its size

Rampant money and credit growth has historically preceded financial crises

For over a decade, China has benefitted from cheap capital in the form of net capital inflows (via its trade surplus, FDI and speculative capital). To prevent the RMB from rising, China has printed enormous sums of money which were used to purchase foreign exchange inflows…

China Money Supply (M2) vs. Foreign Currency Reserves
(in USD)



Source: Bloomberg; Bienville Capital Management, LLC

China's Currency Regime

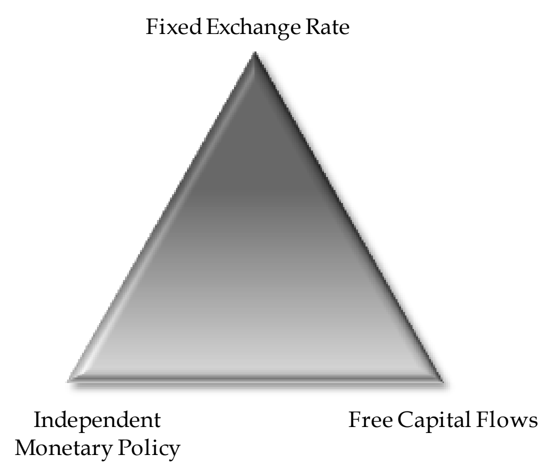
Capital controls are the lynchpin of China's semi-command economy

Without a closed capital account, households would seek higher returns elsewhere, slowing bank deposit growth and preventing the rollover of old debt, as well as new credit creation via the banking system

Fixed exchange rates are easy to manage when experiencing inflows, yet painful during periods of sustained net capital outflows.

- "The Impossible Trinity" states that no country can:
    1. Maintain a fixed exchange rate;
    2. Allow free capital movements; and
    3. Maintain an independent monetary policy
- To maintain it's exchange rate regime, China is able to conduct some monetary policy. However, it therefore must restrict the international flow of capital, including the ability of the Chinese to move their wealth abroad

The Impossible Trinity



China's Economic Model

"China's growth is unstable, unbalanced, uncoordinated and unsustainable."

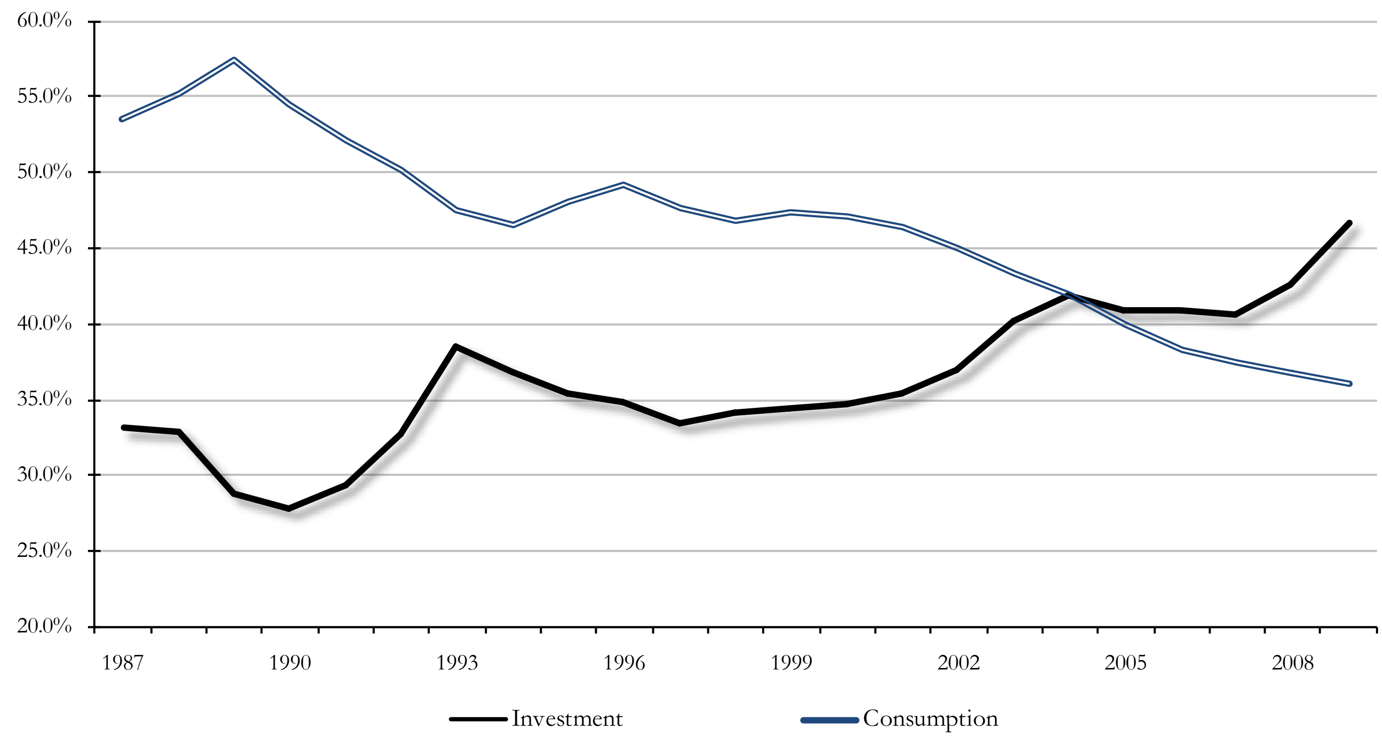
\- Wen Jiabao, Chinese Premier

CHINA'S ECONOMIC MODEL

The banking system is at the heart of China's semi-command economy. Banks with captive depositors are ordered to lend for investment projects of dubious economic merit, creating employment and the illusion of GDP growth

China's economy is deeply imbalanced with investment serving a historically unprecedented and disproportionate role. By contrast, consumption's share of the economy has fallen consistently for over two decades…

China's Investment & Household Consumption
(as % of GDP)



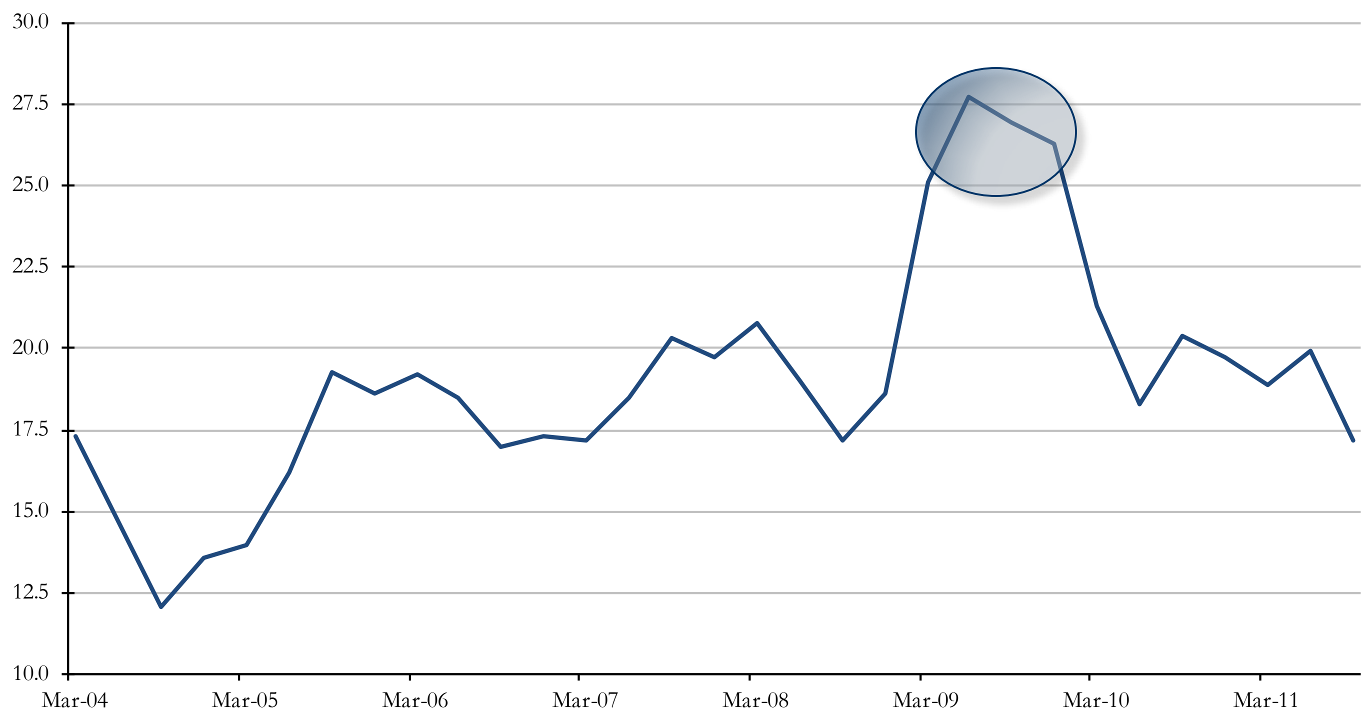
Source: IMF; LSR; Bienville Capital Management, LLC

CHINA'S ECONOMIC MODEL

Factional politics in China drives its "boom-bust" cycle – local government officials want credit for growth, whereas central government technocrats focus on inflation and monetary stability

In order to generate "GDP growth," the central government instructs state-owned banks to lend, primarily for investment and real estate projects. The result is rapid credit growth and banking assets. In 2009-2010, the authorities lost control of the expansion (similar to 1993).

China Banking Assets
(in %, YoY)



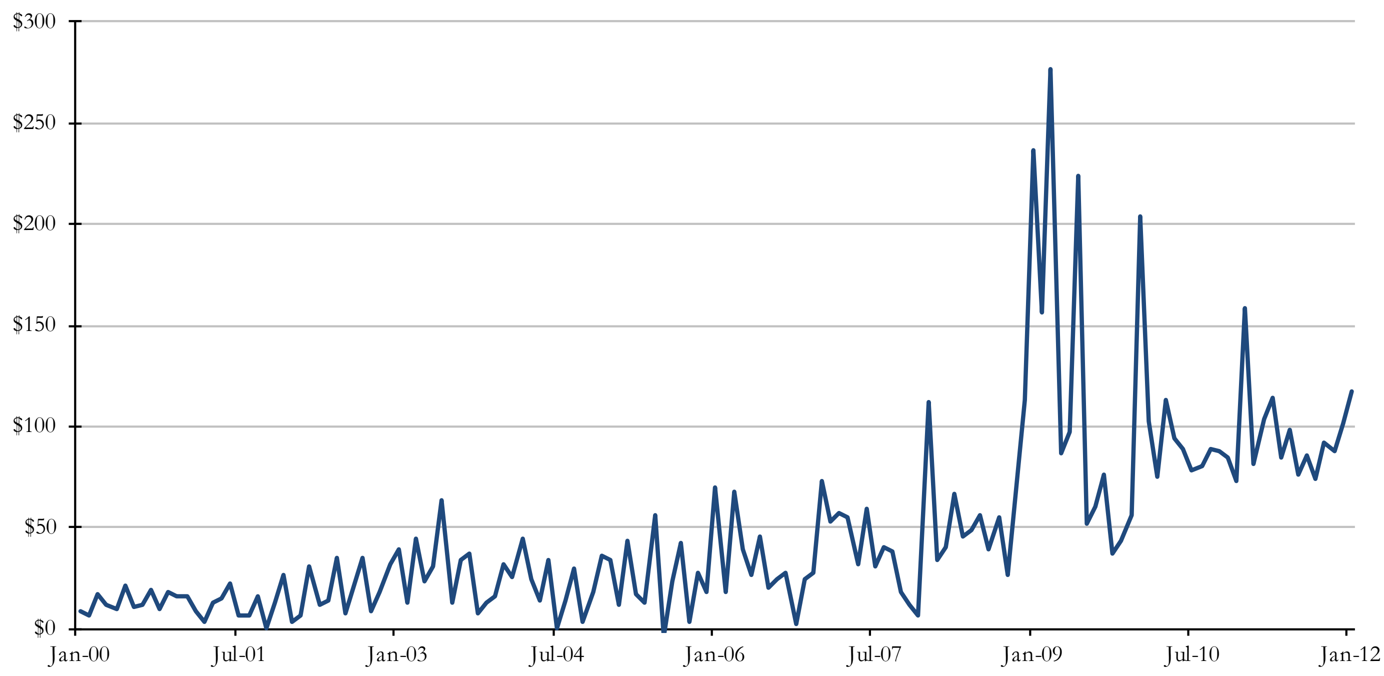
Source: Bloomberg; Bienville Capital Management, LLC

CHINA'S ECONOMIC MODEL

While some NPLs are anticipated, the expectation is that continued high nominal GDP will allow China to grow out of the forthcoming bad loans

In 2009 and 2010, much of the lending went to the thousands of dubious local government financing vehicles (LGFVs).

New Loans in China
(in USD)



Source: Bloomberg; Bienville Capital Management, LLC

CHINA'S ECONOMIC MODEL

Similar to Japan in the 1970s, a lower level of investment will lead to slower growth

The easy productivity gains from shifting to low-end manufacturing for export-led catch-up growth have been exhausted. The focus must turn to consumption

Simple math can demonstrate the harsh reality that confronts China: consumption cannot rise fast enough to offset the inevitable decline in investment. Therefore, the growth rate must fall.

- To increase the consumption share of GDP to the government's target of 50% and maintain overall real growth of 8.0%, nominal consumption growth must rise from ~11.0% to 15.5% over the next 10 years (despite the financial repression and the boost to incomes from investment)
- For investment-to-GDP to decline to a more sustainable level of 35% over 10 years, investment growth must collapse from 17.5% currently to 7.0% (a significant demand and income shock)

	Nominal Growth Rate		Year									
Consensus Case	**Current**	**Target**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Nominal GDP	15.0%	**11.0%**	100	111	123	137	152	169	187	208	230	256
Consumption (4.5% more than GDP)	11.0%	**15.5%**	35	40	47	54	62	72	83	96	111	128
Consumption/GDP	**35.0%**	50.0%	**35%**	36%	38%	39%	41%	43%	44%	46%	48%	**50%**
Consumption Growth Rate Relative to GDP		4.5%										
Investment (4.0% less than GDP)	17.5%	**7.0%**	49	52	56	59	64	68	73	78	83	89
Investment/GDP	**48.5%**	35.0%	**49%**	**47%**	**45%**	**43%**	**42%**	**40%**	**39%**	**38%**	**36%**	**35%**
Investment Growth Rate Relative to GDP		-4.0%										

Source: Bienville Capital Management, LLC

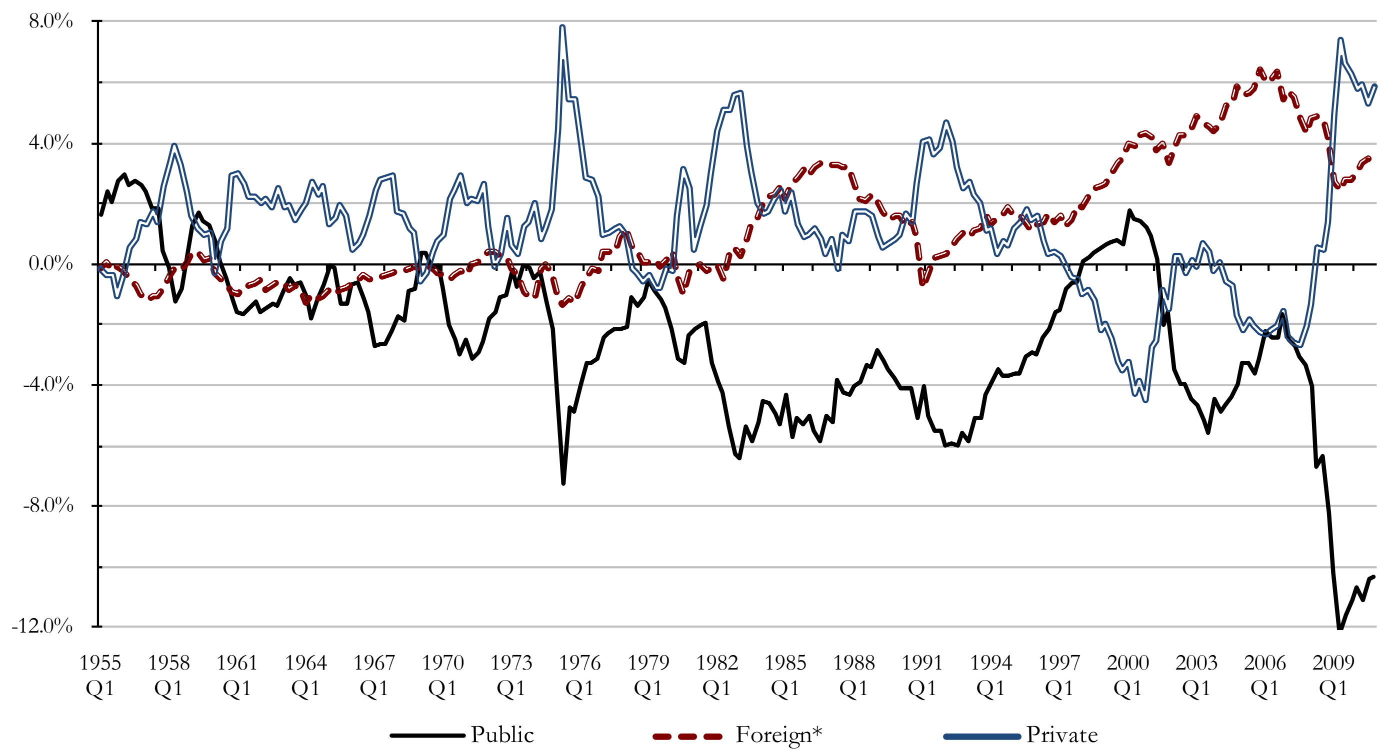
CHINA'S ECONOMIC MODEL

To achieve financial balance and sustainable growth, the U.S. should theoretically devalue its currency and tighten fiscal policy

However, the U.S. can't devalue as the most important exchange rate, the USD/CNY, is set in Beijing, not D.C.

China cannot count on continued export growth from deleveraging Western economies. As the flow of funds demonstrates, the current financial balances of the U.S. are not sustainable. The U.S. needs to dramatically shrink it's budget and trade deficits…

US Flow of Funds by Sector
(as % of GDP)



Source: IMF, LSR; Bienville Capital Management, LLC

CHINA'S ECONOMIC MODEL

The national accounting identity ensures that all financial flows in an economy must sum to zero. Therefore, one sector's financial balance cannot be analyzed in isolation as its effects will be felt elsewhere…

- Since the public sector is in deficit, flows to finance it must come from the private sector and/or the foreign account (i.e., the inverse of the capital account)
- To stabilize the public sector's debt-to-GDP at 100%, the public sector deficit needs to be reduced to a level consistent with nominal GDP (e.g., 4.0%). The private sector—households and businesses—will continue to de-lever, but surpluses can decline marginally
- Therefore, in order for both the public and private sector to necessarily delever, by definition, the adjustment must come from trade (i.e., the current account must move towards balance). However, China's yuan peg prevents this from occurring, but QE achieves a higher effective exchange rate (via inflation)

U.S. Sector Financial Flows	Public		Private		Foreign Account		
Current Balances	-10.0%	+	7.0%	+	3.0%	=	0
Sustainable Balances	-4.0%	+	4.0%	+	0.0%	=	0

Source: Lombard Street Research

THE ENDGAME

"This is the last time that the state will take responsibility for lost capital…Capital and material losses from now on will be handled by the enterprises themselves."

- The People's Bank of China, April 1985

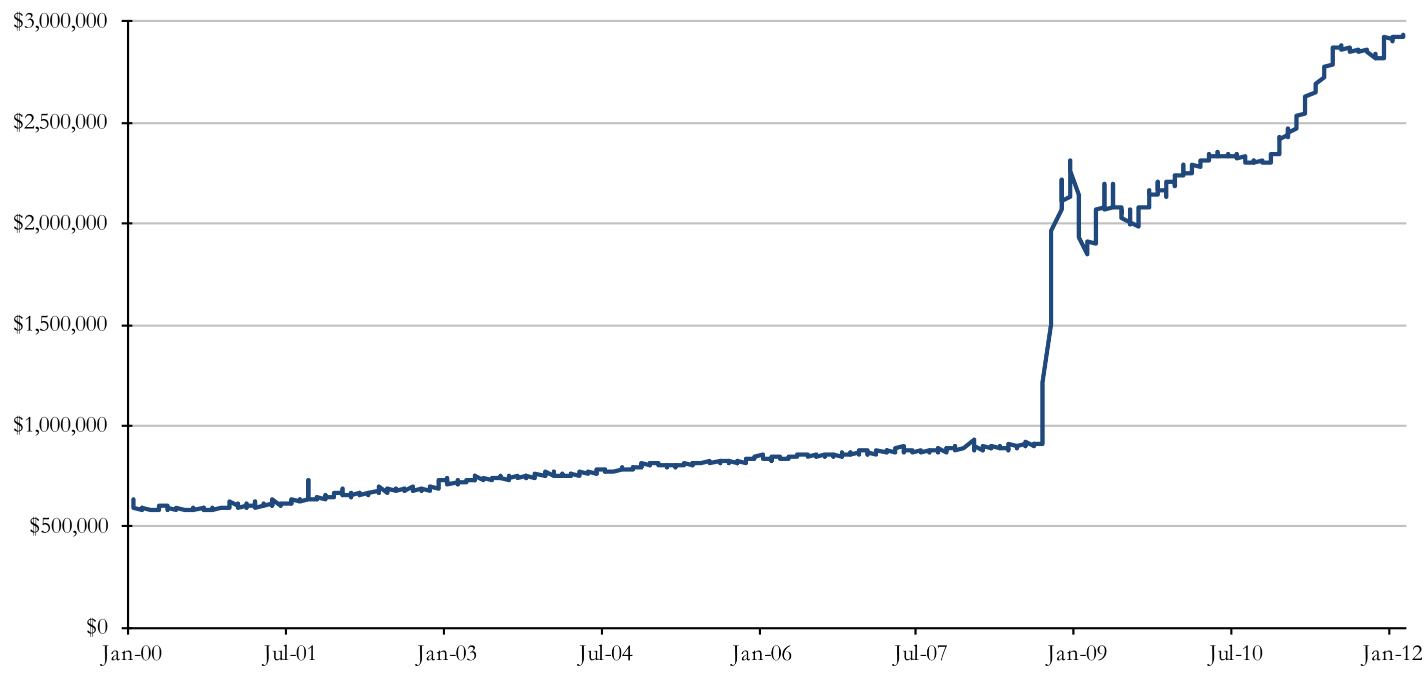
THE ENDGAME

The U.S. budget cannot afford higher interest expense, suggesting ZIRP is a trap…

Expansive monetary policy in the West is being exported to China with inflationary consequences in both asset prices (e.g., real estate) and the real economy (e.g., wages)

Interest rates must remain low to assist the private sector in deleveraging and prevent materially higher interest expense for the federal budget. Thus, QE is likely to be a permanent feature of monetary policy, and therefore a ongoing problem for over-heated China…

Federal Reserve Balance Sheet
(in USD)



Source: Bloomberg; Bienville Capital Management, LLC

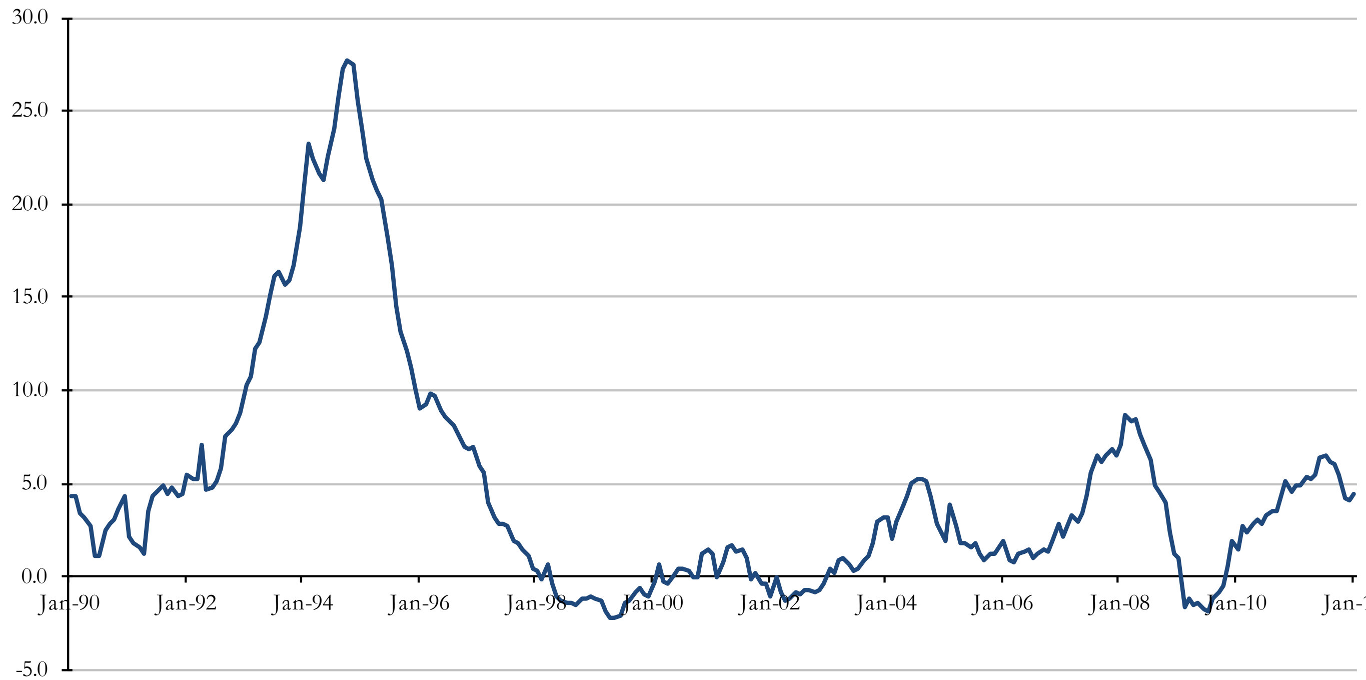
THE ENDGAME

Recently China's GDP Deflator reached 9.5%

"Real effective exchange rate" adjustments via inflation are much messier than adjustments through nominal currency appreciation, which China has long resisted

Because China imports U.S. monetary policy, QE is highly stimulative for its already over-heated economy. Higher inflation in China results in a higher "real effective" exchange rate and a loss of competitiveness (reducing net imports to the U.S.).

China Consumer Price Index (CPI)
(%, YoY)



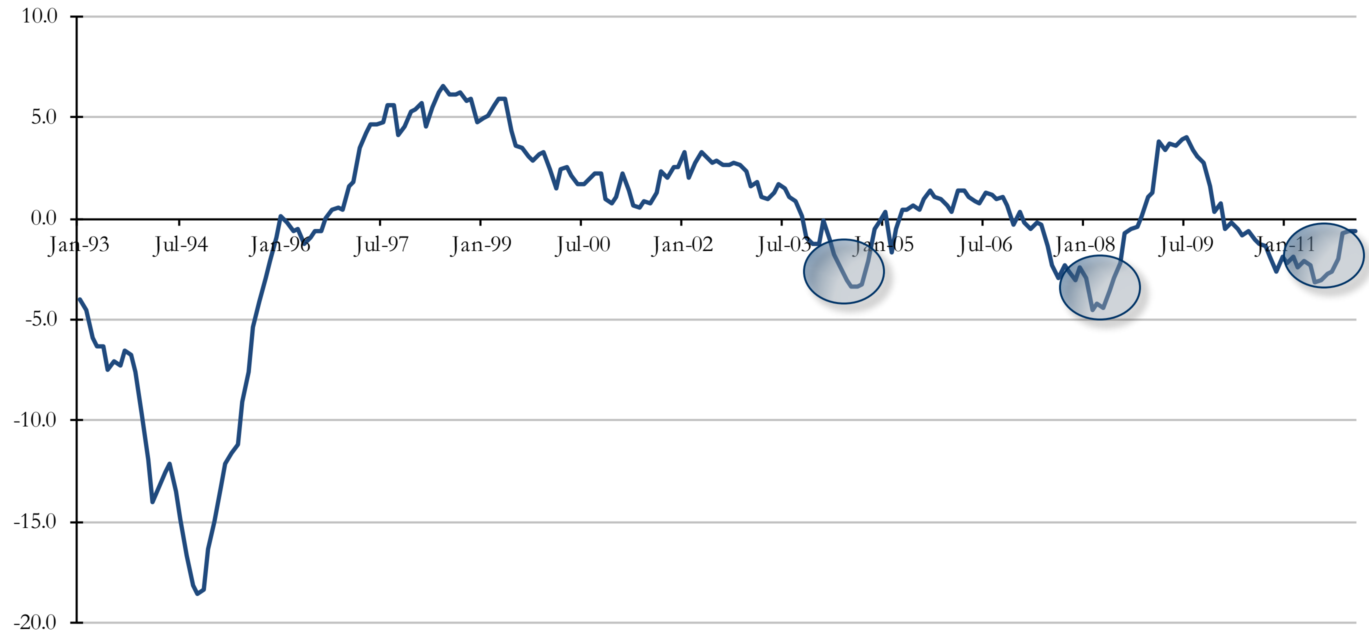
Source: Bloomberg; Bienville Capital Management, LLC

THE ENDGAME

Negative real deposit rates are used to recapitalize China's banking system

Negative real rates serve as a form of financial repression that incentivizes depositors to either speculate on asset prices, or attempt to move their money elsewhere. Although China maintains strict capital controls in order to keep deposits in the banking system, over time they've proven to be porous…

China Real Deposit Rates
(in %)



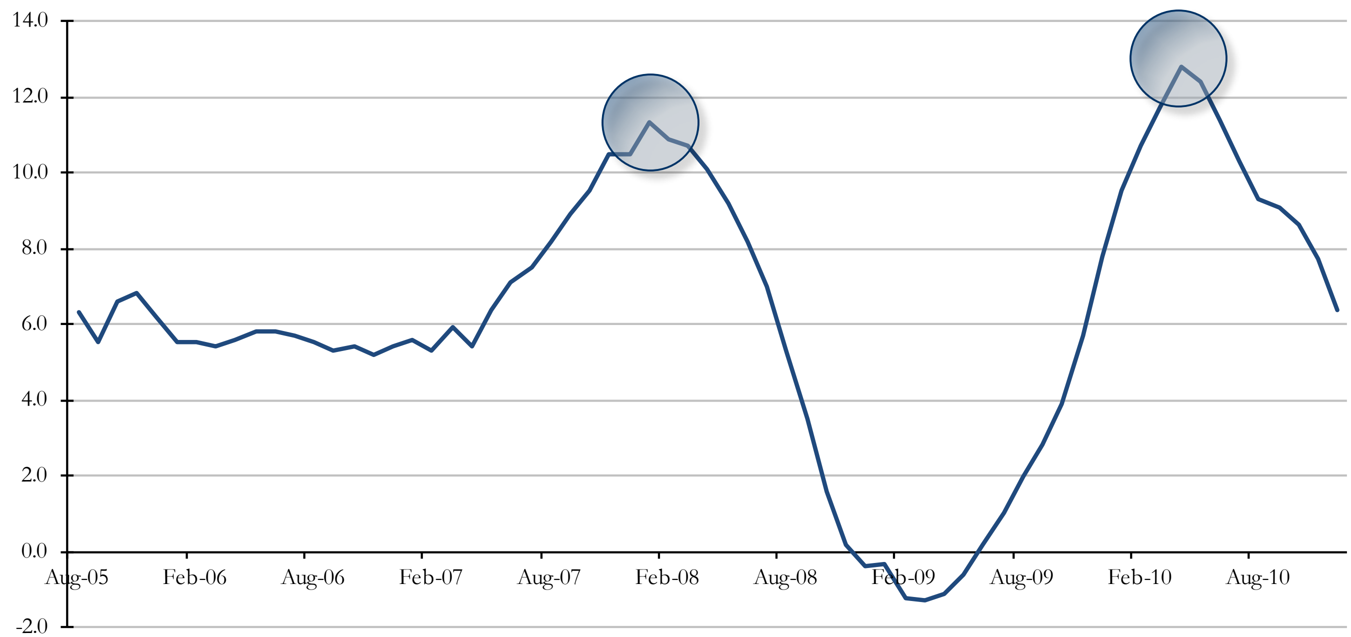
Source: Bloomberg; Bienville Capital Management, LLC

THE ENDGAME

Property prices are now falling in all 70 cities measured

The Chinese people have already been burned by an equity market collapse in 2008. Most recently, they've experimented with property. Now that property prices have begun to fall, we must consider where the excess money will go next…

China NDRC Property Price Index
(in % YOY)

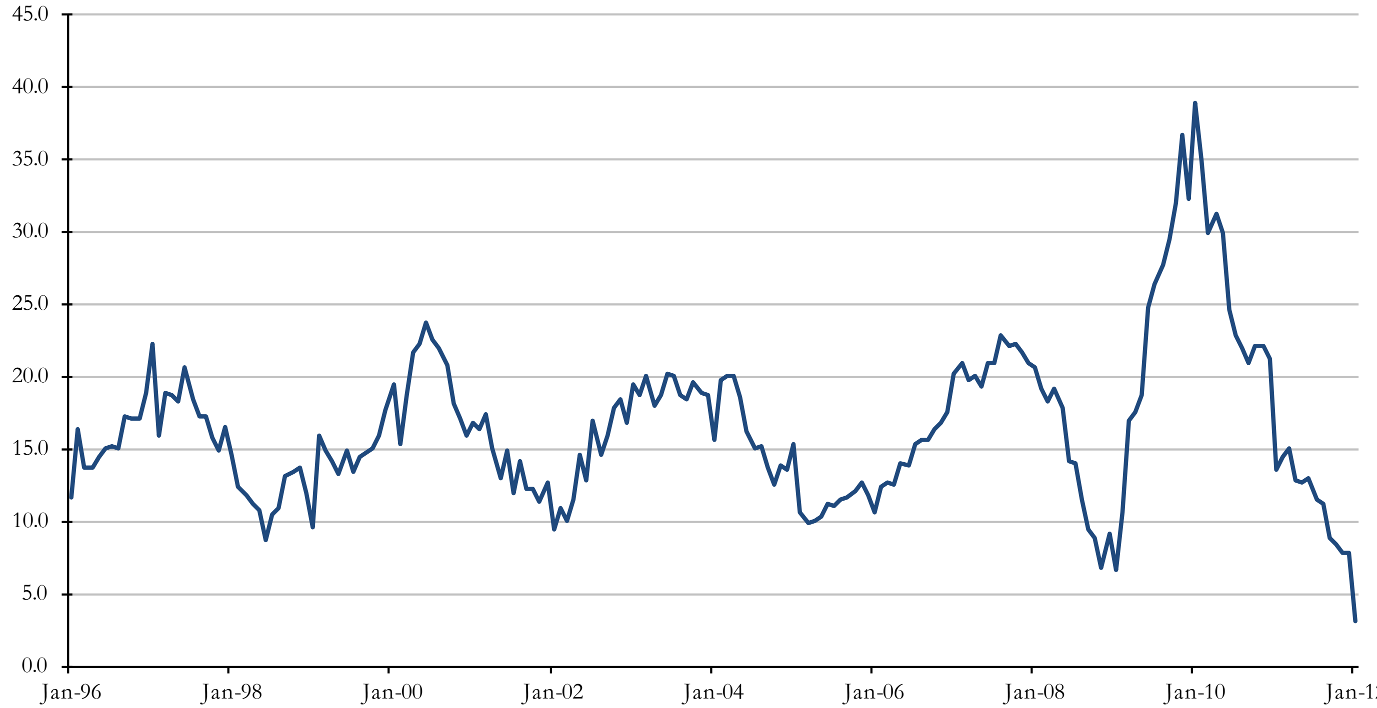


Source: Bloomberg; Bienville Capital Management, LLC

INVESTMENT OPPORTUNITY

Recently, deposit growth has slowed significantly….

China M1 Money Supply
(in %, YoY)



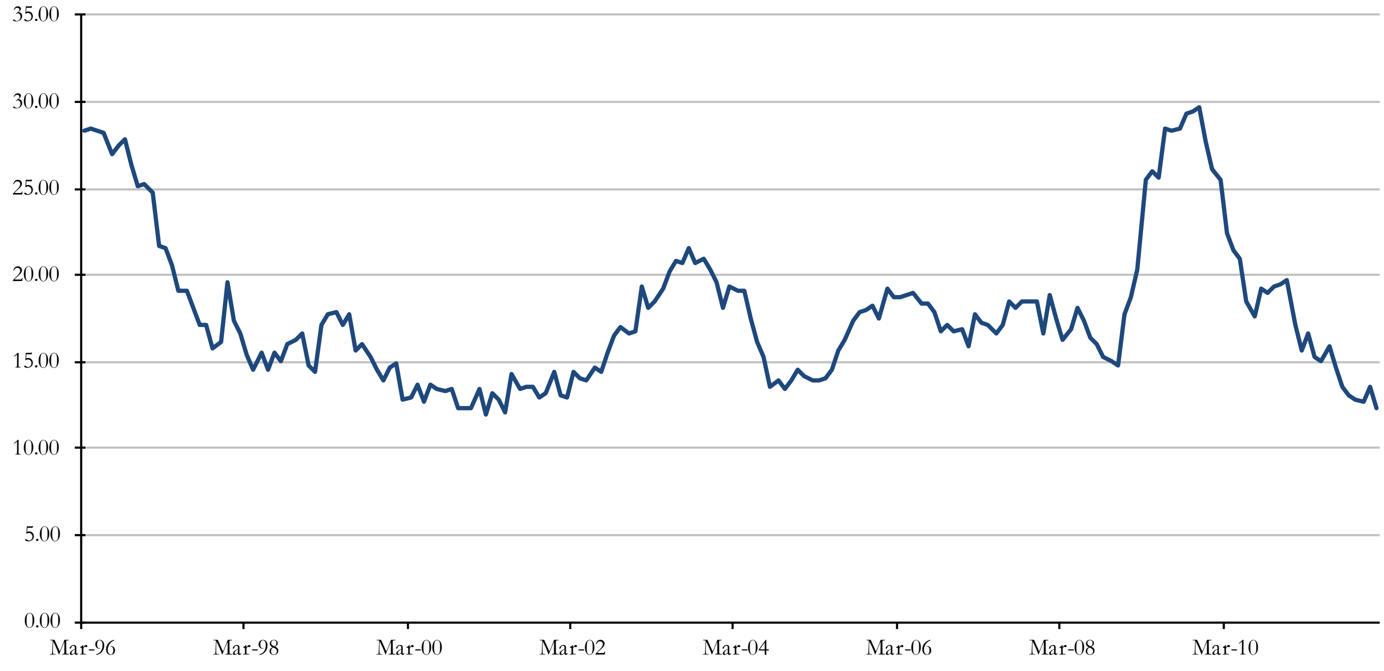
Source: Bloomberg; Bienville Capital Management, LLC

THE ENDGAME

China's target growth rate for M2 is currently 16%

And fewer deposits make it difficult to create broad money, which China's economy has become increasingly dependent on. M2 growth has fallen to the lowest levels in recent history and is well below target….

China M2 Growth Rate
(in %, YoY)



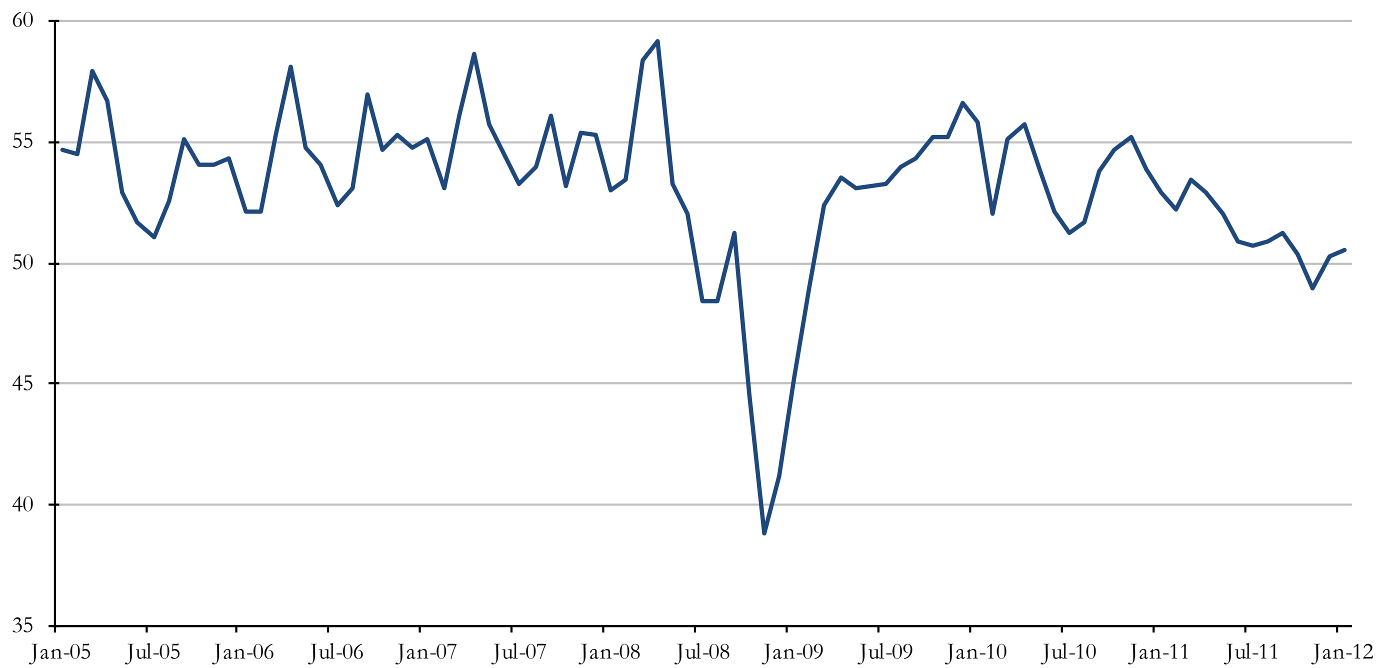
Source: Bloomberg; Bienville Capital Management, LLC

THE ENDGAME

Manufacturing is near contraction territory

As a result of the modest tightening in 2011, combined with an external demand shock from Europe, the manufacturing PMI has deteriorated….

China Manufacturing PMI
(Diffusion Index, > 50 represents expansion)



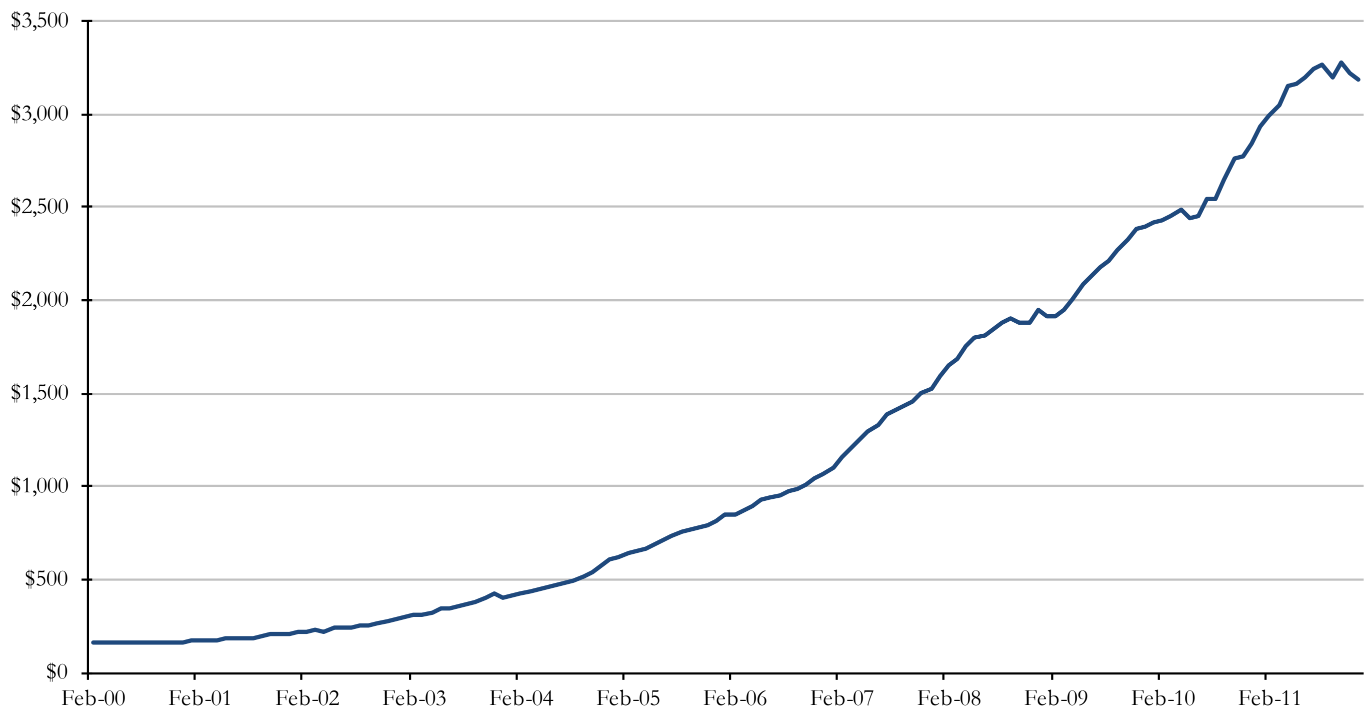
Source: Bloomberg; Bienville Capital Management, LLC

THE ENDGAME

Pegged currency regimes are easy to manage when the country is experiencing net capital inflows

China's foreign currency reserves have also begun to decline, suggesting capital flight has taken hold, an ominous sign for an economy highly dependent on capital controls to keep the insolvent banking system liquid…

China Foreign Currency Reserves
(in USD)

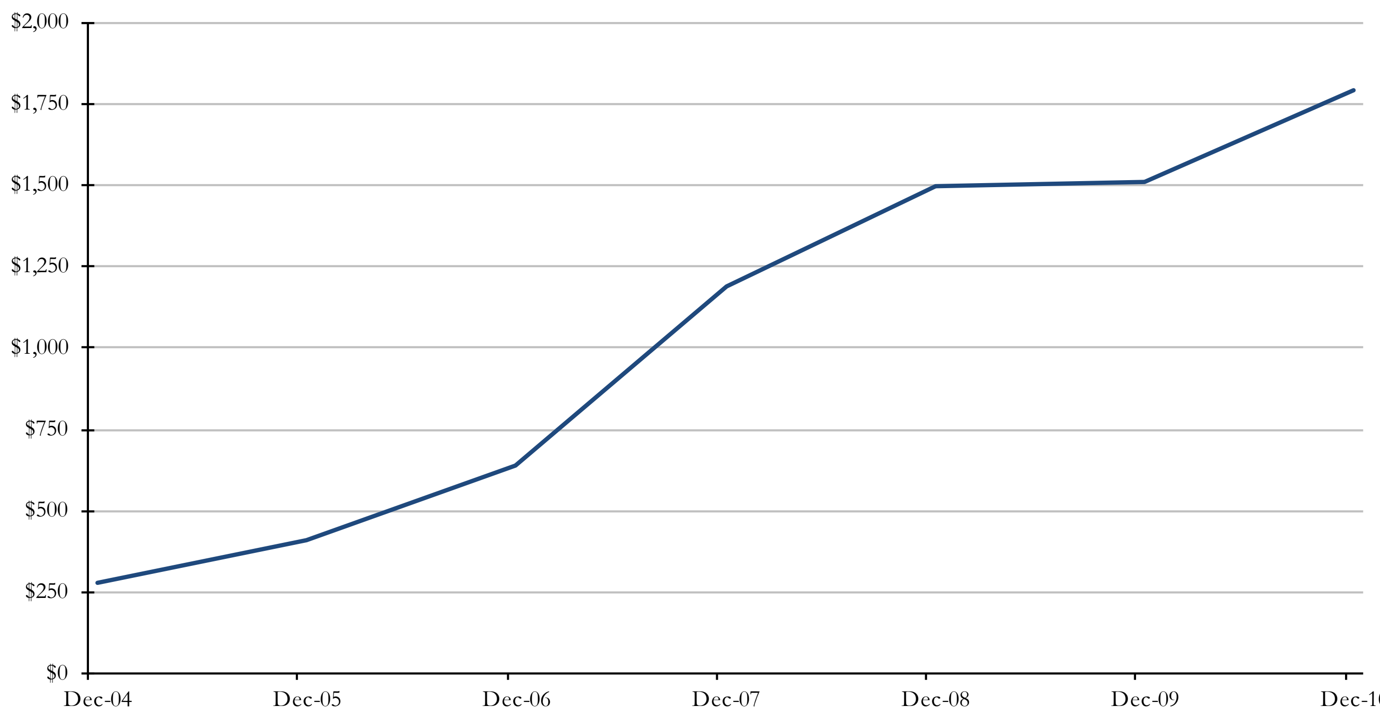


Source: Bloomberg; Bienville Capital Management, LLC

The Endgame

Although China has a strong overall net international investment position, the private sector runs a deficit (in the form FDI), which explains the downward pressure on the currency in times of uncertainty….

China Net International Investment Position
(in USD)



Source: Bloomberg; Bienville Capital Management, LLC

THE ENDGAME

Because broad money in China is significantly larger than their foreign exchange reserves, policymakers do not have as much firepower in defending the quasi-peg as is generally believed.

- FX Reserves are assets with associated liabilities. M2, which includes currency in circulation, demand deposits and savings deposits, more accurately represents the claims on the reserves
- With approximately $3.2 trillion foreign exchange reserves and $13.5 trillion in outstanding money supply (i.e., M2), China's reserve adequacy ratio is only 24%, hardly adequate should China experience sustained net capital outflows

Country	Reserve Adequacy Ratio	Depreciation vs. USD
Thailand	25%	-58%
Malaysia	25%	-48%
Indonesia	29%	-81%
Philippines	32%	-71%
China	**24%**	**???**

Source: Bloomberg; Corriente Advisors; Bienville Capital Management, LLC

CONCLUSION

- For years China has been the beneficiary of cheap capital via net capital inflows. Net capital inflows combined with China's managed exchange rate helped create the illusion of a virtuous cycle (i.e., credit, GDP, employment and asset prices all increased simultaneously)
- Today, investment as a proportion of the economy is unsustainable, external demand is falling and consumption can't rise fast enough to meet growth targets, yet structural inflationary pressures remain
- In order to maintain growth during the leadership transition, the impetus is once again likely to be for investment-led growth. However, more credit-fuelled investment growth is likely to drive inflation significantly higher, risking social instability and an ultimate bust
- Investment-led growth requires growing bank deposits, yet high inflation, negative real interest rates and the collapse in the belief of the "Chinese Miracle" is inspiring capital flight (while many LGFV debts from the 2009-2010 investment binge are now coming due)
- Capital flight pressures the RMB down. To maintain the peg and to roll-over maturing LGFV debt, policymakers may be forced to use foreign exchange reserves
- However, utilizing FX reserves contracts the money supply at the very same time property markets have begun to fall, a toxic combination
- The seemingly virtuous cycle turns vicious. Allowing the currency to fall may prove to be less painful
- As the global economy inevitably rebalances, surplus nations such as China will find growth far more difficult to achieve
- A disorderly unwind of today's imbalances has implications for all investors and business owners

BIOGRAPHIES

M. Cullen Thompson, CFA President Chief Investment Officer	Co-Founder, Bienville Capital Management Previously: Director of Investments, RR Advisory Group Senior Research Analyst, Citigroup Private Bank Senior Portfolio Analyst, Lehman Brothers Associate, Arthur Anderson LLP BA University of Alabama
William H. Stimpson II Chief Executive Officer	Co-Founder, Bienville Capital Management Previously: Managing Director, Bay Crest Securities, LLC Executive Director, JPMorgan Chase & Co. Vice President, Deutsche Bank BA Vanderbilt University
Ralph F. Reynolds Chairman	Co-Founder, Bienville Capital Management Previously: Founder and CIO, Carlyle Blue Wave Managing Director, Deutsche Bank President & CEO, NatWest Managing Director, Morgan Stanley Principal, O'Connor and Associates MBA University of Chicago BA University of Pennsylvania
Donald Stoltz III Partner, Director of Trading	COO, Bienville Capital Management Previously: Proprietary Trader, First New York Securities, LLC Vice President, JPMorgan Chase & Co. BA Pennsylvania State University
Matthew A. Parker Partner Director of Client Development & Strategy	Previously: Associate Investor, JPMorgan Chase & Co. Vice President, BNP Paribas Vice President, Deutsche Bank MBA University of Virginia BA University of Mississippi
Blake Bennett Research Analyst	Previously: Co-Founder/CIO, Intuitive Risk Management Co-Editor-In-Chief, Intuitive Market Thesis BA Vanderbilt University

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Bienville Capital Management, LLC is an SEC-registered, independent investment advisory firm offering sophisticated and customized investment solutions to a select number of high-net-worth investors and family offices. Our investment process is focused on asset allocation, manager selection and portfolio construction—all of which is supported by intense fundamental macroeconomic research.

The members of the Bienville team have broad and complementary expertise in the investment business, including over 100 years of collective experience in private wealth management, institutional investment management, trading, investment banking and private equity. We have established a performance-driven culture focused on delivering exceptional advice and service to a select number of investors. We communicate candidly and frequently with our clients in order to articulate our views.

Bienville Capital Management has offices in New York, NY and Mobile, AL.

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