CHINA'S PARADOX

OCTOBER 2012

M. Cullen Thompson, CFA
President & Chief Investment Officer
cullen.thompson@bienvillecapital.com

"Let China sleep, for when she wakes up she will shake the world"- Napoleon Bonaparte

"SO BASICALLY CHINA IS ONE GIANT EPCOT CENTER," were the words uttered by Chris Pavese, himself unsure of whether they formed a question, a tongue-in-cheek comment, or an apt summary of what we had witnessed touring nearly a dozen Chinese cities this past spring.

What baffled Chris, the Chief Investment Officer of Broyhill Asset Management, wasn't the city of Tianjin, located some 140 kilometers southeast of Beijing, where a $30 billion replica of Manhattan, complete with its very own Rockefeller Center, is underway. Nor was it the South China Mall, the world's largest. Famous, or infamous rather, for the tenants and customers who remain conspicuously absent, Dongguan's outdoor mall memorializes a handful of the great cities from around the world, including Venice, Paris and Amsterdam. What inspired the comment was the shock of learning of plans to recreate Hallstatt, the idyllic lakefront Austrian village, in Guandong province, the southern part of China.

That China's policy-orchestrated investment boom beginning in 2009 engineered a costly misallocation of capital has been well documented, even if the implications are still being debated. Across the country in cities both large and small, visitors are exposed to residential real estate projects incomprehensibly large and impossibly ambitious. At one point, early in a recent trip on the outskirts of Shenzhen, I noticed a defect of the iPhone: its inability to sufficiently zoom out to fully capture the breathtaking expansiveness of any number of ongoing developments we passed.

But this much we had gathered. Having poured over China's published statistics for months, we already knew that bank lending and real estate construction had gone parabolic. We also knew China's money supply had more than doubled since the sky came crashing down on the global economy in the fall of 2008. So it was no surprise that the world's grandest monetary stimulus, hastily enacted in the heat of the Great Recession, had exhausted nearly all sensible investment projects—the ones that could generate cash flows sufficient to service the projects' accompanying debt, as well as give a boost to the country's overall productivity.

But what had not occurred to us was that in their haste, the Chinese had also exhausted creativity—hence, their decision to import versions of great cities from around the world. To deploy the newly-printed money, and to keep its GDP humming along at its preordained rate, China resorted to the tactics of Walt Disney. It's a story that seems destined to be told by Michael Lewis. One that includes all of the familiar themes—greed, hubris and naiveté—featured in *The Big Short*, *Boomerang,* or a number of his *Vanity Fair* articles where a collective madness seems to grip a nation, resulting in billions wasted.[1]

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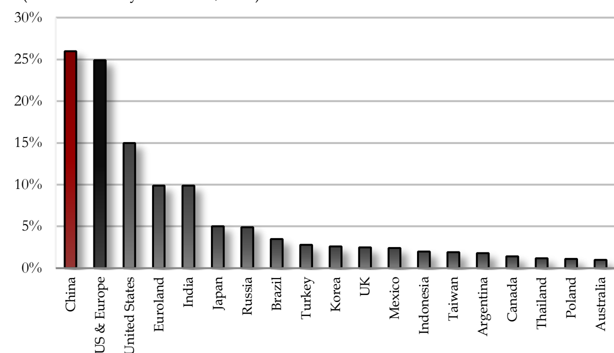
China has awoken. And as Napoleon suggested, it has shaken the world. In the last three decades, China has made a quantum leap in economic significance, catapulting itself from a country of peripheral concern to one of systemic importance. In 1980, China accounted for 2% of global GDP. Today, it represents 14% of the goods and services produced globally. When factoring in both the size and volatility of its growth, in 2010, China was more impactful to the global economy than the US and Europe combined.[2]



[1] Ironically, shortly after I had written this sentence I ran into Michael Lewis, one of the best chroniclers of the financial crisis, at a small hotel in Spain where I pleaded with him to tell the China story in *Vanity Fair*
[2] Source: Bienville Capital Management; IMF; Bridgewater Associates

As part of its 10-fold increase in fixed asset investment over the past decade, China became the marginal demand for nearly all commodities, consuming 53% of cement, 48% of iron ore and 45% of steel.[3] China has a disproportionate impact on global liquidity, asset prices and risk appetite. And as a persistent 'surplus' country, China is also a central contributor to the global imbalances that set the perilous backdrop for the financial crisis that erupted in 2008—imbalances that have yet to fully adjust. It is for these reasons alone that the Middle Kingdom cannot be ignored. China can no longer be an afterthought in the minds of investors.

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China presents any observer with an array of bizarre and seemingly irreconcilable contradictions: it is the 2nd largest economy in the world, yet on a per-capita GDP basis it ranks around 90th; although it dominates global manufacturing, hardly anyone can name a single Chinese company; China's finished products are sold globally at market prices, yet the majority of its factors of production are strictly controlled by the government;[4] its leaders insist its political economy is intended to ensure equality—a "harmonious society"—yet it has resulted in stunning inequity. In smaller Tier 2 and 3 cities, shanty dwellings are overshadowed by towering and obviously empty apartment buildings; and in Shanghai, the world's most populous city, you may find the bar of your hotel on the 87th floor, a statement of modernity, yet you're advised to not drink the water, one of man's basic necessities.

On this last point, I couldn't help but laugh recently. At the recommendation of a friend I began reading a number of works by Jonathan Franzen, arguably one of America's best literary novelists. It was in *Farther Away,* a compilation of essays, where Franzen wrote of his first visit to Shanghai, which he described as the "most *advanced* place" he'd ever seen:

> *It was as if the gods of world history had asked, "Does somebody want to get into some really unprecedentedly deep shit?" and this place had raised its hand and said, "Yeah!"*

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One of the joys of reading and research is stumbling upon random ideas or concepts and thinking about how they can be applied across seemingly unrelated disciplines. For example, consider the passage below, ignoring the author's formatting:

> But everything you notice is important.
> Let me say that a different way:
> If you notice something, it's because it's important.
> But what you notice depends on what you allow yourself to notice
> In a world where we're trained to disregard our perceptions.
> Who's going to give you the authority to feel that what you notice is important?
> It will have to be you.

The passage is from *Several Short Sentences About Writing,* an excellent book I purchased somewhat compulsively during a recent visit to the bookstore. The reason this particular passage caught my attention was simple: it described the process by which we began to study China nearly three years ago. There was no designated Investment Committee meeting, nor a mandate to analyze the structure of China's economy. We simply began to notice. And what we noticed not only felt important, it also felt wrong. But we had to allow ourselves to notice these things. We had to give ourselves the authority to feel they were important because we, like many others, had been trained to disregard these perceptions. We, like others, had been told that China was a "miracle economy," implying that it was not subject to the natural laws of the universe, and therefore its proclaimed uniqueness couldn't be understood by curious Western analysts.

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Admittedly, China is an intimidating subject. Its political system is both peculiar and opaque and its economy is sort of a hard to define, hybrid structure—one that appears to oscillate between command system and market economy. China's banking system is less of a mechanism to intermediate savers and borrowers than an extension of the Treasury: banks lend when instructed to do so and the inevitable non-performing loans are assumed to be liabilities of the central government. China's monetary policy is also an enigma: foreign inflows are welcomed, yet outflows are prohibited. And its central bank, the PBoC, often appears to be less of a central bank than the world's largest hedge fund, "long" some $3.2 trillion of foreign exchange reserves and "short" an equal amount of domestic currency.

[3] Source: GMO
[4] Most notably energy costs and borrowing rates, both of which are heavily subsidized by the state

But aside from these peculiarities, perhaps most intimidating is that China's history is so long, and so dense that when setting out to analyze it, it's hard to determine a starting point. This is an issue even historians apparently struggle with. In the opening portion of his book, *On China,* Henry Kissinger noted that "a special feature of Chinese civilization is that it seems to have no beginning. It appears in history less as a conventional nation-state than a permanent natural phenomenon." China just sort of "strides into the historical consciousness."

China no doubt entered our respective minds at varying times. But for our purposes, a few dates stand out. For instance, 1978 was when China disbanded a number of agricultural communes and opened its economy to the world, igniting fast growth. It was in 1993 when local governments borrowed excessively from banks, causing the money supply and inflation to soar. The resulting 50% devaluation of the Chinese currency created a formidable competitive advantage in global trade. It was in 2002, shortly after China's ascension into the WTO, when the trade-weighted U.S. dollar, which China's currency was conveniently pegged to, began its long and steady decline, supercharging China's competiveness and exports along the way.[5] And it was in the fall of 2007 when China's policymakers likely recognized a critical, yet formerly underappreciated flaw in its export-led growth model: it was constrained to planet earth. Having surpassed the U.S. as the world's largest manufacturer, China had already saturated the globe with low-cost goods, many of them purchased with borrowed funds.

So the demand shock of the Great Recession marked the end of China's export-led development model. As the deficit countries in the West were forced to reduce their persistent over consumption, the surplus countries in the East, previously thought to have been insulated, found themselves exposed. To combat the decline in trade, China decided to mobilize its extraordinary pool of domestic savings. They invested in roads, rail, airports, and of course, real estate. Lending went ballistic. One-third of mortgages outstanding at the end of 2009 were extended in that very year. Bank loans as a whole increased by roughly 10 trillion RMB, equating to 30% of China's economy, double the level of 2008. A GDP-equivalent increase in the U.S. would have seen new loans increase by $5 trillion (enough to build "bridges to nowhere" everywhere). So as the rest of the world teetered on the verge of recession, China's economy seemed to defy gravity. In 2009, it posted growth of 9.2%. In the following year, as the Federal Reserve experimented with another round of quantitative easing to ameliorate the aftershocks of the global recession, China's economy leapt another 10.4%. So what in retrospect should have served as a harbinger of trouble was construed as further evidence of invincibility.

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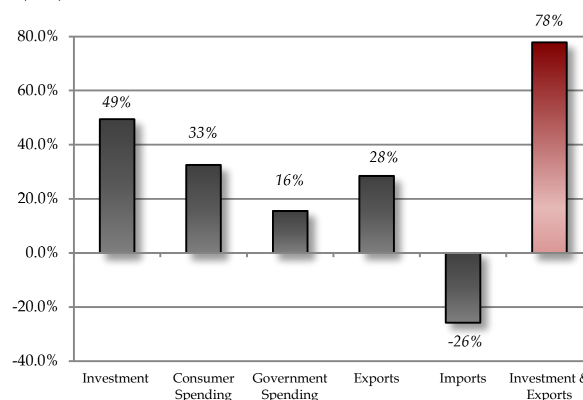
In any economy, and irrespective of differences in political or economic organization, growth can be calculated by summing the change in three basic components:

1) Consumption (both private and government);
2) Investment (infrastructure, real estate, inventories);
3) Net exports (of goods and services)

It's these components that a local official in Danyang was referring to when at dinner one evening he suggested that "China has three horses of economic growth. And today the carriage is out of whack," a concession no doubt facilitated by copious amounts of moutai, China's gasoline-like liquor that serves as both a measure of status and truth serum. Of course the whackiness he was referring to is the obvious lopsided nature of China's growth: nearly 80% comes from exports and investment. When viewed from this perspective, it leads one to wonder which is more surprising: that China is slowing, or that anyone at all is surprised by it?



So making a judgment about China's ability to maintain a high rate of growth is really a judgment about its ability to export (its biggest customer is Europe, where exports are

[5] From the mid-1990s to 2001, the USD appreciated on a trade-weighted basis so the RMB also appreciated in effective terms. During this time, China's current account surplus was modest at around 2% of GDP. By 2007, as the USD fell, it ultimately reached 10.7%

down 10% over the past year) and the desire and wherewithal for another investment-led stimulus (both low, in our opinion).

But this narrow view fails to address one of the more puzzling aspects of China's economy: why consumption, as a contributor to the overall economy, is so consistently weak. The answer may be different from what you think.

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If you wanted to draw the evolution of consumption in China over the past 20 years, you would first envision a mountain peak, and then began sketching a long, gradually declining line to the right. The slope of the declining line would intensify noticeably towards the end, the period representing 2002 to 2008, where consumption increased annually by 13.2%, but underperformed the 17.3% nominal growth for the overall economy.[6] Once completed, your artistic rendition would represent consumption's share of China's economy, capturing its decline from nearly 60% of GDP in 1990 to 35% today, a level more than twenty percentage points below normal.

But to understand why consumption has underperformed, consider this: in 1992, disposable income in China, the foundation for spending, amounted to 67% of GDP. But by 2008, it had fallen to 58%. So perversely, as China became more entrenched into the global economy, more of the country's earnings accrued to the corporate and government sectors than to the households the economy is organized to serve. And although an increased level of saving in the household sector—the typical explanatory scapegoat of China's thrift—contributed to some of the relative decline of consumption, it was far less than generally believed. Nicholas Lardy, the author of *Sustaining China's Economic Growth after the Financial Crisis*, an essential read for anyone desiring more detail on the quirkiness of China's development, believes the rise in savings only accounts for about 25% of the relative decline in consumption. By contrast, Lardy shows that weak relative consumption "is primarily due to falling household disposable income."

This brings us to China's central paradox: with investment representing nearly 50% of GDP, China's economy is dangerously imbalanced. To enjoy sustainable growth it needs to shift dramatically towards more consumption. Yet many of the policies in place today, most notably the closed capital account and low real interest rates paid on deposits, benefit the political elite and state-owned enterprises at the expense of households, depriving them of the very income needed to consume. In essence, they are biting the hands ultimately needed to feed them.

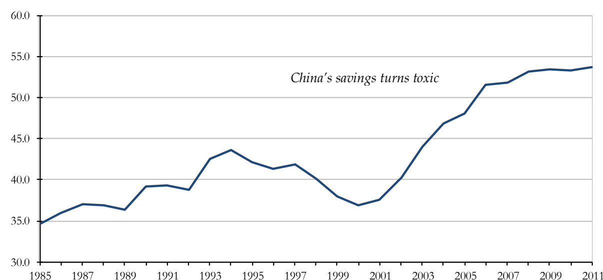
Consumption is low because disposable incomes are relatively low, and incomes are low for structural reasons, the intended and unintended consequences of previous policy decisions. But there is no magic switch, no button to push to swiftly recalibrate China's structure of production. Addressing these structural issues requires structural reform, reform that addresses the way income is distributed throughout China's economy. This is a contentious issue, however. One that is assumed to be zero-sum in the eyes of those in politically-connected sectors: for the households to win, they must lose. But even when assuming this political obstacle can be overcome, a meaningful rebalancing will take time, requiring a decade or more before consumption in China reaches 50% of GDP, still a comparatively low level for a country of China's size and global importance. In the interim, the inevitable slowdown in the rate of investment will have knock-on effects to incomes, many of which are dependent on manufacturing and construction. It's implausible therefore to believe that consumption can rise fast enough to offset the declining contributions of exports and investment. [7]

So China has a problem. Growth is falling, leading to a cacophony of calls for action over the past several months. But these pleas for additional stimulus, for more investment spending, seem to overlook a few critical points.

For one, policymakers in China have no desire to exacerbate today's imbalances or recreate the excesses of 2009. They have made this abundantly clear, both publicly and privately. But it's also important to recognize that a significant investment-led stimulus could push China's investment ratio, now close to 50%, above the savings of the country, currently around 52%. Meaning that despite saving over half of its national income each year—a reflection of stunning internal imbalances rather than prudence—China would be required to import capital from foreigners to fund unproductive investment projects. This would represent a remarkable circumstance in the history of economic affairs.

[6] Lardy, Nicholas, *Sustaining China's Economic Growth after the Financial Crisis*

[7] In an article for Institutional Investor's Alpha in July 2011 we suggested growth would slow: http://www.institutionalinvestorsalpha.com/Article/2859807/Search/Domestic-disturbance-Chinas-boom-is-more-investment-than.html?Keywords=bienville+capital



In years past the need to import capital may have been less of an issue. For over a decade China has been the beneficiary of sustained net capital inflows originating from three sources: China's perennial trade surplus, foreign direct investment, and speculative capital hoping to profit from what was believed to be the uninterrupted appreciation of the RMB. These persistent inflows resulted in abundant deposit growth that served a crucial role in China's ability to maintain high rates of growth: they kept the banking system, long suspected to be insolvent, sufficiently liquid. Bad loans could be rolled over and new ones for growth were easily funded. In a sense, the entire economic structure is dependent on liquidity in the banking system, and indirectly, the closed capital account, which has historically kept it there.

But high inflation over the last few years has pushed up wages and resulted in a rising "real" exchange rate, eroding China's external accounts. Its current account surplus has fallen sharply from over 10% in 2007 to less than 3% today. Rising unit labor costs have also crushed returns on capital, making China less attractive as a destination for foreign direct investment. And the speculative inflows have begun to reverse, with current estimates of outflows ranging from 3 to 5% of GDP. These outflows have turned China's capital account negative and resulted in its first balance of payments deficit since 1998. This was evidently such a shock to the financial media the numbers were initially reported incorrectly—they were listed with a plus rather than a minus sign. "This is the biggest thing in macro in 2012," according to an unnamed macro hedge fund manager, "and yet no one is talking about it." But the importance has not eluded everyone. CLSA's Russell Napier believes that with a more porous capital account and now a BOP deficit, "China's policy options are more constrained than they have been at any stage since 1993."[8]

[8] China's capital account deficit was $71.4bn in Q2

China's banking system is also undergoing another fundamental transformation, one that is contributing to the present illiquidity and therefore hamstringing banks and policymakers alike. Chinese households, desperate in their search for positive real returns on their savings, have mobilized their deposits deep into China's so-called shadow banking system, specifically to the lightly regulated wealth management products, or WMPs, that are being offered by an increasing number of banks. But despite offering higher yields, these products don't appear to be linked to specific assets. Recent comments from Xiao Gang, the chairman of the board of the Bank of China, in the China Daily are worthy of reprinting:

> *China's shadow banking system is contributing to growing illiquidity risk in the financial markets. Most WMPs carry tenures of less than a year, with many being as short as weeks or even days. Thus in some cases short-term financing has been invested in long-term projects, and in such situations there is a possibility of a liquidity crisis being triggered if the markets were to be abruptly squeezed.*
>
> *In fact, when faced with a liquidity problem, a simple way to avoid the problem could be through using new issuance of WMPs to repay maturing products.*
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> *To some extent, this is fundamentally a Ponzi scheme. Under certain conditions, the music may stop when investors lose confidence and reduce their borrowing or withdraw from WMPs.*

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When you build a bridge, a Hallstatt or an Ordos, money is spent, people are employed and resources are consumed. Statistically, it contributes to the reported GDP of the country. But a more qualitative assessment is needed to determine whether it contributes to the collective wealth of a nation.

For every country, there is an appropriate level of capital stock—the investment in roads, rail and manufacturing capacity that provides the backbone of an economy. But what seems to have been overlooked in most discussions on China is the sole purpose of investment is ultimately consumption. This harsh reality has not been lost on Diana Choyleva of Lombard Street Research, who explains that "we produce to consume more and we invest in order to produce more. Investing more to produce more when there is no increased propensity to consume or availability to export more is a dead end."

In a market economy, the level of investment is derived from future expectations. If producers envision increasing demand, they will invest the necessary resources to meet it. But in China, investment is policy driven. It's diktat. Investing is a means to an end—GDP growth. But ultimately, producers need markets. They need end buyers for the additional output that investment allows. Otherwise the investment will prove unprofitable, scaring off the capital needed to finance it.

As a number of emerging economies have discovered, the investment-led model is addictive. Early in the process the country benefits from the increased spending on infrastructure. It provides employment, lifts millions out of poverty and results in impressive top-line growth. Foreign capital flows in. The exchange rate is kept artificially low, causing credit and the money supply to expand, which sends asset prices into orbit. These reflexive dynamics give the appearance of a virtuous cycle—the illusion of perpetual growth. But growth dependent on unproductive investment requires ever increasing amounts of investment. I assume this is what Jim Chanos, the thoughtful short-seller and founder of Kynikos, was referring to when he suggested to Charlie Rose that "China is on the treadmill to hell." Ultimately you pay a penance for the model's inherent flaws.

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Over the past decade or so there has been a subtle yet notable evolution in the way the intelligence community analyzes geopolitical threats. Rather than treating all risks as puzzles—situations where answers exist—analysts have begun incorporating the notion of mysteries into their assessments. To understand the distinction, consider the following excerpt from *Risks and Riddles*, an article posted on Smithsonian.com by Gregory Treverton. [9]

> *During the cold war, much of the job of U.S. intelligence was puzzle-solving—seeking answers to questions that had answers, even if we didn't know them. How many missiles did the Soviet Union have? Where were they located? How far could they travel? How accurate were they? It made sense to approach the military strength of the Soviet Union as a puzzle—the sum of its units and weapons, and their quality.*
>
> *But the collapse of the Soviet Union and the rise of terrorism changed all that. Those events upended U.S. intelligence, to the point that its major challenge now is to frame mysteries.*

According to Treverton, the former vice chairman of the National Intelligence Council, to analysts in the Pentagon, terrorism represents a mystery. With puzzles, incremental information is additive. Ask a question, find the answer. New intelligence typically represents progress in the goal of understanding. But with mysteries, additional information can be meaningless. Without a broader understanding of the issue, it may be just noise.

Terrorism represents a mystery because, as Treverton describes, "terrorists shape themselves to our vulnerabilities, to the seams in our defenses." The threat they pose actually depends on us. For example, the 9/11 hijackers did not choose commercial airlines for their method of attack because they were aviation specialists. They did so because they recognized gaps in our aviation defenses. So in contrast to puzzles, mysteries "pose a question that has no definitive answer because the answer is contingent; it depends on a future interaction of many factors, known and unknown."

Like all social and economic systems, which are complex in nature and exhibit characteristics of interconnectedness, China represents a mystery. Its future course cannot be predicted because the outcome is contingent on a number of foreseeable and unforeseeable factors and policies, both domestic and global. So the goal should not be to solve to a precise answer, but rather to form a qualitative understanding of the issues in order to sufficiently imagine the risks. The intent should be to frame the uncertainty, which hopefully enhances versatility.

We believe China has reached an inflection point. Because it has exhausted its ability to grow at high levels through exports and investment, its structural growth rate is falling, and likely by half. Such an outcome would be perfectly consistent with other Asian countries, such as Japan and Korea, who initially pursued similar development models but found rebalancing somewhat elusive. For China, it will be more easily attained at growth rates of 4%, than 8%.

A remarkable degree of confidence has been placed in the ability of China's policymakers to precisely command an evolving economy. We worry this confidence may be misplaced. Although China has seen truly commendable development, lifting millions out of poverty, we view the country's recent growth through two lenses: the first whereby an undervalued currency and inexpensive labor supercharged exports, and the second where nearly 5 out of 10 units of growth has been engineered by the outright

[9] http://www.smithsonianmag.com/people-places/presence_puzzle.html

fiscalization of the banking system—that is, by printing money. So what we've witnessed over the past 30 years is an era where essentially free labor was subsequently met by essentially free capital. China has yet to demonstrate that it can grow in a sustainable fashion.

Regardless of what China's growth ultimately proves to be, the composition of it is likely to be meaningfully different—that is, far less oriented to fixed asset investment. And less fixed asset investment implies less demand for a number of industrial commodities, some of which is now reflected in prices. This of course has implications across the global economy, as well as investor portfolios, whose emerging market and commodity exposure has been mostly contrived on the extrapolation of previous trends.

China is not Epcot, as even Chris will attest. But neither is it a miracle. It will experience hiccups. It will hit bumps along the road to increasing levels of prosperity, which is perfectly natural for any developing country.

More important, a number of benefits could accompany more balanced growth in China. For one, less demand for industrial commodities will reduce the implicit tax on the developed world, easing their ongoing deleveraging. And second, it will assist in the needed rebalancing of the global economy. China, in conjunction with Japan and Germany, represent the world's 2nd, 3rd and 4th largest economies. They cannot collectively maintain large, persistent trade surpluses. Doing so would require other countries, such as the U.S. and Europe, to continue running large and persistent trade deficits. Keep in mind that a current account surplus represents a deficiency of domestic demand. By adding more to the supply of goods than demand for them, a surplus country places a burden on the remainder of the world. It was this toxic and unsustainable dynamic that led the world to the abyss in 2008. By contrast, more balanced growth in China, whereby the consumer becomes a more significant factor in the global economy, will provide needed demand in a world deficient of it.[10]

"Each is a piece of the continent, a part of the main," wrote John Donne in *No Man Is An Island*, his famous poem reminding us that nothing truly occurs in isolation. The interconnectedness of the global economy ensures that we are all linked in some way to China's development, its policies and its successes and failures. China is a mystery whose future is not predictable, but one that we all have a vested interest in framing and hopefully understanding.

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[10] Nicholas Lardy believes that if consumption in China had simply kept pace with overall nominal GDP it would be 25% higher today

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