Chinese Banks are Imitating Washington Mutual
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Dear Fellow Investors:

Once upon a time there was a bank based in Seattle, Washington called Washington Mutual. The bank grew by acquisitions in the 1990's and enjoyed the prosperity of the United States of America. It raised its common stock dividend every year from 1989 to 2006 and on April 18th of 2006 reported their 1st quarter 2006 earnings. Profits grew 15% in the first quarter of 2006 as compared to the prior quarter ended December 31st of 2005. Here is how Washington Mutual's Chairman and CEO, Kerry Killinger, described the results:

"We are very pleased with our first quarter results," said Kerry Killinger, Washington Mutual chairman and chief executive officer. "The company's strong performance demonstrates the benefits of our continued diversification and enhanced operational focus. This past quarter we had particularly strong results in Retail Banking and Card Services."

"These businesses added customers at a record pace and delivered significant revenue and earnings even in this difficult interest rate environment," Killinger added.

Today there is a bank called China Construction Bank. It is the third-biggest commercial lender in China. On August the 22nd of 2011, China Construction Bank reported that its first half profits rose 31% to $14.5 billion, buoyed by higher income from fees and interest. Here is how the web site mystockmarketnews.com described the bank's results:

"Like other Chinese lenders, the bank has benefited from rising interest rates and higher fees and commissions as it diversifies its revenue sources.

Interest income in the first half of the year rose 24 percent, while income from fees and commissions jumped 42 percent to 47.7 billion yuan ($7.5 billion)."

Unfortunately, Washington Mutual is no longer in existence. The reason they no longer exist was actually shown in the 1st quarter report in 2006. Despite reporting an operating profit of $985 million dollars in the quarter, Washington Mutual and its executives were preparing it to run headlong into the realities of the conflict between the income statement of a bank and its balance sheet. The bank was lending a massive amount of money to people who were buying homes with no money down under the premise that home prices would never drop nationwide. Many of those loans were made to people whose incomes were never verified and logically would never have the income to afford what they bought.

On page two of their earnings report, Washington Mutual reported tangible equity as 5.85% of tangible assets and non-performing assets as .59% of total assets. The provision for loan and lease losses was $82 million and net charge offs were $105 million. Remember, this was in the first quarter of 2006. Residential real estate prices in the most popular markets in America like Southern California, Arizona, Nevada and Miami were already starting to crater. Washington Mutual was a major player in those markets on the West Coast of the US. Washington Mutual had $26.156 billion of shareholders equity at the end of March in 2006, total loans of $240 billion. The percentage of these loans which would default wiped out the bank and put them into the hands of JP Morgan with FDIC assistance.

China Construction Bank was one of the main institutions that the government of China has used between late 2008 and early 2011 to stimulate the Chinese economy through lending to special purpose vehicles for building condos, office buildings and infrastructure. The purpose behind the speculative development loans was to avoid the economic contraction happening around the world which Chinese policy makers correctly foresaw in 2008. The average citizen in China can't afford to buy the condo residences which are being built by these quick buck speculators. China Construction Bank's activities are described in the mystockmarketnews.com article this way:

"The bank said it was strictly controlling lending to industries designated by the government as having excess capacity, such as iron and steel, coal and plate glass. Meanwhile, it boosted lending to small and medium-size companies.

Smaller businesses have usually struggled to get bank financing. Such lending increased 9.5 percent by the end of June over December of last year, compared with a 6.8 percent increase in total corporate lending.

Construction Bank, which is relatively heavily exposed to the property sector, also said it was limiting lending to local government investment entities, whose debts have ballooned in the wake of a binge of recession-fighting construction investments."

It is estimated by Fitch and other reliable sources that more than $2.7 trillion in loans were made to real estate developers at the municipal level on spec developments. We have seen estimates of loan losses ranging from 30% to 70% and reports show that interest payments of as much as $140 billion are due this year alone. The Chinese government has already allocated $464 billion to their version of a TARP program to deal with the capital which these loans are beginning to destroy. Here is how Bloomberg explains these circumstances recently:

"Chinese lenders expanded credit at a record pace in 2009 and 2010, making more than 17.5 trillion yuan ($2.7 trillion) of new loans as the government moved to offset a collapse in exports during the global recession. The surge in loans exceeded credit expansions in the U.S. before its financial crisis, in Japan before its stock and property bubbles collapsed in 1990 and in South Korea before the Asian financial crisis of the late 1990s, according to Fitch."

If China Construction Bank has its fair share of these massive loans and the default rate runs 30%, $300-500 billion in bad loan write-offs wouldn't look very impressive in comparison to a $14.5 billion dollar profit on the income statement. The grave difficulties which are hiding in the capital structure of this bank are showing up the same way they did with Washington Mutual in 2006. The stock market kept giving Washington

Mutual a lower and lower price-to-earnings ratio and the stock lagged performance benchmarks in 2006. Here is how Bloomberg describes what is going on recently with the Chinese Bank stocks:

"Investors are cutting their estimates for the value of Chinese bank assets. The MSCI China Financials Index's price-to- book ratio, a measure of share prices relative to net assets, tumbled to 1.8 on July 29, the lowest level since February 2009, from 2.8 two years ago, according to monthly data compiled by Bloomberg. The ratio for Chinese lenders slipped below that of the MSCI Emerging Markets Index on June 21 for the first time since January 2006, data compiled by Bloomberg show.

Industrial & Commercial Bank of China (601398) Ltd., the world's largest lender by market value, slumped 8.2 percent from the end of March through July 29 even after saying bad loans dropped almost 4 percent in the first quarter. The stock gained 1 percent today.

Credit-default swaps on Bank of China Ltd. (3988), the nation's third-largest lender by assets, jumped to 153 basis points from 106 on March 31, according to data compiled by Bloomberg and CMA, which is owned by CME Group Inc. and compiles prices quoted by dealers in privately negotiated markets."

The bottom line is that Washington Mutual is only in existence in the world of litigation. For those of you out there who like to avoid these kinds of risks, we at Smead Capital Management recommend you avoid China, avoid the commodities which are used most heavily in construction, avoid the makers of construction and mining equipment, avoid the countries which have benefitted the most from China's uninterrupted growth, and avoid the vehicles used for financing all of this growth. Economist Gary Shilling said it this way:

"*'China isn't this juggernaut that's going to grow forever without any interruption,' Shilling said in a July 14 interview with Bloomberg Television's Betty Liu, adding that the government may be forced to bail out banks as bad debts grow.*"

With the capital they use to recapitalize banks like China Construction Bank, we believe China won't be able to continue their non-economic building spree. The inevitable economic recession/depression in China which we expect to follow will turn the asset allocation world upside down, in our opinion. Buyers beware!

Best Wishes,

William Smead

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