# Down and Out in Wenzhou

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Dear Fellow Investors:

In early 2006, I wrote a piece called "Down and Out in Bloomfield Hills". Our argument back then was that the economy of the rest of the US could look and act the way the economy of Bloomfield Hills, Michigan was acting even before the nationwide residential real estate market had fallen apart. The auto industry's decline had caused wealthier residents to practice austerity and frugality, which looked very similar to the behavior of the generations most affected by the 1930's depression. In effect, Bloomfield Hills was foreshadowing what would happen in the rest of the US. Here is how Jeffrey Laslow of the Wall Street Journal wrote it in 2006:

*Foreclosures are up and charitable giving is down. A local country club has a waiting list—for members who want to quit. The market for expensive homes is so slow that Michael Robbins, a divorce attorney here, says one of his clients is still living with his ex--three months after their divorce was final.*

*With the Michigan economy battered by the ailing auto industry, the ripples are being felt across the state—even here in one of the nation's wealthiest communities. At a time when there's a growing gap between the rich and the poor, Bloomfield Hills offers a clear reminder that the wealthy often can't escape from the severe problems of a local economy. And that, in turn, is putting pressure on a wider swath of less-wealthy residents who depend on the rich for business.*

Our theory proved to be true. The problems selling homes and the urge to reduce debt and live inside our means swept across the US during the "Great Recession" of 2007-2009. Bloomfield Hills was prophetic and told us a great deal about how to get ahead of the curve.

What triggered our walk down this painful memory lane was an article by Bloomberg News writer, Jun Luo, at Bloomberg's website on June 12th, 2012 titled, "Angry Bagmaker Shows China Slowdown Worst in Wenzhou". In the article, Mr. Luo describes the struggles of an export-based economy of 9 million people which appears to have hit the wall. He does it through the eyes of business owners, a cab driver and Chen Xijun, a director of the city's Chamber of Commerce:

*Jiang Xiangsong has 18 days to pay a 2 million yuan ($314,000) bank debt or his suitcase company in eastern China will go bankrupt. He's close to tears as he realizes his last hope, a government-backed office, won't help.*

*"This is totally useless: If I had any collateral, why the hell would I come here?" he yells at an official in Wenzhou's state-run loan service, set up to help small businesses after rising bankruptcies and suicides prompted Premier Wen Jiabao to visit in October and pledge support.*

*Wenzhou's more than 400,000 businesses make everything from shoes in dusty side streets to synthetic leather in dilapidated factories, much of it financed by unregulated lenders that spread during China's record 2009-10 credit boom. The decline of so-called shadow banking in the city, triggered by Wen's move to rein in a national property bubble, has left Wenzhou bearing the brunt of the country's economic slowdown.*

*China's plans for a more targeted stimulus than the 4 trillion yuan package unveiled in 2008 ($586 billion at the time) mean Wenzhou may see little reprieve. Wen's administration in March picked the city, five hours by train south of Shanghai, for a trial program designed to boost capital for private companies, an effort that's failed to quell locals' gloom.*

*"In previous years, it was difficult," Chen Xijun, a director at the city's Chamber of Commerce, said in a June 6 interview in the city. "This year it's completely dark. We have no sense of direction where the economy is heading."*

Much like in the US in 2006, the Chinese government officials and the worldwide media need to believe that what is going on in Wenzhou is not the first domino in a series of dominos which fall over the next two years. The Chinese economy and its "miracle" of the last 30 years were originally driven by the competitive advantage of cheap labor. The cheap labor advantage China had over other worldwide manufacturing countries became connected with over one billion intelligent and hard-working people. These people wanted a better life for themselves and either found it in their own business or working for someone who owned one. Millions of them moved from other, more rural areas of China to some of the more than 50 multi-million person mega-cities like Wenzhou.

To keep up with all the growth, a great deal of infrastructure was built and China became a major producer of coal and steel. The ability to own your own home started about 25 years ago and the booming economy consistently outperformed the expectations of even the most optimistic fans of China. This led to blistering appreciation in home prices. Most studies indicate that it takes about 12 times the average household income to buy the average home in China versus the peak of 8 times at the end of Japan's real estate bubble in 1990 and 6 times income at the height of the American version of "Flip this House" in 2005. Bloomberg News reported June 18, 2012 the current situation on the ground in China:

*China's home values fell in a record 54 of 70 cities tracked by the government in May as developers cut prices to boost sales amid housing curbs.*

*The eastern city of Wenzhou led declines with a 14 percent slump in values from a year earlier, while Beijing and Shanghai recorded losses of as much as 1.6 percent, according to data released by the statistics bureau today.*

Wenzhou is a city of entrepreneurial small to medium-size businesses which rely on the export market. Its financing came from the extensive "shadow banking system". When the central government tightened credit in 2011 and came down hard on the shadow banking system, Wenzhou got hit the hardest. Here's how Luo explains:

*As small businesses sought finance to expand, the city of 9 million became one of the nation's biggest centers for shadow banks, unregulated lenders that demanded 21.6 percent on loans in April, compared with 7.6 percent from commercial banks, according to central bank figures.*

*Wenzhou had the worst non-performing loan ratio among the 21 cities tracked by Shenzhen Development Bank Co. (000001) last quarter. About 60 business owners fled the city in the first two months of the year to avoid paying their debts, China Business News reported. The exodus has continued, said Zhou.*

Zhou is Zhou Dewen, head of the Wenzhou Small and Medium-size Enterprise Association. He describes what is going on the ground in the "shadow banking system":

*"Wenzhou's private lending system was built on trust, and now that trust is gone," said Zhou. He estimates there is about 1 trillion yuan of idle private capital in the city because "nobody is willing to lend to others."*

Shops are offering 40 percent discounts, cab drivers sit idle and laborers are headed to other cities to find work in other metropolises. It is estimated that the shadow banking system made $600 billion worth of loans each year in 2009-10 in a $6 trillion Chinese economy. More importantly, it fed capital to the most entrepreneurial businesses and provided attractive interest rates to those in search of capital in a country where stocks have done very poorly since their peak in 2008 and deposit rates at banks have been below the rate of inflation indefinitely.

At Smead Capital Management (SCM), we believe the next Chinese population areas to get hit hard are the coal mining and steel manufacturing cities. On October 19th of 2010, David Barboza of the New York Times wrote about the city of Ordos and the Ghost City of Kangbashi, which was built next to it for about one billion dollars. Back then, Ordos was booming. Here is how Mr. Barboza described things back then:


*Source: The New York Times*

*By many measures, this resource-rich city in northern China is a fabulous success.*

*It has huge reserves of coal and natural gas, a fast-growing economy and a property market so sizzling hot that virtually every house put up for sale here is immediately snapped up.*

*There is just one thing largely missing in the city's extravagant new central district: people.*

*Ordos proper has 1.5 million residents. But the tomorrow land version of Ordos — built from scratch on a huge plot of empty land 15 miles south of the old city — is all but deserted.*

*Broad boulevards are unimpeded by traffic in the new district, called Kangbashi New Area. Office buildings stand vacant. Pedestrians are in short supply. And weeds are beginning to sprout up in luxury villa developments that are devoid of residents.*

*"It's pretty lonely here," says a woman named Li Li, the marketing manager of an elegant restaurant in Kangbashi's mostly vacant Lido Hotel. "Most of the people who come to our restaurant are government officials and their guests. There aren't any common residents around here."*

What we know now that we didn't know in October of 2010 is that the price of coal and the price of natural gas would have plummeted to their currently depressed price. Therefore, the economic base of Ordos proper is significantly undercut and it is very likely that cities like it, which had a virtuous circle of prosperity, are hitting the wall. Think of it like this. Phoenix was booming as retirees flocked to the nice weather. Homes rose in value and the economy boomed. As the economy boomed, locals bought houses. As houses soared in value, investors got rabid. Ultimately, prices and nefarious loans brought the last buyers at the top in 2005-06. The real estate boomed because the economy boomed and the economy boomed because the real estate boomed. We at SCM call this a virtuous circle.

China's economy boomed and China real estate boomed. The government force fed stimulus into its economy in 2008-2011 to avoid the kind of recession that the US went through from 2007-09. The stimulus was heavy on infrastructure or "fixed asset investments". These real estate developments use massive amounts of heavy industrial equipment, capital and enormous amounts of commodity inputs. As the input prices for coal and steel rose, those areas where they are produced boomed just like Phoenix had in 2005.

We see Wenzhou and export-oriented cities like it entering a deep economic slump. Ordos and heavy industrial/mining centers like it can't be too far behind. BBC News visited Ordos for a follow up report on March 17th, 2012. Here is how they described what they found:

**Ordos: The biggest ghost town in China**
**By Peter Day** Ordos, Inner Mongolia, China

***In Inner Mongolia a new city stands largely empty. This city, Ordos, suggests that the great Chinese building boom, which did so much to fuel the country's astonishing economic growth, is over. Is a bubble about to burst?***

*A huge statue of the mighty warrior Genghis Khan presides over Genghis Khan Plaza in Ordos New Town. The square is vast, fading into the snowy mist on a recent Sunday morning.*

*Genghis Khan Plaza is flanked by huge and imposing buildings.*

*Two giant horses from the steppes rise on their hind legs in the centre of the Plaza, statues which dwarf the great Khan himself.*

*Only one element is missing from this vast ensemble - people.*

*There are only two or three of us in this immense townscape. Because this is Ordos, a place that has been called the largest ghost town in China. Most of the new town buildings are empty or unfinished. The rampant apartment blocks are full of unsold flats. If you want to find a place where China's huge housing bubble has already burst, then Ordos is the place to come.*

In our opinion, when manufacturing slows to a crawl and natural resource mining and heavy industrial activity hit the wall, get ready for at least a deep recession, if not a depression. The bear market in commodities could be just getting started and those who have "suckled on China's bounteous teat" could be ready for their own economic decline. The Chinese economy runs the risk of being "Down and Out" like Wenzhou.

Best Wishes,

**William Smead**

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