Train Wreck Waiting to Happen

August 2, 2011

William Smead
Chief Executive Officer
Chief Investment Officer

Dear Fellow Investors:

A Wall Street Journal Op/Ed piece on July 9th explained why China was the developed country and the US was the emerging market. One of the examples was the high-speed rail system which has been put in place in China. The Op/Ed described how wonderful the rail system is and how much of a contrast it produces with the infrastructural neglect which has been allowed in the US. Within two weeks of this Op/Ed, the rail system was exposed for what it is, and in our opinion, what China has become. It is a metaphor for the economy of the country of China which is headed for its own economic train wreck.

To understand the Chinese economy you have to pay close attention to the unfolding drama between three powerful government entities which is playing out at this moment. The first entity is the Totalitarian Communist Central Government. It chose to avoid the deep recession in 2008-09 by artificially stimulating their economy by mandating that their four large government-owned banks lend $2 trillion to special purpose vehicles for real estate development. The leaders of the party believed that it was politically untenable to go through an economic contraction in 2009, because the vast majority of Chinese citizens are not prospering and participating in the uninterrupted GDP growth in China.

This stimulus was executed by the second entity, local communist party officials at the municipal level, who by law can't borrow money. Hand-picked friends of communist party and military officials were allowed to form special purpose vehicles. These vehicles put developers in the position to make the local officials quite wealthy and prestigious. The instantaneous wealth creation of developing raw land and the over-capitalization of this land prepares these municipalities for massive wealth destruction.

The irony of the moment is that inflation, caused by the stimulus and its easy money, has resulted in a massive rise in commodity prices. This inflation hits the more than one billion people in China who have not been made wealthy by "communist capitalism". At incomes of less than $3500 per year on average, these folks can't afford a home and now see pork prices rising 16% year to year along with the price of other major staples in the normal citizen's budget. The Central government is now tightening credit and attempting to "gently" slow China's economic growth to alleviate this inflation.

The third entity was introduced by Bloomberg's writer, Chitra Somayaji, in an article titled, "China Regulator Said to Tell Banks Provisions for Bad Loans Are Inadequate". The China Banking Regulatory Commission is beginning to pester the four large banks in China to increase loan-loss reserves based on the stimulus of 2009 and 2010.

"China's banking regulator told lenders they haven't set aside sufficient funds to cover losses on loans to local governments and ordered them to accelerate debt collection, a person with knowledge of the matter said.

The lenders were told this month that they are lagging behind the China Banking Regulatory Commission's schedule for revising the loan agreements on infrastructure projects, the person said, declining to be named because the information is confidential. The agency had asked banks to collect two repayments a year after construction is completed.

The comments reflect persistent concerns that $1.7 trillion of lending to local governments may spur a wave of bad debts that could lead to the nation's third banking bailout in less than two decades. As much of 30 percent of the credit may sour, Standard & Poor's estimates, after a surge in lending that powered China's recovery from the global financial crisis."

While Standard & Poor's estimates 30% of these loans may sour, Yin Zhongqing, a Chinese Communist Party official, predicted in early January of this year that 70% will go bad. If these condo, commercial and infrastructure projects are being built to make it look like the Chinese economy is succeeding and not based on demand, why should any of these projects payoff? How did the condo projects and housing developments in Miami, Phoenix and Las Vegas do which were built in 2005 through 2007? The humor in watching the Chinese Banking Regulatory Commission scold the 80% government-owned banks for being slow to recognize bad loans is almost too much for us at Smead Capital Management. This is one Communist-controlled entity criticizing another Communist-controlled entity for doing exactly what the Central Communist government wanted them to do. It looks like Abbott and Costello doing the "Who is on first, what is on second" skit. Unfortunately, Abbott and Costello did this in the land of make believe, not in what is supposed to be the second largest economy in the world. Did I fail to mention that most experts see the China economy surpassing the US economy in the next twenty years?

As we have examined what goes on in China through the lenses of writers for all of the major news organizations, there is one thing that keeps popping up. When everything was hunky dory in China there was no need to worry about conflicts between powerful governmental entities. The Central government wanted to show the world that they are truly the greatest nation on earth. They did this by executing a "command" economy under the assumption that a group of 70-year old men, educated in US colleges in economics, could make better decisions for everyone else than those individuals can make for themselves. We believe what they are really showing is that a "managed" economy can massively over-capitalize one of its main segments and poison its economy much faster than the free market. About the only thing missing in China is Congressman Barney Frank explaining his rigid oversight of the developing real estate bubble.

None of this would have been possible if lending rates had not been falling in the developed economies over the last 30 years. Since China has pegged it currency to the US dollar, there was no ability for the Yuan to regulate activity as it overheated. Normally, when an economy booms like China, interest rates rise and the currency appreciates significantly. This automatically cools exports and construction spending. Instead, the easy money policies of the US and the willingness of US investors to participate in everything from emerging markets equity and debt offerings to commodity indexes and gold has kept a flow of capital available at an unusual point in a normal economic cycle. The exclamation point in the last year was funding, by US investors, of a slew of "flim-flam" Chinese Initial Public Offerings (IPOs) and some semi-legitimate ones like DangDang and Youku. It seems like the IPO stupidity is almost always the end of the cycle.

Someday soon, as the charade of uninterrupted GDP growth catches up with the Totalitarian Communist Government, we believe the entire Chinese banking system will have to be recapitalized to the tune of over $1.5 trillion. At that point, there won't be enough money to lend for new projects to even maintain existing GDP levels. The high-speed train called China Economic Dominance will get knocked off the tracks. In our opinion, there will be an economic contraction in China lasting three to four years. Commodity prices will plummet and countries like the US, which have been punished by boom commodity prices during an anemic economic recovery, will flourish. Whether China is to become a truly great economy will be determined by what they do in the aftermath of the coming economic train wreck.

Best Wishes,

William Smead

The information contained in this missive represents SCM's opinions, and should not be construed as personalized or individualized investment advice. Past performance is no guarantee of future results. Some of the securities identified and described in this missive are a sample of issuers being currently recommended for suitable clients as of the date stated in this missive and do not represent all of the securities purchased or recommended for our clients. It should not be assumed that investing in these securities was or will be profitable. A list of all recommendations made by Smead Capital Management with in the past twelve month period is available upon request.

This Missive and others are available at www.smeadblog.com.