The Absolute Return Letter
February 2011

Find the Hat

"If spending an amount equal to half of the world's second largest GDP to buy up foreign currencies is not currency manipulation, then what is?"

Martin Wolf, Financial Times

The perils of Chicago

Many moons ago, long before I joined Goldman Sachs, a London based employee of the firm went to Chicago to attend a seminar on options and futures. This goes back to the 1970s when proper men still wore hats, and our friend was indeed proper, so he showed up in Chicago in full British-style attire, including his beloved woollen hat. Lo and behold, Chicago can be a very windy place and, shortly after arriving in the Windy City, his hat blew off and was completely flattened by a passing car.

Our friend thought it reasonable that Goldman reimbursed him for his loss so, after having acquired a new hat, the cost found its way to the expense report, which he submitted on his return to London. In those days Goldman was quite a small firm, and expenses were controlled with an iron fist by one very senior person in New York, who shall remain unnamed. When he saw the expense report, he went ballistic and immediately demanded for our friend to re-submit his expenses, this time without the hat.

Now, our friend was not giving in that easily. He was truly upset about the loss and only found it fair that Goldman compensated him, so he re-arranged his expenses, with the total adding up to the exact same amount, but the hat had mysteriously disappeared. Then he wrote in big fat letters across the expense report: "Find the Hat!"

For reference only

Fast forward to China anno 2011. I suspect there is not one but many hats hidden in the national accounts of China and, thanks to Wikileaks, we now have a very public figure admitting as much. In a leaked 2007 cable Li Keqiang, who is the favourite to become the next premier, confided that official Chinese GDP figures are "man made" and "for reference only" (surprise, surprise), and that one should rather look at alternative measures such as electricity consumption, rail freight volumes and bank lending, if one wants a true picture of economic growth in China[1].

So let's do precisely that. In chart 1 below I have plotted Chinese GDP growth against the electricity output over the past 15 years, and an interesting pattern emerges. During periods of low economic growth (the Asian crisis in the late 1990s, the US recession in 2001 and the global credit crisis in 2008-09), GDP grows much faster than the electricity output. Conversely, during periods of strong economic growth (2002-07 and 2010), GDP growth is lower than the power output. Clearly the GDP numbers are massaged.

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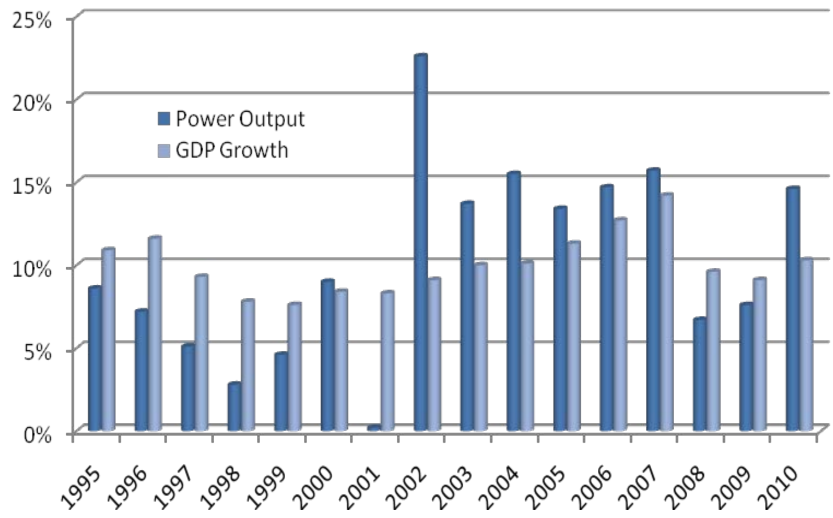
[1] *Source: http://www.wikileaks.no/cable/2007/03/07BEIJING1760.html*

Chart 1: Chinese GDP vs. Electricity Consumption



Source: Simon Hunt Services

Digging one level deeper reveals something rather more serious. Assuming the electricity stats tell the true story, and that the GDP numbers are 'for reference only' (remember, not my words!), China's economy experienced a dramatic slowdown as 2010 progressed (see table 1). Total power consumption (year on year) grew by a whopping 22.7% in Q1 last year but only by 5.5% in Q4. The slowdown in Q4 was in fact so dramatic that the power output dropped 6.3% quarter on quarter! There were some restrictions in place on the use of electricity in Q3 and Q4 which did have some impact, but those restrictions were dropped in November, so it cannot be the only explanation. This story is largely ignored by the sell-side banks, most of whom have no interest in offending their new pay masters.

Table 1: 2010 Chinese GDP vs. Power Output

	GDP	Power Output
1Q10	11.9%	22.7%
2Q10	10.3%	18.0%
3Q10	9.6%	11.0%
4Q10	9.8%	5.5%

Source: Simon Hunt Services

Inflation is taking off

Turning to inflation, a similar picture emerges. According to the official stats, Chinese consumer price inflation moderated to 4.6% in December, down from 5.1% in November. However, anecdotal evidence suggests a much more serious problem, in particular in the largest cities, where actual inflation is running close to 20% according to my sources.

As I prepared for this letter I received an email from China specialist Simon Hunt, who notified me of the fact that the National Bureau of Statistics of China has just announced that the weight of food in the consumer price index has been reduced as of 1st January. In an emerging economy such as China, where 35-40% of disposable income is spent on food items, sharply rising food prices are actually likely to lead to food accounting for a *higher* percentage of overall disposable income, so the Chinese reaction defies all logic. There can only be one motive: to cook the books. The CPI numbers appear to be as rigged as the GDP numbers.

I don't really know whether actual inflation is currently running at 8%, 10% or possible even higher. All I know is that it is a much bigger problem than the official numbers suggest. Allow me to pass the baton to Andy Xie who summarises the situation very well[2]:

"China has entered the era of inflation. How high inflation averages over the next five years is mostly determined by the monetary expansion in the past decade. It is too late to try to push inflation back. What is needed is to take actions to safeguard stability during this inflation era.

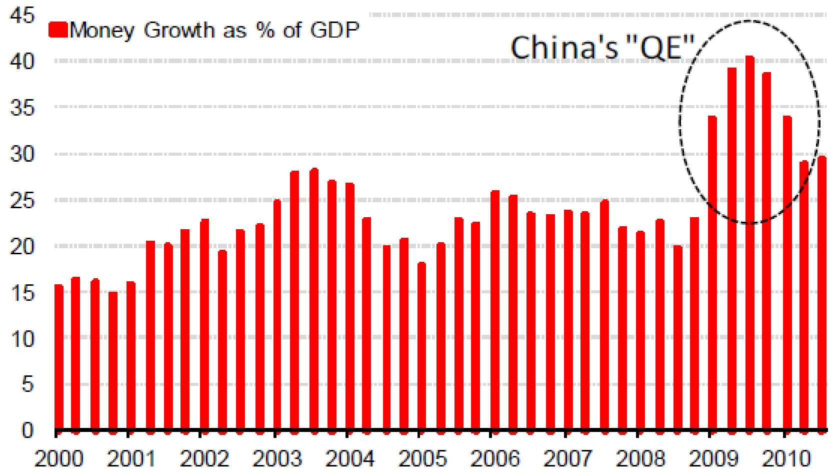
"Around 2004-05 the situation changed. China's labour market became balanced. Pockets of labour shortage emerged, especially in the export sector. The prices of raw materials began to rise rapidly, because the demand in Russia and other former Soviet Block economies began to grow again. The market conditions in labour and natural resources became biased towards inflation, i.e., monetary growth would more likely cause CPI inflation. This is why China had a serious inflation problem in 2007. The government raised interest rate and resorted to price controls to contain inflation.

"The global financial crisis interrupted China's inflationary trend. Many analysts interpreted the situation as proof that inflation was never a lasting problem and China was still deflationary due to overcapacity. Such thinking led to a massive 78% increase of money supply in three years. The financial crisis was a temporary shock that decreased China's inflation by reducing the prices of natural resources. As soon as the global situation stabilized in 2009, the trend of rising prices of natural resources and labour continued. Because China added so much money in an inflationary economy, the current inflation problem is much bigger than in 2007 and will take many years to digest the problem."

The end of cheap labour

Andy's point is central to understanding the challenges facing China's leaders today. China can no longer rely on abundant supplies of cheap commodities and labour. This marks a fundamental change, which is likely to reduce the structural growth rate by several percentage points in the years ahead. As Andy points out, the structural change was lost on many as the financial crisis of 2008-09 took its toll. Consequently, monetary policy became extremely accommodating at a time where underlying inflation pressures were already at dangerous levels (see chart 2).

Chart 2: China's version of quantitative easing



Source: SocGen Cross Asset Research

As a result of the above, the Chinese leadership currently finds itself in a bit of a pickle. On one hand, indications are pretty clear that the

[2] *"Maintaining Stability in the Inflation Era", Business China, 29 November, 2010*

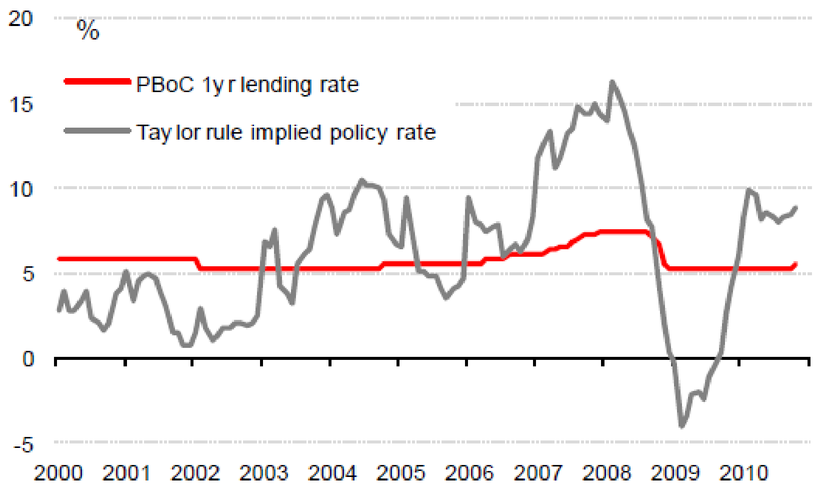
economy is at grave risk of overheating. On the other hand, the transition of power from current President Hu Jintao and Premier Wen Jiabao to the next generation of leaders is fast approaching. Although the National People's Congress, where the new leaders will be officially instated, is not taking place until March 2012, the new power structure will almost certainly become apparent to the outside world at the next party congress, scheduled for October of this year.

Given the importance of this changeover and the significance the Chinese assign to not losing face, the leadership will do *anything* in its power to maintain the economic momentum until after the March 2012 congress. This increases the probability that the Chinese monetary authorities will fall further behind the curve in the months to come and make the landing so much harder when it ultimately happens.

Behind the curve

In a recent research paper[3], SocGen attempted to estimate how much behind the curve the Chinese actually are, using the Taylor rule[4] as a guideline (see chart 3). According to SocGen's calculations, the People's Bank of China should tighten by approximately 200 basis points in order to close the gap. That will almost certainly *not happen* ahead of the congress next year.

Chart 3: China's monetary policy is behind the curve



Source: SocGen Cross Asset Research

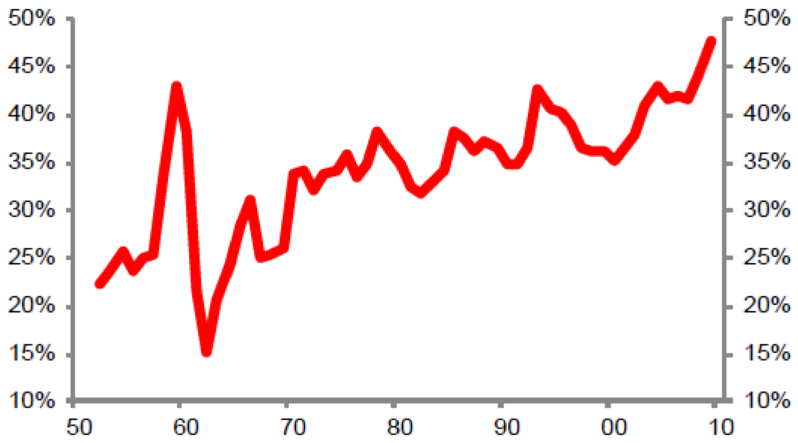
Having said that, signs of overheating are abundant. Housing affordability has reached ridiculous levels with residential properties now trading hands at values that exceed 20 times disposable income in both Beijing and Shanghai. Tokyo peaked at 8 times disposable income at the height of its property boom, and the US peaked at a mere 6.5 times. Meanwhile, according to the credit rating agency Fitch, private credit has now reached 148% of GDP, which compares with 41% for the average emerging market economy.

All this is a function of a monetary policy which has been extremely accommodating for an extended period of time, but it is also a function of years of over-investment. China has in recent years invested to an extent never experienced before anywhere in the world. To have fixed investments account for nearly 50% of GDP is unprecedented (see chart 4).

[3] *"The Dragon which played with fire – Will China overheat?" SocGen Cross Asset Strategy, 20 January, 2011.*

[4] *The Taylor rule is a monetary policy rule that stipulates how much the central bank should change the policy rate in response to divergences of actual inflation rates from target inflation rates and of actual GDP from potential GDP.*

Chart 4: Chinese Gross Capital Formation as % of GDP

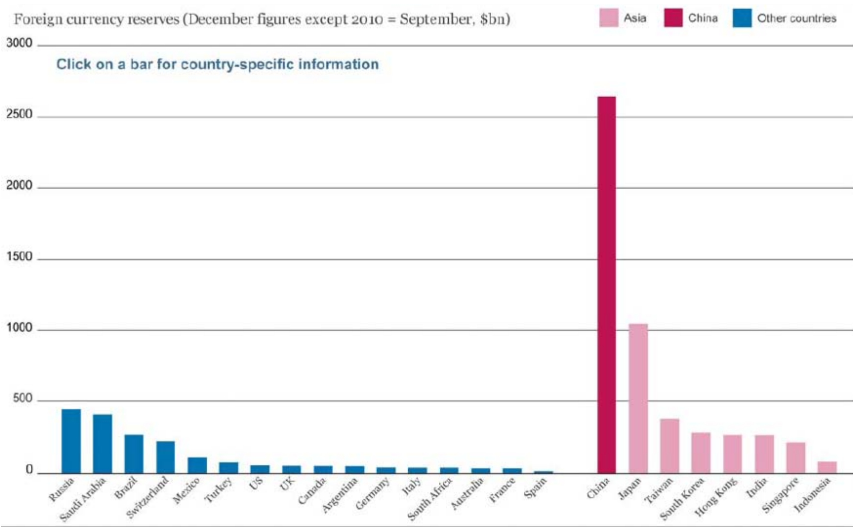


Source: SocGen Cross Asset Research

It goes without saying that when you create too much capacity, the return on invested capital will ultimately prove disappointing. But China is not a capitalist economy where one needs to worry about petty things like that (or so they seem to think). It is driven as much by its desire to dominate on a global scale, as it is by basic economic considerations.

One such example is the dry bulk shipping industry. Dry bulk freight rates tumbled over 40% last year despite a rapidly improving global economy. The collapse in freight rates was the result of global overcapacity caused by China's expansion programme in this market. And it is not the only example. Signs of overcapacity are popping up everywhere. I hear that there are 3.3 billion (!) square metres of floor space available throughout the country, yet more is built every year. The most grotesque example is Ordos, a city in Inner Mongolia built for one million people, yet virtually nobody lives there.

Chart5: Foreign Exchange Reserves (as at Sep. 2010)



Source: Financial Times, IMF.

The consumer pays the price

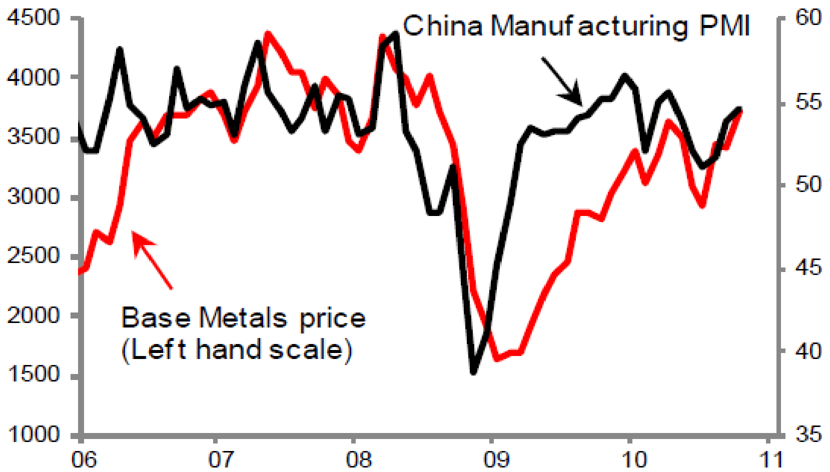
And with investments in fixed assets growing by almost 24% last year vs. 2009, whilst consumer spending grew by 'only' 18%, there is nothing to suggest that China has done anything to reduce its reliance on fixed investments. However, China's one-sided approach with a focus on investments to facilitate export growth at the expense of domestic consumption is a very risky strategy. Over the past decade, China's foreign exchange reserves have grown from about $200 billion to a whopping $2.7 trillion (see chart 5), accounting for over 5% of global

GDP. In the last century, only two other countries have pursued such a strategy to the effect where their reserves reached 5-6% of global GDP – the United States in the 1920s and Japan in the 1980s. Both ended in tears. Lots of tears!

If the Chinese overextend themselves, and the banking industry ultimately goes bust, one needs to bear in mind that it is *always* the consumer who ends up bailing out the banking industry in a banking crisis, either directly (through banks defaulting on their liabilities) or indirectly (through increased taxes). In China, however, with the consumer accounting for such a low percentage of GDP (36% today vs. 45% ten years ago), a banking collapse could create a *very deep* recession, as the consumer is not well positioned to cushion a sinking banking sector.

Now, when the Chinese ultimately bite the bullet and force the economy to slow down meaningfully (and I believe it is a question of when, not if), the biggest victim is likely to be commodity prices, and none more so than base metal prices, which in recent years have been highly correlated to the fortunes of China (see chart 6). Remember - when an economy, which has grown accustomed to expanding by 10% per year for more than a decade, suddenly experiences 'only' 5% growth, it will feel like a recession, and its people will react accordingly.

Chart 6: Chinese Manufacturing vs. Base Metals Prices



Source: SocGen Cross Asset Research

Deteriorating demographics

Looking further ahead, China faces other problems. Its one child policy will have a dramatic effect on demographics in general and on the all-important dependency ratio (defined as non-workers as a percentage of the working population). In 2012 the dependency ratio will bottom out at 39% before beginning its relentless rise over the next 40 years (see chart 7).

As its working population dwindles in size, labour costs will rise, and China will have to move up the value chain (as Japan did), where labour costs account for a much smaller part of total production costs. As it moves into these new markets, it will increasingly antagonise the Americans and Europeans. Imagine the American reaction when Boeing does a 'Detroit' and goes to Washington begging for help, because it has been squeezed out of its lucrative civil aircraft market by some Chinese company.

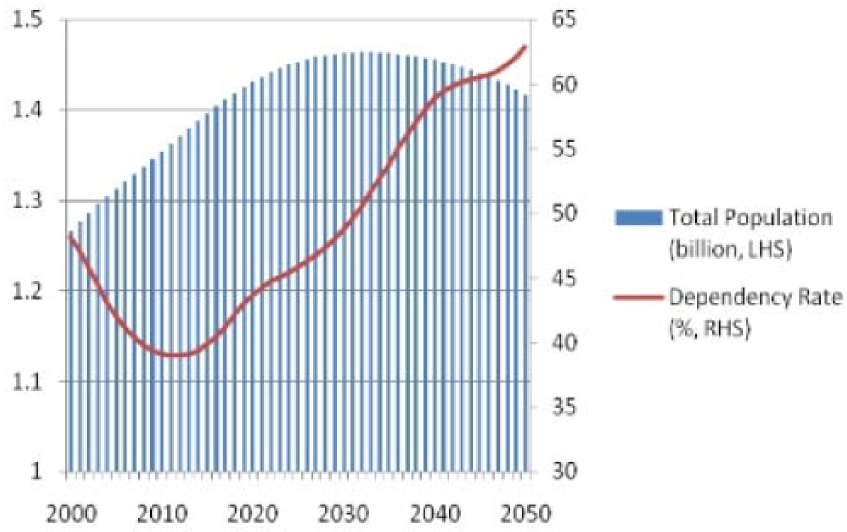
For this reason, and unless China fundamentally changes its approach, rising protectionism – possibly even a trade war – is all but inevitable. Our economic advisor, Dr. Woody Brock, wrote a brilliant essay recently on the subject[5]. Drawing on the work conducted by Nash and Harsanyi,

[5] *"Bullies on the Block: China, Iran, North Korea and Others – Time for Just Desserts", December 2010.*

which earned them the Nobel Prize in 1994, he argues that Western governments need to change their 'pussycat' attitude towards China and adopt a much more aggressive approach:

"...the role of threats is not to create conflict, but rather to prevent it. When threats are mutually credible, then neither side has an incentive to do battle knowing what will happen to them if they do. Rather, each has a very strong incentive to reach a compromise and to avoid conflict."

Chart 7: China's Dependency Ratio Soars



Source: IHS Global Insight, Inc.

I am not sure the political leadership in the West understand this dynamic. Neither do they seem to comprehend the relatively strong bargaining position they are in. As Simon Hunt pointed out in a research note the other day:

"China's increase in manufacturing capacity is such that the country needs the rest of the world more than the rest of the world needs China."

This fact has been lost on many. Instead it has become a rather childish discussion along the lines of: "do this or we will sell your government bonds". The reality is that they have no interest whatsoever in destroying value, so this risk appears grossly exaggerated.

Still early days

Now, let's shift gear. As always, there are two sides to the story. And despite my concerns that the current investment boom will end in tears, China presents a hugely attractive *long-term* investment opportunity, as it grinds its way to becoming the largest economy in the world. China is a growth story unlike anything we have ever seen and anything we are likely to ever seen again. In short, it is the fastest industrial revolution ever experienced. In the 30 years since the economic reforms began, GDP has grown by a factor 10, and GDP per capita is now almost 20% that of the United States whereas, 30 years ago, it was only about 4% the US level[6].

Put slightly differently, China today is where Japan was in 1950. Would you bet against China continuing on a path similar to that of Japan? I have found an interesting chart in a presentation made by Kingdon Capital Management (see chart 8), which puts the opportunity into perspective. Despite the enormously aggressive investment programme conducted by the Chinese in recent years, and despite all the near term risks that follow, the magnitude of the opportunity going forward, which crystallises when one looks at the chart, is just awe-inspiring.

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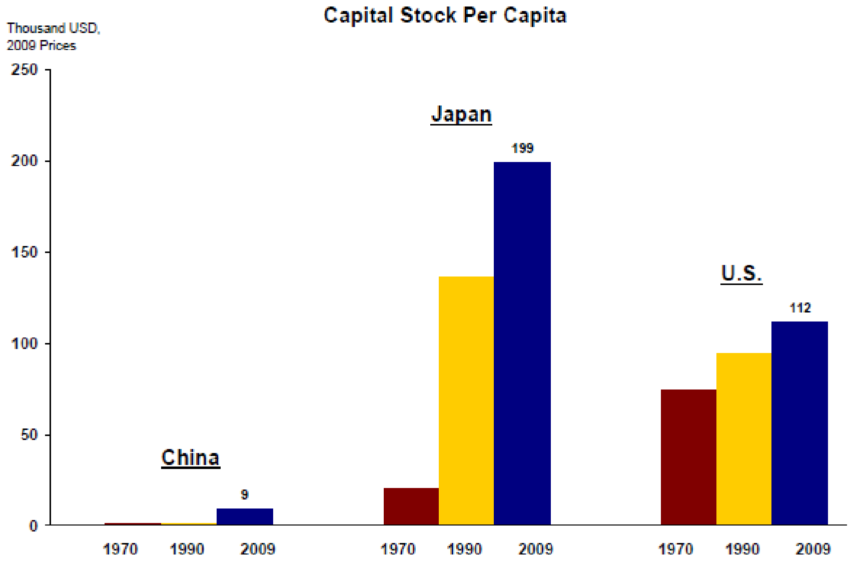
[6] *See http://www.theburningplatform.com/?p=8990 for an account of Asia's rise.*

Chart 8: China's Capital Stock



Source: Kingdon Capital Management LLC, DSG Asia

Many in Europe and North America see the Chinese as a long term threat, and in some ways they do pose a threat. But you can also argue that in a democracy we get the leaders we deserve, and it is up to us to elect leaders who are not afraid to take them on, as Woody Brock advocates. If we can make China understand that it takes two to tango, it can turn into the biggest business opportunity we have ever experienced in the Western world. Europe and North America took 250 years to develop a 600 million strong middle class, which grew out of the industrial revolution and which is the foundation of our society today. China has the potential to create a middle class in excess of 1 billion people over the next 30 years!

China also presents a very opportune way out of our demographic problems. As I have argued in previous Absolute Return Letters, as our society grows older, the *only* way to maintain economic growth is through rising exports; however, as I have also stated repeatedly, we can't all export; someone needs to be on the other side of that trade. That's where China comes in. As the Chinese middle classes grow in size, we need to ensure that we have the products and services they demand.

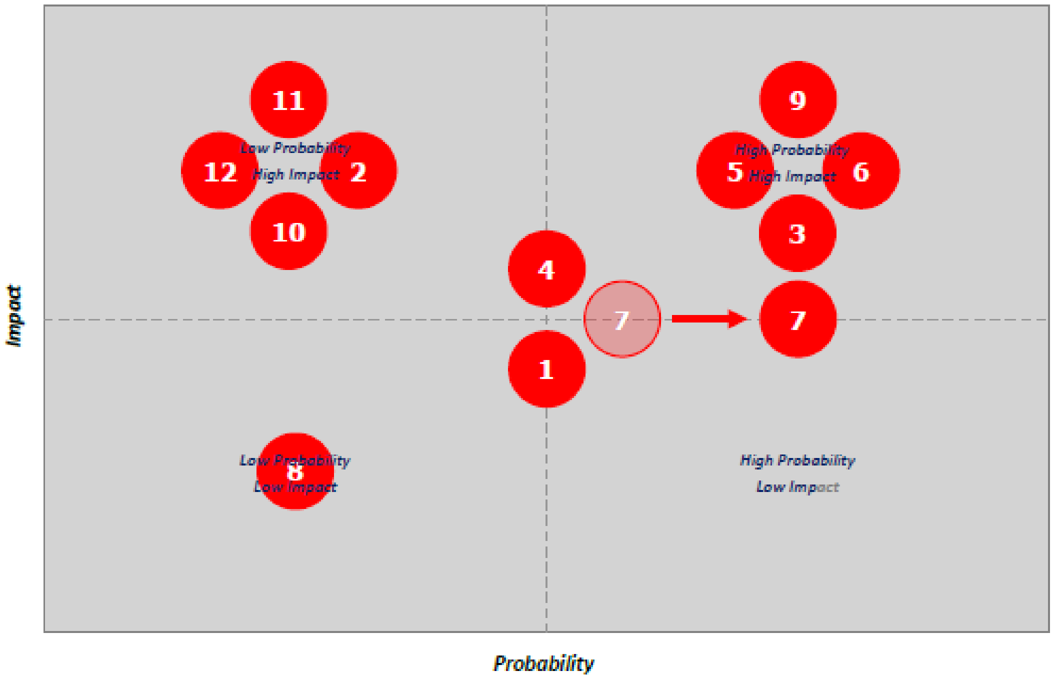
Unfortunately, before we get to where we want (and need) to be, and everyone dances to the same tune, we will probably have to endure a trade war or two, with a little bit of xenophobia thrown in from time to time as icing on the cake. I don't know how long all this will take, but what I do know is that it is the *only* way out of our problems longer term.

Happy New Year – let's see whether China can pull a rabbit out of the hat.

Niels C. Jensen

The ARP Risk Assessment Chart

Next 12 Months



1. High yield priced for perfection?
2. The risk of double dipping
3. Japan running out of fiscal options
4. Beggar thy neighbour mentality
5. Capital flows into EM countries leading to inflation and other problems
6. Chinese hard landing
7. Food inflation induced civil unrest
8. Is India an accident waiting to happen?
9. European contagion and solvency risk
10. Massive refinancing programme of sovereign and bank debt
11. Premature withdrawal of monetary support
12. Israel launching a pre-emptive strike on Iran's nuclear facilities

We introduced the ARP Risk Assessment Chart in the December 2010 Absolute Return Letter, and plan to make it a regular feature going forward.

Following the devastating floods in Australia, which damaged many crops, we have increased the probability of food inflation induced civil unrest. Australia is a major producer of grains and the much reduced output from there is likely to have a significant effect on wheat prices in 2011, which may destabilize more fragile political regimes.

Please note that our decision was taken before the recent uprisings in Tunisia and Egypt. The demonstrations in both countries have been portrayed in the world's media as a cry for freedom; however, particularly in Egypt, rising food prices are a major problem and have played a significant role in the events of recent days. Egypt imports almost half the wheat it consumes, and chronic water shortages make it difficult for the Egyptians to boost domestic growth.

The real risk, though, is that social tension spreads to some of the large oil producing countries in the Middle East. Should that happen, oil prices could go much higher.

Absolute Return Partners in the News

Advisor Perspectives – a leading financial website and publisher of financial news and newsletters –have announced their first ‘Venerated Voices™’ awards, recognising those financial markets commentators who were most frequently read by financial advisors during 2010.

In the category ‘Individual Commentators’, the Absolute Return Letter made it into the Top 10 and, I think it is fair to say, into some very good company indeed. I am a huge fan of Jeremy Grantham myself (and of several other names on that list, I must confess), and he deserves every accolade which comes his way. I must admit I feel very humbled to see my name mentioned in the same context as Jeremy’s.

Thank you to everyone out there who reads the Absolute Return Letter on a regular basis. It is often hard work to put these letters together (just ask my wife), but moments like these make it all worthwhile.

The Top 25 Venerated Voices™ by Author

Advisor	**Firm**
Jeremy Grantham	GMO
Bill Gross	PIMCO
Van R. Hoisington and Lacy H. Hunt	Hoisington Investment Management
John P. Hussman	Hussman Funds
Kendall J. Anderson	Anderson Griggs
Niels C. Jensen	**Absolute Return Partners**
Mohammed El-Erian	PIMCO
Howard Marks	Oaktree Capital
Rob Arnott	Research Affiliates
Paul McCulley	PIMCO

See here for further details of the awards.

Important Notice

Absolute Return Partners

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We are a company with a simple mission – delivering superior risk-adjusted returns to our clients. We believe that we can achieve this through a disciplined risk management approach and an investment process based on our open architecture platform.

Our focus is strictly on absolute returns. We use a diversified range of both traditional and alternative asset classes when creating portfolios for our clients.

We have eliminated all conflicts of interest with our transparent business model and we offer flexible solutions, tailored to match specific needs.

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