



The Next Great Bubble?

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One more bubble, please.

After the bubbles in technology, housing, and commodities, we saw the mother of all bubbles: the one in global liquidity. The world economy seemed to require bubbles for its continued functioning.

I get the distinct feeling that investors' prayers are now being answered: There's a new bubble now - or an old one is being re-inflated, depending on your perspective even as I type this. I'd like to call it the Troubled China Revival Program (TCRP).



Why start reserving bubble-naming rights? Well, I recently received an email from a friend that had the following subject line: "China ... [Record Loan Addition](#), [Record Money Supply](#), [Record Auto Sales](#), [Record Imports of Copper](#), [Iron Ore](#), and [Coal](#), [Strong Property Sales](#)."

I checked every figure (the hyperlinks above are mine), and every single one checked out. I couldn't quite believe what I was reading. I had thought China was in a spiraling-down recession. But even the decline in electricity consumption -- a true gauge of economic growth -- [decelerated](#) from 3.7% in January and February to a mere 0.7% in March.

So is China really the first nation to rebound? Is this the first sign of a rebounding global economy?

I'm sorry to say that the answer to both questions is no.

China's fortunes over the past decade remind me of Lucent Technologies in the 1990s. Lucent (now **Alcatel-Lucent** (ALU)) was selling equipment to dot-coms. At first, its growth was natural, the result of selling telecom equipment to traditional, cash-generating companies. Thereafter, it was only semi-natural: Dot-coms were able to buy Lucent's equipment only by raising money through private equity and equity markets,



since their business models didn't factor in the necessity of cash-flow generation.

Funds to buy Lucent's equipment therefore quickly dried up, and the company's growth should have decelerated or declined. Instead, Lucent offered its own financing to dot-coms by borrowing and lending money on the cheap to finance the purchase of its own equipment. This worked well enough - until the time came to pay back the loans.

The US, of course, isn't a dot-com. But a great portion of our growth came from borrowing Chinese money to buy Chinese goods - which means that Chinese growth was dependent on that very same borrowing.

Now the US (and the rest of the world) is retrenching, corporations are slashing their spending, consumers are having moments of sickening recognition - and the consumption of Chinese goods is on the decline. This is where my dot-com analogy breaks down. Unlike Lucent, China has nuclear weapons. It can print money at will, and can simply order its banks to lend; this is a communist-command economy, after all. Lucent is now a \$2 stock - but China won't go down that easily.

Let me explain: The Chinese central bank has a significant advantage over ours. Mr. Bernanke and company may print a lot of money (and they did), but there's almost nothing they can do to speed the velocity of money: They simply cannot force banks to lend without nationalizing them (and only the GSEs have been nationalized). They also cannot force corporations and consumers to spend. Since China isn't a democracy, it doesn't suffer the problems of one.

China's communist government owns a large part of the money-creation and money-spending apparatus: Money supply therefore shot up 25.5% in March. Since it controls the banks, it can force them to lend (which it has also [done](#).)

Finally, they can force government-owned corporate entities to borrow and spend. And the government itself can spend quickly - which is important when trying to build infrastructure. This isn't some slow, touchy-feely democracy: If the Chinese government decides to build a highway, it simply draws a straight line on the map. Any obstacle -- like a hospital, a school, or a politburo member's house -- can become a casualty of the greater good. (Okay - maybe not the politburo member's house).

Though China can't control consumer spending, the consumer is a comparatively small part of its economy: Currency control diminishes the consumer's buying power. All of this makes TARP 1 and 2 look like child's play. If China wants to stimulate the economy, it does so - and fast.

That's why we're seeing such robust economic numbers.

China doesn't have the kind of social safety net one sees in the developed world, so it



needs to keep its economy going at any cost. Millions of people have migrated to its cities, and now they're hungry and unemployed. People without food or work tend to riot; to keep that from happening, the government is more than willing to artificially stimulate the economy, in the hopes of buying time until the global system restabilizes.

It's literally forcing banks to lend - which will create a huge pile of horrible loans on top of the ones they've originated over the last decade (though of course we can't see them). Don't confuse fast growth with sustainable growth. As I've [discussed in the past](#), China is suffering from Late Stage Growth Obesity. A not-inconsequential part of the tremendous growth it's seen over the last 10 years came from lending to the US. Additionally, the quality of late-period growth was, in all likelihood, very poor, and the country now suffers from real overcapacity.

As a US taxpayer, I'm delighted to see the Chinese economy coming back to life. A new bubble in China means the US government will have to spend fewer taxpayer dollars on the bailout (or will at least borrow less money from the Chinese). Furthermore, the Chinese are an extraordinary potential market for American goods.

Identifying bubbles is a lot easier than timing their collapse. But as we've recently learned, you can defy the laws of financial gravity for only so long. Put simply, mean reversion is a bitch. And the longer inflated prices persist, the harder they fall when financial gravity brings them back to earth.

Another casualty of what's taking place in China are US interest rates. China is the largest holder of US Treasuries. China sold us goods; instead of driving the US dollar down and the renminbi up -- as would be the natural order of things -- China parked its money in the US dollar via Treasuries. This artificially propped up the dollar vis-à-vis the renminbi.

Now China needs to stimulate its economy. It's facing a very delicate situation indeed - which is a nice way of saying that China's screwed. China needs the money internally to finance its continued growth. However, if it were to sell dollar-denominated treasuries, several bad things would happen. Two come immediately to mind:

1. Its currency would skyrocket - not good for China, because it would lose its (relatively) competitive low-cost producer edge.
2. US interest rates would go up dramatically - not good for the US (its biggest customer), and therefore, not good for China.

This is why China is desperately trying to figure out how to withdraw its funds from the US dollar without driving the dollar down. Good luck with that.

And the US government isn't helping: It's printing money and/or issuing Treasuries at a



fast clip, and needs somebody to keep buying them. If China reduces or halts its buying, we may be looking at high interest rates, with or without inflation.

The latter scenario worries me most.

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