HindeSight

HINDE CAPITAL

www.hindecapital.com
Jul 2015

"It doesn't matter if the cat is black or white as long as it catches mice."

Deng Xiaoping, 1904-1997

Red Capitalism is thriving. The Communist Party (CP) has managed to authenticate and legitimise the gambling habits of a billion plus people, that is its very own party members. They have officially sanctioned a stock investment boom, providing untold riches to its people. They have instigated one the greatest feats of financial engineering, barring the US sub-prime heist, to mitigate risk by implementing the largest debt-to-equity swap in history. They have provided all of the debt ridden SOEs with a means of re-capitalising their ailing balance sheets by shifting their debt into equity and transferring the risk from their own (and by definition the State's) balance sheet onto that of the people's very own household balance sheet. So lucky are Auntie and Granny Wang that they sang on brokerage floors to herald the benevolence of their leaders.

Even when the debt-for-equity became more of a debt-for-debt swap, as new listed SOEs and quite frankly every man and dog borrowed to enjoy the nation's gift, their leaders continued to endorse the growing mania. Even when the recent stock mania just fell into panic, no matter, the State ended the red peril to their comrade’s accounts by effectively closing the market. You see there is no end to the tools that a command driven economy can access to guide posterity.

China has been a curious conundrum for analysts of any discipline, understandably so because the country is a maze of opaqueness. Dr John Hulsman, a member of the Council of Foreign Relations recently wrote of China that, 'about the only thing I am entirely sure of is that it remains the least understood great power in the world and it’s that analysts are all so very confident and yet so very polarised about its future'. He went on to surmise that China watchers of all stripes seem unequivocal in their belief that the CP leadership exudes administrative excellence unparalleled in the world. A testimony to Confucian education of China's elite. We would concur, so fabled is the PRC regime control that it has become an unquestioned truism.

Deng once pronounced it was glorious to be rich. But at what expense? China's debt has surged from an official US$2 trillion to US$28 trillion, with $1 of growth in GDP to be shown for $4 of debt. China resides over the largest misallocation of capital in history predicated on the accumulation of vast amounts of excess debt. In this HindeSight we explore how a particular psyche prevalent in China has led to an economic miracle fallacy. The Chinese regime is ailing and it bodes ill for the global economy and the interaction between State and man. China's continued mishaps prove the State is not omnipotent and the control of the issuance of money has untold and harmful ramifications for sovereign rights, both national and individual.

In the knowledge that most analysts seem so certain of the CP leadership, we posture gently that China's cultural affinity for gambling is so endemic in its society, that its leaders have subconsciously and unwittingly made increasingly risky wagers with the economy. At first incremental in their planning they have now moved from more majhong-esque strategy to the more ‘all-in’ Western betting form - a martingale. To win at the martingale strategy one doubles up on each bet, but to succeed one needs unlimited resources.

Central banks may have unlimited ability to print money but they are constrained by the fiscal and psychological effects of people's faith in the value of the currency created. So not even governments have such a luxury, as eventually a 50 - 50 call will break any central bank. China, over the last decade since the GFC, has made a number of such bets which when observed through the prism of the global debt gamble, makes the CP seem no more sophisticated than their Western counterparts. The CP likewise are stumbling under the weight of their own debts.

The Debt Gamble

Everywhere we look appears to be a gamble between creditors and debtors. Today, debtors and creditors alike are caught in the 'debt trap'. Despite ZIRPs and now even NIRPs, where debtors get paid to hold debt, the world seems intractably and insolvably boxed-in by ever growing debt burdens. The economic and indeed political debate has been over who should foot the bill – creditors or debtors?

Notwithstanding a debt jubilee, where all debts are forgiven (best for the debtor, still not great for the creditors), the way to deleverage with least hiatus is to *grow* the economy out of its predicament by receiving enough revenues by which to pay back the interest and principal owed. The debates on creating growth revolve around providing short-term fiscal stimulus or belt-tightening, austerity measures. Either way, the aim is to increase income relative to costs.

Encouraging reform of the public sector, reducing the State costs and encouraging entrepreneurial endeavours is the more sustainable pathway for achieving growth. Not everyone agrees with this and so herein lies the ideological battle we witness today around the world, no more so than in Europe. Europe is a federal state that prefers more state control of enterprise and greater welfarism, which are seen as 'fairer' modalities for growing a country.

History is replete, however, with how government indebtedness has led to continuous economic failure. The 2008 Crisis itself, far from being a failure of free markets, symbolised an innate failure of a form of State capitalism, that of the State monopoly of the issuance of money. The abuse of the supply of money in ever increasing amounts to arrest the failures of TBTF and various private institutions has enabled a far more protracted demise of our economies than if failure had been recognised. Such failure, so needed in capitalism to allow fresh roots to flourish, is considered almost unconscionable by policymakers today. The money issuance encourages price inflation as a means to mask the collapse in existing money and credit in circulation.

The only price inflation we have witnessed to date is that of asset appreciation, including stocks, housing and bonds, whose ownership is not widespread, and so this has merely exacerbated the social fractures of inequality caused by a welfare indebted State.

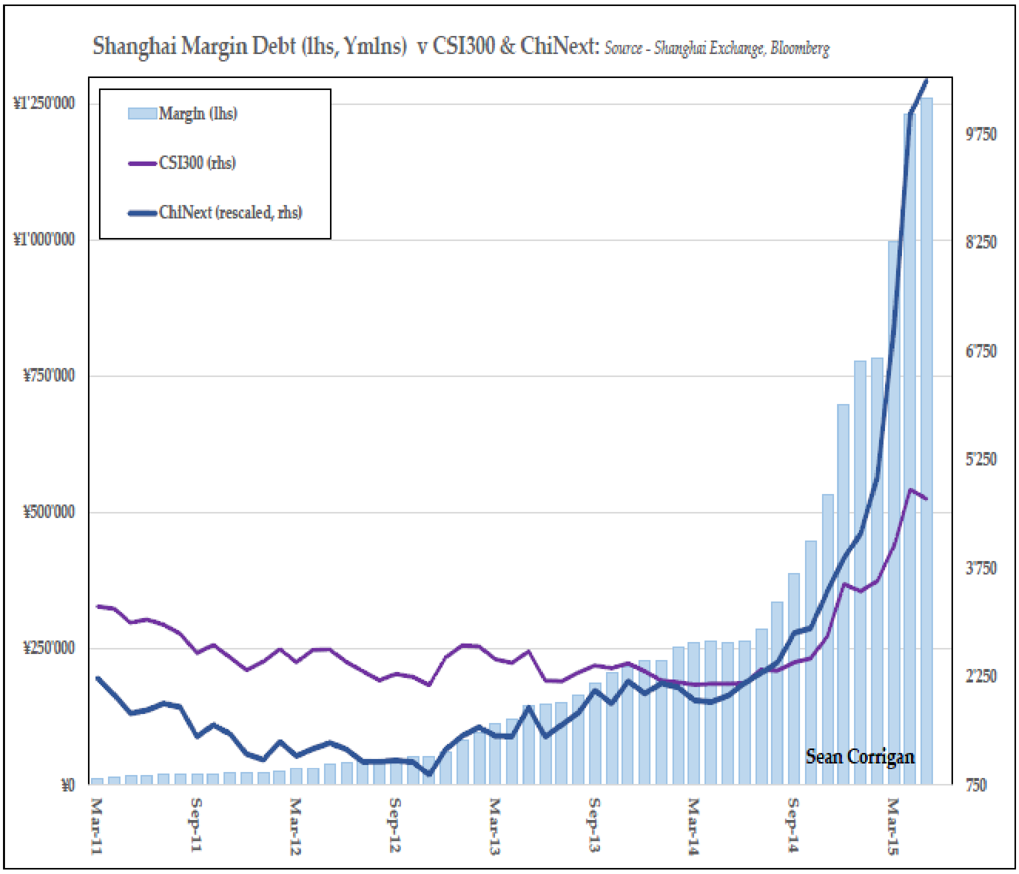
The debt burden has thus been controlled by holding rates below the market rate of preferred lending, for who would pay their neighbour to borrow money from them? (Answers on a postcard if you actually have a logical answer to this question and conundrum). This has helped borrowers to service their debts but it hasn't helped repayment, so a repayment crisis such as we witness in say Greece still remains.

The debt malaise seems to have crept insidiously around the world and remains stubbornly entrenched, impacting not just emerging and less developed countries but even those more 'stable' developed nations. Japan symbolises this entrenchment but their creditors haven't called time because the Japanese government owes its own people. Foreigners tend to be less malleable and more impatient. Now every developed country is heading toward Japan-styled debt traps. Europe, itself, suffers from a similar debt deflationary straitjacket as it suffers from an internal, rather than an external debt problem.

The EU, unlike in Japan though, has numerous sovereign nations that are exposed to this internal debt, and it is clear in trying to resolve their debt problem there has been no political solidarity when it comes to sharing such a burden; especially when the periphery country debtors are perceived to be feckless and profligate spenders in contrast to the erstwhile prudent saver nations. In essence, any intra-European transfers – let's say from Germany to Greece – is nothing but a zero-sum game. What is a gain to Greece, is a loss to the rest of Europe?

But what of China?

Stage 1 to 3: Stock Metastasis



www.hindesightletters.com

China's Problem Gambling

Ethnocentrism often lies at the root of International conflict. It is the belief that one's own country is at the centre of the world. China historically referred to itself as the Middle Kingdom, Zhōngguó or literally Central Kingdom. The term originally reflected the cultural significance of the central region of a China, whose Emperor had unified the various independent states. As time passed, the term has been used as a means of unifying Chinese people and their significance in the world by referring to themselves as the centre kingdom (of the world). For our mind, there is no doubt that China is at the centre of economic importance right now and whilst the events of the EU have caught our eye, it equally won't have escaped people's notice that something has been afoot in China – the panic and mania that is overwhelming stock markets.

It is fascinating to observe that whilst many financial participants have been debating the China economic miracle, there were very few in recent years who recognised that such economic feats were yet again supercharged and predicated on the recycling of debt. In China's case this is by use of the semi-fixed yuan exchange rate, which is also so crucial to the continuity of the global monetary system today – Bretton Woods II. As most readers know, we have continually stated that the defining nature of this international and financial monetary system is that it finances the United States' enormous external deficit and its associated fiscal deficit at low interest rates, whilst supporting an investment boom in Asia – mainly China. This is how the dollar hegemony thrives. We have written extensively about how China has resided over the greatest misallocation of capital in the last 200 years. Last year in an interview, Ben stated (not Bernanke, our Ben):

"I feel more disposed to a collapse in 90% of asset classes – equities, bonds and commodities, but with the other 10% cash and gold going up in (relative) value. This is the outcome in a deflationary scenario. I envisage this more than I expect higher asset prices and goods inflation. I see too much stress in the system to expect a muddle through. The likely trigger (or hope) for the deflationary outcome is China, irrespective of European and other Anglo-Saxon woes which still remain. Of course, one country's capital is another's consumption, so the world is inherently interlinked."

In 2008, in response to the Great Financial Crisis, China gambled on the largest stimulus initiative it had ever embarked on when it ordered drastic cuts in bank rates and a near US$1 trillion package to ignite loan production to SOEs, which then set-off a once in millennial real estate boom. Its initial success in preventing any financial contagion from the developed countries perversely provided the blueprint by which the developed countries then sought to solve their own solvency and liquidity issues. A hint as to why such a bold action was taken can perhaps be traced to the cultural psyche of a nation.

Gambling is embedded in the traditions of the Chinese. It has been performed by its people for thousands of years with the first account of gambling found as far back as the Shang dynasty of 2000 to 1500 B.C. The Ming period from 1600 to 1900 A.D. witnessed epidemic levels of gambling, which many historians attribute to the demise of this once rich and powerful dynasty, with cricket fighting and paper mahjong being the principal culprits. The Chinese will also bet on anything from horses, ducks, cockerels, dogs, football and more recently a myriad of casino games, where the allure of free credit, drinks and promotions are so enticing.

China's addiction to gambling is an open secret. National lotteries aside, gambling in China is actually illegal. As any visitor to China or the self-styled China(town) in major metropolises around the world can testify, the street side bustle of mahjong and card players is a seemingly enchanting past-time. Who cannot forget the staccato 'rat-a-tat-tat of Mandarin dialects' rabidly commenting on the games in a fervour of communal debate. The public flouting of the gambling laws seems even innocent and just harmless fun.

Even the young 'play' for money with Auntie and Uncle Wang, Granny and Grandpa Tang. They are enthralled by the mystical qualities of luck, fate and chance. Numerology plays a central role in many Asian cultures and China's is no exception. The number 8 is extremely lucky, a fact not lost on the Western online poker site www.888.com which no doubt targets clients of Oriental origin. The number 4 on the other hand, whose vowel when spoken sounds like the word for death, is a sign of bad luck at the tables of fortune.

In short, gambling is illegal but socially acceptable, which makes acknowledgement of addiction problematic and there are widespread issues. The Chinese people have elevated levels of gambling addiction compared to their Western counterparts. It's endemic. An epidemic even. These elevated rates have been exacerbated by the rapid expansion of gambling venues within the Pan-Pacific region.

The continuum of worsening gambling addiction follows the labels of 'pathological' to 'problem' to 'disorderly' gambling. Pathological gambling refers to a condition where the sufferer shows persistent and recurrent maladaptive behaviour, resulting in dysfunctions in the areas of work, studies, social and family relationships. The disease gets progressively worse as individuals experience high rates of gambling-related fantasy, start lying and use it as an escape. They then experience substantial interpersonal, financial and legal difficulties, accompanied by substance abuse, mood / anxiety disorders and even suicidality.

Chinese gambling addicts experience have 5 times as much occurrences of the extreme affliction compared with any other nation – disorderly. In San Francisco, 70% of Asians cite gambling as their community's number 1 social issue, with over 21% of them considered pathological gamblers. Compare this with the 1.6% of North Americans who are problem gamblers, which by the way is a recognised psychiatric disorder. In China alone, the amount spent on illegal gambling is estimated at over one trillion yuan (US$200 bn plus), which is approximately the financial output of Beijing.

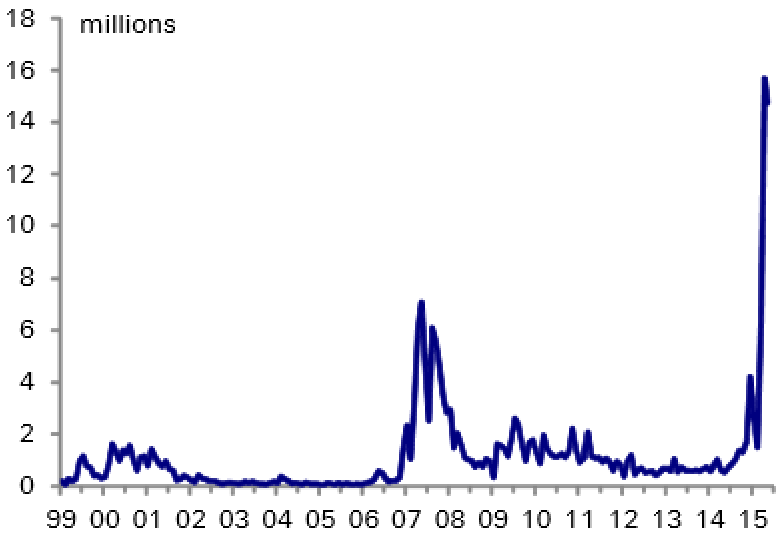
Another BRIC in the Wall

Fast-forward to the present day and we have begun to witness the real extent of China's gambling addiction on the grandest of scales. A multi-billion dollar underground industry has migrated into an 'open market' trillion dollar industry – that of the Chinese Stock markets.

The Chinese Stock markets have replaced mahjong as Auntie Wang and Granny Tang's favourite pastime. Flipping stocks is the real thing and it's not only socially acceptable, it has actually been actively encouraged and promoted by the State. Gambling just became legal. But why?

For all the talk of reform of the markets in preparation for liberalisation of the capital account, China is desperately trying to prevent an uncontrolled collapse of its over-leveraged economy, which rests on extremely indebted Local Governments and SOEs. Far worse, this debt consists of a complex and interconnected web of investment financing vehicles, themselves over collateralised by ailing or absent commodities and housing stock.

New Individual investor account openings: Shanghai & Shenzhen only

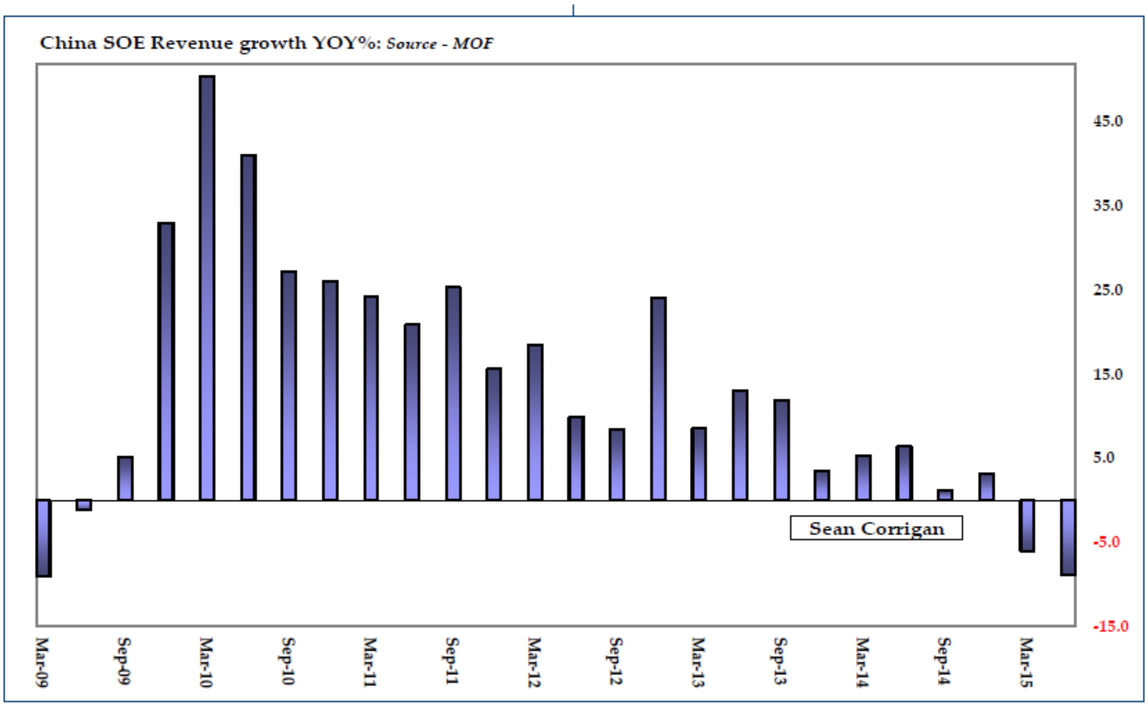


Source: Deutsche Bank

The recent encouragement of stock investing has been part of what has been, until now, a successful attempt to re-capitalise the very same SOEs that the government provided untold stimulus to, in 2008.

So whilst the top-down pronouncements and government directives contradict the rapidly worsening real economy, it was yet again the *latest gamble of the State* to promote a bail-out of its over indebted system in no doubt one of the largest debt-to-equity swaps in history.

One needs to look no further than this chart to understand why the Chinese authorities are trying to reignite the economy with a stock market bull run. Perhaps this time, instead of the West following the Chinese playbook, the Chinese have taken a leaf out of Ben Bernanke's book, that of herding the markets higher in a vain attempt to create an illusion of real wealth.



www.hindesightletters.com

As Sean Corrigan, editor of our subscription publication, ‘Money Macro & Markets’ – which you can find at the hindesightletter.com site – "Let us remind you that this present mania for stocks is nothing less than a tacitly encouraged means for deleveraging companies at the expense of the greater risks being run by the legions of first-time buyers and amateur margin traders who snap up their counters."

Sean hat-tipped the potential for a mania in the Chinese markets, whilst residing in his old investment seat – perhaps more from the stance of – can the authorities really engineer this debt-for-equity swap?

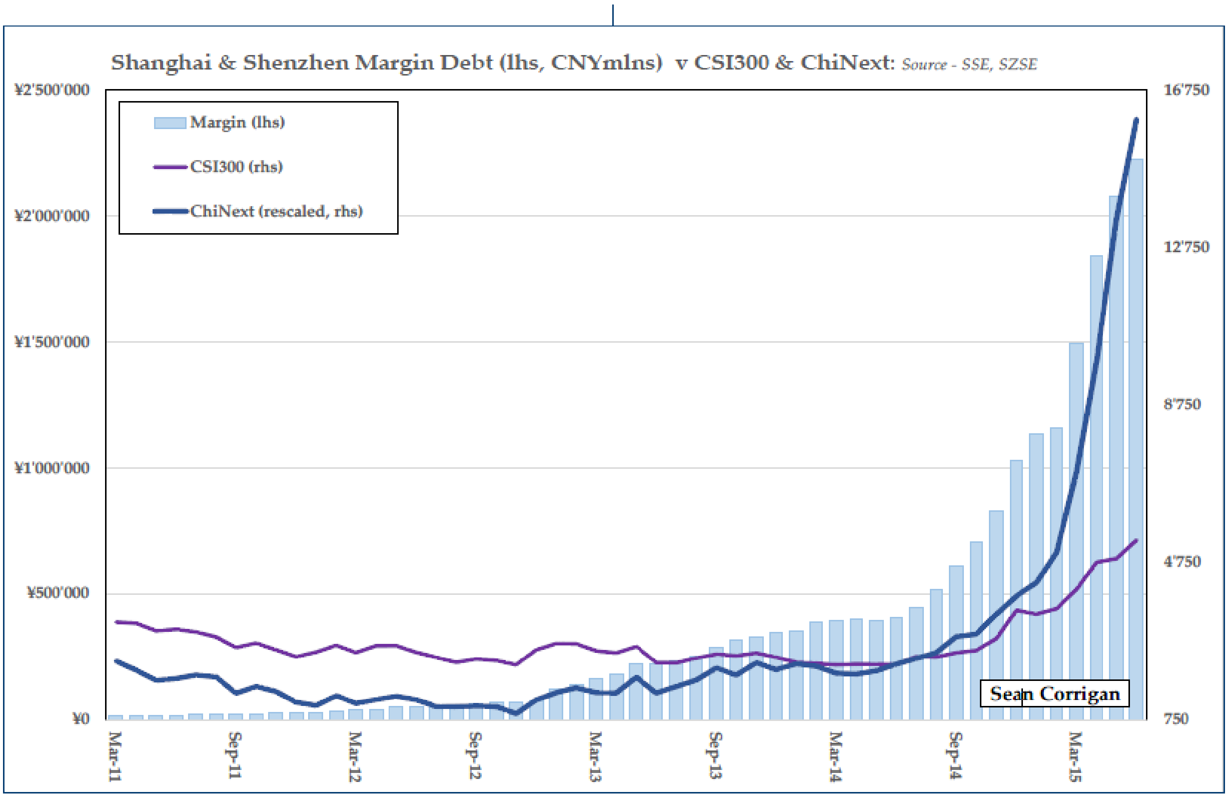
To give you an idea of the magnitude of the stakes in play here, I am going to quote liberally from Sean's ‘Money Macro & Markets’, May letter 2015:

> **"**Turnover in April was CNY30 trillion – or around $4.8 trillion dollars – with 90 billion shares a day changing hands, up 44% from March and 8.7 *times* the level of a year ago. To put such mind-boggling numbers in perspective, NYSE volume for the month was a lowly $1.4 trillion at a rate of around 1.6 billion shares a day. Turnover in the US is therefore of the order of 100% of GDP per day – which should be enough frantic short-termism for anyone's taste. In China last month, it hit *560%* of GDP. Dollar volume on Shanghai alone was greater than that in all of the Americas – North and South – combined and one in every two shares traded anywhere around the globe was traded in China, according to WFE data! ...
>
> "As the Chinese madness intensifies, the last seven weeks have seen 17.7 million new stock accounts and 7.4 million new fund accounts opened (some of these latter heavily leveraged), draining household accounts of Y1 trillion in deposits last month and piling that cash up instead on the books of the non-bank financial institutions with whom they deal. Try as it might, it is obvious that the PboC just cannot force its ongoing infusions of monetary assistance into the wellsprings of real economic activity, rather than adding them to the ever expanding walls of this latest and arguably greatest speculative bubble.
>
> Faced with an economy stalling under the weight of its own contradictions; with unknowable quantities of capital either utterly wasted or helplessly locked into sub-marginal uses; with the debt load crushing and the monetary system riven with fraud and inefficiency, like latter day equivalents of the Duc d'Orléans, regent of France, and his Scottish adventurer advisor, John Law of Lauriston, the CCP's top men have also opted to bamboozle the masses under their sway. By holding out the prospect of the fabulous gains to be had in developing a little-known wilderness far from the nation's heartland, they have sought to exploit the enthusiasm thus kindled in order to transform some of that mass of unpayable debt into supposedly sure-fire equity holdings. With the AIIB in place of the *Banque Générale* and the central Asian vastness of the 'Silk Road Economic Belt' taking the place of the pestilential Louisiana bayous, we can see all too many parallels.**"**

Xi and Li really are riding the tiger with this one.

Yes, lest we forget, the Chinese have always bet on tigers as well, not just crickets! Unfortunately, this bet has become less of a "therapeutic *debt-for-equity* swap on a truly titanic scale, (rather) a frantic *debt-for-debt* swap as Auntie borrowed all she could get her hands on to maximise her chance of gain." Not only did Auntie borrow but so many of the newly listed SOE companies pledged stock in return for more bank financing. This is reminiscent of the heady days of the U.S. Roaring Twenties and the *Baburu Keiki* of Japan in the late 80s.

Stage 1, 2, 3 & 4 Complete Mestastasis, Now Death?



www.hindesightletters.com

Sean documented the continuing insanity:

> "The attempt to convey in words alone a sense of what is afoot there quickly becomes an empty exercise in superlatives so, for the moment, let us simply try to let the numbers speak for themselves.
>
> And what numbers they are! In terms of turnover, things were simply extraordinary. April and May combined saw $10 trillion's worth of shares traded (versus $4.5tln in New York), meaning that for every $7 which changed hands in the whole rest of the world combined, $8 were bought and sold in China. At that pace, China's turnover was 5 1/2 times its GDP while the multiple of national income realised Stateside was a mere 1 1/2. Just imagine what that means for broking house fees – or for stamp duty receipts, for that matter.
>
> Then we come to leverage. Official margin debt has doubled just since February and *quadrupled* since last August, adding over CNY1.1 trillion in that time, equivalent to $180bln or around $50bln a month. The total as of June 18th's peak was CNY2,273bln or $366bln, a sum equating to around 3.5% of market capitalisation, more still of free float. For comparison, margin debt on the NYSE took a full 3 1/2 years of the bull market to double to today's $507bln where it still represents only 2% of market cap – even if that less lofty proportion is still a 98th percentile reading. Despite the ongoing rally in Japan, margin there is an un-exceptionable 0.8% of market cap of the Topix, only some 0.2 sigma's over the post-Bubble mean.

What this means is that in the three months to end-May, Chinese margin debt accounted for 35% of all new loans taken out, equating to 35% of all the re-investment under-taken and to 13% of nationwide retail sales rung up. Since last August, the increase has exceeded the total contemporaneous addition to the stock of M1 money.

As a final attempt to have your jaws drop at the scale of the excess, consider that the addition to margin so far this year of CNY1.25 trillion amounts to the entire income of no less than 50 million Chinese at the average national wage of CNY50,000 a year. That's like saying almost the entire population of England, or of California plus Oregon and Washington State, took on a 100% debt: income obligation and ploughed it – alongside that same income itself – straight into equities as they soared ever upward."

www.hindesightletters.com

The gambling psyche of the Chinese has driven its economic miracle of the past few decades. Far from State Capitalism engaging in thoughtful planning, it has perhaps lurched haphazardly and reactively from one policy decision to another. We are possibly not witnessing true reform in China to foster open democracy, instead are the policymakers merely restraining elitist groups and seeking to solidify the central power base?

The liberalisation of stock markets has been a policy gamble to arrest their debt-ridden economy, whereby they have recklessly encouraged a transfer of (more) risk from SOEs (large state-owned enterprises) to their population. Their poor beleaguered people cannot grasp the magnitude of the deception. They are so addicted to their own need to gamble, the recent stock mania and crash has only compounded to seal their economic fate.

The situation in China highlights the continued global struggle between the State and individual rights. How ironic that the command economy should fail at the hands of an open stock market (of sorts), when the West shifts ever further towards the closing of markets and State capitalism, so associated with such a command economy.

The largest debt-for-equity swap in history has failed. The question is, are we now all in it together or not?

A little State secret: the State can't control the economy and markets at its will. At some point the system fails to work properly, destroying any wealth created. Such wealth is merely an illusion – mere vapour.

Deng Xiaoping was once reputed to have said, "Some people insist stock is the product of capitalism. We conducted some experiments on stocks in Shanghai and Shenzhen, and the result has proven a success. Therefore, certain aspects of capitalism can be adopted by socialism. We should not be worried about making mistakes. We can close it [the stock exchange] and re-open it later. Nothing is 100% perfect."

It is clear that the Chinese authorities took his advice at face value. In recent weeks, the mania in the markets has begun to turn to panic and the authorities suspended over half of all stocks on the exchanges on July 7th and 8th. At one point, even the companies themselves requested their stocks be suspended because bank covenants had been breached, as they had pledged their own stock as collateral for bank loans.

This *truly* unprecedented behaviour was just part of a list of extraordinary measures undertaken by the mighty ruling party. We list a few here. The PBOC implemented a rate cut and RRR reduction, whilst brokerages, fund managers and insurers were instructed to buy even more stocks. The liquidity came via a direct line of credit from the PBOC to the China Securities Finance Corporation (CSFC), a provider of margin financing who would then guarantee ample financing for all of brokerages. CSFC by the way is an SOE no less!

The China Securities Regulatory Commission (CRSC) ordered companies to buy back 20% of all the stock they had issued in the past six months. The Insurance regulator (CIRC) increased the equity allocation back from 30% to 40% (which it had only just reduced the week before) and doubled single-stock holding limits from 5% to 10% for good measure as well.

One of the best quotes on recent events we saw, was from Goldman Sach's China Strategist Kinger Lau, who said: "Leveraged positions aren't big enough to trigger a market collapse... it's not a bubble yet... China's government has a lot of tools to support the market." Is this gentleman completely nuts. He certainly must be a loyal citizen and one of the cadre. If peak financing of $355bn or 12% of the value of all freely traded shares on the market (which is apparently the largest ever recorded in financial market history) then we would say Lau has been smokin' too much of the Shanghai opium pipe of old.

Sean Corrigan did some further great analysis on margin, which he presented in 'MidWeek Macro Musings' (a publication that comprises of about 7 to 9 pages each time with really insightful charts on money, macro and markets) alongside a pithy explanation. In the 8th July weekly, Sean wrote that at the peak of the market, the margin (if you include the shadow as well as official margin debt) would have been at a staggering 25%. The 12% was the official margin debt.

The shadow margin was flourishing in the P2P sector:

> "Nor have they yet gotten to grips with the many-headed hydra which is the nation's flourishing internet-based P2P network, a teeming ecosystem which counted over 1700 members at the last reckoning at the end of 2014 but which is probably even more populous now that the demand for funding has become so unstoppable. The interaction between firms, individuals and the banks and other financial intermediaries who come between them has become so profuse as to leave one dizzy. As Tencent laid out in a lengthy article on the topic, whether on the TV or internet, in the press or on stationary advertising hoardings, it is currently impossible to avoid the ubiquitous advertisements for sources of margin finance. *'We provide the funds – you keep all the profit',* as one of the more prominent temptingly declares. Needless to say, the contractual terms of such arrangements are carefully drafted so as to evade any regulatory restrictions, including the ostensible (but fundamentally non-existent) separation of the funds' providers from the intermediary offering the 'service'."

The extent of the impact on the wider economy has been for all companies to reallocate their dwindling capital to this new mania and 'The Economist' thinks this crash will have no impact on the broader economy! Sean:

> "To take a different example, smartphone manufacturer Xia-omi has recently launched a consumer finance arm which is to be expanded into an asset management company. Meanwhile, companies in languishing sectors, such as steel manufacture, electricity distribution, coal mining, and real estate, are said to be particularly active in redeploying their capital – and, no doubt in making avail of their credit lines – to reap the rewards not just of stock speculation per se, but also to profit from the usurious fees and interest charges – often amounting to several percentage points per day – to be had by funding the punting classes."

Early on, we highlighted the extent of China's gambling addiction. When we bear this in mind, we may begin to question the decision-making of the ruling party this past few decades. We may begin to look at those decisions in a new light. So China, far from being some sophisticated, well-controlled command economy, could it have been just one chaotic gamble after another; a juggling of the mahjong pieces to keep the Chinese economic juggernaut moving forward.

The 5-year and 20-year plans we have read off so much of in the China Communist Plenums seemed to point to such a certainty of direction. They were so seemingly assured of their outcomes. But surely, those who cheered the might of Mao's descendants must be really beginning to question whether the State really has omnipotence to manage the levers of its economy?

We have read in 'The Economist; recently that the Chinese ran and marshalled the economy well. This is plainly ridiculous. There has certainly been a semblance of growth and stability, but this is now unravelling and instead of restructuring the equivalent of 225% to 250% debt to GDP (which is likely to be far worse when the murky world of WMPs and LGFV is fully accounted for), they have chosen to shift the risk onto Auntie and Granny in a stock market bubble.

It's clear that years of State intervention have built up consequences which are being exposed with magnifying proportions as they attempt to shift risk from closed, less liquid and frankly completely opaque parts of the economic balance sheet to the relative transparency of the open capital markets. (We say 'relative' transparency, for let's be under no illusion, there is no central body of gilded governance and accountancy consistency among these listed companies).

It seems that the talk of market liberalisation, whilst telegraphed, has begun to be undertaken out of desperation to arrest the collapse of its economy at the hands of ailing balance sheets. Pulling a tiger out of the proverbial hat may seem somewhat easier than transitioning China to a more open-market economy when its country is swimming the tide of quicksand, as its debt sucks in all round it. And as we have warned, sucking the rest of the world in with it.

'The Economist' patently miscomprehends what the Chinese have been doing here. By trying to save the economy with a vast debt-for-equity swap, they have merely succeeded in creating an even more highly geared economy whereby ill-gotten equity gains were being redistributed into other sectors, such as Real Estate, the very asset that has been at the centre of the over-reaching economy.

Xia Dan, an analyst with Bank of Communications Co, summed it up nicely when he told a reporter that: "There is a renewed enthusiasm about buying real estate, which stimulated a rise in both sales and prices. The bullish stock market has generated massive wealth, strengthening a willingness to buy houses... Momentum in first-tier cities is particularly strong."

And as Sean pointed out:

> "As has been the case in every great financial mania since the days of John Law, each element of the madness is now fuelling the other. The NBS itself admitted that no less than 97% of the minor improvement in the April profit numbers for 'above-scale enterprises' was due to gains realised on firms' stock investments, not to any brightening of operational conditions. With UOB Kay Hian economist Zhu Chaoping calculating that such entities' notional holdings had doubled in a year to just shy of CNY1 trillion, there must seem plenty of scope for more of the same."

The fall-out of a failed attempt to revive the economy through this latest gambling directive by the ruling party, far from having little impact on the economy will most likely accelerate their deflating economy. 'The Economist' wrote that because stocks account for only 15% of household assets, the stock market crash will have little impact on consumption. This misses the point entirely. It is the investment spending boom which has driven the economy this past few decades and it is this which is now even more levered and fragile, as despite stock markets being up 75% or more since the bottom, loans and investment decisions had been taken out/on with values substantially higher than here. And whilst we will have a momentary reprieve in the markets with a State induced bounce, it will be a dead cat bounce as companies and investors take any opportunity they can to offload their losing positions. **The risks in China are so similar to the sub-prime crisis with Real Estate risk at the epicentre of the problems.**

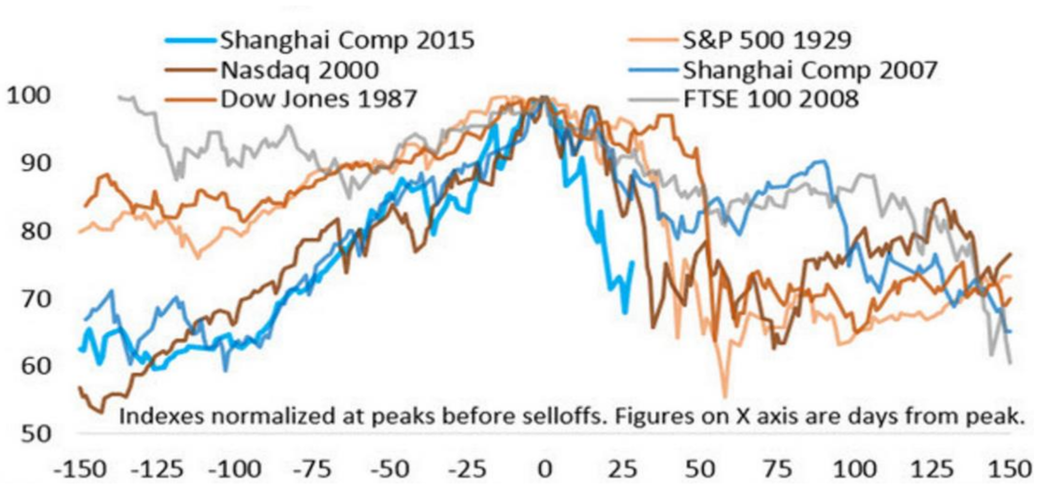
We would add though, in contrast, that in the annals of this history this market movement may well look like a flat line in the upward trajectory of a stock market. For at some point, China will build a US-styled 401k deeply liquid capital markets in both debt and equity to satisfy Chinese wealth and savings via a growing pension fund industry. If you look at the 1950s to 2015 in the US stock markets you will get the picture, but this assumes a big ask. Will China establish the yuan as the global monetary standard supported by a large military complex as have the US? For that is what must happen for this trajectory to potentially occur, although 1 billion active investors could be a very powerful dynamic, aging demographics aside. Before all this can happen the Yuan is overvalued and the PBoC and CP will resort to substantial devaluation – they have no choice as Fed interest rate signalling and yen weakness has pushed the proverbial horns of the impossible trinity upon them. This would be counter to their reform talk.

Unfortunately, the recent opening of the stock markets (the HK-SH connect) wasn't about reform either. This was a last-ditch move to shift the risk dynamics of the economy and when it didn't work the authorities panicked and shut down the roulette table. The losses are too big. The next step is surely to just socialise and restructure all the local government and SOE debts, but this will then threaten the power base of the regions, something the ruling party doesn't readily meddle in.

Take it on the CHINext

So fast has the mania and crash been, it is faster than anything that has preceded it in history. The duration, and hence velocity, of the crash has been so swift that the editors of Kindleberger's Mania, Panics and Crashes: A History of Financial Crises', may well have already written the first and last draft about this astounding event already. The chapter should tell 'how gambling was so endemic in China that it was only a matter of time before China's cultural crowd of speculators from the authorities to Auntie would turn into a deranged and maddening crowd fuelling stocks to an average value of 147x earnings. The subsequent crash would put the final nail in the coffin of a collapsing economic superboom.'

Fastest Mania to Panic on Record



Source: Bloomberg

As with any mania there is always the "new, new thing", as Michael Lewis once wrote. Sean picked up on this notion when he wrote:

> **"**Much of the focus of the wider 'investing' public is, as ever, on 'concept stocks', whether internet-related, telecommunications, or so-called 'cleantech' in this incarnation. Partly, this is because these are the ones being talked up by the regime as offering the pathway to a brighter, more prosperous future now that the smokestack days are fast fading into oblivion. Partly, however, such New Era counters are prominent because a sizeable proportion of the new stock market gamblers are students – some, moaned one dis-gruntled professor to Xinhua, devoting up to six hours a day to 'researching' and trading their plays instead of studying to master their disciplines. How very non-Confucian!
>
> As we have also seen, many such companies are them-selves benefitting from providing the financial and informational infrastructure bubble. Thus, for so long as it lasts, they are able to produce a simulacrum of earnings growth and hence are seemingly able to validate some of their student sponsors' bullish prognostications."
>
> The extent of Premier Li Keqiang's gamble had even extended to a personal endorsement of Beijing's third OTC board, where - as with any good mania - the IPO market exploded. In China, the State controlled the pricing of IPOs, not the market. They were held at artificially lower prices and then let loose on the market. The number of listed firms skyrocketed from 2013's 343 (combined market capitalisation of CNY137bln) to May 2015's 2,486 (market cap CNY850bln). So far, June has seen a further 114 new members, projecting a year end total in excess of 4,000...
>
> "...the regime which, desperate to keep the plates spinning using any and all means, has already announced that not only is it looking at relaxing (!) rules for IPOs and at providing NEEQ (as is the Third Board's official designation) entities with an easier exit onto the slightly less Wild West uplands of the ChiNext NASDAQ analogue, but that it will set up a 'Strategic Emerging Industries Board' at the Shanghai Stock Exchange in order to *'attract private capital in emerging and creative businesses, and provide an exit channel for private equity and venture capital investors'*."

Saving Face

Addicted to their own *mianzi (face)*, Chinese officials would far rather deny that problems exist than deal with them. We believe their gambling mentality and inability to recognise when they are wrong has maintained a charade of economic posterity.

President Xi Jinping referred to the slowing Chinese economy as the 'new normal' after years of double-digit growth. The arrival of the AIIB to help fund the new Silk Road projects has come at a convenient time. Whatever any economist says, China is still not shifting away from a country blighted by over investment in infrastructure building to grow its economy.

There is nothing new about how the Chinese are behaving. When we saw the Bloomberg headline on the morning of the 8th July – that they had banned stock trading – we just laughed with incredulity. We thought why not just suspend them all! Don't do half measures. At least that way you can guarantee they won't fall. Now all those overseas investors who participated in the market are locked in, as the ban is in place for over 6 months. As one colleague quipped, it's like hedge funds gating their funds in 2008 – the Chinese stock market is now just one big closed hedge fund. We must say that the legendary investor Stan Druckenmiller's comments on ChiNext being a sign of a recovering China economy are proving to be very, very wide of the mark. We couldn't have disagreed with him more at the time. We were genuinely surprised he made that comment. Like

'The Economist' doesn't get it, we believe he too has missed the bigger picture we have discussed here.

(Our point is not to poor scorn on Stan or score our own intellectual points. Just like the CP leadership none of us are omnipotent, we are all fallible and how we manage our mistakes and losses is more a measure of our own self-worth.)

This whole debacle has been about herding the collective to arrest medium term outcomes. **It is a fallacy that China can stymie the impacts of market forces even within a socialised form of capitalism (State Capitalism).** Of course, evidence would appear contrary – in the past the State has had the firepower to bail out banks. Think 1999, when Asset managers were used to bail them out at behest of government and then of course the famous floating of the banks to recapitalise them in 2003.

Think about how the State set up a stimulus program in 2008, as mentioned earlier, which saw excessive bank lending to SOEs and Local Governments (LGFVs) to fund white elephant infrastructure and industrial projects. Think of all those new SOEs that were formed to take advantage of this cheap credit, as private companies were not included in the mandate. But like with most emerging economies, what tends to be the one most important driver of economic success? It is housing and a booming real estate market which has been the sole basis for a massive expansion of credit and supply of capital in such countries. In China specifically, this helped fund all these local govt infrastructure and industrial projects. Again, it looked like the State could control outcomes.

It's the local governments who own the "LOCAL" or agricultural land. The State has tried to control the real estate bubble and it looked like it was taking the heat out of it carefully, but in reality it has been the local governments and SOEs who have a stranglehold on local land prices and prevented a complete rout. They have controlled what could be sold. Even though projects were technically insolvent they have been able to supply enough capital by selling off small parcels of land at sky high prices and thus borrow again based on this scarce market value. As in reality, if the market was freed of such influence prices would plummet with all the supply available. But as we all know, it appears now that the Local Government (LG) are now just selling land from one LGFC to another, so it's a game of musical chairs or pass the parcel. It has an end game and it's an exploding parcel for those local governments and by dint China.

Yet it is also true that the central state doesn't get involved in LG budget affairs. There is talk of property taxes and enforced selling of wasteful assets accompanied with LG fiscal budget limits. But if this does happen, civilian unrest is likely. The State has forced banks to convert loans to LGs into newly issued LG bonds at lower interest rates, which is effectively what happened in the 90s and was never paid back. Pretend and extend in effect. Remember, the plan of late 2013 to allow mixed ownership of SOEs, where private companies could hold a minority stake in SOEs? That has been disastrous as it just widened their (SOE) asset base and postponed the inevitable – cue stock market mania and panic.

It seems the reform of the past two decades occurred because it didn't upset the applecart, it enriched people – now reforms attack the status quo and vested interests. (We repeat, it seems to us that reform now is less about open democracy and more about controlling the China "resource" barons and debt implosion). These SOEs have a good thing going and have a judicial advantage relative to private enterprises. Just as in Japan in the 80s, even to the present day, these collective interests are crowding out true efficient deployment of capital by the private sector. They have helped to maintain the charade but it is clear it is unravelling and other than full socialisation of losses, the State is powerless to prevent or lock in the losses.

Of course, under the guise of "liberalisation" we also have this HK_SH connect and an "open" stock market. Well the State found it can't control this either. The difference with an open market place which has instant liquidity, as opposed to the glacial illiquid housing market, is there for all to see, plain as day. The State can't mask the realities that half these companies don't actually exist. Take ChiNext. The stock market is not a barometer of the economy as Druckenmiller suggests. It has been a nationalist encouraged version of Mahjong and Sic Bo on the grandest of stages. No amount of enabling and then disabling stock account openings and margin levels going forward can alter this fact.

The Chinese market has seen consistent speculative failure over the years – you can't say it's a fledgling market any more. Corporate governance and sound accounting practise (or audits of) is sorely missing though and yet it's still not young in duration.

The question that we must ask ourselves – and we will leave you all to ponder it **– is this, does the failure of the Chinese authorities to manage their stock market reflect the realities that even in the developed world stock markets cannot be underpinned by QE and intervention indeterminably?**

The Western markets may not have the same excesses in individual margining and silly valuations as China, although median values are high, but there is clearly still high credit, high margin exposure in Western equities. We have begun to believe all markets can be held up by the Central Banks/ State – we have conditioned ourselves to a 'don't fight it mentality'.

So unless by some miracle China can build the market to new highs in the next few years, the fall-out on the Chinese economy will continue. This is just another sign that interventions to maintain the Bretton Woods II monetary system cannot continue.

Of course, we all want to believe the maintenance of the status quo is more likely, that the world continues to limp along for decades and that it's even possible that the immense technological innovation we have witnessed to date in such a parabolic fashion will erode the debt bubble and boost nominal GDP levels. We ignore or hope that there will be no conflict between aging demographics and continued automation, but this is clearly not a given and for now is part of a much wider debate.

We can see decades of debt eroding, but without visually higher CPI prices our collective debt is still rising. Asset inflation can alter the net debt calculus in our favour – if assets rise to such a point that interest expense incurred to buy them cannot be met by cash flows, then prices will fall and debt to equity metrics will once again become problematic. We are clearly on the cusp of this with markets rallying and then failing. The parcel is being passed, the only question is – can we find new players to pass it to? Are we truly "One for All and All for One"? The State secret says otherwise.

Next month we will look share some of work from our subscription letters, Money Macro and Markets/ MidWeek Market Musings continuing our decade long theme concerning the demise of the Bretton Woods II monetary system. In our August HindeSight letter, 'The Great Wall of Money' we look at the case for Yuan devaluation and what this means for Global assets and economies

ABOUT US

Hinde Capital is a London based Investment Manager, specialising in developing world-class investment solutions for institutions, family offices, trustees, as well as high net worth private clients and their advisers. Hinde Capital offers investors a range of disciplined investment strategies that draw on the founders' real-world trading and risk management experience attained from previous senior trading and money managing roles at some of the largest global financial institutions.

Our principle aims are to help investors achieve real adjusted returns and provide long-term wealth protection. We offer funds and strategies that both grow capital and accrue income. This are run in Managed Accounts, Off Shore Funds and as Exchange Traded Products.

Established in 2007, Hinde Capital launched its first fund the same year specialising in the precious metals sector, Hinde Gold Fund, BVI Ltd. Hinde Gold Fund's primary aim is to provide our investors with exposure to the precious metals market through a highly liquid, actively managed fund with low leverage and security of assets.

Hinde Dividend Products were introduced in 2014 to provide a series of equity income strategies run by both strategy and geography, based on our proprietary valuation models the Hinde Dividend Value Matrix®. The SG Hinde UK Dynamic Equity ETN (50% Hedge) was the first of a series of equity traded products. We run European, US and MSCI Asian versions.

The strategies range from long only, 50% hedged to market neutral, enabling investors to switch between more or less exposure to stock markets but without negating the reinvestment of their dividends in the stocks held.

We will monitor the growth of money and credit and try to track them as they flow through the system, changing its topography as they do. Trade numbers, business revenues, production, prices, and payrolls, whether these bring surplus or deficit and involve borrower or lender will figure. All will be examined, as will market activity itself—the building of positions, whether the mood is trend following or mean reverting, bullish, bearish or plain bamboozled.

In all, we will do our best to keep you entertained as well as informed and to provoke many of the right questions as well as to provide some of the right answers.

DISCLAIMER

This document is issued by Hinde Capital Limited, 10 New Street, London EC2M 4TP, which is authorised and regulated by the Financial Services Authority. This document is for information purposes only. In no circumstances should it be used or considered as an offer to sell or a solicitation of any offers to buy the securities mentioned in it. The information in this document has been obtained from sources believed to be reliable, but we do not represent that it is accurate or complete. The information concerning the performance track record is given purely as a matter of information and without legal liability on the part of Hinde Capital. Any decision by an investor to offer to buy any of the securities herein should be made only on the basis of the information contained in the relevant Offering Memorandum. Opinions expressed herein may not necessarily be shared by all employees and are subject to change without notice. The securities mentioned in this document may not be eligible for sale in some states or countries and will not necessarily be suitable for all types of investor. Questions concerning suitability should be referred to a financial adviser. The financial products mentioned in this document can fluctuate in value and may be subject to sudden and large falls that could equal the amount invested. Changes in the rate of exchange may also cause the value of your investment to go up and down. Past performance may not necessarily be repeated and is not a guarantee or projection of future results. The Fund is categorised in the United Kingdom as an unregulated collective investment scheme for the purposes of the Financial Services and Markets Act 2000 and their Shares cannot be marketed in the UK to general public other than in accordance with the provisions of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemption) Order 2001, as amended, or in compliance with the rules of the Financial Services Authority made pursuant to the FSMA. Participants in this investment are not covered by the rules and regulations made for the protection of investors in the UK. Participants will not have the benefit of the rights designed to protect investors under the Financial Services and Markets Act 2000. In particular, participants will lose the right to claim through the Financial Services Compensation Scheme. The securities referenced in this document have not been registered under the Securities Act of 1933 (the “1933 Act”) or any other securities laws of any other U.S. jurisdiction. Such securities may not be sold or transferred to U.S. persons unless such sale or transfer is registered under the 1933 Act or is exempt from such registration. This information does not constitute tax advice. Investors should consult their own tax advisor or attorney with regard to their tax situation.