China's Year of the Monkees

By John Mauldin | January 24, 2016

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While we in the West get used to writing "2016" on our documents, China is getting ready for its own Lunar New Year. Their calendar kicks off the "Year of the Monkey" next month. At the rate they are going, though, Chinese markets look more like that hapless rock band that can't quite reach the main stage.

China isn't the only reason markets got off to a terrible start this month, but it is definitely a big factor (at least psychologically). Between impractical circuit breakers, weaker economic data, stronger capital controls, and renewed currency confusion, China has investors everywhere scratching their heads.

When we focused on China back in August (see "When China Stopped Acting Chinese"), my best sources said the Chinese economy was on a much better footing than its stock market, which was in utter chaos. While the manufacturing sector was clearly in a slump, the services sector was pulling more than its fair share of the GDP load. Those same sources have new data now, which leads them to quite different conclusions. If you have exposure to China – which you do if you own just about any stock listed anywhere – you'll want to read this issue carefully.

Let me remind you, before we delve into China, that the early-bird pricing for my annual Strategic Investment Conference ends next Sunday at midnight. I will admit to taking no small amount of pride in the fact that almost everyone who talks to me about the conference says it's the best investment conference they have ever attended. I carefully craft a blend of speakers each year to speak to the particular dynamic environment we find ourselves operating in. Attendees who have been to most of the conferences tell me that the experience gets better every year, and I have worked hard to continue that positive trend.

This year the theme of the conference is Decade of Disruption. We will convene special panels on what the Federal Reserve will do to try to prevent or to respond to the next recession. More QE? Negative rates? I am not looking for mere predictions – those are cheap. I want to discuss – wargame, if you will – the nitty-gritty implications of what will ensue if the world's reserve currency goes to negative rates. (I will introduce you to the man who has figured out how to do hundred-to-one leveraged bets on whether there will be negative rates in the US. For some portfolios and companies, that could be a lifesaver.) How would the other major central banks respond? I believe we are getting ready to enter a new and far more intense round of currency wars.

There will also be multiple panels on ways to find income in a low-interest-rate environment. I'm inviting some of my favorite biotech companies for a breakout panel presentation. And for the first time we will be doing a practical panel on portfolio construction and design, with some of the most famous and successful portfolio strategists giving you their thoughts about investing in what will be a transforming world as we enter the Decade of Disruption. Of course we will look at the European, Chinese, and emerging markets, too.

We have just announced that Niall Ferguson and Jim Grant will be speaking this year, in addition to David Rosenberg, Gary Shilling, Lacy Hunt, and David Zervos. As a special treat, we have all three founders of GaveKal – father and son team Charles and Louis Gave and Anatole Kaletsky.

(It's a rare event for them to gather from around the world. It's always fireworks when they're together.) Neil Howe, one of the world's foremost experts on demographics and generational trends, will be making a special first-time presentation at my conference. His speech will be entitled "The First Turning," a preview of the book he is writing, which is a follow-up to one of the most prescient books ever written, *The Fourth Turning* (back in 1997).

Of course George Friedman will be there, as well as my friend Pippa Malmgren, to talk over geopolitical dynamics. Thursday night will be a special treat as we move the entire conference one mile down the road to a very large country and western bar, where we will have barbecue, longnecks, and some politics. Michael Barone, Steve Moore, and Juan Williams will show up to hash over the coming elections. (And who knows, maybe a few particularly well-known politicians will grace our presence.) You don't want to miss Mark Yusko's first presentation at my conference, either. There will be at least a dozen other speakers and panel members. And we are still negotiating with a few significant "power names" that will only enhance your experience.

We will be making available special software that will let you know who else is in attendance and to schedule networking meetings with those you want to meet. Frankly, the most impressive thing about the conference, beyond the speakers, is the caliber of the attendees. I guarantee you will meet people this year who will make your business or investment portfolio better just by your knowing them.

The Strategic Investment Conference will be held in Dallas May 24–27, ending at noon on Friday, so there will be plenty of time to get back to wherever you need to be from the very convenient DFW airport. Don't procrastinate. Sign up now. And now let's turn to China and the rest of the world.

Don't You Make My Beige Book Blue

On Tuesday Beijing released its quarterly economic growth update. China's GDP growth has been hovering near 7% for years. That number – if it were even correct – would be a dream come true for most of the world.

We learned this week that China's growth declined all the way to 6.9% last year (horrors!). That's still wonderful by any other country's standard, but the fact that China showed any decline at all made some people think the sky was falling.

Now, it may well be the case that China's economy is faltering, but its GDP data is not the best evidence. As we have discussed (see "Weapons of Economic Misdirection"), GDP numbers don't tell us much even if all the data inputs are correct – and in China they are most certainly not correct, for reasons I've written about before. Nor are other numbers that emanate from the Chinese government reliable.

To whom can we turn for reliable data? My go-to source is Leland Miller and company at the

China Beige Book. Full disclosure: I have been a long-time advisor to CBB, and they have been very generous in sharing their time and information. What makes them different is that they have rather large teams collecting on-the-ground reports from local observers and companies all over China and compiling the information they collect into a massive quarterly review. If I remember right, they amass over 2,000 different data points each quarter, which makes their work as useful as the Fed's Beige Book, which is similarly sourced from all over the country. I'm not aware of anything else like it. China Beige Book consistently flags important changes months before anyone else does.

CBB's Leland Miller was on CNBC right after the China GDP number came out. Watch the video below, and you'll see he was not impressed.

Leland and I caught up on the phone a few hours after that TV appearance. He bent my ear with more detail on the Chinese economy, some of which I can share with you. The changes in China are stark when you step back from this month's fireworks and consider them in a longer-term context.

China Beige Book started collecting data in 2010. For the entire time since then, the Chinese economy has been in what Leland calls "stable deceleration." Slowing down, but in an orderly way that has generally avoided anything resembling crisis. As any emerging market becomes larger, its growth invariably slows down. This is a normal trajectory of developing economies. What is impressive is that China's has been a *stable* deceleration. That is an unusual outcome that I can't really remember occurring anywhere else. It is why so many observers keep expecting a "hard landing."

It was Leland, by the way, who gave me the title idea for last summer's "When China Stopped Acting Chinese" letter. China Beige Book noticed in mid-2014 that Chinese businesses had changed their behavior. Instead of responding to slower growth by doubling down and building more capacity, they did the rational thing (at least from a Western point of view): they curbed capital investment and hoarded cash. With Beijing still injecting cash that businesses refused to spend, the liquidity that flowed into Chinese stocks produced the massive rally that peaked in mid-2015. It also allowed money to begin to flow offshore in larger amounts. I mean really massively larger amounts.

Leland said at the time that the stock rally had little to do with China's actual economy, which his data showed to be on the mend. That's no longer the case.

Dealing with a Different China

China Beige Book's fourth-quarter report revealed a rude interruption to the positive "stable deceleration" trend. Their observers in cities all over that vast country reported weakness in every sector of the economy. Capital expenditures dropped sharply; there were signs of price deflation and labor market weakness; and both manufacturing and service activity slowed markedly.

That last point deserves some comment. China experts everywhere tell us the country is transitioning from manufacturing for export to supplying consumer-driven services. So if both manufacturing and service activity are slowing, is that transition still happening?

The answer might be "yes" if manufacturing were decelerating faster than services. For this purpose, relative growth is what counts. Unfortunately, manufacturing is slowing while service activity is not picking up all the slack. That's not the combination we want to see.

Something else China Beige Book noticed last quarter: both business and consumer loan volume did not grow in response to lower interest rates. That's an important change, and probably not a good one. It means monetary stimulus from Beijing can't save the day this time. Leland thinks fiscal stimulus isn't likely to help, either. Like other governments and their central banks, China is running out of economic ammunition.

One quarter doesn't constitute a trend. Possibly some transitory factors depressed the Chinese economy the last few months, and it will soon resume its "stable deceleration" course. It is hard to imagine what those factors might have been, though. The data is so uniformly negative that it sure looks like something big must have changed.

What does this economic weakness say for Chinese stocks? Probably nothing. It should be clear to all that the Chinese stock market is completely unrelated to the Chinese economy. They don't move together, nor do they move opposite each other. They have no consistent connection at all – or at least not one we can use to invest confidently. I went to Macau when I was in Hong Kong a few weeks ago, just to observe the fabled fervor with which the Chinese gamble. The place did indeed have a different "feel" than Las Vegas does. I'm not the only one to think that the Chinese stock market is just an outpost of Macau, but one in which leverage and monetary stimulus can overload the system.

Let me say that there are real companies with real value in China. But the rules on the ground, not to mention the accounting, make it a particularly treacherous market to invest more than your own "gambling money."

China's currency is another story – and a much deeper one.

Yuan Flew Over the Cuckoo's Nest

Recent Chinese stock market volatility has had more to do with China's currency than its stocks. Donald Trump and other politicians (yes, he is one) often assail Beijing for devaluing its currency and acquiring an unfair advantage.

First, the Chinese have actually been manipulating their currency upwards. While countries in the rest of the world have been letting their currencies devalue against the dollar, China has maintained an effective dollar peg until very recently. And then the "move" that seems to have everybody in a dither was only about 4%. To be fair, what really had the markets worried was that this move might presage an effective devaluation. And considering that China has watched the euro, the yen, and nearly every emerging-market currency drop anywhere from 30 to 50% against the yuan – a rather painful experience for its export sector – the Chinese have been quite patient.

I find it fascinating that we can be singularly focused on China and its currency, which has moved only slightly, and not pick on those countries that are openly and aggressively manipulating their currencies down. Seriously, if you want to have an intellectually consistent argument, why not talk about what those evil people in Europe are doing to lower their currencies against the dollar? Or Mexico? Or almost any other country in the world? If you are truly against the strong dollar, then why not just say so and promote a policy of further massive quantitative easing and competitive currency devaluation? That is the only logical conclusion to the Chinese currency-bashing polemics. I guess all the loose talk is just another misguided attempt to Make America Great Again™.

In a normal world, nations with trade deficits naturally see their currencies weaken. No one needs to intervene or manipulate markets. When you bring stuff in, you send cash out. When you send stuff out, you bring cash in. It's as effortless as breathing. **And if your cash is useful only for buying things in your local country, when too much of your money is offshore, your currency is going to weaken.**

Then why has the dollar gotten stronger even as we continue to run massive trade deficits? Because the dollar, being the world's reserve currency as well as the currency for international trade, is in demand. In fact, it is in such demand that if we closed the trade-deficit gap (as we have been starting to do), the dollar would get even stronger, because the world needs dollars to facilitate global trade. We do indeed enjoy a special privilege. Which is why I want to think at my conference about the consequences of the world's leading trading currency going to negative interest rates.

It is true that politicians everywhere try to pervert the trade process and gain short-term advantages by cheapening their currencies. Most are smart enough not to equate their currency valuations with national pride. I wonder if Trump, et al., have thought through the consequences of their seeming desire to see the dollar weaken. Hopefully someone will enlighten them soon.

Back to our story: does Beijing think it can boost exports by manipulating its currency lower? I don't think so. Remember how their business model works. Unlike, say, Saudi Arabia, China doesn't simply extract resources from the ground and export them. China *imports* raw materials, transforms them into finished goods in its factories, and then exports those goods. Their gain lies in the value added in the manufacturing process.

That means that China can't grow exports without also growing imports. Pushing the yuan lower helps, but it's a relatively inefficient tool for reducing the trade surplus.

Cheapening the currency has another consequence China doesn't want. It makes imported products more expensive for Chinese consumers. The country's abilities are growing fast, but it still depends on outside sources for many important goods. Making them cost more doesn't help build the consumer-driven economy Beijing says it wants.

For those reasons and more, China Beige Book has a contrarian view on the Chinese currency. They believe Beijing wants the yuan to rise, not fall. So what is happening with all these interventions the Chinese authorities are making in the currency market?

The first point to remember is that the adjustments have all been quite small – far smaller than the hoopla suggests. For all the clamor that erupted last year, the yuan fell just over 4.5% against the dollar. That's quite a lot if you are leveraged 10x, as currency traders often are, but for most merchants and consumers the change was hardly noticeable.

Recall all that happened in 2015. Aside from the stock market fireworks, China won acceptance of the yuan into the IMF's reserve currency basket. It also watched the Federal Reserve finally make a first, tentative move toward higher rates and a correspondingly stronger dollar. If all that couldn't crush the yuan, it's not clear to me that anything will.

Nevertheless, periodic adjustments make headlines because they happen so unpredictably. I think the surprises are intentional. The People's Bank of China wants to keep markets guessing about its intentions. This tactic allows them to gradually nudge their currency in the desired direction. And by *gradually*, I mean over years or even decades.

Let's go back to the two Chinese sages I quoted at the beginning of the letter. You have to know the Chinese leadership is steeped in such philosophies:

> "It does not matter how slowly you go as long as you do not stop."
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> – Confucius
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> "Be extremely subtle, even to the point of formlessness. Be extremely mysterious, even to the point of soundlessness. Thereby you can be the director of the opponent's fate."
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> – Sun Tzu

The second point is critical: China controls its currency by both central bank action and subtler tools. They have immense power to nudge the currency up or down. Tightening and loosening the controls is like turning a volume knob. They can crank the yuan up or turn it down.

Presently they are clamping down harder than usual in order to deter speculation. Much of this is happening under the radar, one business and industry at a time. Nevertheless, people are starting to feel the consequences.

China Law Blog (what, it's not on your regular reading list?) is a great resource from Harris & Moure, a Seattle law firm that helps companies navigate the Chinese import-export maze. I like it because they write in language that can be understood by anyone. They said this on Jan. 14:

> Regular readers of our blog probably know that our basic mantra about getting money out of China is that if you have consistently follow[ed] all of China's laws, it ought to be no problem. Not true lately.
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> In the last week or so, our China lawyers have probably received more "money problem" calls than in the year before that. And unlike most of these sorts of calls, the problems are brand new to us. It has reached the point that yesterday I told an American company (waiting for a large sum in investment funds to arrive from China) that two weeks ago I would have quickly told him that the Chinese company's excuse for being unable to send the money was a ruse, but with all that has been going on lately, I have no idea whether that is the case or not.

> So what has been going on lately?
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> Well if there is a common theme, it is that China banks seem to be doing whatever they can to avoid paying anyone in dollars.

I heard similar rumblings when I was in Hong Kong earlier this month. China is making it very, very difficult to move capital outside the country. They do this in many different ways, as you'll see if you read the article above. Banks and bureaucrats all over China are clearly responding to some kind of central edict.

We don't know exactly why Beijing is doing this. If, hypothetically, they wanted to make it difficult for foreigners to take short positions against the yuan, what they are doing would help. And we know they are restricting access and bringing regulatory oversight to bear on those who want to short the yuan.

Leland Miller is very confident – and I concur – that China will not impose any major overnight devaluations, as so many people fear they will. Doing so wouldn't move them toward their goals and would send them backwards in some respects. I have talked with other veteran Chinese watchers who also agree. The Chinese will continue to do whatever they do in very deliberate, often confusing, and sometimes downright mysterious ways.

If we do see a huge devaluation, it will mean something is very, very wrong in China. It will be an indication that the wheels are coming off. The Xi Jinping government will do all it can to avoid getting stuck in that position.

Leland reminded me that China is scheduled to host this year's G-20 summit meeting in September. The last thing the Chinese will want is negative economic headlines while the leaders of the world's top economies gather in Hangzhou.

On the other hand, the Chinese can't control the headlines or the rumor mill on the trading floors. This limitation might explain their vigorous resistance to speculators who want to provoke a devaluation. Beijing wants to squelch that trade before it attracts more attention. It is very easy to believe that their concern is as much about maintaining the appearance of control as it is about the actual currency valuation.

Understanding all this is hard because we want there to be a binary choice: i.e., the yuan must go up or must go down. Beijing doesn't see it that way. They have very long-term goals and don't mind taking a circuitous path toward achieving them. What they can't countenance is anything that makes the Chinese public lose faith in the government.

In other words, the exchange rate can do whatever it will so long as the public believes Beijing is either in charge or at least neutral. The authorities intervene when necessary to preserve that perception. Otherwise, they seemingly take a hands-off approach.

The macro traders who think they can provoke Beijing into a major one-off devaluation aren't likely to get one, in my view. To paraphrase Keynes, Beijing can stay stubborn longer than traders can stay solvent.

The Other Side of the Coin

As I noted above in reference to Donald Trump, FX rates have two sides. If one side goes up, the other must go down. If you believe the yuan will weaken, you also believe the dollar will strengthen, which in fact it has done in recent years.

Bearish yuan sentiment is also bullish dollar sentiment. A month or so ago, when the Federal Reserve told us it foresaw four interest-rate hikes in 2016, many thought this trajectory would be positive for the greenback. They might have been right, too, but now it appears unlikely that we will ever find out. No one expects a Fed move next week, and the odds are getting slimmer that we will see any more rate hikes through the end of 2016. Maybe just another token move this summer? And maybe the data trends can turn around – that is something we all would like to see. But the markets are not expecting more than one or maybe two interest-rate bumps this year.

So something curious has happened. People turned bearish on the yuan because they were bullish on the dollar. Now the prime factor behind the expected dollar strength has changed, but the bearish yuan sentiment is still with us. And dear gods, what will happen when the world goes into another recession and the Federal Reserve starts another round of easing? That scenario would be dollar bearish. Will US politicians stand up and accuse the Federal Reserve of participating in a currency war? Just asking.

Is there some new, different reason to think the RMB is headed down? Maybe. The faulty circuit-breaker scheme behind this month's Shanghai stock selloff didn't inspire confidence in Beijing. Whatever Chinese citizens think, it sure looked like a bone-headed move from the outside.

Yet remember what happened. When Shanghai couldn't stay open for even an hour without tripping the breaker, the powers that be recognized their mistake and backtracked quickly. By their standards, that response was equivalent to jumping into hyperspace. Chinese authorities rarely move so fast.

You can call their reaction panic if you want, but it also shows something else: flexibility. A supposedly hidebound, dogmatic regime turned on a dime when it had to. Would the same have happened in the US? I don't think so. We would have watched markets crash, convened a blue-ribbon panel to investigate, and then made some tweaks a year or three later.

Admitting mistakes is hard, even for communist governments. That Beijing can do it when necessary suggests that they will not be easily bullied.

I began this issue by comparing Chinese markets to the Monkees. If you never saw their 1960s TV show, it was a shameless attempt to exploit Beatlemania. As a band, the Monkees were strictly made-for-TV.

Yet something unexpected happened. The four young actors turned themselves into musicians. Some of their music was forgettable, but some of it was pretty good, too.

China's attempts to build modern markets and join the international financial elite can be funny to watch – but won't always be so. Like the Monkees, China has a chance to actually become what it once only pretended to be.

The Chinese are in the middle of that process right now. Beijing has many Daydream Believers. Bet against them at your peril.

Hollywood (Florida), Cayman Islands, and Surprises

I fly tomorrow to Hollywood, Florida, where I will participate in the ETF.com conference with some 2000 people, talking about all things ETF. I will be giving the keynote address at the Tuesday lunch, doing interviews, holding meetings, and of course doing the rounds of dinners and gatherings every evening. I expect to learn a lot. If things work out, I will get to spend some time with old friends Dennis Gartman, Mark Faber, Steve Blumenthal, Jeff Gundlach, Jason Hsu and Mark Yusko, plus join in tons of meetings and dinners and make new friends. It will be a very busy three days.

The following week I fly to the Cayman Islands to speak at the Cayman Alternative Investment Summit, one of the biggest hedge fund and alternative investment gatherings outside of the US. They have an impressive lineup of speakers, and I note that this year the celebrity guest speaker is Jay Leno. That should be fun. I just looked through the speaker list and noticed that Pippa Malmgren, who will also be at my SIC conference, is speaking, and it will be fun to catch up with her again. I will be on a panel (moderated by KPMG chief economist Constance Hunter) with old and brilliant friends Nouriel Roubini and Raoul Pal. At least I know that with those two guys there is no need to wear a tie.

It was interesting to go back and listen to the Monkees while I was writing this letter. They were a part of my youth, and they got a lot of radio time. Who can forget "Last Train to Clarksville," "Daydream Believer," "I'm a Believer," "Pleasant Valley Sunday," or "Stepping Stone?" In doing the odd bit of research here and there, I found out that at their peak in 1967, they outsold the Beatles and Rolling Stone combined – though after their string of hits they fell off the charts faster than subprime mortgages. Leader Davey Jones passed away in 2012, but the remaining three still put together reunion tours every so often, and if they ever get near me again I might just go. They also cranked out their share of forgettable songs, but you nostalgia buffs can groove on their greatest hits here.

Since it's just us friends talking, I will admit to actually buying a stock a few days ago. It's a huge regulatory issue for me to mention what stocks I'm buying in this letter, so I won't. But this was a company and an industry (not energy) I am familiar with and have been following for a while, and their stock has been dropping like a stone. When their physical dividend got to 27%, I called my broker and a few analysts and asked what gives. I heard all sorts of reasons as to why the stock might be going down, but when I look at their free cash flow, which is now about 75% of their total market cap, it looks to me as if they have plenty of coverage on their dividend. This is a company that is not going away. But at the price I bought, even if they cut their dividend in half, which I don't think is likely to happen, I would still get a 13% yield, which in my considerable experience is pretty juicy.

When I get on the phone with friends, they are talking about all sorts of MLPs with yields in the teens, some of which I wouldn't touch with a ten-foot pole and others of which I have to admit are quite tempting. Yields that high can cover a lot of sideways movement in the market for a long time. Companies that analysts don't seem to understand and that are in unloved industries – but still have a dominant business model and a management team that is solid – are starting to show up on my radar screen. I tend not to buy individual stocks but prefer to buy managers. Just a personal preference. But every now and then I make an exception, generally when I see something of compelling value. Right now it looks as though I randomly picked the absolute bottom for the company I bought, but who knows? In another month that yield might be 30% as another slide comes along. Or there could be a dividend cut. But frankly, where I bought it, as long as they keep paying me that dividend, I really don't care.

If the stock works out, I'll look back and wonder why I didn't put 10% of my portfolio in it. I am very light on fixed-income and yield plays – I'm actually very happy about that, as there are too many opportunities that give me more potential than the typical fixed-income 3–4% returns – but I could use more of them. If the stock doesn't pan out, then you'll hear me say it wasn't that big a deal. I'm just as human as anyone else. I'll let you know in a few years whether I was an idiot for not buying more or whether I was an idiot for buying at all.

You have a great week. Mine is going to be Fast and Furious. I am really looking forward to it. There will be lots to learn and some really great conversations.

Your analyst,

John Mauldin

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