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Made in China

According to China's National Bureau of Statistics, nominal Chinese GDP, sparked by a 20.9% surge in urban fixed-asset investment, grew at a year-over-year rate of 12.1% in the first quarter. Yet, according to China's heavy construction machinery trade group, sales of excavators, loaders, bulldozers, etc., plunged at year-over-year rates of 27% to 48% in the same quarter—and in the same China. A fair-minded observer, blending macro and micro sightings, might thus conclude that the economy of the People's Republic lacks coherence as well as forward propulsion.

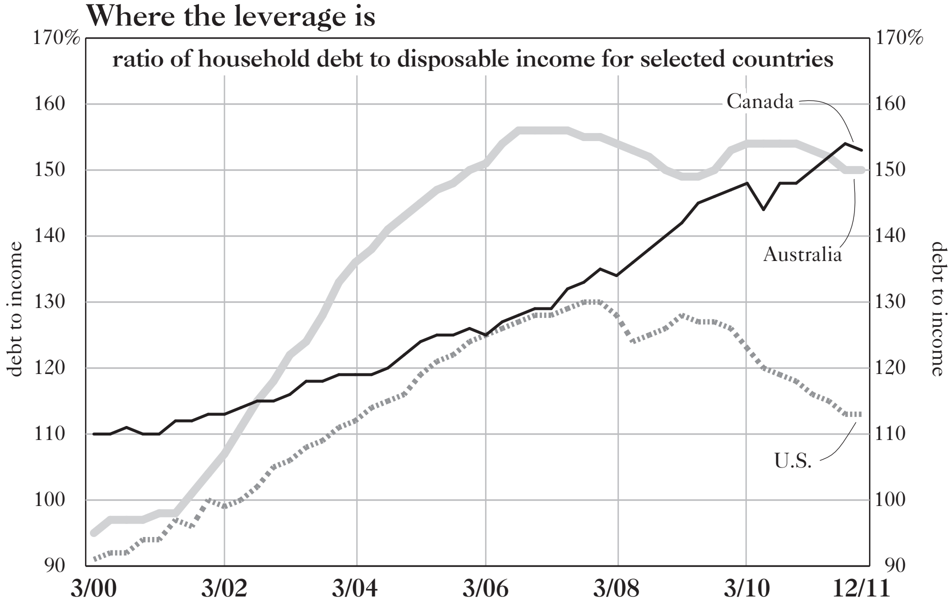
Now unfolding is a reappraisal of the credit-swollen Chinese enterprise taken from three different vantage points. Construction-equipment manufacturer Zoomlion is the first, the Australian dollar is the second and the Canadian dollar is the third. They make a worrying triptych, in our opinion. In preview, we remain bearish on the People's Republic and its manifold derivatives.

Zoomlion Heavy Industry Science & Technology Co. (1157 on the Hong Kong Stock Exchange) featured in these columns last year as a miniature of China's debt-addled industrial economy (*Grant's*, Oct. 21). If you missed that analysis, you would have no reason to doubt that a precipitous fall in construction-equipment sales wouldn't make some dent in the fortunes of a $7.2 billion-revenue construction-equipment manufacturer. But Zoomlion managed to report an 8% jump in first-quarter revenues, paced by a 40%-plus jump in concrete-machinery sales.

Hats off to Jefferies & Co. analysts Julian Bu and Zhi Aik Yeo for their May 2 note on this curious triumph. They observe that Zoomlion is selling a lot of equipment in markets where customers would seem not to need it. One such hot spot is Jiangsu Province, which accounts for 15% of national concrete volumes. In Jiangsu, utilization rates on concrete-related machinery fell to 36% in 2011 from 47% in 2010. Then, too, the analysts observe, developers and local governments are notoriously slow-pay. A would-be buyer of a Zoomlion concrete placing boom or truck-mounted concrete mixer might very well be short of funds.

Which, however, turns out to be no insuperable problem in the short run. Zoomlion offers its machines for nothing down and with E-Z terms postdelivery. "[M]ost importantly," the Jefferies team points out, "the new machines bought on credit are further used as collateral to obtain loans from banks." So a self-propelled concrete truck, for instance, is actually a kind of mobile bank-credit procurer. True, such equipment might be judged redundant by conventional lights. But to those conversant with Chinese financial practices, they are essential cash-management tools. "Many of the unneeded machines are put either in a warehouse or simply outside covered with canvas," the analysts write. "We heard that 50%-60% of the concrete

Where the leverage is



sources: Reserve Bank of Australia, the Bloomberg machines sold by Zoomlion in 1Q haven't been started."

Of course, this can go on only so long. When a customer finally defaults, Zoomlion sends a repo man to secure its collateral—though if the equipment happens to be engaged in a public project, the government may order it unsecured. Reports the April 30 *South China Morning Post*: "Mainland [China] developers' financial health has raised warning bells, as most of the top 30 listed players record negative cash flows and post debt ratios exceeding the last big downturn in 2008."

How to hedge against the faltering Zoomlion economy? Currencies are one possibility—though, of course, a risky one. We have our eye on the Aussie and Canadian dollars.

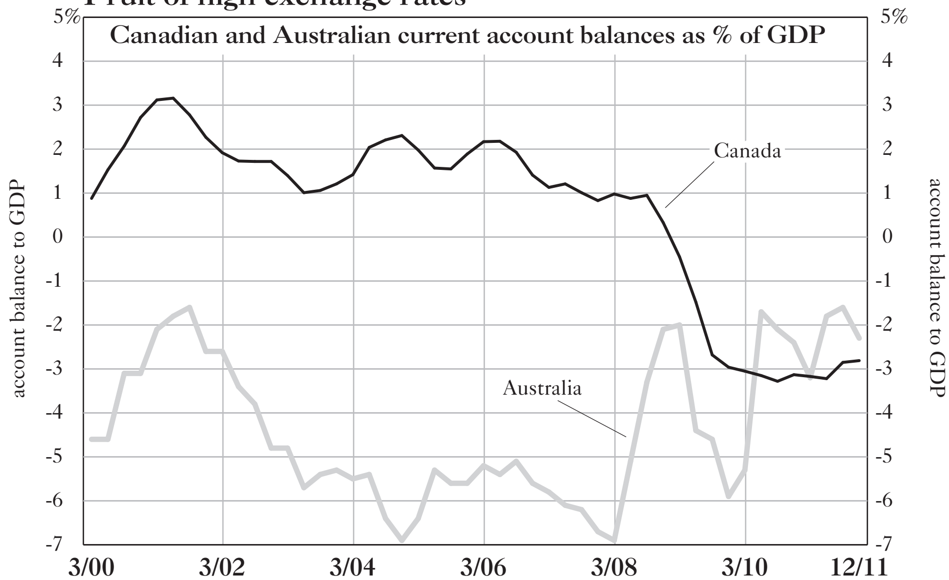
"What do you call a credit bubble built on a commodity bull market built on a much bigger Chinese credit bubble?" inquires Société Générale analyst Dylan Grice in an April 25 research note. "Leveraged leverage? A CDO squared? No, it's Australia."

Australia has become a kind of Chinese appendage. Mining investment is the dynamo Down Under, Philip Lowe, deputy governor of the Reserve Bank of Australia, noted in a March 7 talk to the Australian Industry Group: "Over the next few years, mining sector investment will reach new highs as a share of GDP, and is likely to account for around 40% of total business investment," he said.

The Chinese boom has put Australia through its paces. Since the modern era of paper currencies and floating exchange rates began in 1971, the Aussie dollar has commanded an average of 88 American cents. At year-end 2000, before China got rolling, it bought 56 cents. When, on Monday, it bought fewer than 100 cents, observers gasped (it had been quoted at 110 cents as recently as last July), but even 99 cents is high in the long-term scheme of things.

The elevated Aussie dollar is more than a mirror to the goings-on in the People's Republic. It is also the cause of a rolling redistribution of economic energy inside the $1.5 trillion Australian economy. Manufacturing is down and out (the country consistently imports more goods and services than it exports), and tourism, too, has suffered. Capital flows have become a force to reckon with. Three-quarters of Australia's government debt is held by nonresidents, while Australian banks fund only 64% of their assets from local deposits or equity.

Fruit of high exchange rates



source: The Bloomberg

"The decade-long investment boom in the natural resources sector combined with a two-decade-long economic expansion (Australia last suffered a recession in 1991) has led to a significant increase in debt and asset prices," colleague Evan Lorenz notes. "The ratio of debt to disposable income for Australian households rose to 149.6% in December 2011 from 96.8% in December 2000. For comparison, debt to disposable income in the United States stands at 112.7%. Aussie house prices are high enough to land the country near the bottom of the international scale of housing affordability."

If we are right that Zoomlion is no anomaly but a window on the Chinese credit structure, the Aussie dollar would be at risk. It might be anyway. On May 2, Alberto Calderon, chief executive of BHP Billiton's aluminum, nickel and corporate development groups, told a Sydney investment audience that the pace of his company's investment in Australia was going to slow on account of rising costs and growing uncertainty about China. Next day, Rio Tinto CEO Tom Albanese echoed Calderon: "Coal is an increasingly difficult business in Australia," he said, indicating that the pace of Rio Tinto's Australian investment would also decelerate.

"I've been speaking with a few engineering consultants in Australia," Adrian Hart, senior manager of BIS Shrapnel, a Sydney market research firm, tells Lorenz by phone. "They tell me that when they scope out costs now for some of these big mining projects, such as for coal loaders or things like that, typically costs are double what they were five years ago."

But let us say, Hart proceeds, that China continues to generate 8% growth—that things do go according to the five-year plan. "I have quite serious concerns about the middle of the decade when a lot of the construction boom related to mining will have peaked and should begin declining significantly thereafter. I don't see the same scale of projects yet lining up to sort of match what we are seeing right now." If, indeed, things are so good they can hardly get better, it follows that engineering construction firms like Monadelphous Group (*Grant's*, Jan. 13), which trades at 15.9 times expected fiscal 2012 net income ending in June, may be quoted at peak earnings.

And perhaps we have seen peak interest rates. On May 1, the Reserve Bank of Australia trimmed its target cash rate by 50 basis points, to 3.75%. Not the least of the props under the Australian dollar has been the RBA's nominal rates, unusually (for today's world) pitched above zero.

Canada, too, is dining at the great Chinese restaurant. Seven percent of Canada's exports are consigned to the People's Republic, and Chinese is the third most-spoken language in Canada, behind English and French. And as Canada and China have grown closer together, so has Canada come to resemble Australia.

House prices are high and rising in Canada as they are Down Under. Canadian manufacturing exports are in the doldrums, just as Australia's are. And the Canadian dollar exchange rate is historically elevated, just like Australia's.

Post-1971, Canada's dollar has fetched an average of 83 American cents, but vibrant Canadian commodity exports and a rush of inbound Chinese investment (*Grant's*, May 20, 2011) have pushed the loonie to 100 cents.

"What became clear to me," Vijai Mohan, portfolio manager at Hyphen Fund Management, tells Lorenz, "especially when you go look at old research reports, which I love to do, the Canadian dollar wasn't called a commodity currency 10 years ago—it was just the Canadian dollar. Yet today it has morphed into this leveraged investment play that is basically all things emerging markets and global growth. That's part of what has driven the Canadian dollar to an extreme.

"The Canadian dollar, to me, is what should be a classically mean-reverting relationship," continues Mohan, who says he is short the loonie. "Seventy-five percent of Canadian exports go to the United States, and Canada, although they would disagree vehemently, is essentially part of the United States. [Note to Canadian readers: Alternatively, the United States is essentially a part of Canada—ed.] It shouldn't be all that different. However, the currency itself is near an all-time wide relative to the U.S. dollar. I found that fact very interesting. Digging deeper into all of the main factors that matter, whether it's purchasing power parity, current account deficits, the weird things happening in the real estate market, inflation differentials—these things are at historic wides."

As for interest rates, three-month Libor stands at 1.35% in Canada, 4.18% in Australia and 0.47% in America. By the law of interest rate parity, as every CFA charter holder knows, the Canadian and Aussie dollars should depreciate against the greenback. For ourselves, we draw our principal bearish conviction on the Aussie and Canadian dollars not from interest rates but direct from Zoomlion. We continue to believe that China is less than it seems.

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