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Sell a non sequitur

The asset-allocation votes are in for 2017, and the results are confounding. For instance: Buy copper, coal, iron ore and/or the stocks of the companies that mine them. Yet also: Sell China's renminbi, the currency of the top consumer of those very commodities. You can understand either proposition in isolation, but the two of them together? An enigma. Skipping down to the bottom line, *Grant's* is bearish on industrial commodities.

China, say we, is a smoldering volcano. As with any volcano fixing to erupt, you can see the smoke and smell the fumes. You ask the geologists when it will blow. They say that the timing is uncertain. Very helpful.

So, a little, with us. We observe the excesses in China's lending and borrowing, the capital flight, the speculation, the government's suppression of unwelcome economic information, the empty cities and the inflated asset prices. When might the eruption occur? The timing is uncertain.

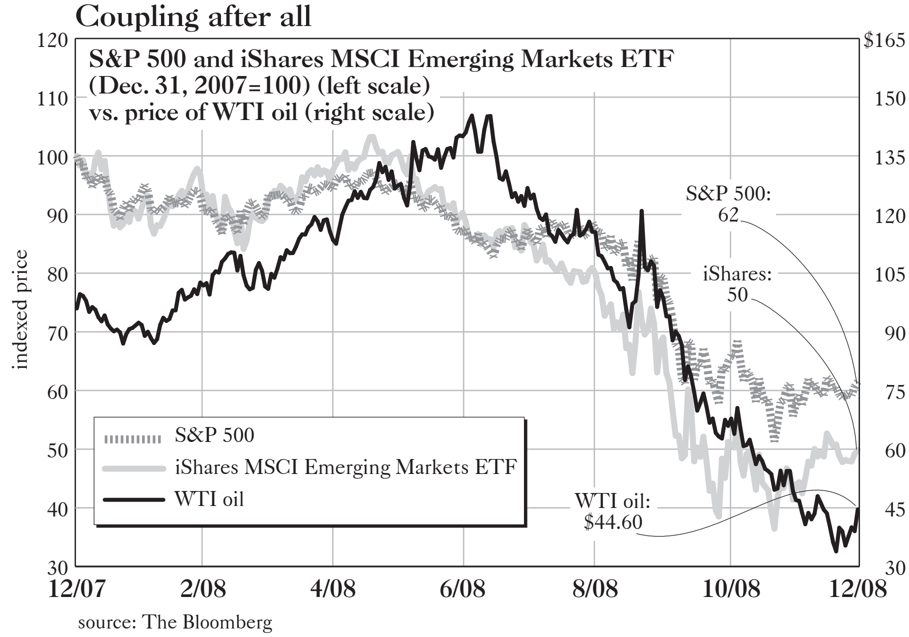
However, the speculations proposed in this unfolding analysis require no Armageddon-like triggering event. A deceleration in Chinese economic growth would do the trick. So, equally, would a small crisis in wealth-management products (of which more in a moment).

Copper is our exhibit A. Red China takes more than 40% of the world's annual production of the red metal. North American and South American copper consumption combine for just 12% of the grand total. Nothing short of the construction of a very high, very thick and extremely beautiful pure copper fence between San Diego and Brownsville, Texas, would help to reconfigure the balance. Nonetheless, speculators are long a net 44,484 copper contracts, near a record-high dating back to at least 1992, according to the Commodity Futures Trading Commission. At a price of $2.61 per pound, copper costs 22% more than it did at the close of 2015.

Steel, iron ore and metallurgical coal constitute our exhibit B. According to data quoted in the Oct. 13 *Hindu BusinessLine*, China accounts for 44% of global steel consumption and imports two-thirds of all seaborne iron ore. No matter how big the Trump administration's infrastructure build-out may prove to be, the United States will remain a relative cipher in the world steel situation (America consumes 95 million tons out of slightly more than 1.5 billion tons per annum). Yet 68% of the 250 investors surveyed last week by the Singapore Exchange Ltd. predicted that iron ore prices will end the new year flat or higher. This would follow a 81% rally last year.

What happens in China by no means stays in China. On Dec. 29, Ramaco Resources, Inc., a metallurgical coal company with four mines in development in West Virginia, Virginia and Pennsylvania, filed a registration statement to go public. Donald Trump may have a soft spot for coal, and for the voters who mine it, but it's the People's Republic on which Ramaco management is banking. The registration filing observes that "premium global quarterly coal benchmark prices have rebounded significantly since early 2016, rising from $81 per

Coupling after all



source: The Bloomberg

[metric ton] in January to March 2016 to $200 per [metric ton] in October to December 2016, as government policies curtailing the number of working days at Chinese coal mines in China curbed domestic supply."

What the prospectus does not acknowledge is the speculators' contribution to the upside whoosh in the prices of met coal, along with iron ore and copper. Christopher Balding, an associate professor of business and economics at the HSBC Business School in Shenzhen, tells colleague Evan Lorenz that, yes, Chinese mine-production capacity has lately been pinched. He says that "there is still plenty of surplus capacity," which leads him to conclude that the principal motive force in last year's levitation of industrial-metals prices was financial speculation through wealth-management products.

Implicit in the bullish arguments concerning industrial commodities is the notion that their prices can decouple from the goings-on in China. Veterans of 2008 will shudder. One of the abiding misconceptions of that annus horribilis was that the emerging markets could "decouple" from the sclerotic, debt-plagued West: America's housing crisis was allegedly America's problem alone. "Decoupling is not a myth," asserted *The Economist* in March 2008. "As America's economy struggles to stay aloft, the developing world is learning to spread its wings."

"In 2007," Lorenz points out, "the U.S., the UK and Spain—the three largest economies facing deflating housing markets—generated a combined current-account deficit of $936.6 billion, or 66% of all such deficits that year. Reciprocally, China generated a current-account surplus of $353.2 billion. One country's deficit is another country's surplus, of course. The idea that a mere financial crisis among the world's biggest spenders would somehow not damage the world's biggest producers didn't add up."

Not that that insight immediately carried the day. In the first half of 2008, the price of West Texas Intermediate rallied to $145 a barrel from $96. The ensuing collapse—to $34 by December—was devastating. "In fact," Lorenz notes, "by year-end 2008, more money was lost in the plucky EMs than in the crisis-wracked developed world. In those 12 miserable months, the iShares MSCI Emerging Markets ETF wound up falling by 50%, the S&P 500 by 38%."

Following the Great Recession, Beijing set out on a mighty borrowing binge—in 2009, new lending reached 40% of GDP. The hangover, too, has proved epic. For relief, the Chinese have turned to the hair of the dog. They borrowed more and more money to make more and more "investments." The trouble—or, one trouble—is the diminishing returns on the umpteenth investment.

"For example," Anne Stevenson-Yang, co-founder of J Capital Research, tells Lorenz, "you had a perfectly good high-speed rail line between Beijing and Tianjin. They spent nearly RMB 2 billion to upgrade the speed by 50 kilometers an hour. The upgrade is not actually realized because the duration of the journey is 20 minutes with the current high-speed line and the acceleration and deceleration periods are like five minutes each. So you can only run at that speed for the 10 minutes in the middle."

The statistical dimensions of the Chinese credit jag are no less amazing for their being familiar. Thus, between 2010 and 2016, the sum of new loans averaged a sum of money equivalent to 27% of GDP. Between year-end 2008 and Sept. 30, 2016, China's bank assets grew at a compound annual rate of 18%. Those assets today add up to RMB 222.9 trillion ($32.2 trillion). It's the equivalent of 297% of Chinese GDP and 43% of world GDP. The United States, which has had its own extensive experience in overdoing it, shows commercial-bank assets in the amount of $16.8 trillion (as of Sept. 30), or 90% of U.S. GDP.

How Sealand Securities Co., Ltd., a lilliputian mainland broker, laid the Chinese bond market low on Dec. 15, after disavowing RMB 10 billion worth of bonds that the company claimed were fraudulently purchased by rogue employees, is a story you may recall in the prior issue of *Grant's*. There's a sequel. On Dec. 20, two subsidiaries of Cosun Group, a mainland telecom company, defaulted on bonds worth RMB 312 million ($45 million). It came as a jolt that Cosun, which is chaired by Wu Ruilin, one of China's richest tycoons with a reported fortune worth RMB 98.2 billion, defaulted at all. With news next day that Wu himself had guaranteed the debt (thank you, Fred Sheehan), there came another jolt.

No matter, the bondholders might have reasoned: China Guangfa Bank Co., Ltd. was also on the hook as a guarantor. Or was it? It was not, the bank declared on Dec. 26: The credit documents were fake, and its guarantee was nonexistent.

"For better or for worse, market order in China depends upon the wide and unquestioned application of implicit guarantees," Logan Wright, a director of the Rhodium Group, recently advised his clients. It would seem to follow that, as mistrust replaces trust, banks would be cutting exposure, including to nonbank financial institutions.

Lorenz called Wright to draw him out on this point. "Larger banks still don't have a strong appetite to lend to nonbank financial institutions [on an] overnight [basis]," said Wright. "You've seen volumes continue to weaken. The end-year numbers were slightly negative year on year, and that's the first time that we've seen that. We turned into negative territory on interbank lending in the past couple of months. That is surprising."

It should not be so surprising if the bacchanalia of the wealth-management products were on borrowed time. A WMP is a kind of blind pool. You, the customer, contract with a bank to purchase a short-term investment in something or other. The details of the investment are judged to be of no particular importance. The expected return is rather what counts. The commercial bank, having sold the WMP, may shunt it off to a nonbank financial institution for the sake of lightening its balance sheet and pleasing its regulators. The nonbank, or "shadow bank," will invest the customer funds in stocks, bonds, other WMPs and—of particular interest for our purposes—the likes of iron ore and copper. Leverage is, or at least was, available in the repo market.

The prospectus for the typical wealth-management product runs to just a dozen pages. "Basically," notes Stevenson-Yang, "it says, 'we will indirectly invest in private equities via a trust. The lock-up period is *x*, the fees are *y* and the minimum investment is *z*.' Salespeople are not allowed to represent that—there's a guaranteed return, but they say it verbally and the bank websites give the returns on previous products and expected range of returns on new ones." No interim reports are issued. There's hardly a need when all are trusting and trustworthy. As of June 30, an estimated 26.3 trillion renminbi ($3.8 trillion) of WMPs were outstanding.

Because, in China, too, the knee bone is connected to the thigh bone, the bond market's wobbles are duly conveyed to the jury-rigged tower of WMPs. Wright again: "The most meaningful transmission channel from this month's stress in the bond market to the real economy is likely to take place via reduced issuance of wealth-management products, which will pressure bank-asset growth. Banks must continue issuing rising volumes of WMPs in order to maintain deposit and asset growth, as this has been the key marginal funding source for many joint-stock and city commercial banks over the past two to three years. . . . Should WMP issuance slow in aggregate, bank asset growth will follow."

The Party cadres may welcome a little controlled distress among the buyers, sellers and holders of WMPs, so some observers suspect. The authorities reason (or seem to—we write from lower Manhattan) that, to bring credit growth down to earth, the WMP mania must subside. A sign of the regulators' intent to lower the speculative temperature is talk that the People's Bank this month will begin including WMPs in calculating total bank credit.

Once upon a time, the Communist Party was content to solve its problems by throwing borrowed money at them. No more, at least not for the time being. EZ money and low interest rates are no known cure for capital flight and a weak exchange rate. Indeed, since September, the PBOC has been draining short-term funding while offering longer-term funding facilities and gradually raising interest rates—a sort of Operation Twist with Chinese characteristics (*Grant's*, Dec. 23, 2016).

Last week the central bank put the domestic market through the wringer. To understand how a Beijing wringer works, it helps to know that Chinese corporations may not borrow at home only to remit the proceeds abroad. Many, trying to get money out of the country, do the next best thing. They lend the renminbi to their offshore subsidiaries in Hong Kong. The subsidiaries sell the Red currency—the Hong Kong renminbi are designated CNH—for dollars or euros or what have you. As of November, Chinese companies had lent the equivalent of $520 billion to their foreign subsidiaries in this fashion.

By lifting interest rates, the central bank forced the wiggle-room-seeking companies to call their cozy loans to their Hong Kong affiliates. It forced them to sell those dollars, euros etc. in exchange for renminbi. Or to try to execute those transactions: Renminbi deposits in Hong Kong banks evidently fell far short of the volume required to accommodate the sudden demand. On Jan. 5, the overnight rate for borrowing the suddenly precious renminbi shot to an intraday high of 105%. It was this rate spike that caused that much-publicized post-New Year leap in the renminbi/dollar exchange rate.

Just how much wealth-management money is parked in commodities we have been unable to determine. To judge by the visible disconnect between, on the one hand, the workaday forces of commercial supply and demand and, on the other, the monumental rallies in industrial metals, we are prepared to guess that the WMPs are an important bullish bulwark to the prices of met coal, iron ore and copper. Kick that prop away, and the metals markets might assume a very different cast.

BHP Billiton Ltd. (BHP on the Australian Securities Exchange), Rio Tinto Ltd. (RIO) and Fortescue Metals Group Ltd. (FMG), please copy.

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