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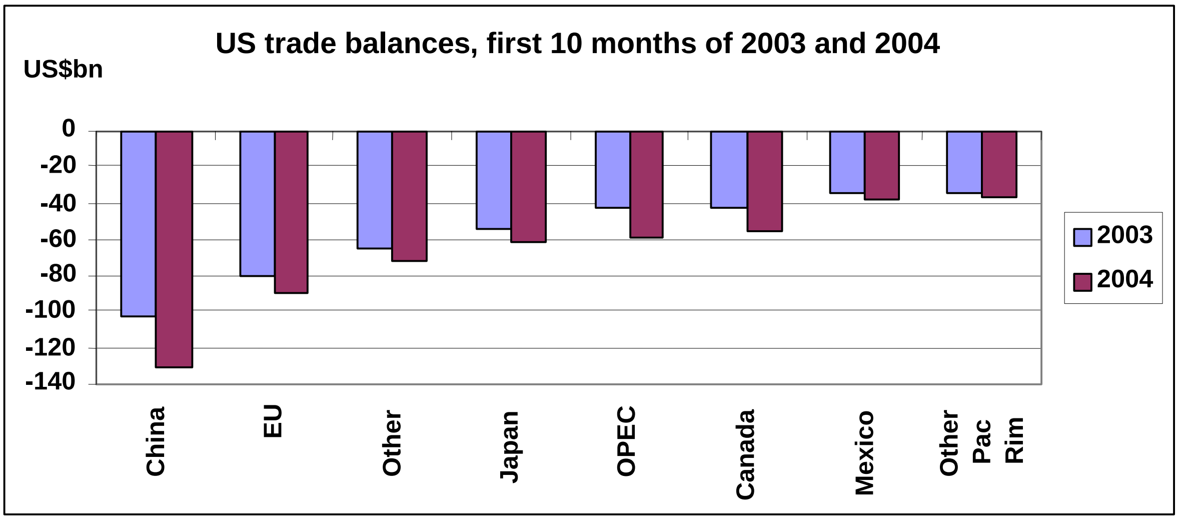
GOING FOR BROKE

Bill King's Report on Tuesday picked up a Bloomberg story on China's US$438bn of bad debts. If China was a US$12trn economy, like the US, then this would represent a not inconsiderable 3.7% of nominal GDP. But China weighs in as a US$1.5trn economy in 2004 and US$438bn is equivalent to 28% of annual output. Even allowing for the possibility that Bloomberg has over-egged the pudding – more conservative estimates start at US$200bn – the scale of debt restructuring required is improbably large. In a Reuters story this week, Huarong Asset Management Corp, one of China's key debt-clearing firms, announced the sale of 16 bad debt pools to Wall Street banks to the tune of US$2.2bn. Strong work, but presumably these were some of the more attractive assets. Could it be that the western world is tempting China to overreach itself to the point of economic implosion? News of another record monthly US trade deficit (US$55.5bn) underlines the importance of external trade to China. The Baltic Freight Index is busy recoiling from its recent peak, now that the opportunity for seasonal deliveries to the west coast of America has passed. Simon Hunt has warned that this seasonal slowdown is likely to develop into something more significant during the first half of 2005. If there is overcapacity and unprofitable trading already, a slowing pace of external demand can only aggravate the situation. What if the US actually strengthens its bargaining position over Chinese importers next year, forcing Chinese producers to choose between capacity utilisation and loss limitation? A depreciating US Dollar continues to work in the home country's favour as Chinese producers must absorb the soaring Dollar cost of raw materials and energy without the luxury of pricing power in US markets. In the short term, cheap imports help to hold down the US consumer price index and in the medium term, China suffers a serious interruption to its GDP growth as its export industries are crippled by a faltering financial system. Bad as it is, America's credit system is in better shape than China's or Japan's. Let's face it, the 'Dollar area' is a credit quality minefield.



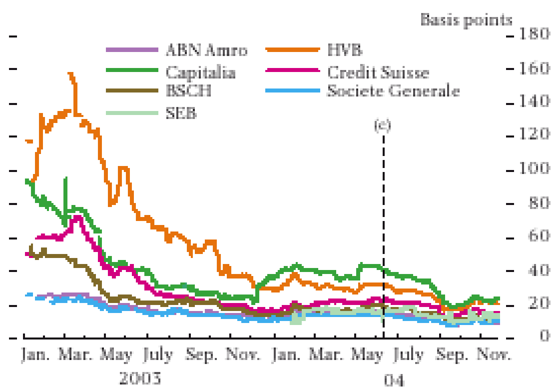
SWISS BANKERS FUNDING THE AMERICAN BINGE

Andrew Hunt (to be found at economist@hunteconomics.com) reckons the Swiss banks' frustration with the lack of enthusiasm from its domestic lending customers has driven them overseas. Domestic loan growth is running at 4% per annum, but foreign lending at a 30% rate. Burnt by recent experiences in the US bond market, the Swiss banks have been more active in the inter-bank markets. This sounds like hot money finance for the US current account deficit. Andrew comments: "although the CHF [Swiss Franc] may offer the appearance of a 'safe haven' from the US$ (and even for those who are perhaps fearful over the Euro's ultimate longevity), the Swiss banking system is conspiring to mobilise even larger fund outflows from the CHF into the global financial system." "… although Switzerland has a sizeable trade surplus of around CHF10bn (US$8.7bn) per annum, it also has a capital outflow from its banking system of around (net) CHF20bn per annum. This would seem to explain why the Swiss National Bank has been spared the task of conducting much foreign intervention over recent months, even as the US$ has fallen on the exchanges."

DERIVATIVES BITE BACK

During the past few months there has been an audacious shrinkage of credit default swap premia in US and European banks, a further contraction of corporate credit risk spreads and a euphoric contraction of emerging market economy credit spreads, as illustrated in the charts drawn from the latest Bank of England *Financial Stability Review*. The potential for the mis-pricing of risk has exploded, particularly since the US election, with highly-leveraged institutions attempting to make up for lost time (and lost performance) in a lacklustre year for market returns. So, in some ways it was reassuring to read of the collapse of China Aviation Oil. According to the report in *The Economist*, 11th-17th December, China's monopoly supplier of jet fuel sought court protection on 29th November after incurring US$550m of losses trading oil derivatives. "CAO acknowledges that it

CDS premia for selected European banks(a)(b)

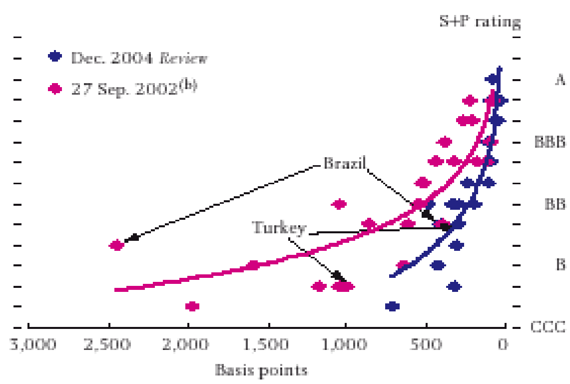


Source: Markit.

(a) Daily closing prices of five-year senior CDS contracts; gaps represent days for which there are no data.

(b) The banks with the highest current CDS price from each banking sector.

Sovereign credit rating and bond spreads for selected EMEs(a)



Sources: JP Morgan Chase & Co. and Standard & Poor's.

(a) Lines represent logarithmic best-fit lines. Ratings are plotted linearly.

(b) Peak in bond spreads.

speculated in crude oil futures, rather than just hedging its position, and bet wrongly that prices would fall. It blew through its own $5m internal trading limits back in 2003, but kept doubling up in an attempt to make good the deficit and told nobody about its mounting losses for over a year. And, as recently as 20th October, its parent sold $120m-worth of shares in the subsidiary to outside investors to cover losses, without telling those investors that anything was amiss."

LULA'S SHAKY COALITION

The *Latin American Weekly Report*, a publication from Joe de Courcy's stable, draws attention to the defections from Lula de Silva's coalition government. New elections are not due until 2006, but the withdrawal of the PMDB (Partido do Movimento Democrático Brasiliero) and PPS (Partido Popular

Socialista) members is a severe blow. "After a string of departures of old friends and allies from the government, a renewal of hostilities by his old comrades in the landless movement and criticism of his policies from within his party, over the past few days Lula has witnessed two important defections from his ruling alliance – one affecting his government's ideological credentials, the other its capacity to get its initiatives approved in congress." One of the stated reasons for the PPS defection was that "this government, regrettably is conservative, not left-wing". Little wonder, then, that Brazilians have "up to US$150bn of assets overseas that haven't been reported to the nation's tax authorities", according to a Bloomberg story on Tuesday.

INDIA'S RESURGENCE

One of the biggest beneficiaries of the more relaxed risk environment over the past month or so is the Bombay Stock Exchange, which had a double-digit month. Jon Thorn's India Capital Fund achieved a 13.4% monthly return, which has completed the recovery from the Spring election-related losses. Speaking to Jon earlier this week, and reading the interview in the latest Welling report (10th December), it is difficult to refute the fundamental grounds for financial optimism. I urge you to read the interview for a broader appreciation of the investment case, particularly in relation to that of China, on which Jon is also structurally bullish. Jon gives four reasons to prefer the investment opportunities in India. First, anyone who isn't Chinese and doesn't speak the language is at a disadvantage there; second, India has a more congenial investment environment as a legacy of its well-developed and Anglo-Saxon legal structures and large pools of highly trained financial and IT professionals. Third, unlike China, with its dependence on the export of manufactured goods, India has potential for increased growth without enormous capital expenditures and despite clogged ports. Fourth, India is much better prepared for growth in terms of energy infrastructure. Power projects adding over 10,000MW to its generation capacity will be instituted in the next decade. An added bonus for the India story at present is that tax revenues are soaring by 18% annually. A government bond auction was cancelled because the funds weren't needed! A sovereign bond upgrade cannot be far away.

VENEROSO'S CAUTION ON GOLD EQUITIES

Frank Veneroso, as many of you will know, is an excellent analyst and speaker as well as a committed advocate of gold and gold equities. So, his gloom-laden speech on gold equities in New Orleans earlier this month has ruffled quite a few feathers in the gold world. Frank has released an expanded version of his text, The Risk to Gold Equities Grows. His central argument is to beware gold's fair weather friends. "We have warned that funds and prop desks that trade in gold futures and forwards are pure momentum players who follow short term trends. They have no investment commitments to any of their markets. When these trends falter they often all try to exit at once and together. This is illustrated in crashes that occurred in silver in April and copper in October." To this list, we can now add gold bullion in December. Frank's bearish short-term conclusions for both bullion and gold equities are predicated on the view that the US Dollar has fallen about as far as is likely, and will shortly commence a spirited rally. This rally will be heavily reinforced by official currency intervention in his view. "Why does intervention sometimes work? Because speculative bandwagons displace currencies from their short-run economically determined equilibria. Speculators are trend followers. If their positions are extreme, intervention, by changing the price trend, can cause speculators to unwind positions en masse." To his credit, Frank concedes that, "if the dollar index breaks long term chart support at 80", then a re-think is required.

FINALLY

We welcome Robin Griffiths back from his nautical endeavours and look forward to hearing his views on markets, commodities and currencies at the dinner on Thursday evening. In January, we welcome back Michael White and would appreciate it if you would sign up as soon as possible for either of the two events, dinner on Tuesday 18th or lunch in the City on Thursday 20th.

Peter Warburton

JAPAN: RESPECT

It is never quite clear how seriously it should be taken, but the ritual visit by Japan's prime minister to the Yasukuni shrine to honour dead soldiers always generates heated comment. In one respect, the visit can be seen in the same light as the great and the good commemorating Remembrance Day in Britain, where both head of government and head of state are on parade. In this sense – which is an insider's view – it amounts to no more than honouring the dead. In Japan's case, the issue is complicated by the fact that Yasukuni also enshrines the souls of war criminals. At least, that is the view of outsiders, and none more vociferously than the Chinese.

The *Financial Times* of 15 December ('Japanese support leader's war shrine visits') reports on a survey carried out by NHK (the Japanese equivalent of the BBC) which found that 46 per cent of those asked thought the prime minister should continue visiting Yasukuni, while 40 per cent said it was natural he should pay his respects to the war dead and 53 per cent said China had no right to meddle in such matters. Even within Japan, there is ambiguity about this whole business, embodied by the split between the nationalist and pacifist tendencies. For the most part, these have been side issues for decades. There is no reason to believe Japan is about to turn militarist, though the desire for a UN seat has aroused nationalist passions. Nor is there any reason to believe that China is about to invade Japan, despite the recent probings by its nuclear-powered submarine.

If the US and China are in a struggle for dominance of East Asia, however, it follows that Japan and China are also. That is obviously true at the economic level. It is not a big step from there to the geopolitical and military level also. So, where there is cause to remain alert – and reason not to dismiss entirely the NHK survey – is the possibility that someone on the outside may make a mistake in the way he interprets something as innocuous to the insider as paying respect to the war dead.

CHINA: OR ELSE

The prospect of serious tension between Japan and China seems remote. When it comes to Taiwan, however, the rhetoric is as pointed as ever. The *People's Daily* reports on a regularly press conference by the State Council's Taiwan Affairs Office where officials continued to rail against the programme of Taiwan President Chen. The spokesman claimed that Chen was openly promoting a new constitution and that he had called China a foreign country and an enemy.

Just as it is hard to know how seriously to take the heated comment around the Yasukuni issue, so it is hard to know how much posturing is involved in China-Taiwan relations (as opposed to real threats of action). Since various commentators have told us this year that Taiwan is a high-risk issue, perhaps it would be as well to pay attention to a definite sting in the tail of this article. "We have the utmost sincerity to try our best for peaceful solution of the Taiwan issue," Li (Taiwan Affairs Office spokesman) said. "We firmly oppose the attempt to separate Taiwan from China by any person in any way." Much hangs on the interpretation of that word 'firmly'. Article at: China will not sit idle.

Robert Brooke