

China in a Bull Shop

Editorial Comment from the HRA Journal

The reason for this revisit to the “BRIC” story is the enormous amount of press about the “burst bubble” in commodities this month. It’s an important, some might say, critical, topic. How we should act and react in the market is intimately related to the type of market we are in. Viewed in isolation, a bear market rally will look pretty much like a small piece of a bull market rally. But while you might be looking for periods of weakness to accumulate positions in a bull market you’d be much more likely to be watching like a hawk for any weakness as a sell signal in a bear market rally. (Note – comments about the commodity markets can be found [here](#), other free articles on the site appear [here](#))

Much of chatter recently focused on “unsustainable” growth in China. This is said to prove the point that commodity prices have to fall.

We look at metals and energy commodities as individual cases (and so should you) but some general clarifications have to be made. There is too much erroneous information out there and too many analysts comparing Chinese oranges to North American apples and proclaiming them equal. There are several parts to the bear case and we’ll touch on each briefly:

1: Unusual Length

We find it surprising that this one comes up any more but it does. We won’t know just how long China’s (or India’s or ...) secular expansion lasts until it’s come to an end. What we do know is that if it looks like recent periods of above trend growth in the region, namely Japan and South Korea, it will last for at least 25-30 years.

This is not wild eyed optimism. Similar growth periods moving through mass industrialization in both Europe and North America had similar time frames. That is about how long it takes to move to and through the process and to upgrade infrastructure (both public and private) to the level where it becomes sustainable. There is absolutely nothing unusual about the length of the China expansion and we expect the one just starting in India will fit the pattern as well.

Unusual Strength

Another common concern is that the growth rates being experienced by China are so high that they must denote an overheating economy. Again, there is no evidence to support the idea that growth rates are unusually high, especially if one lops a percent or two off the “official” numbers, as most observers do.

China’s growth has averaged about 9% over the past 20 years. An

impressive number, but not unusual under the circumstances. During their own periods of rapid industrialization and economic development other Asian countries managed the same feat. Japan grew at an annual rate of 8% for 30 years (1950-1980) and Hong Kong and South Korea managed averages of 7.7% and 8.1% respectively for over 35 years from 1960 until 1995. There is nothing "magical" about China's performance. It is not out of line with its Asian neighbors or, for that matter, with North America during its late 19th - early 20th century industrialization.

3) Zero Sums

Basically, the zero-sum argument holds that any increase in commodity usage is merely a diversion of resources from other countries. In other words, China is acting as a giant assembly line, which is partially true, and most of the "usage" is simply parts and sub assemblies that are moved from other places to be fitted together and shipped out again.

It's easy to see the political appeal of this theory. Job losses and trade deficits can be blamed on cheap labour and westerners, especially Americans, can smugly assume that any gains made are just accounting fiction that involved some level of cheating.

Whatever the emotional appeal of this theory it doesn't stand up to close scrutiny. Yes, there is a lot of assembly and remanufacturing going on in China but that is not the main area of commodity consumption. A boat load of DVD players or kid's shoes does not contain a lot of metal. Power lines, wiring, and sewer pipes do. That is where the bulk of the consumption ends up. It is not substitution; its addition. More to the point, it's additions to infrastructure and durable goods. It's not stuff that will get recycled in two years. Economics is not a zero sum game. If it was, all attempts at development and economic betterment would be pointless. And North Americans would still have the living standard of their great great grandparents.

4) It's inherently unstable

This argument is based on concerns about economic imbalances and overinvestment. It's another popular one with politicians which usually leads to them blaming the US Current Account deficit on "excess saving" elsewhere on the planet. Excess saving?

Although this argument sounds the silliest it's ironically closest to the truth. One of the most interesting outcomes of our study of periods of rapid growth was the apparent underlying cause. It's not some form of selfless Asian togetherness or good karma or a form of government suited to whipping up the populace into a homogeneous production line. It's savings. Period. High levels of savings were the most consistent predictive data across all the economies that saw extended surges of growth in the past 50 years.

High savings levels that allow for high investment levels at a relatively low

cost of capital are the secret to the success of one Asian tiger after another. All of the countries noted earlier in this article have and had extremely high levels of savings in relation to GDP. Most of them range from 30-40%. That's a level unheard of in the West and it easily explains the high capital formation and enormous levels of investment. Why do they invest so much? Because they can.

It's All About Savings

Like its predecessors, China has seen surging savings levels in recent years. There was a dip during the Asian Crisis in the late 1990's but the rate moved back up to the 40% level in the past five years. Based on current rates the strong growth profile of China is expected to continue for some time.

Western economists have warned about these levels. They assume they must be too high and that they imply overinvestment. We see no reason to assume there is less "dumb money" in Asia than anywhere else but, in the end, it doesn't seem to matter much. China, like the US, has an economy that is efficient (some would say ruthless) about punishing firms that build the wrong things at the wrong time.

The important thing is that the money is there to keep the investment coming. It's also very important to note that most of the savings are domestic. Yes, China is the poster boy for Foreign Direct Investment (FDI) lately but most of the funds still come from domestic sources or from nearby Asian neighbors.

So far, there is no evidence that savings rates are slackening. Chinese companies are generating profits that can continue the party, though their return on capital is lower than the West. Again, this makes sense. When there are huge pools of money looking for a home those funds have to and are willing to accept a lower return. It's supply and demand. It's also something we shouldn't be complaining about. All those "excess savings" help explain the relative popularity of US Treasuries and America's ability to hold down real interest rates.

One final promising note on savings rates deserves a mention. India, most people's choice for the next country to see a growth lift off, is seeing its own rapid increase in savings rates. It started much later than China's but India's domestic savings rates has moved through 30% in the past year or so. While there are some growth impediments to deal with like an overweening bureaucracy the evidence is that savings alone will ultimately trump this. As with China, India's growth surge will include intensive commodity usage. Evidence suggests that the savings rate alone is the best predictor and it's pointing to a longer and stronger boom.

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