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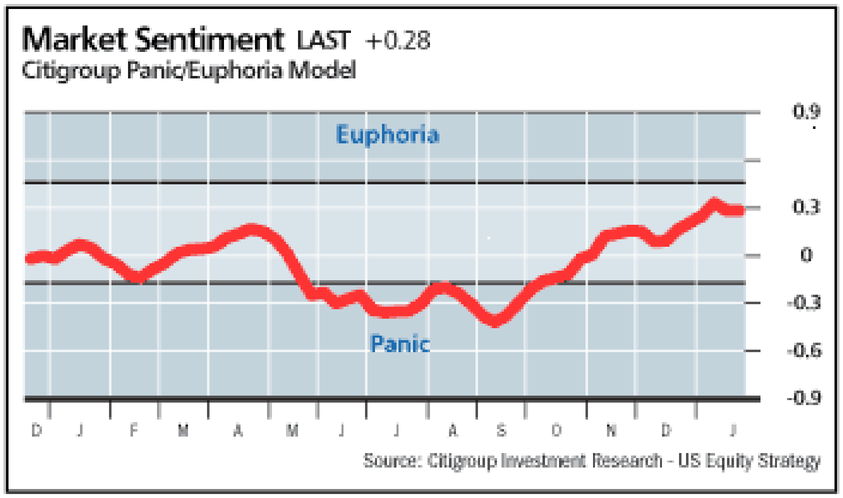
LePoidevin Letter

Investors Overly Optimistic
Chanos on China Bubble



Stock markets typically bottom out at the point of maximum pessimism and top out with excessive optimism. In the spring of 2000, the technology-heavy NASDAQ index hit a record-high of 5000 and was valued at seventy times earnings projections, (15 is average); yet a record-high 80% of the investing public predicted even higher prices. By comparison, in March of 2009, a record-low 17% of the investing public was bullish on stocks; and, even though valuations were at their lowest level in 30 years, the general consensus at the time was that it was the start of the next great depression.[1]

The theory is that if the public is bullish and expecting higher stock prices, then the majority have already done their buying. If the maximum buying is already behind the market and there are no buyers left, then the market has reached a top. At the point of maximum pessimism, the sellers have done their selling and markets bottom.

Citibank has a proprietary index which measures the overall sentiment of the market. This past summer, according to Citi, the overall mood of investors was one of panic. Stocks were

[1] http://online.barrons.com- Market Lab

down 10% for the year, and talk on the street was of “double-dip recession.” In the panic atmosphere of last summer, bond prices had soared, to the point where 10-year U.S. yields hit 2.6%. In the August 2010 LePoidevin Letter, “Bad News from Bond Investors,” I recommended stocks rather than bonds. Since that time, stocks have climbed by over 20%.

Today the investor mood has improved substantially. The consensus appears to be that the recovery has taken hold and that 2011 will be a good year for stocks. The Citibank Market Sentiment indicator is at its highest level since 2007. Remember that 2007 was not a particularly good time to be entering the market, just before the big sell-off in 2008. The current optimistic economic and stock market outlook, then, just might be a good opportunity to take some chips off the table and to relocate back to government bonds.

One potential problem that the markets may have overlooked is with China itself. The conventional wisdom is that the roaring Chinese economy is in a sustained boom, and will continue to propel a global economy despite weak U.S. and European consumption.

One contrarian opinion on China is that of famed hedge-fund manager James Chanos, CEO of Kynikos and Associates. Chanos has in the past made some pretty good money selling short (profiting from a stock’s decline): for example, when he first uncovered the fraudulent accounting at Enron; then when he made a few more bucks by selling short pools of sub-prime mortgages as the U.S. housing market collapsed. Unlike many hedge fund managers, Jim tells people what he is doing before the event unfolds. So, when Chanos makes a bold prediction, one ought to give it some serious consideration. His prediction at present is that China’s hyper-stimulated economy is heading for a crash!

He notes that China is dependent upon construction spending for 60% of its economy, which is almost unheard of. To put that into perspective, the Western World floated up to between 15% and 17% construction spending as a percent of GDP at their peaks of real estate bubbles. With that type of dependency, you need to keep construction going to keep GDP growing. That is why he has coined China “an economic treadmill to hell.”

Last year China built about 30 billion square feet of new construction. Consider Dubai, Chanos said, “At the peak of its building boom, there were 240 square meters of property under development for every $1 million of national GDP. In urban China today that ratio is four times as high.”[2] During this boom, the Chinese economy has consumed over half of the world’s industrial commodities like copper, iron ore, and cement.

The problem is like that of most property bubbles, in which the housing market is fueled by cheap and easy money, which in turn promotes huge speculation. Although there are no official government reports, even the Head of the Chinese Ministry of Housing admitted that vacancy rates were a problem, when asked about a reported 60 million unoccupied units.

The Chinese government promoted real estate construction as a stimulative measure in 2008; but now it is taking some incentives away. Last month, it announced that the

[2] Fortune Magazine – “Chanos vs. China” – December 6th, 2010.

minimum down payment for second properties would be increased to 60%. China has increased the minimum-reserve requirement for big banks on seven occasions to date, thereby limiting lending. It has also increased interest rates four times.

In 2007, the U.S. government attempted to cool spending and housing speculation by slowly raising interest rates. But then, of course, the boom turned into a bust. China's economy may soon turn down in a similar fashion, sooner than most people think.

The greatest beneficiaries of the Chinese property bubble have been the commodity exporters such as Canada, Australia and Brazil. Interestingly, these are also the sole remaining property bubbles left in the world. A China property bust would likely negatively affect these very same countries. Chanos believes that the most sheltered economy will likely be the United States.

If you would like a no-obligation review of your portfolio, please do not hesitate to give me a call.

Sincerely,

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