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MACROCOSM

More Anbang For the Buck

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Donald Luskin

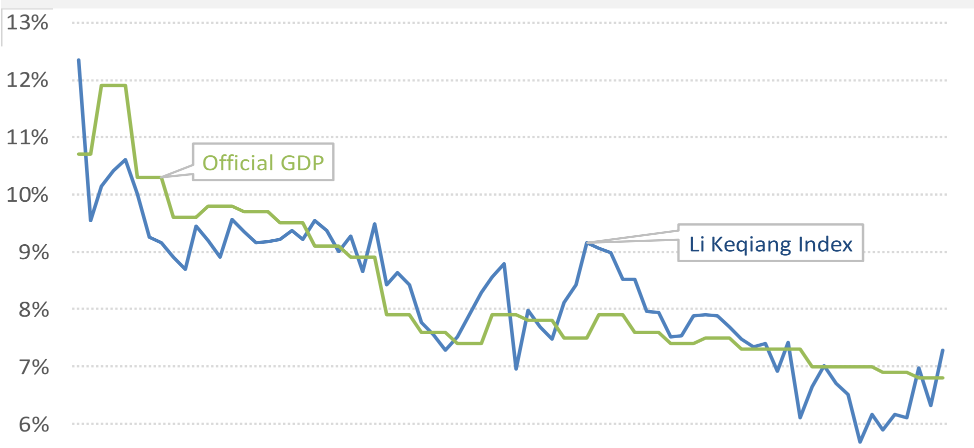
Politics thwarted the Starwood bid – but China will be back: it still has $1.7 trillion to spend.

We don't have strong opinions about China as an investment opportunity. But we do have strong opinions about it as a global macro risk factor. We're delighted to see that factor playing out very much as we've been expecting over the past year, in which our views have been very different from the extremely pessimistic consensus.

- *We are especially excited to see earlier-than-anticipated confirmation of our expectations that China would draw down its vast foreign reserves by accelerating purchases of global assets* (see "On the December FOMC" December 16, 2015).
- Yes, Anbang Insurance Group's $13 billion bid for Starwood Hotels ultimately failed (for reasons we will examine shortly). But its value nearly matches that of *all* China's US acquisitions last year, which itself was a record. And Starwood has not been China's only play this year.
- This opens up a debate on whether China can, in fact, afford to deplete its reserves going forward. We think it can and will (again, for reasons we will examine shortly).
- *When it does, this will have extremely important long-term impacts on the valuation of global assets, on the dollar, and on inflation.*

First, though, we want to note that Chinese growth seems to have

China output growth, official and unofficial measures YOY



Source: Bloomberg, TrendMacro calculations

Update to strategic view

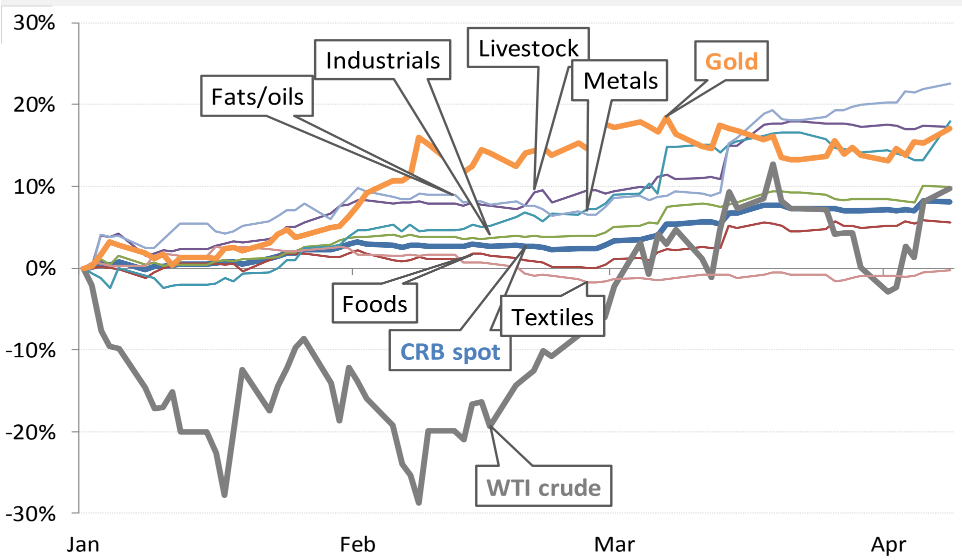
ASIA MACRO, FX, US MACRO: Anbang's bid for Starwood was thwarted, but it nevertheless points to a wave of Chinese acquisitions of Western assets. Chinese growth has quietly stabilized, thanks to deft handling of the RMB exchange rate. But the RMB remains very strong, so acquisitions look cheap at the same time as China is encouraging a drawdown of excessive foreign reserves. It's a delicate political process, as it was for the Japanese who went through a similar evolution in the late 1980s after the Plaza Accord. It points to rising global asset prices, a weaker US dollar and higher inflation – as dead money comes to life, moving from savings to investment.

[Strategy dashboard]

substantially stabilized. Since China's stock market crash last summer, a consensus developed that China is at risk of imminent collapse that systemically threatens the global economy. We've never seen China as much more than a fairly standard story of exhausted hypergrowth (see "China: Toil and Trouble, but No Bubble" July 10, 2015).

- At the crest of the China panic last summer, the so-called "Li Keqiang Index" of simple transparent economic statistics put Chinese output growth at 5.7%, while official GDP was still set at 7% (please see the chart on the previous page).
- *That was the bottom.* Now, without much fanfare, and while the official estimate has been moved down twice -- most recently to 6.8% – the Li Index has crept up to 7.3%. New official GDP estimates will be released Friday.
- Compelling corroboration that China is stabilizing has come throughout the new year, from a broad look at the commodities markets. Overall, they've been steadily moving higher – even as oil prices and global equity markets were in steep corrections (please see the chart below, and "Yuan Direction" February 16, 2016).

CRB spot commodity indices, oil and gold Cumulative, year-to-date



Source: Bloomberg, TrendMacro calculations

- *The key to China's stabilization has been its deft and opportunistic handling of its currency.*
- We believe the 2014-15 surge in the US dollar (see "Dollar Strength: A Crude Connection" April 23, 2015) made the renminbi – through its gradually strengthening flexible dollar-peg begun in May 2005 – highly uncompetitive versus the euro, the yen and other non-dollar currencies (please see the first chart on the following page, and "On the RMB Devaluation" August 11, 2015).
- China's first move to deal with it was last August's small *de*valuation (again, see "On the RMB Devaluation"). Then in February, China seemingly reversed course and *re*valued (again, see "Yuan Direction"). But because the dollar itself was falling then,

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Recommended Reading

Inside the deal: How Anbang's chairman Wu nearly landed Starwood
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Financial Times
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Financial Times
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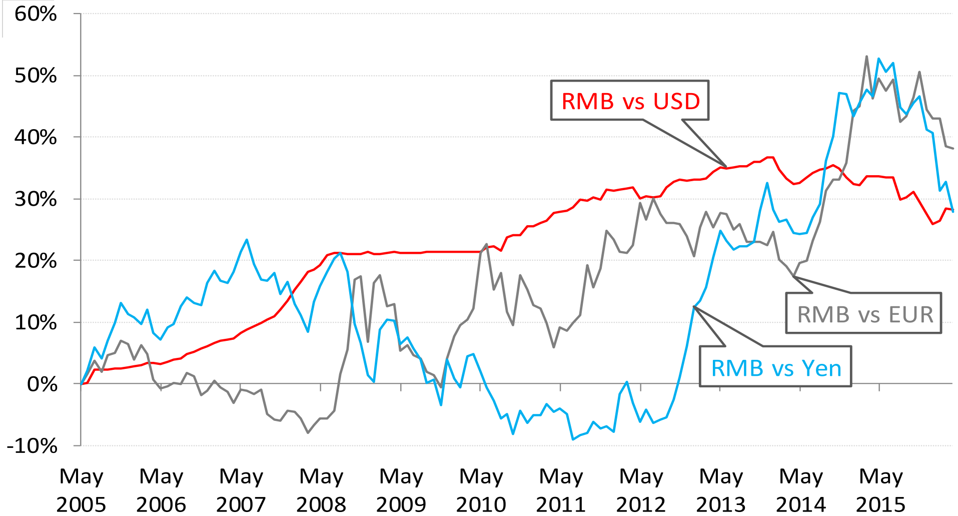
China FX relationships since strengthening peg vs USD in May 2005

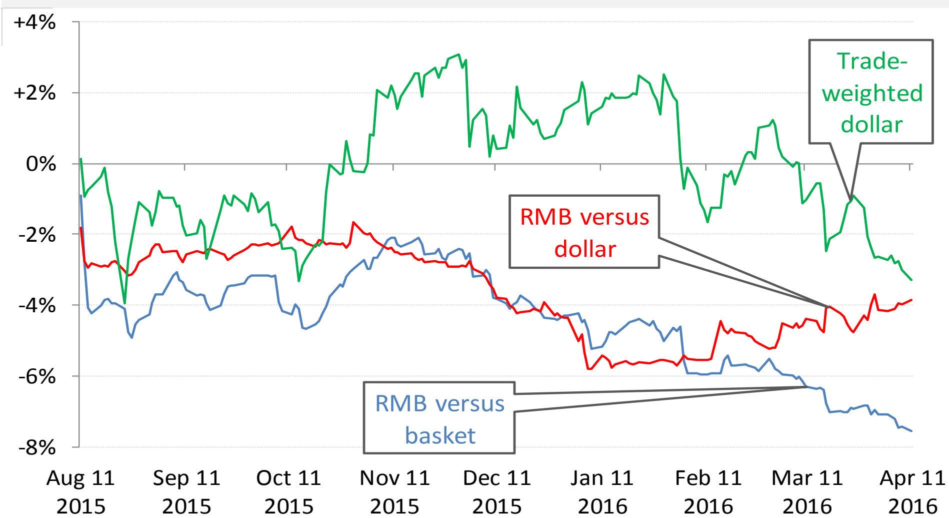


Source: Bloomberg, TrendMacro calculations

RMB nevertheless weakened versus the "reference basket" of currencies that China actually targets (please see the chart below).

- *Perfect! For China, strengthening RMB versus USD deflates the US protectionists like Donald Trump who argue* (see "Trumped!" December 14, 2015) *that China is a mercantilist currency manipulator. At the same time, RMB in fact weakens versus the other currencies against which it had become too strong, thanks to USD strength in 2014-15.*

Key FX relationships since day before August 2015 RMB devaluation

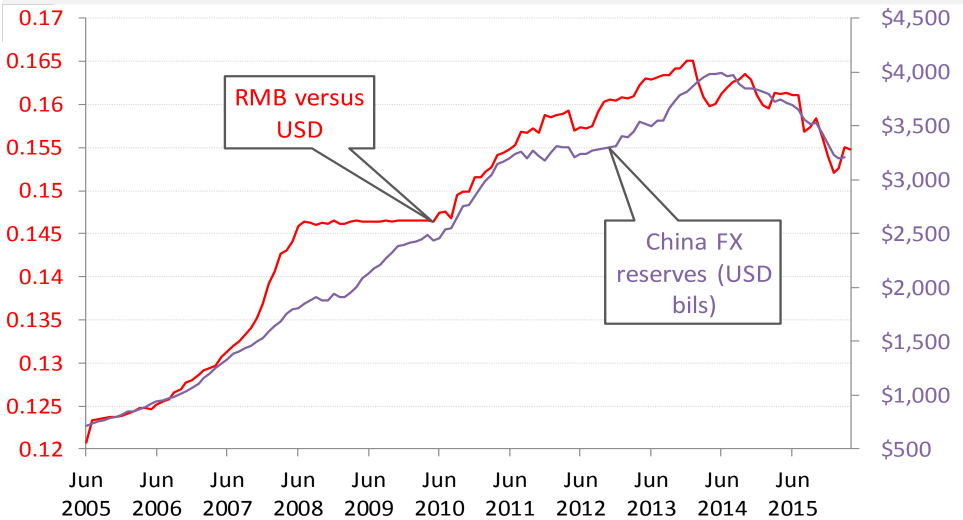


Source: Bloomberg, TrendMacro calculations

While this game of 3-D chess has been going on in FX markets, it's fascinating to observe what has happened to China's foreign reserves position. The conventional wisdom is that China has accumulated vast reserves in order to cheapen its currency. It's a classic cash-flow argument – China buys USD and sells RMB, thus weakening RMB versus USD. But the actual evidence turns the conventional wisdom on its head.

- *In fact, the decade of China's great foreign exchange accumulation has corresponded with RMB strengthening, not weakening. And as reserves have fallen somewhat over the last year and a half, RMB has weakened, not strengthened* (please see the chart below).

Relation of China/US exchange rate and China foreign reserves



Source: Bloomberg, TrendMacro calculations

- *With a strong USD having led to a too-strong RMB, we think China would be happy to see its reserves diminish further, if that remains consistent with a weaker RMB.*
- Indeed, independent of exchange-rate issues, China has been very public for years now about its frustration with holding so many dollars. Back in early 2009, when the US Federal Reserve announced its first round of quantitative easing through long-term Treasury purchases, the People's Bank of China understandably began to become concerned at what this could mean for the long-term value of its USD holdings.
- The next month, PBOC Governor Zhou Xiaochuan wrote a scathing essay for the Bank for International Settlements calling for global monetary reform, moving away from the US dollar as the world's reserve currency (devastatingly citing the critique of Bretton Woods known as the Triffin Dilemma).
- Even if the US dollar were as good as gold, why should China – now vying for the title of world's biggest economy – have to hold so many of them? The US doesn't hold any RMB reserves.
- The argument might be that China, while large, is still an immature economy that is subject to shocks – the risk of which calls for reserves as a form of insurance.
- This underlies the recent highly publicized critique from investment manager Kyle Bass. He argues that China's reserves are overstated at about $3.2 trillion – and their true value of about $2.7 trillion is right at the cliff-edge of what China needs to minimally meet its insurance function. Bass predicts that with further capital

flight reducing reserves, China will fall over that cliff-edge and a currency crisis and credit collapse will ensue.

- We agree more with our friend Michael Pettis of Peking University, who argues that Bass is wrongly holding China to simplistic cookbook standards for small emerging markets with undiversified trade portfolios. Pettis calculates that an economy as large as China, and with China's heavily diversified portfolio of imports and exports, can meet the insurance function of reserves with less than $1.5 trillion.

Which brings us back to Anbang, and its thwarted bid for Starwood. If Pettis's outlook is right, China has $1.7 trillion to spend. And with RMB having strengthened so much over the last decade, and especially over the last two years, from China's perspective the world looks like a bargain.

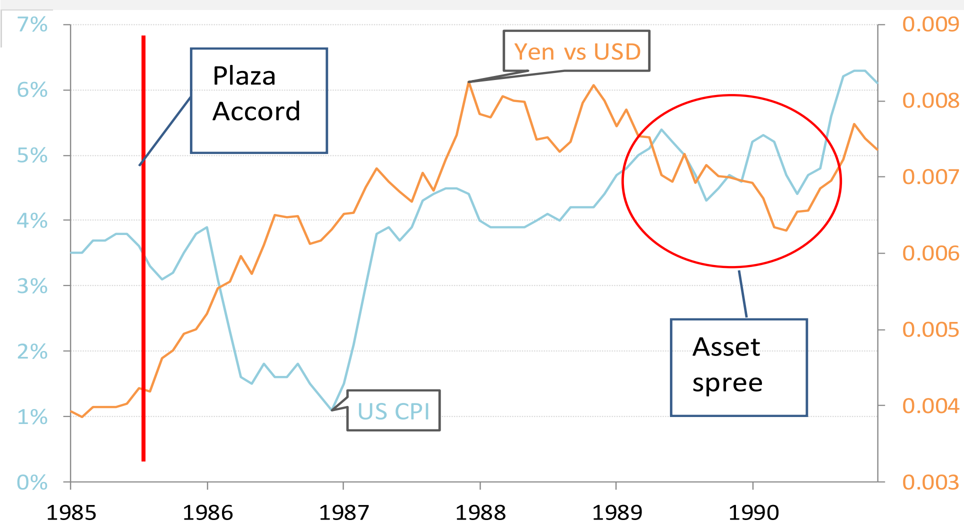
- Already, China invested last year a record $15 billion in the US, and a record $23 billion in Europe (with RMB having appreciated more versus the euro than the dollar – see "On the March ECB Policy Decision" March 10, 2016).
- *Such investments are politically fraught, on all sides of the transactions.*
- In one sense, China would like to encourage at least a certain class of investors to stay local, and support the sagging Chinese equity markets.
- But for China's wealthy elite, the message has gone out that To Invest Outside of China is Glorious. No less a personage than PBOC Governor Zhou said, in February:

> Chinese enterprises make more outbound investments than before as they "go global". This is a natural outcome of policy open-up and better understanding of the international market by Chinese entrepreneurs. Outbound investments have been growing rather rapidly, which is a good thing.

- Meanwhile, in the West, Chinese investments are treated, rightly or wrongly, with suspicion – which puts up formal regulatory barriers and informal political barriers.
- China is well aware of these barriers, and we think that factor underlies the failure of the Anbang bid for Starwood.
- On the surface, the story appears to be that the China Insurance Regulatory Commission determined that Anbang's bid violated a rule that overseas investments must not exceed 15% of an insurer's assets. But the determination of the value of the assets in the denominator of that calculation has a great deal of wiggle-room, so we think it's more likely that a judgment was made in China that Anbang's frantic bidding war against Marriot – an iconic American company – was becoming a bit unseemly.
- *But we don't for one minute think that China's decision is meant to discourage Chinese acquisitions of US assets. Quite the contrary. It is part of seeking a political optimum that will allow for the maximum of such acquisitions over time.*

- *We expect many, many more acquisitions by China. It's not exactly a sequel – call it a "reboot" – of a movie we've seen before: the global asset-buying spree by Japan in the latter half of the 1980s.*
- After the Plaza Accord of September 1985 – in which the US used protectionist tariff threats to blackmail its major trading partners into strengthening their currencies versus the dollar – Japan's foreign reserves quickly quadrupled, and the value of the yen versus USD doubled. At the same time, Japan was near the same point in its development cycle as China is today – the end of the era of hypergrowth, facing a new secular age of difficult adjustments to slower growth.
- *We think China will now do what Japan did then – go on a buying spree of overseas assets. With an appreciated currency and a vast hoard of savings, acquisition targets look cheap – and the imagined investment returns they will generate (even after paying top-tick for them) looks attractive relative to the mere savings returns being earned before.*
- For Japan the climax was in 1989 and 1990, with the acquisition of highly visible trophy assets such as Rockefeller Center, the Pebble Beach Golf Course, and the Hotel Bel Air. All the while, there were the same kind of xenophobic objections that are now being raised about China's forays. It wasn't long after those acquisitions that Michael Crichton wrote the best-selling novel *Rising Sun* – ostensibly a murder mystery, but in fact a polemic about the dangers of Japanese corporations controlling US businesses.
- The Japanese acquisitions post-Plaza Accord helped power a mergers-and-acquisition boom, in part because Japanese buyers became a reliable bid.
- At the same time, it was a period of resurgent US inflation – with the Consumer Price Index advancing from about 1% growth in early 1987 to over 6% by the end of 1990 (please see the chart below).

After September 1985 Plaza Accord, US inflation and yen strength



Source: Bloomberg, TrendMacro calculations

- One of the great mysteries of the post-Great Recession global macro environment has been the persistent low level of inflation world-wide, in the face of what ought to have been massively inflationary actions by central banks. There are many possible explanations. But we think a key factor has been the world-wide immobilization of money in the form of savings – and its concomitant withdrawal from spending and investing.
- *In other words, monetary velocity has fallen more sharply than money creation has risen.*
- *China's foreign reserves are the greatest savings account in history – effectively dead money, earning virtually no return. The drawdown of, say, $1.7 trillion of that account – that is, its conversion from savings to investment – could be the long-needed change at the margin that revives monetary velocity, and ultimately revives inflation. And all else equal, by increasing the effective quantity of dollars, USD should weaken.*
- *With the global economy now liberated from nearly a decade of the highest inflation-adjusted oil prices in history, followed by the unleashing of China's pent-up savings – which would inspire, as a second-round effect, other cash-hordes to be put to better use – it's not crazy to think that we could be near a secular transition-phase in which the era of "secular stagnation" finally comes to an end.*

Bottom line

Anbang's bid for Starwood was thwarted, but it nevertheless points to a wave of Chinese acquisitions of Western assets. Chinese growth has quietly stabilized, thanks to deft handling of the RMB exchange rate. But the RMB remains very strong, so acquisitions look cheap at the same time as China is encouraging a drawdown of excessive foreign reserves. It's a delicate political process, as it was for the Japanese who went through a similar evolution in the late 1980s after the Plaza Accord. It points to rising global asset prices, higher inflation, and a weaker US dollar – as dead money comes to life, moving from savings to investment.