



Lending Reversals: East and West

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The chorus singing of the need to separate commodities from broader views of market movement appears to be growing again. It's possible to separate this into "supply constraint" and "Asia rising camps", but in general it is recognized that both come into play. Supply constraint singers realize that the mineral commodities sector was under capitalized for a long period beginning about 1980. Asia rising tunes increasingly look back to the last decade to recognize that mineral prices were already tied to Asian growth in the 1990s. Our contention that a "decoupling" of metal prices from western markets has taken place stems from Asian growth, while our expectation of continued historically high prices is based on supply constraint. The two need to be weighed against a second post-Crunch decoupling to gauge timing.

Germany, France and Japan all recorded small but positive economic growth in Q2. Canadian housing sales in July were the highest ever recorded. While we do view these stats as part of a post-Crunch bounce partly related to government generated stimuli, the early awakeners are hardly random. Germany and Japan have high personal savings rates. France and Canada (especially the latter) have banking systems that were largely unscathed by the Debt Crunch. A large portion of the Canadian housing turn-over is first time buyers who had been scared away from the market but now feel they should take advantage of low interest rates. These are the industrialized economies that are best placed to recover from the impacts of a credit squeeze because they have cash or available credit, though Japan and Germany need to work on domestic consumption.

The American, British, Spanish and most eastern European economies that haven't made the Euro zone yet are still dealing with badly damaged debt systems and weak savings rates. The larger three also have serious housing bubbles to unwind still. Americans have of necessity begun to save again, and it is likely that as much as other factors that caused a decline in US consumer confidence in the just released Michigan index. That in turn has caused numerous trading algorithms to flash red lights on equities and commodities screens, and green lights on the greenback buying machines. While American consumers quite rightly focus on saving, Chinese are learning how to borrow, and to lend. That is the other decoupling that is going on, and it needs to be carefully watched.

Healthy saving rates are *inherently* a part of industrializing growth spurts. High internal savings rates generate available capital for investment and promote lower interest rates. Foreign investment did help by kicking off the expansion in almost every case, but that had to generate an excess in the domestic economy and that excess had in turn to get spread around to expand the "middle class". Once underway this process lasts decades. These savings circulate in the economy both as consumer spending and as funds available for corporate borrowing. Chinese policy this year has been geared to using some of the 50%+ savings rate its citizens have been piling up. Those policies have been working better than expected.

During the first half of 2009 lending in China has literally exploded to over 7 trillion Yuan, versus a targeted 5 trillion for the entire year that had been expected from loosening policies. The rate of new lending did slow considerably in July, but markets continue to expect the government to focus on tightening the supply of funds with a combination of higher interest rates and higher capital requirements for commercial banks. That is showing up as red in equity markets, on a global basis.

Two points are worth noting. One is that the Chinese lending surge this year is in part a bounce from efforts early last year to slow an economy that was overheating. Many analysts who are fashionably “China wary” again missed the fact Beijing was already standing on the monetary brakes when the credit markets blew up in New York. The early 2008 tightening was having its impact just as the Credit Crunch killed off trade later in the year, so some of this year’s lending boom does relate to pent up demand. The other point is that concerns about the glut of lending in China are centered on *capital allocation*, not concern that banks have over extended capital use.

While consumption resulting from this lending surge may be denting China’s savings rate, that rate is still very high. Concerns about overheating aside, a focus on how to see these savings better employed is still front and centre. China just signed an agreement with the ASEAN group, the economies to its south and southeast, to simplify and encourage cross-border investment; this follow-ups agreements on goods and services trade. India also signed a similar accord with this group ahead of their annual meeting. On a population basis, ASEAN is a group in which Indonesia (current growth +4%) equates to another Brazil, and Viet Nam (current growth +3%) and the Philippines (0.4% growth in Q1) each equal another Germany.

Capital flows in South and East Asia will increasingly be regional. Asia is decoupling from western banking. Markets will at times view this with concern given the nascent aspects of some Asian banking systems. The volatility in Shanghai’s markets is typical of emerging economies. These are certainly worth keeping in mind to gauge the likelihood of broader market consolidation, and especially in the metals space we follow.

We do expect the current consolidation to continue until the lending surge in China is tempered. However, as we have already noted this is reason to take gains and wait for better pricing, but not a reason to run from the metal markets. We have never suggested that China’s growth was going to somehow fix the problems of western over indulgence, but we do think it is going to replace the west over time within its own region. Perhaps as importantly, at this point we simply don’t see how China could screw up its banking as badly as the west has. Ω

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