2015 – China’s Annus Horribilis

For the Japanese, their *anni horribili* at the end of the 1980s are chiefly remembered for overpaying for the Rockefeller Center and golf club acreage. When the Brazilians come a cropper, it’s a case of party like its 1959, and return to the basics of fresh air, coconuts and sunshine. But when it comes to *hubris* the Chinese, as in everything, outdo everyone. The new self-proclaimed *Masters of the Universe* have managed to end the year choking themselves, and their economy, to death in a cloud of Purple Fumes (cue the Performer once known as Prince) and shown that as for regulation (and development) of financial markets the Chinese, to put it more politely, could not run a booze-up in a brewery.

The last weeks of 2016 saw several prominent financial market figures disappear and then reappear (including the reputed Chinese version of Warren Buffett), the aforementioned pollution disaster and the start of criminal investigations relating to the FANYA schemozzle. There is an innate tendency for institutions in the capitalist side of the Chinese economy to deteriorate into illegality and irregularity with remarkable speed. In this aspect the Chinese system appears most akin to the rip-roaring US markets of the late 19th century when Robber Barons ruled the roost on Wall Street and established suffocating and anti-competitive cartels/trusts.

FANYA

For the mining community the most important thing about China is the demand aspect as this has driven so much of the global mining industry’s thought process over the past 20 years, however for the

The establishment of the FANYA Exchange with its focus on

specialty metals seemed like a logical and inevitable evolution of the Chinese dominance of the production of (many) specialty metals and the substantial position it also held as a processor and end-user. FANYA initially started out with specialty metals and then diversified into fixed income products. The problems in the Bismuth, Indium and Antimony trading by the exchange's investor base are well documented now.

In mid-July Metal Bulletin reported that the Fanya Metal Exchange had suspended accepting applications from companies to sell Indium, Germanium and Bismuth on the exchange between June 23 and August 31. An official from Fanya, who refused to be named, cited "Liquidity-related problems" were the major reason for the decision. That there should be "liquidity problems" in trading notoriously illiquid metals in the pre-FANYA era, comes as no surprise to participants in the global market for specialty metals.

While FANYA has been most (in)famous its metals trading, it has also had a fixed-income element, which not unsurprisingly has reputedly also gone bad. The Financial Times reported in September that "hundreds of well-heeled urban professionals who had purchased high-interest rate products from the Fanya Metal Exchange united with distribution agents who sold them in an unusual protest….in the financial heart of Beijing".

The FT captured the moment at which the head of FANYA, Shan Juiliang was manhandled by a crowd in Shanghai. They dragged him off to the police to have him arrested. Whether his potential fate at the hands of the crowd or in the Chinese legal system will be a better one will remain to be seen.

The big question, as everyone knew six months ago that FANYA was going down in a welter of financial irregularities, is why did it take so long to look into the matter? Obviously people

in high places wanted to cover their behinds (and unwind positions) before the Great Unwashed cottoned on. However, the public are now so far ahead of the authorities in catching a whiff of scandal that the Powers that Be are last to know.

Chinese "Statistics"

Time and again we have seen the Chinese "issue" with deceptive practices on bonded warehouses and the collateralization and double-counting of fictitious or "massaged" inventories. It is very easy to create theoretical liquidity by miscounting (read exaggerating) warehouse numbers then creating paper instruments based on the bogus holdings, trade them fast and furiously and voila, liquidity. The whole scheme (never let the word "Ponzi" cross our lips) comes apart at the seams when someone wants physical delivery and then the game is over. In China of course the small and medium sized investor can be stalled for a while, while the big fish exit their positions and when the curtain is eventually pulled back to reveal that the "cupboard is bare" then the recriminations start flying. A few random death sentences may be meted out (involuntary organ donations, anyone?) and the matter is regarded as swept under the rug until the next time.

The result though is that China has blown up chances of being taken seriously as a locale for trading of commodities due to this repeated flaunting of warehouse statistics which are at the root of the credibility of any market in the metals trading world.

Bubbles

The Chinese cannot be criticized for having "bubbles" in their stock exchange(s) for the US is a repeat offender in this regard, with Alan Greenspan being a notorious bubble-blower with a goodly part of the US economy and the High Net Worth sector regularly refilling their coffers through repeated pump and dumps on a truly grand scale. However in the case of China

a casino-ish atmosphere has not only existed, but been encouraged. The closest that the US has come to this was the dot-com era market of 1998-2000, which was mainly tech/media/telecoms (rather than a whole market) and 1929, which was a very long time ago and before hardly any legislation governed markets.

While regulators in the West, in the wake of a market bust, go into a frenzy of reregulating and attempting to close the gate after the horse has bolted, the Chinese on the other hand are quite shameless with the goal being to reinflate the bubble as fast as possible. Investors in the West go into soul-searching wondering why they were suckered or why they suckered themselves, whilst in China introspection seemingly has no place and mass amnesia is seen as the cure for all ills.

Robber Barons

China looks like the US in the Age of the Robber Barons in the late 1800s. The trouble for China is that we are talking about 130 years ago. It is not that hard in this day and age to be up to date in regulatory and supervisory matters and systems. If you can have stock tickers wrapped around office blocks then why can’t you buy in some skillsets on market regulation? The answer is largely because the authorities don’t want to appear to be taking advice from the *Gwai Lo*. Frankly they could save themselves (and everyone else) a lot of grief is they forsook the financial Wild West (East?) and got their house in order in 2016.

Riding the S-Curve

Or we could less charitably say going down the S-bend! We found an interesting thesis, posited by a Charles Hugh Smith, that tallied with our own view that China is following a well-trodden path down which Japan, Taiwan and South Korea have already travelled. China would like to think it is different and heading down some Middle Kingdom version of the Thousand

Year Reich (oops!) when in fact it is just doing what all economies have done since the dawn of time, and that is pursuing an S-shaped trajectory.

We have seen this process described as being somewhat akin to a rocket's trajectory with an ignition phase as the fuel of financialization and untapped productive capacity is ignited. The high growth rate of credit and production overwhelms all other factors, as rising profits and production increases wages which then support further expansion of credit and consumption which then supports more production (or excess-capacity).

After this the thrust that comes from "financialisation" is exhausted, and the previously fast-growing economy moves forward on momentum alone. As the economy weakens, this momentum is to the downside. This is where we find ourselves now in the China cycle as everything that worked in the boost phase reverses, as nothing works any more. Investors in China's "markets" lose every bet and officialdom's efforts to reverse the decline end in repeated failure.

Conclusion

While many in Western markets (and particularly in the US) are used to complaints that the system is rigged against the investor class by the Powers that Be, the complaints are usually just hyperbole and blame-searching after the one a decade meltdowns that we have become inured to. In China though, like all casinos, the House always ends up winning and the punters, by and large, end up going home without their shirts. The markets in the West may end up occasionally ripping off investors whereas in China they seem to be set up with the explicit purpose of fleecing the lambs. The results is that the middle and lower middle classes keep having their savings confiscated for the greater good of those higher up

the totem pole that mastermind, tolerate, encourage and then cover-up the scams. It is like China is in the grip of a horde of Bernie Madoff clones.

If 2015 was bad then 2016 has got off to an even worse start with two suspensions of trading on the Stock Exchange in the first few days of the New Year. This was followed by the same old intervention which obviously failed in the first instance because it had to be applied again a few days later. The "Street cred" of the Chinese "powers that be" that pull the financial levers is totally shot. Major figures on the financial stage appear and disappear like characters in a Feydeau farce. Re-education used to involve years in the paddy-fields and now consists of a weekend of being brow-beaten in a board room at the Ministry of Finance. Maybe the old ways were better!

Once a soap bubble is burst there is no reinflating it. The Chinese should face the fact and move on. They are now in a new place that the rest of us in the Western economies have been in all too frequently in recent decades and they may care to learn from it… even if it means having to lose a little face.