Sprott Asset Management

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The Era of China

MARKETS AT A GLANCE

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We don't believe that analysts and forecasters are paying enough heed to China. That's not to say that China is being ignored – far from. Its investment boom and commensurate 10%+ economic growth over the past several years are well known and have been duly noted in the business media. Be that as it may, it still seems that few have stopped to truly ponder the enormous implications of a burgeoning China to the global markets. Although it may be difficult to believe, we still get the impression that China's importance is being under appreciated by the consensus.

Having said that, we are not recommending that people should rush out and buy the Chinese stock market (though having more than doubled over the past year, such a recommendation would have been quite prescient a year ago). There are still significant issues that need to be resolved there. But if we could make only one point in this article, it would be this: It would be almost impossible to overestimate the impact that China has had, and will continue to have, on the global economy. If we were asked to define the "new era", something that is decidedly different about this age from the past, we would not say the *information age* or the *financial revolution* or the apparent *elimination of business cycles*, as many others may answer. To us, if there is a "new era", it would be the **era of China**. This phenomenon, above all others, will have the most profound impact on all aspects of global economics and finance for years, decades, and perhaps even generations to come.

There still exists the general impression that China, in spite of its impressive economic record of late, is still small compared to, say, the US. China's nominal GDP (not adjusted for Purchasing Power Parity; i.e. the fact that a "dollar" can buy a lot more there than it can here) is about a fifth of US nominal GDP (though on a purchasing power basis China's GDP is 80% of the US, albeit having almost five times the population). China's stock market, in spite of its impressive run-up, currently amounts to only $2 trillion in market capitalization – still tiny compared to the US and Europe which boast market capitalizations of over $15 trillion each. But to perceive China as a relatively small, albeit aspiring, player in the global economic scene would be highly erroneous. For whereas the Western world may have mastered the art of paper-pushing, borrowing against the future for current consumption, and (in the case of the US) exporting rapidly depreciating dollars around the world to buy the things that others make; when it comes to the production of real assets and goods, it is China that is the undisputed King of the Hill. In the market for real things, China is getting bigger, faster than even we could have earlier surmised.

This is why we believe it is topical that China get its own MAAG article. We've mentioned China in passing in previous articles, mostly to make the point that the US centric world that most of us have become accustomed to is slowly, but surely, drawing to a close. Although the importance of the US is doubtless still great, there is a sea change afoot that is making it increasingly of less importance in global economic affairs. Many analysts remain of the view that an economic slowdown in the US will spell doom for the current commodity boom. As this article will try to show, the old adage "when the US sneezes, the rest of the world catches a cold" no longer holds true.

The current economic slowdown in the US is a case in point. It is quite clear that, as a result of the housing collapse, there is an economic slowdown occurring in the US as we speak and it is

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likely to worsen as the year progresses. It is therefore noteworthy that the rest of the world continues to chug along, causing many commodity prices to hit new highs. Such a state of affairs (a weakening US economy combined with rising commodity prices) would have been unheard of in the past. We found it interesting when the International Monetary Fund (IMF) lowered their forecast for US economic growth to 2.2% for this year. What is even more interesting is that their projection for global economic growth is 4.9%. By implication, the IMF is projecting that the world **ex-US** will grow at a booming rate of **5.8%** this year! Indeed, it would appear that the IMF is also buying into the view that the US doesn't matter as much as it once did. The US sneezed, and the rest of the world merely shrugged. It has been recently reported that the Chinese economy grew at an astounding 11.1% annualized rate in the first quarter, after posting 10.7% growth in 2006. India has been no slouch either, having grown 9.2% last year. The global economic center of gravity is clearly and convincingly shifting east.

We believe that such a discussion is critical if one is to have a macro view of where commodity markets are heading. Is this a bubble? Or is there a *bona fide* Malthusian shortage that is occurring *in spite* of weakening US economic conditions? We would be inclined to take the latter point of view. It has become quite clear to us that the commodity markets don't need a strong US in order to have wings. We are now more convinced of this than ever before. Recent headlines have only served to highlight the enormous impact China is having on the world. Let's take a look at a few recent developments.

In the past month, China announced its intention to spend $200 billion to expand its railroad system with 10,500 miles of new track by 2010. This will amount to a 23% increase in China's railway system. Put another way, within a paltry **three years** time, China will have built almost one quarter of the railways that, up until now, it has **ever** built in its history. This is a massive project that will require massive amounts of steel and other commodities. China has also announced a 6500 km pipeline to be completed by 2010. This will be double the length of their longest pipeline currently, and will require massive amounts of stainless steel; i.e. nickel and molybdenum.

Railroads and pipelines are merely the tip of the iceberg. China is currently building power plants at the rate of **two every week**. To put this in perspective, this is five times the rate at which power plants are being constructed in the US. (Remember that the US economy, on a non-PPP basis, is supposedly five times the size of China's!) China is already the world's largest consumer of copper. As an aside, to put this in perspective, in 1990 the US consumed four times as much copper as China, and as recently as 2001 the US was still a bigger consumer of copper than China. Today China consumes twice as much copper as the US. This goes to show how quickly things can change when 10%+ growth rates enter into the equation!

50% of China's copper consumption currently goes toward power generation and transmission. It is little wonder, therefore, that China's copper consumption continues to grow north of 10% every year. Needless to say, this fact bodes well for copper demand and copper prices going forward. Much has been made of the negative implications for copper demand of the slowdown in US homebuilding. It would appear that the concerns were overblown because people underestimated China's appetite for the metal, which more than makes up for any shortfall in copper demand due to weakness in the US housing market. Recently, the president of Codelco, the world's largest copper company, said that China "is building cities at an unimaginable rate… urbanization in general demands a lot of copper." As far as copper is concerned, China is clearly king. In fact, just the **growth** in Chinese copper demand is greater than **all the copper that will be used in US housing this year**. As another sign of the voracity of China's power needs, for the first time in history they are now a net importer of coal, even though they enjoy one of the largest endowments of coal reserves in the world. In other news, China recently announced its decision to build a strategic uranium stockpile to fuel future nuclear reactor needs. Albeit, it is experiencing difficulty finding the necessary uranium. China

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is also busily trying to bolster its strategic petroleum reserves, which could amount to 600 million barrels of extra oil demand at the margin over the next two years.

While the Western world has been busy pushing paper, China has been busy building, and demanding, real things. But China is no slouch on the paper pushing front either. At over a trillion dollars, they currently possess one of the largest foreign currency reserves in the world. Furthermore, some of the largest IPO's this year occurred in the Chinese stock market, where issuances of anything from banks to mining companies have been massively oversubscribed. Just imagine the financial possibilities if/when the Chinese were to fully embrace consumer credit! China recently overtook Japan as the second largest auto market in the world and, if it continues to grow 30% as it did last year, it won't be long before it is the world's largest auto market. But 90% of all cars in China are bought with cash. Western companies are racing to introduce consumer financing à la American-style to the Chinese. But with their middle classes growing by 20 million every year, heaven help us if the Chinese were taught the "American way" of bringing consumption forward by spending money they don't have and deferring ultimate payment indefinitely via the endless possibilities of borrowing on top of borrowing. If ever the average Chinese were to consume as much as the average American, the world would be in a whole lot of trouble.

There is little doubt that the day will come when China will be the world's biggest consumer of just about everything. The question isn't if – it is when. The downside, in Malthusian fashion, is that inflationary shortages are being created everywhere. Even though central banks the world over have been raising rates for some time, the latest data points indicated that inflation is worsening. To supply China with all that it needs is an enormous undertaking. Forget the other "new paradigms" you've heard about. This is the biggie. It's the one that is the most important from an investment perspective. The most obvious implication being: sell bonds and buy commodities. But things never go straight up, not even China. Boom/bust cycles aren't extinct and it's a mathematical impossibility that China will continue to grow at this pace forever. Otherwise they will take over the world in short order. But then again… maybe they just might!

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