



The New Epicenter?

"He who will not economize,
Will have to agonize"

Confucius

This past week, we learned that China now holds a record \$1.2 trillion of US debt after adding \$12.2 billion in December. Japan follows closely at \$1.18 trillion.

The news was greeted by the usual outrage of what that means for America. For many years now, the Chinese have been accused of currency manipulation, unfair trade practices, piracy, and simply breaking the "rules," without penalty, because it supports obscene uncontrollable US government spending.

The question always arises: What if the Chinese stop buying?

Answer: They won't, they are just getting started.

The Chinese plan is to own it all, lock, stock and barrel. Chinese ambition will not be contained by the great Wall, oceans, or language barriers. Once upon a time, China only sold its most prized possessions to the British in return for silver. So much silver went to China that the other European nations became alarmed. There are many versions of what happened, but the introduction of opium into China began a reversal of silver flow back out of China, back into the coffers of Great Britain. Eventually, there was a revolt by Chinese leaders who burned 20,000 chests of opium. The loss of that "war" triggered a series of wars and misfortunes which left China a wreck.

It accumulated in what became known as the Boxer Revolution, between 1899 and 1901, which took place against a background of severe drought and the disruption caused by the growth of foreign

spheres of influence. It was an uprising of peasants against the feeble Chinese rulers, but was really an uprising against Western civilization and Christianity.

In order to fight back, the rulers needed help from Japan and Western nations at an economic toll, which once again illustrates how debt destroys nations. The Boxer Protocol of 1901 provided for the execution of government officials who had supported the revolt, provisions for foreign troops to be stationed in Beijing, and an indemnity of 67 million pounds (\$335 million in silver and additional payments in gold), more than the government annual tax revenue, to be paid as indemnity over a course of 39 years to the eight nations involved.

This debt accumulated until December 31, 1940, to a whopping \$700 million (29% to Russia, 20% Germany, 16% France, 11% UK, 8% Japan, 7% USA, 2% Belgium and the rest distributed between Spain, the Netherlands and Austria/Hungary).

There are many opinions on how China became indebted, but the fact that it was indebted to pretty well the rest of the world should serve as a cautionary tale for the USA.

Now fast forward to the present. The shoe is now on the other foot, and while it is not looting, the Chinese are buying everything America is willing to sell. Maoism has faded, and China is making up for lost ground. Once again, by wealth accumulated from trade with the West, money pours into the coffers of China, but they've learned their lesson from past history. Instead, hundreds of billions are being used to buy the West.....from corporations, to commodities, to real estate, to the largest US pork producer.

China now sits on \$3.82 trillion in foreign-exchange reserves and is very strategic in their approach, while American and European leaders become more socialist, the Chinese are becoming true capitalists.

In 2011, Chinese investment in US real estate topped \$10 billion, in 2012 it was \$8.2 billion and it looks likely higher for 2013. From expensive condos in Brooklyn to \$25,000 parcels in Bankrupt Detroit, the Chinese are buying.

True, they don't play by the "rules," but that's largely the fault of US politicians who allow it to happen. While the current US administration preaches equality and sacrifice, they have really abandoned the

principles of sacrifice, hard work and dedication, replacing them with entitlement and comfort. The debt under Obama is mounting, and a whirlwind of agony is around the corner if they don't get focused.

Nations like China have looked to the West with both admiration and envy, fueling a determination to be self reliant. Catching the West, especially the USA, is a daunting challenge. US GDP is about \$16 trillion while China is #2 at about \$8 trillion, so it may take a couple of decades, but with modern technology and the globalization of the world economies, it has become easier and quicker to get traction.

In the past few weeks, the majority of market watchers have been keeping a close eye on Chinese economic data, which seems to be deteriorating. While expectations are still for a 7% growth in GDP (which would be an explosive boom in North America), many pundits think the trend line which has gone from 12-13%, to 10%, to 8% and now 7%, is forewarning of worse to come. True, the Chinese financial system has concerns with "shadow banking" institutions, and often we question how reliable the data or the accounting may be, but remember with their style of government, decisions are made quickly and implemented immediately in this loose form of benevolent dictatorship, versus the totally bungling we've witnessed out of Washington the last few years.

In the most recent shocks to the global economies, these have been different epicenters. In 2008-09, it was the USA financial derivative engineering which created the problem. In 2011, it was Europe. There are some who believe in 2014 the epicenter will be China. Maybe, but unlike those two cycles, China's debt is mainly self contained, and not spread among global balance sheets, it's currency is not free floating, and the financial derivatives are simply not prevalent like they were in the USA and Europe.

The Chinese economy is going through a transition from a producer based to consumer based, and there will be shocks and growing pains as that happens. The shift recently announced by the Chinese government, all but ending the "One Child" policy of the last three decades, may be too late, but it shows they are not afraid to make tough decisions.

In 1965, there was an average of 6.5 births for each woman in China. By 1978, that has fallen to 2.8, and by 2011 it was down to 1.7, below the birth rate most demographers believe is necessary to keep a countries population stable.

Since 1980, the Chinese government has collected a total of \$330 billion in fines imposed upon families who flouted the rule. Now, it looks like the Chinese population will have more adults over 65 than children under age 15, and even more alarming, at present there are approximately 18 million more males under the age of 15 in China than there are females.

America itself is at a fork in the road. Like the British Empire, which over-extended itself and poorly managed its global possessions, it could begin to fade. Part of being great is an inherent desire to be great in the first place. If the goal is to become a nation with a broad middle class that punishes success, then look at Europe, Russia or Cuba if you want that template. Nor does it create more global peace or prosperity.

For now, the USA has the world's largest economy, the most powerful military and its dollar is the world's reserve currency. China wants what the USA had, and has a long way to go still, but it is making great strides. I would never, ever, bet against the USA, but the current path they are on is not the one that made them the largest economy on the planet. They need to recapture that focus on greatness.

Stay tuned,

Vito Finucci
Vice President and Director
Investment Advisor

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