

JVB Financial Group, LLC

CRONIN'S CORNER MONTHLY

A Perspective on the International Economy

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The TV series M*A*S*H was written with an allegorists pen that oozed of irenic ink. A plucky undertaking then, at a time when the US was mired in the macabres of Vietnam, to use a show about the Korean War to highlight the horrors of warfare. Fair enough. What's not fair though is how the war in Korea is regarded. Sobriquets litter history books with the 'Forgotten War' or the 'Unknown War' that pay dubious homage to the nearly forty thousand Americans who lost their lives fighting it. As testimony to, it seems, a national indifference then a recent report revealed that only one in five twelfth graders knew anything about the war and who the main combatants were. Abysmal. However, the purpose of this piece is not to suspire over the deficiencies of a history curriculum but to use it as a contemporaneous reference. The point that so many twelfth graders missed was that the US was essentially at war with China during the Korean conflict as the ardent Chinese government was backing the Communist state of North Korea. The penumbra that China found itself in then is obviously a world apart from the China that has since embraced an economic model of state capitalism and is now, arguably, only a truly communist country in name only. The media has fawned over the Chinese success story with almost lupine hysteria and although the country's meteoric rise deserves most of its rhapsodic acclaim, China's economy is also subject to the fallibilities that can scourge the world's more banal economies.

The imbroglgio that currently embroils Europe may have more of a direct impact upon European economies but China is not prepared to take any chances that any contagious afterclap will be not be benign. In a world that has become increasingly intertwined, occidental accidents will almost inevitably affect oriental economics and vice versa. Therefore, China has publicly lent support to the beleaguered European Union and has put its money behind its oratory by buying Greek Sovereign debt - although the exact amounts of the purchases remain uncertain. The global theater needs an efficient and resolute outcome to the Greek saga to avoid contamination to the other peripheral nations of Europe wherein a default of which could make the Lehman collapse and its aftermath appear Lilliputian in comparison. Of course the Chinese are understandably concerned that a Greek default could muffle and eventually choke off what is, arguably, an insipid global economic recovery. Although China continues to try and develop a sustainable domestic market for goods and services, the economy is still very much

dependant upon her exports with the European Union and the United States being the country's biggest customers. The caterwauling of economic stagnation is ubiquitous in America where, it seems, the FED's financial goading of the economy has thus far not worked. In Europe the blazing mess that is fiscal profligacy has starkly highlighted the tiered economic hierarchy of a system swamped with bureaucratic vacillation and xenogeneic financial imbalances. China's awareness of the depth and breadth of the current economic and financial ructions scarring the globe is obvious. So too has been the country's policy of attempting to make China less dependent upon her exports by developing a powerful domestic consumer base. The fact remains however that China's trepidation of the global farrago might be somewhat salved if this initiative had succeeded but it seems that the Chinese consumer has gone into hiding pursued by the gravitas of inflation.

Chinese authorities have strived to tame the burgeoning behemoth that is the economy, in order to prevent the development of asset bubbles and to tame any inflationary bumptiousness. China's stimulus injection to the tune of almost six hundred billion dollars in reaction to the global financial crisis ensured that the economy would continue to roar its efflorescent rates of growth into the record books. As the global economy began to resuscitate thus too did demand which further added to the country's growth function. Consequently, the country continued to display hyper levels of economic growth whilst the rest of the world stumbled past the recession line. Having raised interest rates four times since the end of 2010 the central bank's solicitous intentions have additionally warranted that the reserve ratio for banks also be raised. The ratio now stands at twenty one and a half percent for the biggest lenders as policy makers take aim at the troublesome rate of inflation. In May consumer prices rose nearly six percent year on year which was the biggest leap in nearly three years. The main culprit behind the dolorous numbers was food inflation which was up nearly twelve percent year on year. Thus, the quotidian dilemma now facing the Chinese is how to curb inflation whilst also cultivating a reluctant consumer. We have, in a previous piece, parsed over the causes of food inflation. As a result of scientific practices with ethanol, QE II and rising oil prices we have seen the price of food been dragged to new acmes. That's just the supply side. In a country that's evolving as quickly as China, people's tastes have been altered

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and the demotic demands have become more sophisticated. Therefore, as food consumption tends to populate a large part of any consumer's basket, whilst food prices continue to boil we think the pecuniary Chinese consumer will remain largely abstemious. This then, we think, could keep the Chinese economy largely, and overly, dependent upon exports. With the global economy currently meandering through another torrent of corybantic economic and financial headwinds, another imminent rate hike then in China might be stymied, at least in the short run. The danger of course is that in its intention to anneal the economy the Chinese authorities may face the risk of a hard landing. The other possible risk facing China, we think, stems from the nostrum of over investment. At the time of writing, investment in China accounts for nearly fifty percent of GDP. The deluge of funds made available during the crisis was used to bankroll seemingly superfluous infrastructure projects such as new motorways and high speed train initiatives. The mantra was that as the economy continued to grow more people would move from the rural areas to the big cities and that the infrastructure needed to be there to support them. Local government created investment vehicles which then put the funds to work and it was these investments that helped keep the Chinese GDP figures fat for the past two years. Now however there are signs of problems. In May the Government declared its intention to spend nearly five hundred billion dollars to bail out thousands of these investment vehicles as local government's dithyrambic spending eventually succeeded in bulging local debt to close to twenty five percent of

the country's GDP. One could argue that this was just a form of fiscal infusion but the Chinese banks were used as conduits for the loans to the local governments so the banks remain vulnerable – at least theoretically. We think the chances of a debt crisis in China are remote as the government will probably absorb most of these loans from the banks. However, there will probably be a percentage of these loans that will turn bad and ultimately we think that such high amounts of debt may restrict China's policy making apparatus – especially when it comes to the inflation moue that we have already discussed. The exact amount of debt remains fuzzy but the cost of servicing an amount even close to what the estimates are will not kowtow to the cheap and higher interest rates will obviously make that task even more expensive.

The lingering malapert that is the fiscal drama on the continent has resurrected fears of a global economic stumble. In recent sessions commodity prices have been slipping as veritable concerns over the strength of global demand are being highlighted. The fractiousness in Europe may ultimately help the Chinese with their inflation problem but even if prices begin to moderate we doubt the Chinese consumer will have an overwhelming impact upon the capricious global economy. China hasn't decoupled from the global theater yet and vociferous support for weary Europe continues to emphasize the heightened importance that global stability and a confident (especially American) consumer is for the Chinese.

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Inflation's upward march has Chinese policy makers tightening rates and Chinese consumers tightening belts.
(Source: Bloomberg 6/28/11)

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