The Great Unwind and Its Impact on China

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The U.S. and the Roman Empire

- There are striking similarities between the current situation in the U.S. and the factors that brought down the Roman Empire, including:
  - declining moral values and political civility at home.
  - overconfident and overextended military in foreign lands.
  - fiscal irresponsibility by the central government.
- Wall Street is a metaphor for the Coliseum, where Romans fought not just individual duels, but a much deeper battle for the heart and soul of the republic – and lost.
- The Coliseum was symbolic of their obsession with wealth and material excesses, destroying its values and exposing its vulnerability, until eventually Rome was overrun by outsiders.

Source: Economist, David Walker
The Great Unwind

- Financial complexity is at the tipping point
  - Today the marginal utility of financial innovation may be negative
- Financial institutions established to managed risk, instead, have created risk
- The think tanks and universities of America did little
  - Have stood by as the crisis ravages their endowments and destroys the credibility of the efficient ranked thesis
  - The “market we trust” school of market idolatry has ended
- A market without effective regulation is a “school for scoundrels”
Conclusion

- In 1980, bank indebtedness was equivalent to 21% of U.S. gross domestic product. In 2007 the figure was 116%.
- A 2004 rule change by the Securities and Exchange Commission that exempted the five largest investment banks from regulation that had capped their debt-to-capital ratio at 12 to 1. Soon it approached 8 to 1.
- The motto “In God We Trust” was added to the dollar bill in 1957. Since then its purchasing power, relative to the consumer price index, has declined by a 87%.
- Full disclosure of investment bank and hedge fund model inputs and assumptions would help to rebuild investor trust.
Since first coined in February 2007, the credit market phenomenon known as the “Great Unwind” has had a profoundly disruptive effect on U.S. and international financial markets.

Disorderly trading and cascading forced selling—coupled with unprecedented levels of illiquidity—has placed the U.S. banking system into a cycle of distress.

As the Federal Reserve/Treasury/FDIC plan attempts to rescue the U.S. from this crisis, the banking system’s movement through the cycle will define the duration of the current recession.
As the U.S. Federal Reserve’s balance sheet swelled from $900B to over $2T almost overnight, the U.S., along with the rest of the G8, went “all-in” with unprecedented levels of government loans and guarantees in a historic effort to ensure that the global financial system would not fail.
The U.S. Valuation Debate Continues

- Accounting rule-makers have come under unprecedented pressure to ease their rules on “fair value accounting,” the practice of marking assets to market prices.

- The father of the compound option theory is Professor Robert Geske of UCLA. His elegant, well-known theories are tempered by the potentially dramatic impact of measurement or assumption error.
  - Assumptions regarding volatility and duration that are overly optimistic (i.e., “compound optimism”) are now often-noted as problematic. Yet, until recently, these assumptions were routinely utilized.
The U.S. Valuation Debate Continues

- An enduring area of option research is the fundamental financial model assumption that future returns will follow a log-normal distribution, the famous “bell shaped curve.” However, this assumption may over price assets in today’s crisis driven market.

- In analyzing the applicability of market inputs, it is important to look at market volatility. Forced selling is inconsistent with the concept of “freely and actively traded.”
Global Lessons: Conclusion

The Great Unwind Begins

- The “Great Unwind” is now underway. As the financial sector grew to extraordinary size, it did so with great leverage.

- The “Great Unwind” does not just describe the eventual liquidation and dismemberment of a generation of Wall Street creations, including the 30x leveraged investment bank business model that spawned these now distressed entities. It also has a note of optimism as the markets will eventually rewind in an orderly fashion under great regulatory scrutiny.

- The major long-term issue is to manage the inflationary effect of the massive expansion of government borrowers across the globe.
More than 30 of the 100 firms anointed by the Boston Consulting Group in January that are “contending for global leadership” are Chinese. No other country can boast so many.

China has become the world’s largest exporter of information and communications technology.

More than 3,500 watchmakers list their services on Alibaba.

China’s banking system is awash with liquidity. Chinese bank lending surged by 21% in the year April ‘08 to January ‘09.

Some shovel-ready projects are already under-way. Transport infrastructure spending in December was already 61% higher than the year earlier.
Challenges in China

- “What to expect in the Year of the Ox”
- Chinese GAAP and obsolete inventory
- Into adverse selection – why are you in the deal?
- Retrading
- One bed, two dreams
- Any deal with a book
- If value rises post-agreement, approval may be withheld
- In JV, pick the CFO
- Learn Chinese, become Chinese
- Create relationships based on mutual trust
- Comrade Zukin “I am ready” – so is China
Cross-border M&A transactions are often precedents for Chinese and U.S. companies, therefore, it is critical to address the additional complexities.

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Panda Bonds to the Rescue

- Amid a dearth of liquidity in global capital markets, sovereign Panda bonds are now on the agenda. It would redirect excess liquidity in the Chinese money system to a global financial system badly in need of a recapitalization, and it would raise China’s profile in international capital markets.

- Should China allow foreign governments, particularly the U.S., to issue renminbi bonds in the domestic market? China has seen only three domestic bonds by foreigners: two by the International Finance Corp in 2005 and 2006, respectfully, and one by the Asia Development Bank in 2005.

- China is also sitting on US$1.9T of foreign reserves and is becoming averse to absorbing more securities denominated in U.S. dollars. Currency risk has become a major concern.

- The Panda bonds would also siphon liquidity out of the mainland money supply, which has surged on consecutive record trade surpluses. That would save the government the expense of having to issue money-supply-sterilizing government bonds, which carry an interest cost.

- Use of the instrument would also develop the domestic capital market and help to establish the renminbi as a major currency in global finance.

Source: Ifre.com
Dow Jones Industrials vs. Shanghai SE Comp

Dow Jones Industrials (2/1/2008 – 4/2/2009) - Datastream

Source: Datastream
Asian borrowers—sovereign and private—are finding it ever harder to tap global financial markets.

(billion dollars)

Source: Bond, equity and loan database of the IMF through Dealogic
Spreads on credit default swaps for Asia, essentially the cost of credit default insurance, have increased since mid-2008.

Sources: Bloomberg and IMF staff calculations
Notes: Measured by iTraxx Indices. Spreads are the annual amount that an entity seeking protection must pay, expressed as a percentage of the value of the debt being protected. A basis point is 1/100th of a percentage point.
Initial Public Offerings Volumes in China and Hong Kong $Billions

Initial Public Offerings Volumes in China & Hong Kong
HK$B

Parched
Initial public offering volumes in
China and Hong Kong, HK$B

Source: Dealogic
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Greater China M&A Quarterly Developments

Source: Mergermarket
Greater China M&A Sector Breakdown 2009 YTD - Value

- Financial Services: 17.6%
- Energy, Mining & Utilities: 16.1%
- TMT: 5.9%
- Consumer: 12.6%
- Industrials & Chemicals: 23.2%
- Transport: 13.6%
- Construction: 0.4%
- Pharma, Medical & Biotech: 1.1%
- Leisure: 2.5%
- Business Services: 2.8%
- Real Estate: 4.1%

Source: Mergermarket
Greater China M&A Sector Breakdown 2009 YTD – Value (cont.)

Source: Mergermarket
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