

Thought Leader Interview with Louis-Vincent Gave Co-Founder and CEO, GaveKal Research

with Stephen Waite, January 6, 2011

In this Thought Leader Interview, we talk with Louis-Vincent Gave, Co-founder and CEO of GaveKal Research, one of the premier economic and financial market research companies in the world. Louis paints an insightful picture of the global economic and investment outlook for the year ahead, with a focus on his areas of expertise – Europe and Asia. Some of the key takeaways from our interview with Louis include:

- The moment of truth has now arrived for policymakers in Europe. Simply preserving the status quo is no longer an option. Before a break-up becomes a high probability, European leaders are bound to try everything possible to defend the monetary Union.
- Policy tightening in China is now the order of the day with structural changes emerging as a key focus. This is bad news for Chinese real estate and potentially tough news for the commodities that are not supply constrained.
- Financial reforms in China will continue, but likely be gradual. Last year was a breakout year for Chinese IPOs in the US and Louis expects to see a continuation of this trend in 2011.
- Tensions in Korea are likely to persist. Louis notes that North Korea is little else but a trump card the Chinese get to play every now and then when they need something from Washington or when Washington bothers them.
- The recent outperformance of Japan's equity markets clearly shows that things may be changing, albeit less for reasons linked to Japan than for reasons linked to the global macro environment. Renewed growth of the monetary base would likely herald a sustainable rally in Japanese equities.

SW: Great to speak with you, Louis. We have lots of ground to cover. Let's begin with the investment outlook. We've seen a recovery in global economic activity and an official end of the Great Recession. The equity markets have perked up while interest rates have remained low in many G-10 economies. Should we expect more of the same in 2011?

LVG: No. Or at least I hope not! When you look back at the past year, what will people remember? The ECB tearing up the rulebook not once, but twice? The Fed embarking on a program of QE with the S&P almost twice the level of its March 2009 lows and an ISM survey at 57? Let's face it: we have witnessed in the past year a level of policy activism that one would usually associate with massive crisis. It's a little bit as if policy-makers got hooked on the drug of their own importance in 2008 and 2009 and can't give up on the interventions. But then, what results did all of these interventions bring? As we say in French, 'tout ça pour ça?' (all this for that?). We are finishing the year with bond yields marginally higher than where we started, equities marginally higher and exchange rates broadly in line. Much ado about not much!

SW: Given the problems we've seen in Greece and Ireland over the past year, many people are wondering if the Euro has a future. What's GaveKal's view?

LVG: How much time do you have? We have as many views as we have staff. Maybe more. I myself change my view regularly on the outlook for the Euro. Having said that, even the president of the European Council now admits that the Euro is in mortal danger. We can thus safely conclude that the fundamental flaw in the single currency project is evident to everybody. As we have argued for years at GaveKal, a durable monetary union cannot exist without a significant degree of fiscal union and of collective responsibility for sovereign borrowing – in other words, without a European “economic government” of some kind. As it turns out, both the founding fathers of the Euro and the Eurosceptics were united in expecting the monetary union to suffer an existential crisis in the absence of a central economic authority capable of organizing fiscal transfers and collective borrowing guarantees. The only difference between the Europhiles and Eurosceptics was in the prediction of what would happen after the inevitable crisis occurred:

1. The Eurosceptics expected the Euro to disintegrate as the surplus countries proved unwilling to support those in persistent deficit.
2. By contrast, the founders of the Euro, led by Jacques Delors, noted that the European Project has always progressed through crises and were confident that once the single currency was threatened with disintegration, European nations would be forced to take the decisive steps towards fiscal federalism and economic government which, back in 1991, the Maastricht Treaty refused to contemplate.

So this moment of truth has now arrived. Europe's leaders face a choice of “more Europe” or “less Europe.” Simply preserving the status quo is no longer an option. The meaning of “less Europe” is obvious—a breakup of the Euro. This is still very difficult to analyze but no longer “unthinkable,” as European officials invariably claimed even a few weeks ago. Still, before a break-up becomes a high probability, European leaders are bound to try everything possible to defend the monetary Union.

And on this note, I would say that this is the silver lining to the current Euro crisis. Today in Europe we are starting to witness a genuine reform of the welfare state: from a push-back in retirement ages in France to Zapatero's taking on Spain's air traffic controllers, it seems that Europe's policy-makers are embracing their

inner Thatchers and repeating the great lady's words: "There is no alternative."

Look at the contrast between the US and Europe. In the US, political opinion is divided between a left that does not want to cut spending and a right that does not want to raise taxes. And sure enough, a wonderful compromise was just reached whereby the GOP got its tax-cuts and the Democrats got their spending wishes. So at least one thing we can look forward to from here is a Europe with less bloated welfare states.

But even without the bloated welfare states, I do not know whether the Euro has a future. Economically, the Euro never made much sense. However, it was always a political project anyway. So the question is now a political question: specifically, will the Germans accept higher inflation for years to come? And will Southern Europeans accept negative growth for years to come? On this last point, I would highlight that for now, the Southern Europeans have no choice but to accept the Brussels Diktat as they are still running primary deficits (i.e., even if they renege on paying interest on their debt, the governments would still be running deficits and having to cut spending.

SW: Are you surprised at how well the European economies have performed amid the financial upheavals in the PIIGs?

No. Not really. In fact this was one of our biggest themes for the year. If you look at the combined GDP of Portugal, Ireland, Greece and Spain, it is as big as Switzerland and Sweden combined. And Switzerland and Sweden are both booming, more than compensating for the bust in the Olive Belt.

SW: Let's talk about Asia, where you live and spend most of your time. There seems to be an important shift occurring in China with the central government focusing more on structural change and less on maintaining high short-term growth targets. What do you make of this and what are the major implications for investors?

One of the issues we have talked about at length all year has been the "Wen Jiabao put," a close cousin of the old (now discredited) Greenspan put. And it works like this: if you know that the Chinese government will not accept a growth rate below 8%, then you should load up on iron ore, copper, etc... and Chinese real estate as well.

But, of course, there is a downside. The Wen Jiabao put of a seemingly government-guaranteed 8% GDP growth rate meant that structural reforms could never succeed and that debt and inflation risked rising to dangerous levels. Fortunately, the indications emerging from the October Communist Party plenum—notably the surprise quarter-point interest rate hike immediately after the meeting ended—were clear: policy tightening is now the order of the day. We expect this tightening stance to stay in place through 2011 and into 2012.

This tightening will be gradual and will comprise the usual monetary tools. First, new lending will be curtailed: net new loan issuance will likely fall from around Rmb8 trillion in 2010 to under Rmb7 trillion in 2011, meaning that year-on-year growth in the stock of credit will fall from 19% this year to 15% next year. Second, banks' required reserve ratio will rise from 18% now to as high as 25% over the next 18 months, depending on the strength of inflationary pressure. Finally, interest rates will be hiked three or four more times by the end of next year.

Moderate tightening should be adequate: for all the recent breathless talk spurred by an unexpected acceleration of consumer price inflation to 4.4% year on year in October, price pressures seem manageable. Both CPI and the broader GDP deflator (5.1% in Q3) are well below their peak levels of early 2008, and money supply growth is trending down, despite an uptick in October. We remain convinced that over the medium term the “new normal” for China will be GDP growth of around 8% and CPI inflation of 3-4%, and that efforts to push growth higher risk an inflationary outburst.

It seems that China is serious about keeping inflation in check and if this means sacrificing the 8% growth target, then so be it. This is bad news for Chinese real estate and potentially tough news for the commodities that are not supply constrained.

SW: China has been slow to reform its financial system and external capital account. Do you see prospects for major financial reform in the months ahead, and if so, how is this likely to affect global financial markets?

LVG: Yes. Or at least I hope so. I think the past 18 months has seen a China embarking on the path of financial reform and financial liberalization, one small step at a time of course; the old ‘feeling the stones as you cross the river’ advice of Deng Xiao Ping. I would imagine this to continue over the next two years. But whatever happens will be gradual. China’s policy makers are not in the habit of up-ending the rules of the game over night. But judged over time, things are going in the right direction. China is far more liberalized today than five years ago and I am sure that I will be able to say the same thing five years from now.

SW: We’ve seen a number of domestic Chinese companies IPO in the U.S. over the past year and some movement by Chinese financials into U.S. brokerage activity? What’s your take on this activity? Should we expect more of the same in 2011?

LVG: Yes. When things work for China, you can usually expect more of the same.

SW: We are seeing rising tensions in Korea. How does GaveKal see that situation evolving in the months ahead?

LVG: I think the tensions are always there and as my friend George Friedman of Stratfor likes to point out, North Korea is little else but a trump card the Chinese get to play every now and then when they need something from Washington or when Washington bugs them. The North Koreans act up, forcing the Americans to ask for Chinese help, who then oblige but who are now owed a favor.

SW: Japan was once described to us as “communism with beauty spots.” It would seem those beauty spots are wearing with age. Toyota stumbled badly in the U.S. and many of the big Japanese consumer electronics companies look like dinosaurs today. How does Japan look to you?

LVG: An old joke in Asia is that Japan is a profoundly socialist country on which capitalism was imposed while China is the opposite. And today, both are returning to their natural predispositions.

Having said this, I would be wary, at least tactically, of selling Japan here. I know that over the past two years, Japanese equity markets have gained a paltry +7.1% while other global equity markets, and especially Japan’s neighbors in Asia, have soared. So why has Japan been so disappointing? And what could change now? Here are a few things to think about:

- **Bank recaps:** In the last quarter of 2010, just as global equity markets were finding their groove, Japanese banks hit the markets with large re-capitalization plans. This sapped investor confidence and proved to be a major liquidity drag. And needless to say, it led to sustained underperformance of Japanese bank stocks.
- **Strong Yen:** With the growing uncertainty surrounding the long-term viability of the Euro, with the board of directors of the Fed developing monetary incontinence, and with record low yields on government bonds around the world, it all of a sudden made little sense for Japanese investors to hold foreign debt securities; simply put, the low yields no longer compensated for the exchange rate risk. As a result, Japanese investors have spent the past two years repatriating capital, which in turn led to a strong Yen and a flattish yield curve. And needless to say, when the world is beset by deflationary woes, a flatish yield curve and a strong currency present very strong headwinds for the market. This is all the more true if, like in Japan, the stock market is heavily geared towards exporters (for whom the high Yen is a drag) and financials (who tend to underperform when long bond yields fall).
- **Lack of central bank activism:** Further re-enforcing the strong Yen was the fact that, unlike in the US, China, UK or Europe, the Bank of Japan hardly expanded its balance sheet in the face of the crisis. Indeed Japan must be the only major economy who, in the past three years, registered low single digit growth in its monetary base. Given the fact that excess liquidity growth can often be a powerful drug for sick financial markets, the lack of activism of the BoJ has undeniably been a headwind for Japanese equities.
- **Lack of political leadership:** Another hurdle for Japanese equities has also been the fact that, unlike any other Western countries, Japanese PM seem to be unable to hold on to their functions for even a year. Needless to say, this hampers considerably the ability to push through a program of genuine reform. The fickleness of Japanese politics means that the BoJ and the bureaucrats of the various ministries find little push back or direction from elected officials. In that regards, it is interesting to note that the two last important Japanese bull markets (1999 and 2005) followed periods of accelerating monetary base growth from the BoJ and that this BoJ activism was a direct result of popular prime ministers (Obuchi and Koizumi) putting pressure on the Japanese central bank.

SW: So where does all of this leave us with Japan?

LVG: The recent outperformance of Japan clearly shows that things may be changing, albeit less for reasons linked to Japan but for reasons linked to the global macro environment. Firstly, deflationary pressures around the world may be abating (this is definitely the case in Asia ex Japan). Consequently, as long bond yields around the world start to rise, Japan may witness a twin positive effect of a Yen that is no longer rising (hereby boosting exporters) and steeper yield curves that help financials outperform. In that regards, the current environment looks very similar to what we witnessed in the first quarter of 2010 and which led to a brief outperformance of Japanese equity markets. Of course, for this outperformance to mutate into a full blown bull market, excess liquidity will have to come from somewhere... and that somewhere will have to be the BoJ. In that regards, monetary base growth is now at an interesting juncture. The next few months on the Japanese equity markets could thus be very interesting. If the growth rate of the monetary base starts to accelerate, then they will definitely be very rewarding. Otherwise, the current rally will be yet another head-fake.

SW: *We appreciate you sharing thoughts about the year ahead with us, Louis. It's always a pleasure speaking with you. Wishing you and the GaveKal team all the best in 2011 and beyond.*

About Louis-Vincent Gave

After receiving his bachelor's degree from Duke University and studying Mandarin at Nanjing University, Louis-Vincent joined the French Army where he served as a second lieutenant in a mountain infantry battalion. After a couple of years, Louis-Vincent left the army and joined Paribas Capital Markets where he worked as a financial analyst first in Paris, then in Hong Kong. Louis-Vincent left Paribas in 1999 to launch GaveKal Research with Charles Gave and Anatole Kaletsky in London. In 2002, Louis-Vincent left the London office and returned to Hong Kong; the idea at the time was that Asia was set to become an ever more important factor in global growth and that, consequently, GaveKal needed to offer its clients more information, and more ideas, relating to Asia. Louis-Vincent contributes frequently to the research and was the main author of our books *Our Brave New World* and *The End is Not Nigh*. Louis-Vincent is CEO of Gavekal and MW GaveKal. Louis-Vincent is a French national. He speaks French and English and is rusty in Spanish and Mandarin. He is married with two sons and two daughters.

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