Kyle Bass: The looming crises in Asia

Robert Huebscher | Advisor Perspectives | 27 May 2014

For the last several years, nobody has been more outspokenly bearish on Japan than Kyle Bass [founder of Dallas-based hedge fund, Hayman Capital, and famous for predicting the US sub-prime crisis - Ed].

In a recent talk, Bass reiterated his doubts about Japan's chances of averting a debt crisis. What's more, he also said China's economy will fall below expectations.

He has changed one aspect of his outlook on Japan. Instead of predicting a collapse of the Japanese bond market, he focused on a severe weakening of the yen - without predicting when that might happen. His predictions for China were equally distressing. He said that its banks will be saddled with non-performing loans and its economy is actually contracting. "I don't think the markets are discounting what's really happening in China," he said.

Bass was featured prominently in Michael Lewis' recent book, The Big Short, for profiting from investments during the sub-prime crisis, which Bass accurately predicted. He spoke on May 19 at in San Diego at the Strategic Investment Conference, which was sponsored by Altegris and John Mauldin.

I'll look at Bass' predictions for Asia's two biggest economies - and how Bass believes investors can profit from their plights.

CHINA

China's economy isn't just slowing down, according to Bass - it's contracting. While China's published rates for annual growth are still positive, Bass argued the nation's economic growth was negative from the fourth quarter of 2013 to the first quarter of 2014, as a result of excessive government spending on unproductive sectors of the economy.

While the People's Bank of China (PBoC) has been more aggressive in its quantitative easing (QE) that the Federal Reserve, Bass said, much of that money has gone into unproductive credit expansion. China's banking assets have grown to over 100% of its GDP in the last three years, he said. If the US had engaged in similar policies - which he said would translate to US$17 trillion in lending over that time period - it, too, would have achieved more than 7% GDP growth.

China's banking assets now total approximately US$25 trillion, or almost three times the size of its US$9 trillion economy. And it's low default rate on bank loans - about 1% - is about to rise, Bass argued. Much of that lending is construction-related, with 55% of China's GDP growth coming from the construction sector. The marginal return on those loans must be

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very small, he argued.

"A rolling loan gathers no loss," Bass said, "and that's what's been going on in China for the last few years." He said it is impossible to believe China could "manipulate" the inputs of its financial system without losing control of the outcomes.

If non-performing loans go from 1% to historical norms "somewhere in the teens" with loss severities of 100% for the worst loans, China would deplete its US$4 trillion of foreign exchange reserves. Bass implied that China would need those reserves to stabilise its banking system, though he did not say so.

Deflation is also threatening China, he argued, with its GDP deflator now below zero. He expects the PBoC to engineer a devaluation of the renminbi as a way to stimulate exports and avert further deflation.

China's leaders are fully aware of the dangers its economy faces, Bass said, and they hope to slow growth in a measured fashion, including through the restructuring of its banking system. "The jury's out whether or not they can do it," he said. "We actually believe they might be able to do that and that GDP [growth] is just going to slow down a lot more than people expect...I'm not saying it is a calamity, a disaster or it's going to end badly for the world," Bass said. "All I'm saying is China is slowing down a lot faster than people think, and you need to think about how to position your portfolio for this."

He advised against shorting Chinese equities as a way to capitalise on his forecast. Instead, he said, investors should look to China's trading partners - Australia, New Zealand and Brazil. Those countries will be forced to loosen their monetary policy, raising rates and creating carry-trade opportunities.

JAPAN

For several years, Bass has maintained that Japan faces an imminent crisis in its bond markets - an uncontrollable upward spike in interest rates. He has been wrong. In this talk, however, he focused more on what will happen to the yen.

Bass expects Japan's reform program to fail. That program is based on "three arrows" - aggressive fiscal policy, which is causing Japan to run a deficit that is 10% of its GDP; aggressive monetary policy, which is the "Abenomic" pursuit of QE that has doubled the monetary base in pursuit of 2% inflation; and, structural reform which Bass said hasn't happened and isn't likely. None of those arrows, either individually or in combination, will be sufficient to normalise the Japanese economy, he believes.

Japan recently instituted a consumption tax, which Bass expects to push inflation up to 3%. But, that will cause real yields to be negative, because Japan's 10-year bond now yields approximately 60 basis points - and that would lead to selling of Japanese government bonds, Bass argued.

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The Bank of Japan (BoJ) might step in to buy those bonds, he conceded, effectively monetising the debt through QE. Japan's QE is enormous relative to that of the US, at 140% of tax receipts, 170% of its fiscal deficit and 14% of GDP (versus 13% of tax receipts, 62% of fiscal deficit and 2% of GDP in the US).

But that QE, he contends, will cause the yen to depreciate. "It's my supposition that at some point in time, once the currency depreciates enough and capital flows leave Japan's current account that you can't hold the bond," he said. "When this happens, I don't know. But I can tell you this: The yen is going to do nothing but weaken from here."

Bass noted that the BoJ is already the primary source of liquidity for Japan's bond market. When it recently stepped away from the market, not a single bond traded for a day and a half, he said.

One way out of this predicament would be to allow interest rates to rise. But Japan can't afford that. It already spends 25% of its tax revenue on interest expenses. A hundred-basis-point increase would cause the country to spend all of its revenue on interest.

Japan has been able to pursue QE because it ran a current account surplus for the last 31 years. Bass said that string has ended, and Japan's balance of trade is continuing to worsen. This creates a paradox for Japan. Either it must buy foreign bonds in order to weaken its currency, or it must invest in capital goods (machinery and equipment) to foster the "animal spirits" that would stimulate growth.

Either way, Bass said, the money would have to come from the banks as they sell their government bonds. And that will force the yen to weaken.

IMPLICATIONS FOR THE US

With the Fed tapering and both China and Japan's currencies likely to weaken, the net impact on the US will be deflationary, Bass said. That trend will be accelerated by the improvement in the balance of trade for the US which had its current account deficit shrink due to increased hydrocarbon production.

The crucial moment will come when the US reports a sub-6% unemployment rate, meeting the target it has set for normalising its monetary policy by ending QE and raising rates. He predicted that will come in July, adding that it will be the Fed's "worst nightmare". Raising US rates would stifle growth and recreate unemployment problems, which would be disastrous politically, Bass said.

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