

# We Will Bury You

On November 18, 1956, during a reception at the Polish embassy in Moscow. Soviet Premier Nikita Khrushchev declared to his audience of Western diplomats that “We [the Soviet Union] will bury you.” This was not a military threat but rather an economic boast. And it was a remark taken very seriously by the West.



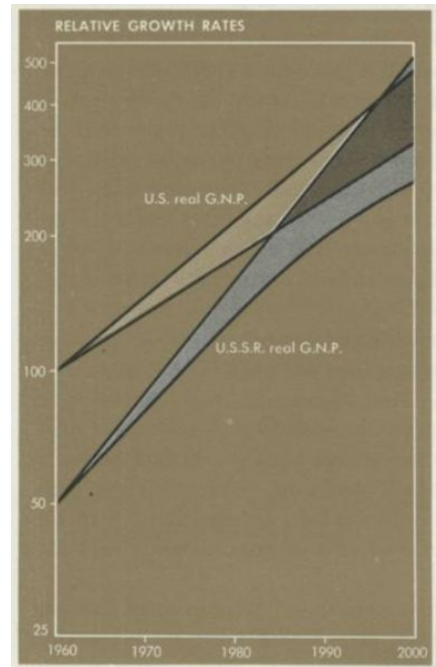
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The Soviet economy delivered exceptionally high growth rates in the decades following WWII, far outpacing developed Western nations. This growth mesmerized Western academics, policymakers, and intellectuals with its astonishing pace. The Soviet Union was hailed as an “economic miracle” and many became convinced that the Soviet’s Command and Control economy was far superior to the West’s capitalist system... and that it was only a matter of time before the Soviets became the largest economic power in the world.

This was not a fringe belief. In fact, it was *the* mainstream narrative and accepted as a matter of certainty. Acemoglu and Robinson relate in their book *Why Nations Fail*, that:

*The most widely used university textbook in economics, written by Nobel-prize winner Paul Samuelson, repeatedly predicted the coming economic dominance of*



*the Soviet Union. In the 1961 edition, Samuelson predicted that the Soviet national income would overtake that of the United States possibly by 1984, but probably by 1997. In the 1980 edition there was little change in the analysis, though the two dates were delayed to 2002 and 2012.*

Unfortunately for Samuelson, his prediction somewhat missed the mark. Not only did the Soviet Union fail to surpass the US in economic supremacy, **it actually went bankrupt (twice!) in the following decades before finally disintegrating as a geopolitical power.**

But in the 70s, while the Soviet economy was beginning its slow descent into irrelevance, another “high growth” country took center stage, quickly becoming Western economist’s new infatuation: Japan.

Japan’s period of high growth lasted nearly three decades. And because of this economic prowess, Japan was also called an “economic miracle”. Economist, politicians, and intellectuals wrote many a books and thought pieces on the superiority of the Japanese economy to that of the laissez faire capitalist system of the West. And once again it became accepted as a matter of fact that the Japanese economy would soon surpass the US in size.

Here’s some excerpts from a *NYT* article printed in 1991 titled *Leaders Come and Go, But the Japanese Boom Seems to Last Forever*, that gives you a good sense of what the common narrative of the time was.

***At a time when the American economy is struggling with recession, the Japanese economy has just completed its 58th month of uninterrupted growth.***

*Setting the new record may not have been an occasion for parades or speeches, but economists are calling this one of the greatest booms in recent history, a period that has not only fundamentally altered the Japanese economy but sown the seeds of even greater friction with the United States. Some have taken to calling this period Japan’s second economic miracle, as important as the one that turned a war-devastated nation into an industrial powerhouse.*



*Japan is a different country today than it was five years ago," said Kenneth Courtis, senior economist with Deutsche Bank in Tokyo. "It will become even more evident in the 1990's. The Japanese economy has so much momentum that, competitively speaking, the 1990's will be over in 1995. The West won't be able to catch them after that." As Mr. Courtis put it, Japan has grown economically by the equivalent of one France since 1985, or by one South Korea each year. Its manufacturers invest more*

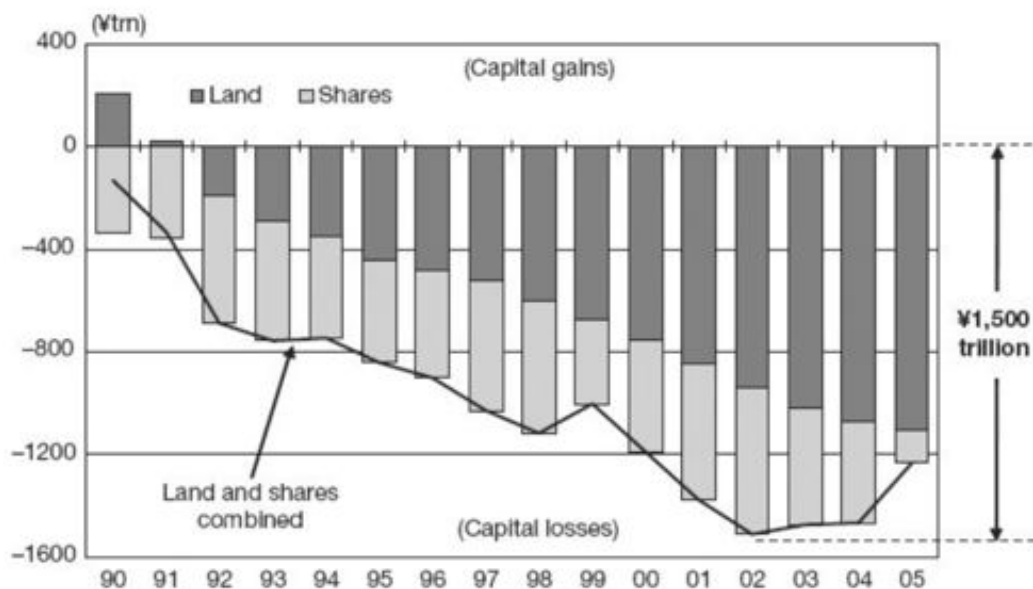
**every year in new plants, equipment and research than American companies, though the American economy is some 40 percent larger than Japan's.**

**This is the change that is likely to make Japan an even more threatening competitor for American companies, many of which used the immense wealth created in the 1980's to benefit their investment bankers rather than investing aggressively in the future. Japanese companies are expected to increase their capital investment budgets this year... Mr. Courtis estimated that Japanese companies spent about \$625 billion on such investments over the last five years, a sum it will take American companies nearly 10 years to spend.**

Of course, we know now that “competitively speaking, the 1990’s” didn’t end in 1995... as senior economist Kenneth Courtis so confidently predicted. Instead, 1991 (when this article was printed) marked the peak of the Japanese miracle economy. What followed was the popping of a gargantuan asset bubble followed by decades of painful deflationary economic contraction.

Richard Koo, wrote in his book, *The Holy Grail of Macroeconomics: Lessons From Japan’s Great Recession*, that falling land and stock prices alone, accounted for the destruction of 1,500 trillion yen in wealth; a figure equal to the entire nation’s stock of personal financial assets or 3-years of GDP. **This makes it the greatest economic loss ever in history by a nation in peacetime.**

So much for miracles...



Do the economic miracles turned nightmares of Russia and Japan remind you of any similar majority consensus today? Hmmm?

LEADERSHIP • U.S. ECONOMY

## Study: China Will Overtake the U.S. as World's Largest Economy Before 2030



It should, and for good reason. China is following the exact growth model used by both 1960s Russia and 1980s Japan. It's called the Gerschenkron growth model and China has implemented it to a T, differing only in its intensity and scale which is unprecedented.

And like Japan and Russia before it, China's economic "miracle" is anything but.

In this month's MIR we're going to explain why just like Santa Claus, economic miracles don't exist...

We'll do this by first laying out the Gerschenkron model for economic growth. A model practically invented by the Soviets and then copied and implemented to varying degrees by Japan, LatAm countries in the 70s, and then finally carried out on steroids by China today.

We'll show you why China not only isn't going to surpass the US economy in this decade or next but is instead headed for an inevitable long and painful deleveraging. One littered with socio-political landmines that will resemble some mix between Japan's meteoric asset bust and the Soviet Union's economic dissolution.

Then we're going to talk about what this means for emerging markets (EM) in general; getting into the growth limitations that EM as a whole currently face. Finishing with why EM is going to be a dead asset class for the remainder of this cycle.

And then of course, we're going to get into the trades to be made off this developing thematic, starting with four shorts (a Chinese tech stock, a currency, a stock index, and a precious metal).

Then we're going to end with a pitch for buying two beaten down North American tech stocks.

Let's begin!

## A Treadmill to Hell...

Alexander Gerschenkron was a Ukrainian born American economist who taught at Harvard during the first half of the 20th century. In 1951, he authored a paper titled *Economic Backwardness in Historical Perspective* in which he laid out his theory on the linear development stages that "backward" countries — backward meaning lacking in socio-economic development and institutions — follow in their transition from agrarian to industrial based societies.

Gerschenkron noted that developing countries suffer from poor infrastructure (ie, they have high investment needs) as well as low savings rates. Since savings are equal to investment (as part of the national accounting identity framework), developing countries are dependent on foreign capital which tends to be a risky and unreliable form of investment.

To get around this, he noted that countries needed to boost their savings rate. Again, because higher savings equals higher investment which means better infrastructure and faster economic development.

The easiest way to accomplish this is by lowering the household income share of GDP.

Now, we're not going to get too wonky here. Just stay with me, this is an important concept and we'll soon get to why this matters.

So how does forcing down the household income share of GDP affect a country's savings rate?

It's pretty simple. You see, GDP is equal to consumption + savings. So a higher savings rate just means lower consumption and vice-versa. And since households make up the vast majority of a country's consumption — businesses don't really consume and governments only consume a little on household's behalf — then lowering household's share of GDP, effectively lowers consumption and thus raises savings/investment.

It's a common and unfortunate misconception that a country's level of savings is reflective of the culture's prudence and spendthrift — "those Germans are so fiscally responsible!". Like many popular ideas in economics, this is completely *falsch* (German for false).

A country's savings rate is determined almost entirely by its government policies and how income (GDP) is divided up between producers and consumers. Germany has a high savings rate because households (those who consume) get a smaller piece of the nation's income pie. The majority of it goes to private industry and government who save/invest more and thus consume less of GDP.

A developing country that increases its savings rate then has more money to invest — typically directed by the government — in large scale infrastructure projects and export oriented industries. This dramatically boosts economic activity and financial maturation which leads to credit creation; more lending, more development, rising asset prices, and more valuable collateral to lend even more against.

These development periods are marked by large current account surpluses, as the country grows by increasing its share of global exports.

A credit fueled development boom begins. And because these countries started off with low levels of development and infrastructure, there's in effect a lot of low hanging productive fruit to invest in. **This kicks off a self-fulfilling cycle of development that can last decades**, as in the case of Russia, Japan, and now China.

This is a very effective growth strategy when there's ample opportunities for the government to direct investment into high return capital intensive projects.

But eventually, Gerschenkron notes, the country maxes out the productive investment it can absorb — you can only build so many bridges and high speed rail lines. But, instead of slowing down investment and increasing consumption (the household's share of income), the vested interests (usually affiliated with the government) are incentivized to keep the party going.

**The vested interests are, vested, because this system of development made them rich and powerful.** And a rebalancing of the economy, from an investment and export led one to a consumption based one, means that they would have to relinquish a large portion of their share of GDP to households. It's probably not surprising, but this has *never* voluntarily happened before in history.

So instead, the country doubles down and tries to grow its way out of debt, usually by adding more debt...

This means they borrow more to invest in even less productive assets. So growth slows while debt accumulation and servicing cost grows. Eventually the costs to service the existing debt stock becomes much larger than the economic growth rate. An unsustainable trend if there ever was one.

In economic speak, this is called the Wile E. Coyote phenomena, or debt trap, minsky moment etc...

There's no good option for getting out of this stage. A painful economic rebalancing is absolutely unavoidable. It's a basic law of accounting and economics. All a country can choose at this point is how they want to take it: swift and violent or long and grinding.



So to sum up, the Gerschenkron model of growth goes like this:

- ❖ Undeveloped countries are plagued by poor infrastructure and have low savings and investment rates.
- ❖ To increase investment and boost development, they lower the household's share of GDP thus increasing governments and producers share of GDP, which in effect raises the nation's savings rate; providing more money to invest.
- ❖ This investment is then directed by the government into big infrastructure projects and export focused industries.
- ❖ The country then grows through increasing its market share of global exports by investing in high return projects.
- ❖ Eventually the country maxes out the productive investment it can absorb, resulting in each new unit of debt having less and less of a positive economic effect.
- ❖ The vested interests who became rich and powerful on the back of the investment led economy aren't incentivized to rebalance. So they keep adding unproductive debt until, eventually, debt servicing costs exceed the economy's capacity to service it and the economy inevitably goes through a painful forced or managed rebalancing.

## The Restless Hand

Now that we know how the Gerschenkron model of growth works, here's a quick rundown on how China implemented it and where things stand today.

China increased its savings and investment rate through a number of means, the primary method being a hidden tax on households.

They implemented this tax by keeping interest and deposit rates well below growth and inflation rates. For instance, in the early 2000s, nominal GDP growth was roughly 18% and inflation averaged around 8-10%. While at the same time, the lending rate averaged only 6% and the deposit rate just 2.5%.

This meant that it was essentially free to borrow money. With the lending rate well below inflation, the policy greatly favored debtors. However, households, who were mostly locked out

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of the lending market, held the Lā shǐ end of the stick, because the amount they earned on deposits was only a fraction of the inflation rate.

Economist, Michael Pettis, estimates that during this time, the Chinese government was able to transfer roughly 5-8% of GDP a year, from the household sector to large businesses and borrowers (local governments). That's a massive transfer of wealth from households to business and government.

Now, since China as a whole was growing in the double digits each year, household income still went up. But its share of GDP shrank each year while that of borrowers (ie, businesses, SOEs, local governments etc...) grew much larger.

Excluding a couple of oil rich Arab sheikdoms — where quality data doesn't exist — **households in China have the lowest share of GDP of any country in recorded history.** So it should be no surprise they have such a high savings rate (north of 40% of GDP) and thus, so much money to invest.

This was a very effective growth strategy for the Chinese over the last 30 years. Primarily, because after 40-years of Maoism, China was severely underinvested and there was ample room for productive investment.

They've been able to modernize and pull off the largest scale urbanization and migration effort in recorded human history. **Over the last decade and a half alone, nearly 280 million people (over 80% of the population of the US) have migrated from the rural countryside to one of China's cities,** achieving a level of urbanization that took the US an entire century to carry out.

Essentially, this growth model is the antithesis of Adam Smith's *invisible hand*. Where instead of millions of economic agents working in their own self interest to direct the allocation of capital. China's growth model has been centered around the visible hand of government, with central authority allocating capital as it sees fit. And it has done so so aggressively that the Chinese call it, "xian bu zhu de shou" (the restless hand).

This restless hand has enabled China to dramatically accelerate growth **by increasing its market share of world exports 10-fold over the last three decades;** from just 2% in 1990 to 21% today (chart via Bridgewater).



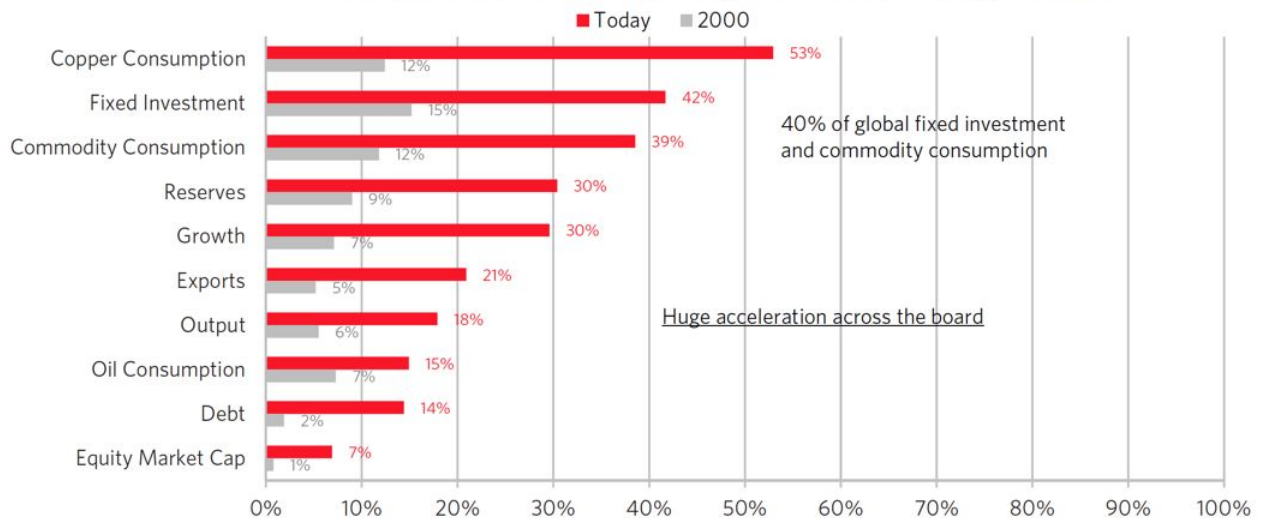
**Share of Global Non-Commodity Exports**

	1970	1980	1990	2000	2010	Today
<b>Developed World</b>	87.8%	83.2%	78.2%	68.1%	53.1%	49.3%
United States	20.2%	18.2%	17.6%	19.4%	12.7%	13.2%
Euroland	32.7%	32.8%	26.9%	23.0%	22.7%	21.1%
Japan	11.7%	13.6%	15.8%	10.4%	7.4%	5.6%
United Kingdom	10.9%	8.5%	7.7%	5.9%	3.6%	3.3%
Canada	6.0%	4.0%	4.2%	4.8%	2.4%	2.3%
Australia	0.4%	0.5%	0.6%	0.6%	0.5%	0.4%
Switzerland	2.8%	2.5%	2.5%	1.8%	1.9%	1.8%
Sweden	2.8%	2.4%	2.1%	1.7%	1.4%	1.0%
Norway	0.1%	0.6%	0.5%	0.4%	0.3%	0.2%
New Zealand	0.2%	0.2%	0.2%	0.1%	0.1%	0.1%
<b>Emerging World</b>	12.2%	16.8%	21.8%	31.9%	46.9%	50.7%
China	0.9%	1.0%	2.0%	5.2%	17.2%	20.9%

Developed world broadly losing market share to EM  
 US and Euroland losing market share  
 Japan peaked in the 1990s  
 EM share has risen to roughly half of global exports  
 China's share has increased dramatically

Here's another chart (again, via Bridgewater) that shows in even starker terms, the incredible advancement in China's share of global economic activity since the start of the millenium.

**China Share of Global Economy and Markets: Today vs 2000**



40% of global fixed investment and commodity consumption

Huge acceleration across the board

China now accounts for over 40% of global fixed investment and commodity consumption.

That's mind-blowing...

God forbid something happens to structurally reduce China's economic growth for any length of time. **Could you imagine the knockon effects in the commodity space alone, if the source of over half of total global demand for copper experienced a gut-wrenching deflationary economic collapse like that of Japan in the 90s?**

Well, we're soon going to find out.

This is because China long ago maxed out its economy's ability to productively absorb investment. And like every other time in history the Gerschenkron playbook has been carried out, China's vested interests — in China it's the local government officials, SOEs, and property developers etc.. — have doubled down...

Since 2008, the Chinese economy added over \$12 trillion in new debt, which was roughly the size of the entire US banking sector back then. This means China's banking system has effectively quadrupled in size in less than a decade; making it the largest financial system by total assets in the world.

Its total debt to GDP now stands somewhere between 240% and 350%. No one really knows how much because the system is so convoluted and opaque, but the number is likely over 300%. **The interest costs on this debt now stands at 16% of GDP, which is much higher than the recorded 6% annual GDP growth.**

For reference, Japan's bubble peaked when debt hit 220% relative to GDP, Thailand at 180%, and the US peaked at 180% before the subprime meltdown.

And what's even more troublesome than the sheer scale of China's debt is the speed at which it has increased. According to Bloomberg, "The IMF identified 43 credit booms in which the credit-to-GDP ratio increased by more than 30 percentage points in five years. All but five ended with a significant growth slowdown or financial crisis. China's debt-to-GDP ratio has risen 54 percentage points in the last five years. Moreover, it started from an elevated level, increasing the chance of a crisis, according to the IMF."

Households, which used to have relatively healthy balance sheets have leveraged up significantly since 09' at the behest of the government to borrow and spend more. Chinese households now have debt worth about 106% of their income, which is roughly the same as households in the US.



We don't need to spill anymore ink talking about China's extraordinary debt levels or the countless examples of large scale pervasive malinvestment — we've covered both quite a bit over the years. But let me end this section with just a few anecdotes and examples.

- Via McMahon's book, *China's Great Wall of Debt* "According to Qiao Runling, the deputy head of the China Center for Urban Development, in 2013, **plans for new cities and new districts were sufficient to house about 3.4 billion people, more than twice China's total population.**"
- According to Jim Chanos, "China is building 20 million apartment flats a year. It needs about 6 to 8 to cover both urban migration and depreciation of existing stock. **So 60% of that 25% is simply being built for speculative purposes, for investment purposes. And that's 15% of China's GDP of \$12 trillion. Put another way, it's about \$2 trillion. That \$2 trillion is 3% of global GDP.**"
- **Real estate in China now accounts for well over the 20% of GDP** level that was seen in both Spain and Ireland before the housing crash and triple the level reached in the US prior to the GFC.
- China is currently building over 25 skyscrapers taller than the Empire State Building. And of the 100 tallest buildings currently under construction in the world, 55 are in China.
- China has built over 30 billion square feet of office space, which as noted by Jim Chanos **is equivalent to one "five foot by five foot office cubicle for every man, woman and child in China."**
- China's internet search giant, Baidu, used IP searches to estimate that as of a few years ago, **there were approximately 50 ghost cities in China.**
- According to the consulting firm McKinsey, between 07' and 14', China's companies went from owing \$3.4 trillion to \$12.5 trillion, **a faster buildup than in any other country in modern times.**
- **China accounts for a staggering 63% of the money created globally between 2007 and 2015.**

Lastly, here's a favorite site of mine called [China Ghost Cities](#) put together by the guys over at J Cap Research. It's their photo collection of the many ghost cities they come across while on due diligence trips in the mainland. My favorite section is of the replica cities. The Chinese have a penchant for recreating any landmark or entire city that's of importance.

Here's the full scale replica of the White House built by the local government in Hangzhou. For what, who knows, but hey, building it increases GDP!



Another great one is the replica of Niagara Falls in Kunming. There's at least two other Niagara Falls replicas built in neighboring provinces.



And then of course, there's the beautiful Eiffel Tower of Zhejiang Province, which is on the outskirts of Tianducheng, otherwise known as fake little Paris, and which in hardly anyone lives.



## What's Next?

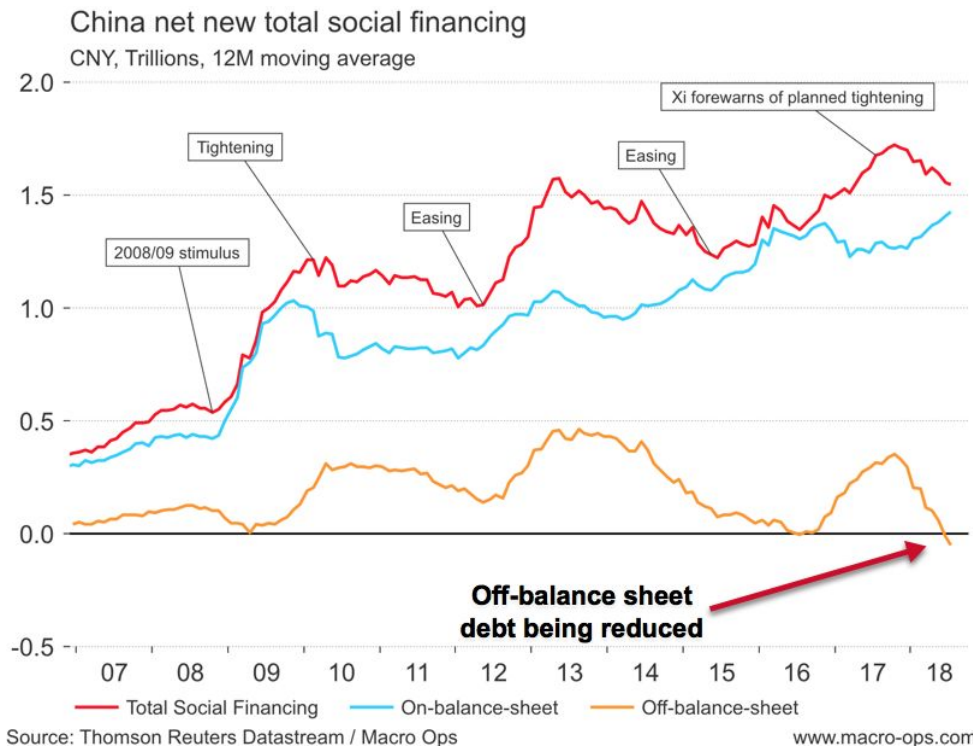
Where does China go from here?

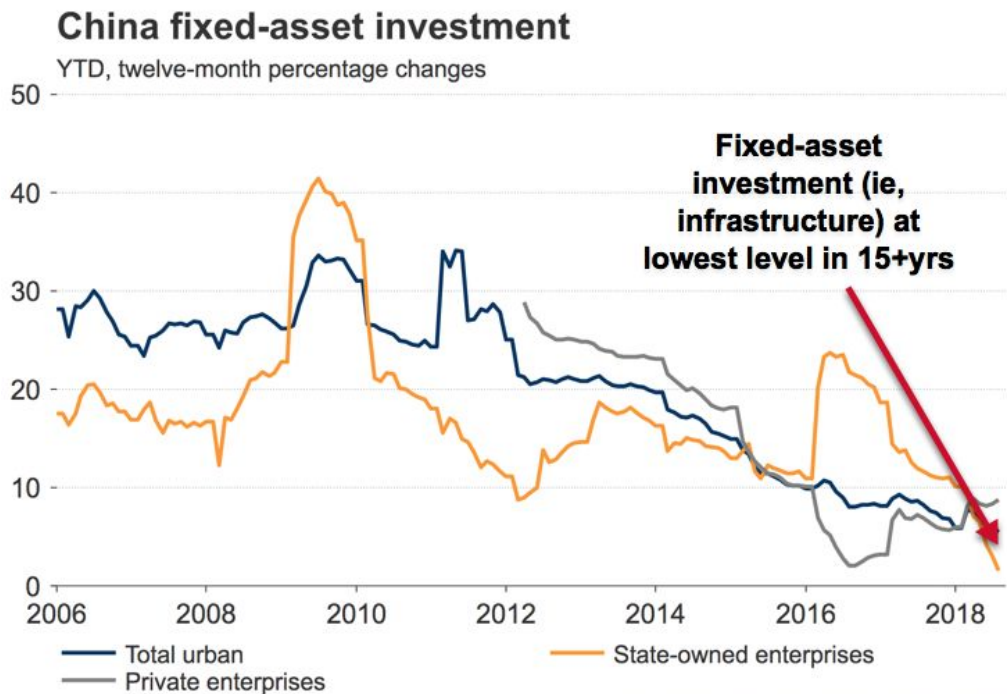
Well, China has to rebalance its economy. It needs to transition from an investment and export led economy to a consumption based one; retransfer wealth from the vested interests in local government and private businesses back to households. In addition, it needs to deleverage by paying down, writing off, or inflating away its debt stock.

The quickest way to resolve a debt problem like this and rebalance an economy is to go through a financial crisis where assets are sold and debt written down. This is what the US did in the 1930s. But China can't go this route because this path involves high levels of unemployment that bear socio-political risks, which the CCP can't afford.

A much more likely scenario (which I believe we're beginning to see now) is one where the CCP takes a gradual and pragmatic approach.

They assign the debt servicing costs to local governments, who are then forced to sell assets in an orderly manner to pay down debt. And then the CCP goes after debt in the most vulnerable areas of the economy, primarily the off-balance sheet / shadow banking sector and P2P lending, while balancing this with leveraging in the visible areas parts of the economy (ie, local government issuing bonds to boost specific investment).





Source: Thomson Reuters Datastream / Macro Ops

**This approach means that we *shouldn't* expect a hard landing and financial crisis.** It's likely to look much more like Japan's lost decades, though China has made it very clear in recent months that they won't make the same mistake the Japanese did and let their currency strengthen. So we should expect the yuan to continue devaluing against the dollar.

When I share this China bear thesis with people I almost invariably get the question "Why now? What's keeping them from kicking the can down the road, again?"

That's a fair question. Chinese leaders have publicly stated as long ago as 2006 that the country had a serious debt problem and that they'd work to deleverage. Only to obviously do quite the opposite over the following decade.

But there's been a very important change over the last year that makes this time different. And that's the centralization of power.

Only two types of government have been able to handle and survive a difficult economic and debt rebalancing like this (1) robust democracies with strong institutions (like the US in the 30s) or (2) strong centralized authoritarian regimes (like China in the 80s).

**This is what the whole anti-corruption campaign and last year's 19th Party Congress where Xi became de facto emperor, are all about: Xi consolidating power.**

Many people have the misconception that the Chinese government is a well oiled machine, where word is passed from on top and carried out at the bottom. But in practice this isn't the case at all.

The real power and control over debt fueled spending has rested with the vested interests at the local government level; from the provincial on down.

There are two Chinese idioms that relate how things actually work, one is 'heaven is high and the emperor is far away' and 'from above there is policy, but from below there are countermeasures'. Meaning, local government officials are free to do as they please, even if it goes against Beijing's wishes.

This is why over the last decade we've seen leaders in Beijing come out talking about the dire need to rein in the country's debt but local leaders continuing to borrow, spend, and build.

The vested interests who have become rich and powerful are reluctant to stop the activities that made them so.

The anti-corruption campaign that has punished or jailed over 1.5 million party members since 2012 has been effective in clamping down on dissidence. Xi now has the control and authority to carry out Beijing's wishes.

The SCMP reported last week that updated party rules "state that failing to implement policies from the top is now officially a breach of discipline that can see cadres lose their jobs or even be expelled from the party. Those who refuse to implement policy directives from the party's Central Committee, who run their own agenda, or 'are not resolute enough, cut corners or make accommodations' in applying them, will be subject to punishment under the new rules, which took effect on August 18."

That's why this time is different...

President Xi clearly stated his intentions in 2016, saying "If we don't structurally transform the economy and instead just stimulate it to generate short-term growth, then we're taking our future... If we continue to hesitate and wait, we will not only lose this precious window of opportunity, but we will deplete the resources we've built up since the start of the reform era." **He finished by stating that the country had until the end of 2020 to make this transition.**

Another common objection I hear is, "they're not deleveraging, they're easing!" But this isn't the case. This misunderstanding is partly due to investors not viewing the data holistically as well as due to intentional misdirection by the Chinese in order to manage the market's response.



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A recent paper by the Paulson Institute (the Macro Polo blog) helps clarify the recent words and actions out of Beijing. Here's some highlights from the report with emphasis by me.

Upon a cursory look, the message from the Politburo meeting seems contradictory, emphasizing both deleveraging and growth. **But this can be reconciled by clarifying just exactly what Beijing means by “deleveraging” in the current context.**

Top policymakers are well aware that they've gotten a lot of flak from businesses and investors, as well as local governments, for tightening policies that have dried up credit. The complaints have grown since the beginning of 2018, so **the Politburo meeting's emphasis on deleveraging is meant to signal that amid grumbling among the masses, the central government is holding the line.** In other words, **Beijing isn't going to do what's popular—opening up the credit spigot again—but rather doing what it deems necessary for China's economic stability.** Indeed, the July Politburo meeting readout notably included Beijing's renewed vow to uphold deleveraging, which was not included in both the April Politburo meeting readout and the December 2017 Central Economic Work Conference.

Even though the emphasis on deleveraging remains fixed, the central government appears ready to tweak its approach around the edges. Based on the readout of the latest State Council Financial Stability Commission meeting, **deleveraging in 2H2018 and beyond will be targeted rather than across the board.** At least for the time being, deleveraging has been tweaked to mean “structural deleveraging.”

What this means in the second half is that deleveraging will mostly rely on administrative measures targeted at state-owned enterprises (SOEs) and local governments. Meanwhile, the existing financial measures will remain but will not be further tightened, and monetary policy will become more accommodative and be more in line with inflation trends. **In other words, Beijing is simply moving from its triple threat on tightening to just a “double” threat.**

**A more accommodative monetary policy does not necessarily mean that credit growth will increase. In fact, credit growth will likely remain subdued because of the continued clampdown on shadow banking. Even in the absence of additional regulations, the shadow banking sector will continue to shrink in size under the existing policy environment.** If Chinese banks remain reluctant to lend to high-risk borrowers, then the disappearance of shadow banking won't be offset by increased lending through formal channels.

You can find the [report here](#), it's worth reading in its entirety.

So China is deleveraging and we should expect this deleveraging campaign to gain momentum over the next two years. The current trade war with the US gives the CCP even greater political cover in carrying out painful reforms as it gives them an easy scapegoat to assign blame.

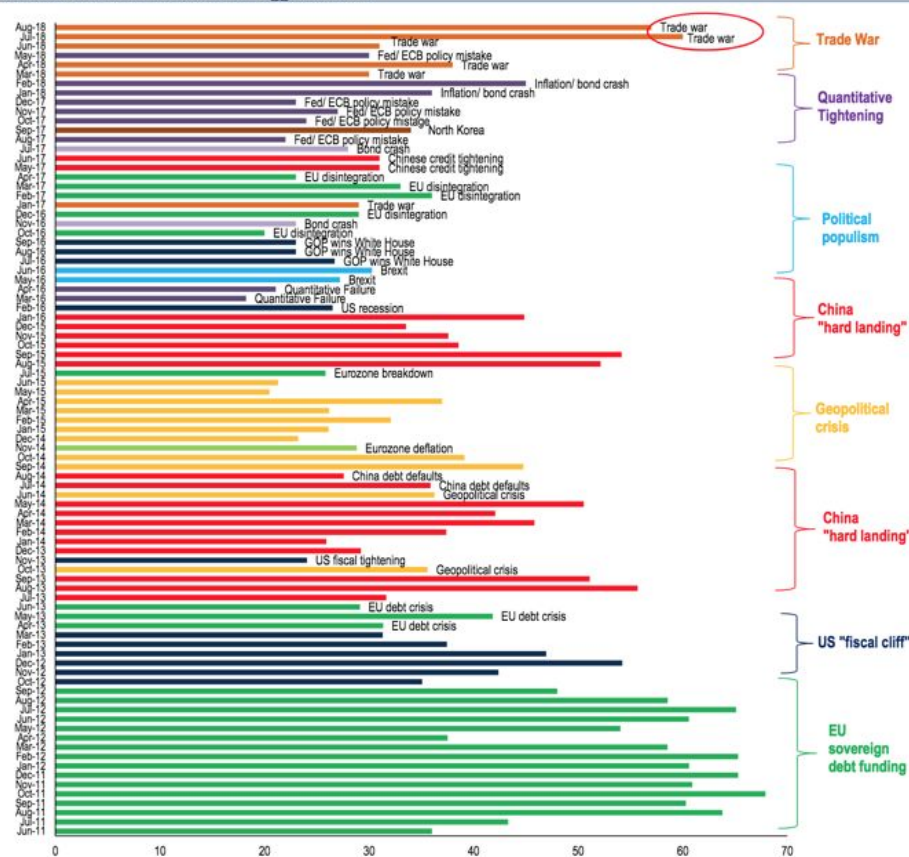
## Why this matters

**The knock-on effects of a deleveraging China will be numerous and far reaching.** The increased market volatility, the bear market in EM, the collapse in gold, and the rise of the dollar are all just the start of things to come.

We covered extensively in the pages above just how systemically important the Chinese economy has become to global demand. There's no doubt that it's long and slow deleveraging will be felt everywhere.

And one thing I find interesting is that this is all starting just as the market's become blind to the China slowdown threat after fretting about it for years. The chart below via BofAML shows that the China tail risk is hasn't been front and center on investor's minds in nearly 4 years.

**Exhibit 2: Evolution of Global FMS "biggest tail risk"**



Source: BofA Merrill Lynch Global Fund Manager Survey

Practically speaking, we should expect EM to continue a slow and grinding descent lower — again, we shouldn't expect any quick crashes, as global liquidity remains relatively robust. It's likely that the EEM breakout of last year was just a massive bull trap. Price should continue lower back into its consolidation zone from here.



China's largest trading partners (shown on the chart below via Atradius) are some of the most exposed to a Chinese deleveraging.



## How to trade it

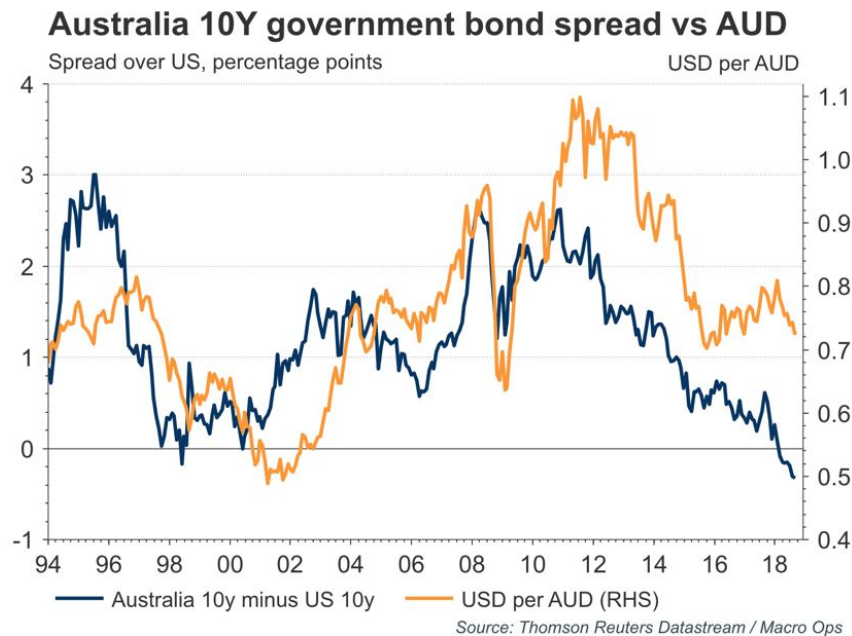
There are many ways to make money off this thematic. One of the obvious ways is to be long the dollar. We've been long the dollar since the start of the year. We took profits on our futures position recently but continue to hold call options.

## AUDUSD

The Aussie looks the most vulnerable of the major dollar pairs and we're planning on putting on a short position this week. Australia has large exposure to China's economy as a major source of commodity exports. The country is also under pressure from a housing bubble (something we'll discuss in next month's MIR) and its own large debt load.



The economy has begun to slow and as a result interest rates have come down. The 10yr AUDUSD interest rate spread is now in favor of the dollar. **You actually get paid to be long the dollar against the Aussie for the first time since 1998.** This makes the trade a no brainer... our target is 0.60 against the dollar. That's a lot of profit potential on this trade.



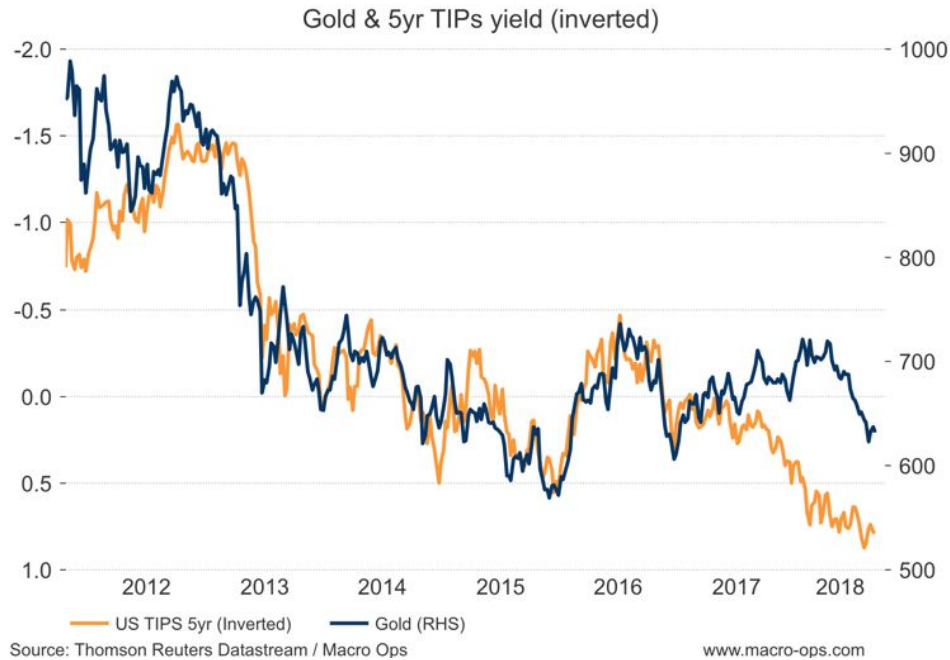
## Gold

We were also short gold since the beginning of this year and recently took profits on what was a very profitable trade for us. We are still expecting a snapback rally at some point but are looking to initiate another short position soon.

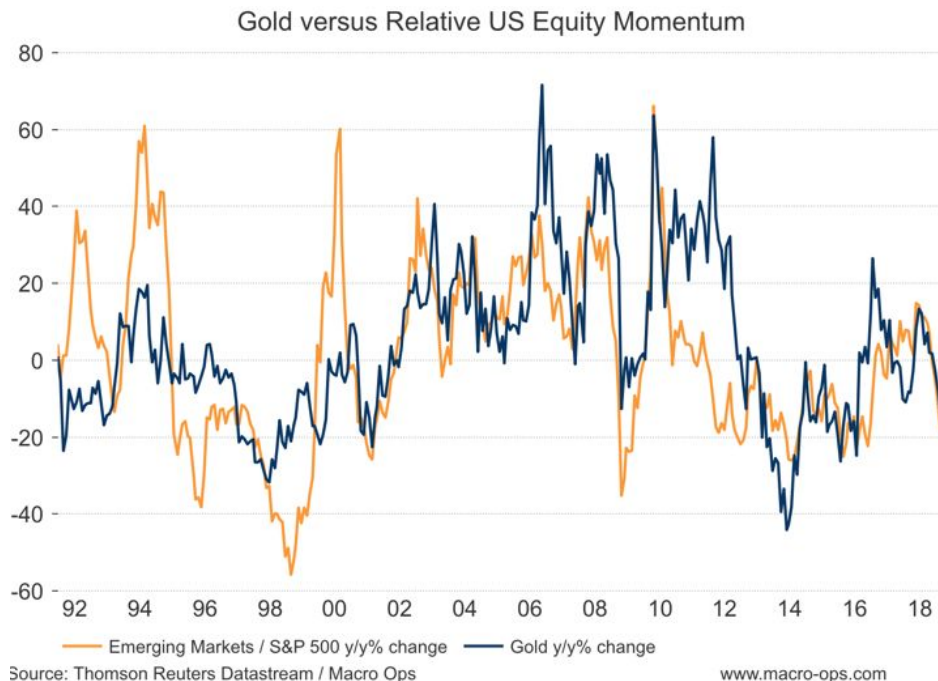
China's deleveraging is a powerful deflationary force, which is extremely bearish for gold.



The large gap between gold and 5yr TIPs still remains. We should expect this gap to continue to close with gold doing most of the work.



Gold is reflective of the relative global demand for one USD of liquidity. So as US assets continue to outperform assets from the rest of the world, gold will continue to fall. We expect gold to hit 1,000 an ounce by this time next year.



**BABA**

Alibaba (BABA) is one of China’s largest tech companies with a market cap of \$414B. BABA has evolved over the years from being just a Chinese version of EBAY to a sprawling FinTech conglomerate that’s closely linked to the CCP. It trades at an eye watering 10x revenues and recently broke down out of an 18-month consolidation zone.

BABA has become a popular hedge fund hotel over the years. That means there’s lots of potential for a crowded unwind of positioning. And better yet, BABA founder Jack Ma made an unexpected announcement last week that he is winding down his involvement in the company. Reasons for this are still unclear, but the bear inside of us would say he’s jumping ship before shit hits the fan.

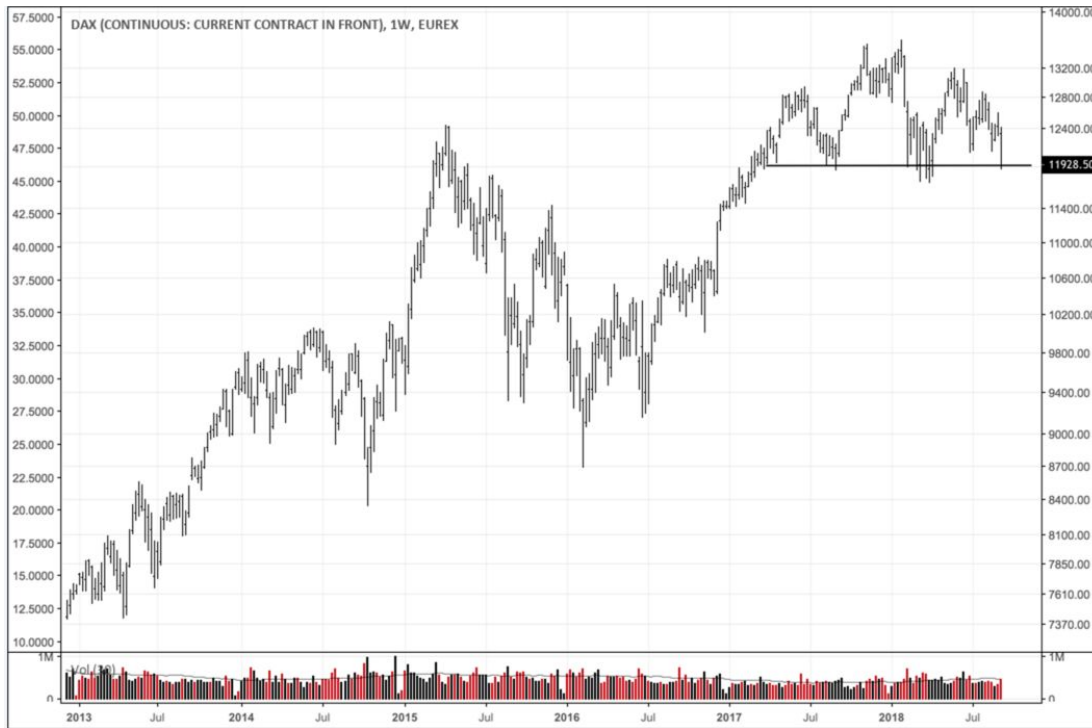
We think BABA can easily lose 30+% over the coming year and probably more. **We’re keeping an eye on the Jan 2020 puts struck at \$110.**



**DAX**

A large 18-month H&S top is about to complete on the German DAX. China is Germany’s third largest export market, with the US being its largest. A slowing China and an escalating trade war with the US will continue to put downward pressure on the German economy.

Shorting the DAX here offers us a high risk-to-reward entry and opportunity to hedge some of the long exposure in our US centric book.





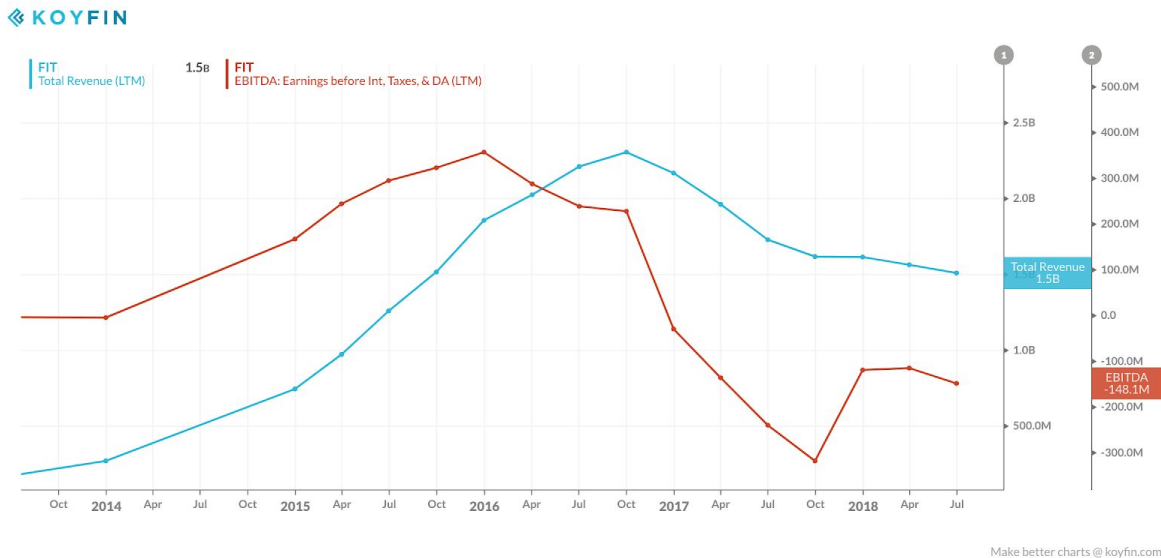
# Micro: Left for dead tech

## FitBit (FIT)



**Company Profile:** FitBit (FIT) is a consumer tech company that invented the fitness tracker wearable category. The company also makes smart watches in which it has a 21% market share; making it the second largest smartwatch maker by sales right behind Apple at 41%. The company has a market cap of \$1.4B and annual revenues of \$1.5B, no debt, and trades at just under 3x cash.

**What The Market is Pricing:** Trading at under 1x sales and less than 3x cash, the market is pricing FIT for a slow and steady decline in relevance. There's good reason for this too. FIT has seen its revenues drop by over 30% since its peak in 2016 along with EBITDA which has collapsed from a trailing-twelve-month (TTM) high of \$358M to negative \$148M today.



The popularity of Fitbit’s devices and the company’s initial success attracted a wide range of competition from Apple and Samsung to cheap Chinese knock offs. This along with a string of failed product launches are what led to FIT’s drop in sales and earnings and the stocks near 90% decline from all-time highs.

FIT has sleepily traded in a narrow range for the last year and a half now and is off most people’s radar. It’s a left for dead consumer wearables tech firm where the market is pricing in the continuing shrinkage of its business.

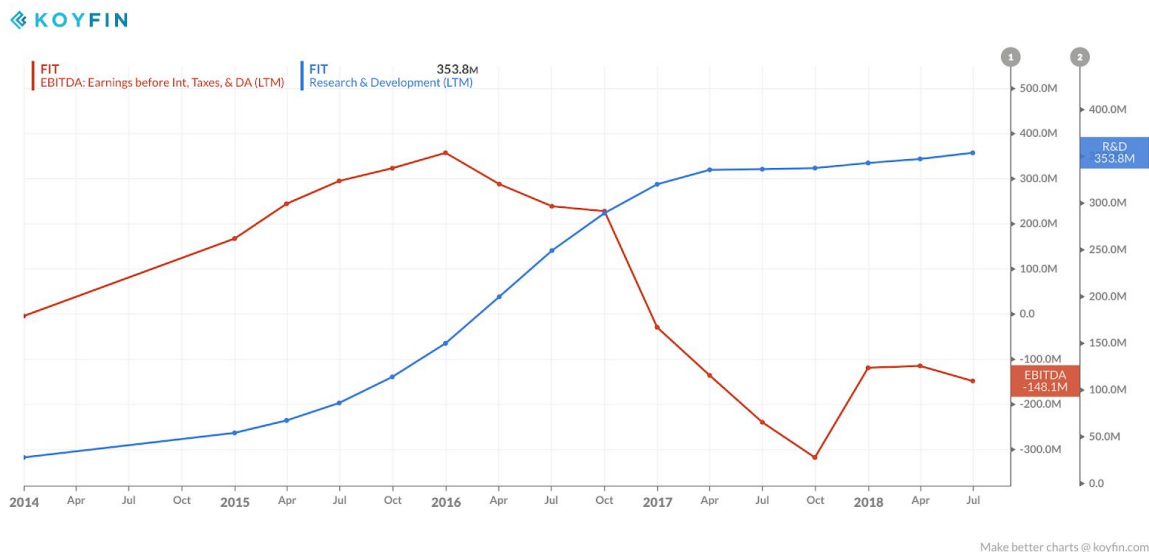
**Our Take (Variant Perception):** FIT has been off my radar for a while. I followed the stock’s epic collapse back in 2015 but had since rarely checked in. That was until my wife recently purchased one of FIT’s new trackers. She bought it because a number of her coworkers had one and they’re all in a workout group together. They use FIT’s social feed within the app to challenge and compete against one another on their weekly fitness goals. FIT has one of the largest fitness-centric social networks in the world with more than 25m MAUs and growing.

My wife turned us onto Stitch Fix (SFIX) — a tech enabled apparel delivery service — earlier in the year and the stock has nearly doubled since. She has a long and profitable track record of tipping me off to consumer trends so I pay close attention to what she’s buying.

Anyways, it wasn’t long after she bought her new fitness tracker that Citron Research put out a bullish report on Fitbit, calling for it to more than double ([here’s the report](#)). I don’t always agree with Citron’s conclusions but I dug into the company and came away agreeing with their assumptions. If anything, I think they’re overly conservative in their price projections.

The bullish case for FIT is simple. It boils down to three things.

1. FIT is in the process of transforming into more of a med-tech company. It's leveraging its extensive health and fitness data, along with its popular brand recognition, to partner more closely with insurers, medical device companies, and corporates.
2. FIT's financials hide the true health of its business. The large drop in earnings has almost entirely been driven by FIT's ramping up of R&D. This is great for FIT's long-term value as the company is investing heavily into its medtech capabilities, which is a huge market opportunity. If FIT were to reduce R&D to a similar percentage of revenues as its peers, the company would instantly generate over \$100m in annual EBITDA.



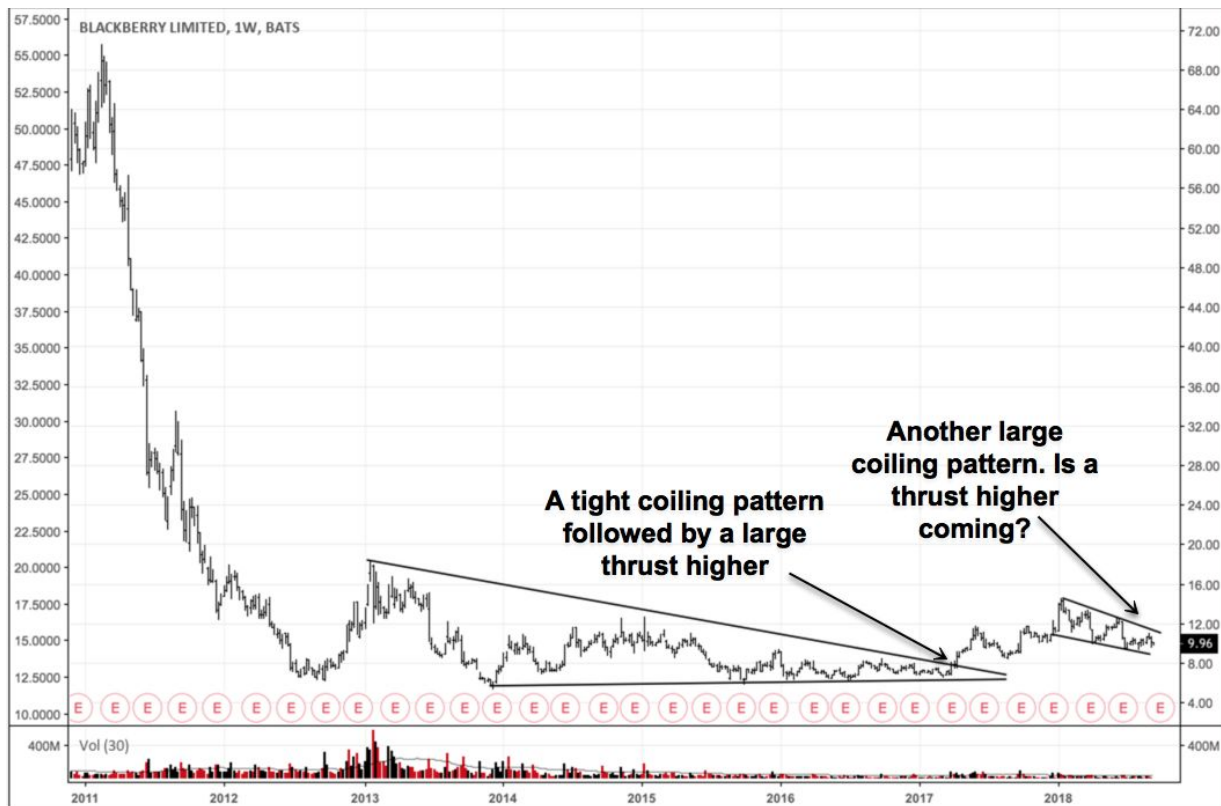
3. Priced at less than 1x sales and under 3x cash, the market is pricing FIT as a dying run of the mill producer of fitness trackers. It doesn't understand that at anytime FIT could lower R&D spend to industry norms and instantly be FCF positive. Nor does it place any value on FIT's massive accumulated health data (most extensive heart rate database in the world) or its developing partnerships within the medical industry. Simply put, there's absolutely no upside being priced into this stock at all.

Everything in this game is about expectations relative to outcomes. And right now the market couldn't be more negative on FIT's prospects. This is great for us because it means it won't take much of a positive surprise to dramatically drive FIT's stock price significantly higher. Just an end to FIT's revenue decline would disrupt the uber bearish take and force an immediate re-rating of fundamentals.

With one of the hottest selling smartwatches this year in the Versa (which is currently sold out) and a number of new products hitting the market going into the end of the year, there's a long list of catalyst that could spark a re-rating.

We think FIT is an easy double, if not 4-5 bagger. Buying right now while the stock trades in its current tight range, gives un an enormously asymmetric entry into a stock with lots of potential for positive surprises. Again, check out [Citron's report](#) when you get a chance.

**Blackberry (BB)**



We first pitched Blackberry (BB) back in June of 2017. You can read the original write up here. Back then the stock was trading for around \$9.50. It's since run up 50+% only to turn back over and roundtrip.

This is typical price action for a stock that's coming out of a long basing period and where the company is going through a major operational transition. The key with these types of plays is patience and to continue to track the fundamental developments and wait for a catalyst.

I think we're going to get that catalyst soon and it'll come in the form of a clear shift in the trend in fundamentals. Let's run through the valuation case real quick.

The two core businesses within BB that will drive its future, and thus valuation, are its automotive software (QNX and Jarvis) and its Enterprise Software and Services segment, which includes EMM, Athoc, and their cybersecurity service.

Starting with the automotive segment, BB currently has 120M vehicles using the QNX platform at an estimated cost of \$2.50 per vehicle. The cost per vehicle is expected to increase nearly 10x over the coming years as multiple components are added to the QNX system.

If we assume then, a very conservative estimate of just \$8 cost per vehicle and a low growth in new vehicles using QNX, say 130M by 2023, revenue from the automotive segment alone would grow to over \$1B a year. BB currently has TTM revenues of \$910M. This would bring in nearly \$400m in EBITDA which is more than twice what the entire company is currently generating.

Enterprise Mobility Management (EMM) represents about half of software revenues today. According to IDC estimates, the EMM market is projected to grow 10% annually. Since BB has the leading technology in this space it's safe to assume that this segment will continue to grow at the 10% market rate, at a minimum.

By 2023, both EMM and QNX should account for close to 90% of BB's total revenues. So not even factoring in BB's expanding licensing business or value creation from its extensive IP portfolio or any value accretive acquisitions, we get a company that in just over four years time is generating \$2B in revenue and \$750M in EBITDA. Slap on a conservative multiple of 15x and that gives us a stock price of \$20; double what it is today.

Finally, we should remember that just back in 2013, Prem Watsa, known as the Buffett of the North, offered to take BB private for \$9 a share — \$1 below where it's currently trading. If you adjust for cash and the \$870M in strategic acquisitions done since then, it means Watsa would be willing to buy the company for \$12 a share today. And that's not accounting for any of the greater visibility now on the company's brighter future.

BB is now Watsa's largest position, making up over a third of his portfolio. At just under \$10 a share it seems we're getting a steal on a company run by a world class CEO in John Chen, who just recently announced that the Blackberry turnaround is complete. There's lot of upside in this forgotten and beaten down Canadian tech company.

## Conclusion

The China deleveraging story is just beginning and will become a more prevalent macro force in markets in the coming quarters. We will be covering different aspects of this developing thematic in future MIRs. Next month, we'll be exploring the connection between China's leveraging and housing bubbles around the world (think Canada and Australia) and some interesting ways to play their coming unraveling.

Till then... thanks for reading and shoot us any questions you have to [alex@macro-ops.com](mailto:alex@macro-ops.com)

Your Macro Operator,

Alex