

John Dessauer Investments, Inc.

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John Dessauer's market review and update as of Wednesday May 25, 2016

China is still making headlines and being criticized. For example, *The Economist* magazine, in a recent issue, took the Chinese government to task for not being more aggressive in reducing debts both private and public. Like so many before them, the editors predicted that - without major change - China is heading for an economic crisis. China bashing has been a popular sport among market pundits, politicians and economists for a long time. However, against long odds, China has lifted hundreds of millions out of abject poverty to a middle class standard of living. What all the critics miss is the human factor underlying China's incredible economic success. My good friend Gary Alexander writes a weekly piece for Navellier and Associates, a mutual fund management organization. Here is his piece for May 17, 2016:

Why China Will Likely Keep Growing

By Gary Alexander

Today marks the 50th anniversary of the start of China's Cultural Revolution. It was like our Great Depression on steroids. In America, the crucibles of 1930s poverty and World War II forged what Tom Brokaw called our "Greatest Generation." Depression-era veterans (like my parents) rebuilt our nation after 1945. All seven Presidents from PT-109 Lt. John F. Kennedy to Navy pilot George H.W. Bush were of that Generation. Our latest Fed Chairs either grew up in the 1930s (Volcker and Greenspan) or studied that era (Bernanke and Yellen), so they have bent over backward to prevent another Great Depression.

Likewise, those who suffered in China's Cultural Revolution vow it must never happen again. China's Depression was far worse - and 35 years more recent - than our Depression. The top nine members of today's Politburo were born 1945 to 1955, so they were in their teens and 20s from 1966 to 1976.

On May 16, 1966, Mao and his wife Jiang Qing issued a proclamation against "scholar

tyrants" to be enforced immediately. By the end of May, China's educational system came to a stop and juvenile mobs took over. It was a revolution of semi-literates against "spectacle wearers." Bad students took revenge on good teachers. Libraries and art museums were ransacked, closed or burnt. Western goods were burned.

I saw the impact of China's Depression first-hand 20 years ago, when I joined a 30-person three-week tour of China with a group of investors. The tour was led by Keren Su, who was born in Hangzhou in 1951. I interviewed Keren Su often during those weeks. His parents were teachers, making his family part of the intelligentsia, which Mao vowed to humble. Keren's father, a professor of Chinese literature, was imprisoned seven years and his mother was sent to a re-education camp. Keren Su was sent to a labor camp for being a child of the intellectual class. He was shipped off to Harbin in Northeast China, and then put on an overnight train to a small work camp 200 miles northeast, where he spent nearly a decade in a frigid labor cap instead of in a warm school room.



Red Guards shame Provincial Party Secretary Wang Yifun in Harbin, China, August 23, 1966
(Photo by Li Zhensheng; Source: New York Review of Books, "China: Surviving the Camps," January 26, 2016)

Our China tour ended on May 17, 1996, the 30th anniversary of the Cultural Revolution. As we met for breakfast before heading for the airport, CNN was carrying news clips from that terrible time. I asked Keren Su if it all started on a single day, or was it more gradual? He said, "Oh, no! One day we studied our lessons and went home to dinner and the next day we came in and a new Red Guard demanded 'Are you a loyal comrade or a bourgeois devil?' Then, I had no home to go to. My parents were both in jail."

Chinese youth, like an oriental Lord of the Flies novel, held political meetings to "struggle" classmates with questionable family backgrounds, like Keren Su.

Teenagers scoured homes for Western clothes, books or other signs of intelligence. Such folks were sent to prisons or to the "uncorrupted countryside."

Keren Su suffered 12 years until he was set free in 1978, age 27. Soon he gained fame by riding his one-speed bike across China. That earned him enough respect to travel more widely. When he led our tour to the Real China in 1996, he didn't choose tourist spots. Our first week was in China's poorest province, Guizhou. We visited farms and schools and local spring festivals, some of which no other Westerner had seen. Everywhere we heard adult survivors of the Cultural Revolution say "it can never happen again." I didn't detect any anger or blame, just a shame over their collective madness - "we did this to ourselves."

Since 1978, China has had a peaceful transfer of power between four survivors of that hard time: Deng Xiaoping (ruling 1978 to 1992), Jiang Zemin (1993 to 2003), Hu Jintao (2002 to 2012), and Xi Jinping.

Deng Xiaoping barely survived the Cultural Revolution, being branded a "capitalist roader." His eldest son, Deng Pufang, was tortured and thrown out a third-story window, rendering him a paraplegic. Now 72, Deng says, "The generation of the Cultural Revolution is in no sense a lost generation, as is often said. Quite to the contrary. All those who passed through that testing have been toughened." For instance, Deng Pufang now fights for the rights for the handicapped in China. "To my way of thinking," he says, "this generation represents a trump card for China and for the reforms which they have set in motion."

The man who ran China from 1993 to 2003, **Jiang Zemin**, also suffered greatly. He was sent to a Cadre School in 1968, even though he was a skilled engineer in his 40s. He endured over a year of political "re-education" (farm labor) in Henan province. His sister, a University counselor, was packed off to a farm for five years. His uncle was crushed in a mob. His children were separated from him and sent to farms. (*For more on Jiang Zemin, see "The Man Who Changed China" by Robert Lawrence Kuhn and his more recent book, "How China's Leaders Think," which profiles the backgrounds of these and other leaders.*)

China's current leader, **Xi Jinping**, suffered even more. In 1962, at the end of the Great Leap Forward (when 30 million died from starvation), Xi's father was purged, spending 16 years in one kind of jail or another, subject to withering criticism and severe physical abuse. At age 15, in January 1969, young Xi was sent to a remote mountain village in the Loess Plateau in Shaanxi, spending six years performing hard manual labor in a harsh, poor, rural climate. He and his cadres lived in a cave house, but by night Xi read books in the dim light of kerosene lamps, sometimes sharing lessons with his cadre mates. By day, he gained favor by carrying a shoulder pole with twin 110-pound buckets of wheat for several miles across mountain paths without showing fatigue. Xi says that time has "influenced me every minute" in ruling China today.

While I was in China, an amazing trend began. Business leaders in their 40s started holding reunions on the labor farms where they had worked in 1966-76. That struck me as a cross between a 20th high-school class reunion and survivors tentatively returning to Auschwitz. About 8,000 attended a reunion in Ruili on the Burma border. One survivor, Hu Guohui, said "If you haven't had a bitter period and survived it, you

can't feel true satisfaction. You end up simply accepting the world about you, instead of relishing it."

China Learned Capitalism from its Closest Neighbors

China's recovery is the most amazing in world history. There was no blueprint for recovery from such a massive reversal. Deng Xiaoping once said "we cross the river by feeling the stones." Translated from Confucius-speak, that means "we're trying what works." His success is based on closely watching failures of the past at home (and in the USSR) while also emulating the success of their neighbors, notably Japan, Taiwan, South Korea, Singapore, Malaysia, and their own tiny capitalist enclave of Hong Kong.

First, China learned decentralization and localized capitalist experimentation. For example, in 1979, the USSR controlled the allocation of 60,000 products and millions of prices. In the same year, China only controlled distribution of about 600 products and the prices of a few thousand items. All of the Soviet Union's 40,000 factories were run from Moscow, while 90% of China's factories were controlled locally. (Source for this section: "China's Economy: What Everyone Needs to Know," by Arthur R. Kroeber)

Deng then decentralized even further, creating "special economic zones," with pro-business incentives. The IMF studied all global economies in the period 1972-2000 and found that democracies averaged 25% of total government spending coming from the local (non-national) level vs. 18% for non-democracies. The figure for China was 54%, but by 2014 government spending at the local level reached 85% in China.

China learned positive lessons from its East Asian neighbors, first Japan, then South Korea and Taiwan. All three experienced phenomenal booms by freeing up their economies, even though the politics in South Korea and Taiwan remained centralized and undemocratic. (It must have bugged Beijing that Taiwan, a poor agricultural province in 1949 when the defeated Nationalists retreated there, had a thriving middle-class making exportable electronic goods.) Taiwan and South Korea are the only two countries to jump from poor (10% or less of U.S. GDP per capita in 1970) to "rich" (50% or more of U.S. GDP in 2010).

Economies that Rose from Poverty to Middle Class or Rich, 1970-2010 (In terms of percentage of U.S. Per Capita GDP)

<u>Country</u>	<u>Pre-1970 Low</u>	<u>2008-2010 Average</u>	<u>Relative Gain</u>
China	2%	18%	9.0-fold
Taiwan	9%	68%	7.6-fold
South Korea	10%	58%	5.8-fold
Thailand	5%	19%	3.8-fold
Malaysia	9%	29%	3.2-fold

Source: "China's Economy: What Everyone Needs to Know," by Arthur R. Kroeber

In 1981, only 16% of Chinese were above the poverty line - most of them barely so. Within 30 years, more than 1.3 billion Chinese lived above the poverty line, with

hundreds of millions in the middle class.

Poverty Reduction in China: The Most Dramatic Rags-to-Riches Story in History

<u>Year</u>	<u>Population</u>	<u>Millions in Poverty*</u>	<u>% of Total</u>
1981	1.00 billion	840	84%
1990	1.13 billion	689	61%
2002	1.26 billion	359	28%
2011	1.35 billion	84	6%

*Poverty is defined as per capita income of \$1.25 a day or less (using 2005 dollars at PPP)
Source: World Bank Poverty and Equity Databank (cited in "China's Economy," page 34)

China has faced far worse challenges than today, when their economy was much smaller and poorer than it is now. They could have faltered in June 1989 after Tiananmen Square, or after the fall of the Berlin Wall in late 1989, or after the 1991 failure of the Soviet Union military coup, or after the high-inflation and currency devaluation of the early 1990s. They could have come down hard on Hong Kong when they inherited that Crown Colony in 1997, or they could have failed during the 1997-98 Asian currency crisis.

Today's slowing growth is to be expected, and healthy. China's challenges are huge but China's resources are far greater than they were in the 1990s. One of their greatest resources is battle-tested leadership. We may not approve of China's lack of open elections, but I can see why they won't risk mob rule ... again.

Thank you Gary.....

I will have the next market review and update for you one week from today on

Wednesday June 1, 2016.

All the best,

John Dessauer

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