



Wealth Creation ... and Preservation

3rd Quarter 2005

Special Report

Lexington, Virginia

THE CHINESE ARE COMING ... AND THEY'RE BRINGING CASH!

In 2005 the Chinese offered to buy Unocal, an American firm which is one of the largest energy companies in the world. The papers were full of the story for a couple of days, after which most people lost interest and the story almost disappeared. That's too bad for a couple of reasons. First, it marked the beginning of the end of America's superpower status. Second, as usual the media got the story wrong. The real story began years ago . . .

In 1987 my wife was part of a small team of geophysicists and computer specialists who were sent to China under contract with the Chinese Ministry of Coal in Beijing. Their job was to find oil in the Szechuan Province. They were not allowed to discuss their findings for several years, but in the early 1990s the Chinese government announced that they had discovered some very large oilfields around some immense salt domes. In fact, it may be the largest single discovery ever.

The Chinese, according to the stereotype, always look at the very long term. Whether that is true or not, they clearly are geared to longer-term thinking and planning than we are. At the time that huge discovery was made in 1988 the Chinese people were not allowed to own their own cars. Millions of Chinese were living on farms with a pre-20th century look; the house had a dirt floor and a thatched roof through which was pushed a TV antenna. Outside the cities there were few paved roads.

Much has changed since 1988. The Chinese certainly think big when they plan; as you may recall, in 1994 I visited the newly completed Pudong District southeast of Shanghai, a planned community of *fifteen million inhabitants*. That is merely one example. This "community" has paved streets - and the Chinese are now allowed to own their own cars. They also are now allowed to wear makeup, and they have been granted freedom of religion. In many ways, they have been given the right to become a consumer economy.

The Chinese use a very intelligent approach to all that they do. They may call themselves Communists, but they are acting in accordance with the strictest definitions of capitalism when they exploit their workforce, import immense amounts of raw materials, pollute and poison their environment, and sell their goods throughout the free world. The leaders have a plan for the future. Unlike the Soviet plan, I believe this one will work. (Actually, the Soviets were wonderfully successful in environmental destruction, but the Chinese are on a remarkably similar path).

I believe that in much less than a hundred years the 21st Century will have been appropriately labeled the "Chinese" century, while the 20th will always remain the "American" century.

The Soviets promised to bury us economically, and Nikita Khrushchev suggested that we would sell them the shovels to do the burying, so to speak. They were wrong in part because huge amounts of Cold War def-

icit spending bankrupted them shortly before it did us. The Soviets led with their military, and we stood up to them. The Chinese are leading with their economic might, and we have no legal or moral defense.

You may remember reading twenty years ago about how the Japanese were creating their own economic bloc by forming alliances with many countries on the Pacific Rim. They even started assembling Hondas in Ohio so as to give the appearance that American jobs were not being lost to Japanese superiority. The Japanese failed in a spectacular way as their stock market and real estate bubbles burst about five years apart, and to this day the Japanese have not come out of their lengthy recession/depression.

Japan began to control the world, so to speak, from a small country with almost no natural resources. China is a much larger country with significant resources, and the Chinese have different priorities than the Japanese - or the West.

The Chinese strategy

I don't claim to know what is in the minds of the central planners in Beijing, but some of it is obvious. The Chinese government is interested in allowing its people to become consumers just like the developed world. Whether they have realized that Communism will never work is beyond my knowledge, but it would be nice to know.

What I have seen in China is a backward economy trying mightily to leap into the present by all available means. One great example is the proliferation of cell phones in China. On my last trip to Hong Kong I couldn't find anyone without at least one cell phone; they were not nearly so prevalent in the rest of China, but they are gaining ground very quickly.

What is so very important about cell phones is that China is moving directly to them instead of investing the trillions of dollars necessary to create the kind of copper cable and fiber optic network we have. The Chinese has leapfrogged the world in this respect and in others, saving huge amounts of manpower and resources while receiving the same benefits as the technologically most advanced societies.

The same is true in manufacturing. The Chinese closed the gap on manufacturing quality much faster than the Japanese. One of the many aircraft manufactured in China is almost an exact duplicate of the 737. I have never read of the Chinese buying the plans or the right to manufacture 737s. Instead, they often buy one or two models and

Questions worth answering

How can you profit from the decline of the West and the rise of China? How can you profit from the coming oil crises? What about the decline of the dollar? Will the Euro survive if the EU doesn't ratify its constitution?

Every American should be vitally interested in the answers to these questions. Unfortunately, many Americans are sufficiently unfamiliar with the issues to even ask the questions. From what I see in my industry, most financial advisers are only concerned with their prospecting for new customers.

I am working hard to produce some meaningful answers which will enable us to survive and prosper. More than ever I can use your help in finding unusual news stories and items which may lead to some answers.

Update for December 2008:

The Chinese stock market rose dramatically in much the same way as the American stock markets. It then began to fall rapidly in early 2008. Now that the Chinese economy is expected to see much slower growth, the Chinese stock market may remain at depressed prices indefinitely. I suggest waiting for things to stabilize before investing in China again.



Charles W. Kraut, MBA is a private individual licensed for the sale of insurance products and, in certain states, as a Registered Investment Adviser (RIA). *Wealth Creation and Preservation* is published as a means of disseminating information compiled from numerous sources in such a way as to reflect the conclusions drawn by Charles Kraut in his analytical work. Those wishing to copy this publication or otherwise disseminate it to others are required to contact Charles Kraut first for permission.

None of the information or opinions printed in *Wealth Creation* should be construed as an investment recommendation either for the sale or purchase of any security, savings account, insurance product, or hard asset. Recommendations are made only in consultation with Charles Kraut. The opinions expressed in *Wealth Creation* are solely those of Charles Kraut.

Insurance and investment products are not insured by the FDIC or any other government agency. You may receive more or less than you paid when you redeem your investment or insurance contract. Always consult the investment prospectus before investing.

Past performance is no guarantee of future results. Charles W. Kraut makes no guarantees whatsoever regarding the performance, return, or dividends of any savings, insurance or investment program. Guarantees which are made, if any, are offered by the product provider and are stated as such in the product literature.

reverse engineer them to make their own. China's biggest advantage is manpower; skilled labor is available for less than a dollar a day in many manufacturing centers.

With all that manpower (and so many potential consumers) the main thing the Chinese need is resources. Thinking long-term, the Chinese government (operating largely through its "privately held" corporations) is buying the world's assets. Chinese corporations have for several years been signing deals with companies all over the world to guarantee themselves access to whatever they will need in the future. This has gone unheralded and largely unnoticed in part because, as I mentioned, the Chinese are doing this in a very intelligent manner. They do not wish to roil markets nor arouse the ire of governments; rather, they prefer to work quietly and to make themselves appear just like any other buyer.

This strategy worked well until the Unocal offer. Suddenly our Congress awoke and realized that American strategic assets were begin sold to a country which was 1) a major economic competitor, 2) a very significant competitor for the world's scarce resources, and 3) a potential military threat to our allies (particularly Taiwan and South Korea) and even, ultimately, to ourselves.

One of the reasons for my recent trip to Panama was to get a firsthand look at Chinese assets in the Panama Canal area. Typically, the Chinese did not attempt to buy the Canal, which appears to be competently operated and managed by a private corporation. Instead, the Chinese have built immense container facilities at each entrance. They have also been buying up other assets including land in the former Canal Zone area.

The United States no longer considers the Panama Canal a strategic asset (this is called revisionist history by some) because we now have an Atlantic Fleet and a Pacific Fleet. Besides, the world's navies today focus on aircraft carrier groups, and no modern carriers can fit through the Canal. However, the Panama Canal remains a very significant choke point (and profit center) for a large percentage of the world's commerce, and I am not very comfortable with a major Chinese presence there. For that matter, I would not be thrilled to see *any* country establish a major presence there in the absence of an American commercial or military presence, and we have neither since Jimmy Carter "gave" the Canal to Panama.

What's the big deal with Unocal? First, it is a major American producer of oil. They also have operations in Canada, Thailand and Indonesia. Unocal is the kind of company which is considered a major Ameri-

can asset of strategic importance. Selling Unocal to the Chinese is not as serious a matter as selling General Dynamics, the huge defense contractor, but it is a serious matter for other reasons, especially when you assemble the rest of the puzzle.

Prior to making an offer for Unocal the Chinese signed major agreements to purchase oil and natural gas from important sources in Canada and in South America. They also contracted to build a pipeline from major refineries in northern Canada to the Pacific, where the oil will be loaded onto tankers bound for China.

This is significant for two reasons. First, the US government has no energy policy (to my knowledge) which impacts *producers* of oil. All the US government does is to *stockpile* oil (the Strategic Reserve). That supply could conceivably keep us going for ninety days or so. Anyone can tell you that controlling the source of supply is much more important than controlling an inventory.

Second, the Chinese are wisely buying oil from stable nations instead of the Middle East and Venezuela. American oil companies should have been doing the same for years. After all, much of our national debt was created in attempting to defend our strategic interests, and we should be very interested in seeking sources of supply we do not have to defend. It would be interesting to see what our oil really costs us when you factor in diplomatic and military expenses. I won't even ask the question about whether we can in any way equate the value of the life of a soldier to a certain quantity of oil.

The bottom line

If the world was "awash in oil", as more than one energy analyst has declared it to be in recent months, we would not need to be especially concerned about what the Chinese are doing. Unfortunately, we are not only not awash in oil, but we are rapidly running out. Reliable statistics indicate:

- 1) We are finding only one barrel of oil for every four barrels we consume.
- 2) There has not been a major oil discovery anywhere in the world in the past decade (the exception may be the Falkland Islands, but that is another story).
- 3) Much of the world (including the United States) has already passed the peak of its production of crude oil.

- 4) The whole world will pass its peak production no later than 2010 and possibly much sooner.
- 5) We are consuming oil faster than at any time in history,
- 6) Current world consumption of oil is around 30 million barrels per day and is projected to rise to 50 million in the next fifteen years.
- 7) Our entire economy - for the U.S. and the entire world - relies on crude oil.
- 8) After a century of tinkering there are no inexpensive and reliable substitutes for fossil fuels including oil and gas.
- 9) At projected levels of consumption we will run out of oil by 2100 and possibly much sooner.

Do you understand why the Chinese are so busily buying up assets we foolishly expected would be ours to control?

By the way, the Chinese have lots of U.S. dollars to fund their purchases of U.S. assets. Every month we buy \$60 billion more in foreign goods than we export in American goods, and the difference is made up in dollars. The Chinese hold many of those billions of dollars. Anyone who has been reading *Wealth Creation & Preservation* for a while knows that someday those dollars will be spent. Why should anyone with cash in hand be prevented from buying whatever they want?

The problem

The Chinese are making arrangements all over the world to purchase as much of the "easy" oil as they can. They are now in direct competition with the entire Western world (as well as Japan) for resources we absolutely depend on. The case can be made that the Chinese have already purchased enough oil to prevent further expansion of the U.S. economy. We have allowed this to happen, blithely ignoring the fact that our entire civilization depends on oil.

The United States is not prepared for a world with shrinking oil reserves. We have failed to develop alternate energy sources. We have squandered precious resources with our huge SUVs and our long commutes. We have yet to confront the reality of diminishing supply. Our leaders are encouraging us to spend to stimulate the economy, and we have responded by using one out of every four gallons of oil produced throughout the world. **Everything** depends on oil. *Even if oil were not used for the production of energy we could not live without it.*

Plastics and other materials derived from crude oil are found everywhere, including places you would not expect to find it.

There is no doubt in my mind that this problem will lead to one crisis after another, along with military conflict. Worst, it is a problem which will manifest itself sporadically over a long period of time. If we have allowed ourselves to be lulled into a false sense of security (which of course we have) we will not be motivated to take the necessary steps to develop alternatives in time.

The other problem

Oil and natural gas are not the only things on the Chinese shopping list. China has become Australia's biggest customer for metals and minerals, and Australia happens to be the world's biggest source of many of those materials. Australia is making the mistake of selling ore and refined materials to the Chinese rather than adding significant value to them by making finished goods and selling them instead. This is to China's advantage because of their low labor costs and burgeoning population. However, the world is beginning to run out of some critical minerals just as consumption is increasing in leaps and bounds. That bodes poorly for the entire world over the intermediate and long terms.

The solution(s)

We need a national energy policy which will encourage the development and commercialization of energy sources not related to fossil fuels. It should not be a handout or a grant; the government's role should be coordination, not funding. This is not a government problem or an industry problem; it is an economic problem. In a free society like ours we tend to "go with the flow" and do not concern ourselves with long-term planning. Corporations can keep their shareholders happy by acquiring companies that make products that are in demand when their own products are in decline. No single company or industry is in a position to respond to this coming crisis.

What needs to happen is for someone to be given the incentive and motivation to develop cheap energy from sources that will take over when the current sources become too expensive or unavailable.

Is such cheap energy possible? If we find it it will be only one more "miracle" in a string of millions of such miracles since the Industrial Revolution began. I believe there are solutions, but we probably won't find them in ethanol or wind turbines. We probably won't find them in nuclear power, either. Even though today's nuclear power plants are much safer than their predecessors we still will have to deal with the prob-

blems of waste and safety - and terrorism. Nuclear power will not provide us with a substitute for the industrial feedstock uses of crude oil and natural gas. There are no solutions on the horizon for those problems.

Sources

For more information about Peak Oil and the Chinese plan to buy foreign assets, I recommend the following:

www.peakoil.org

www.wolfatthedoor.org

www.powerswitch.org

www.eia.doe.gov/neic/infosheets/crudeproduction.htm

www.dailyreckoning.com

The Party's Over, by Richard Heinberg

The Oil Factor, by Stephen and Donna Leeb

Resource Wars, by Michael T. Klare