The Silk Road Revisited

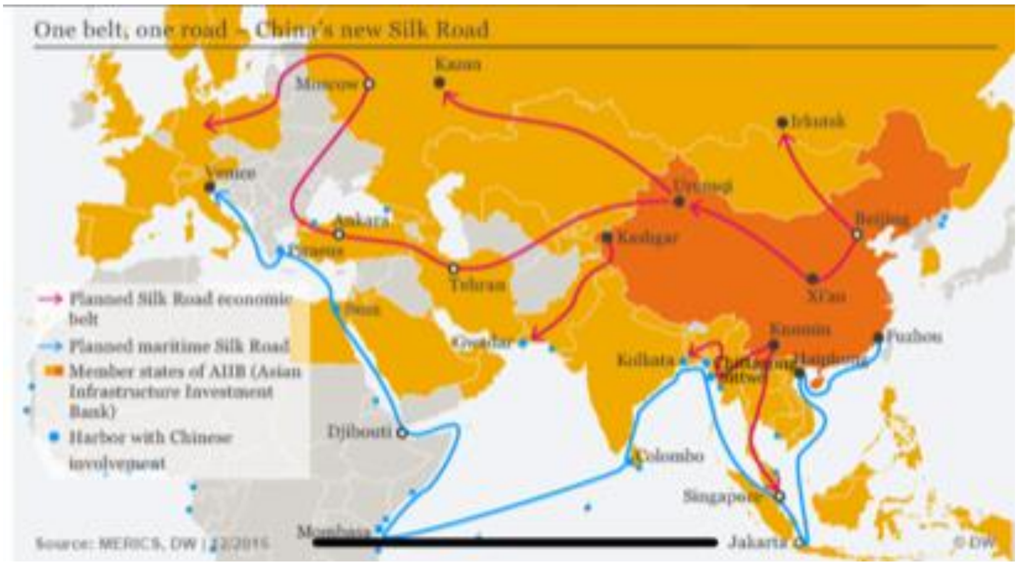
The Old Roads

Nowadays, everyone talks about “la route de la soie”. In the old time, that road left China from X’ian. The former routes ran north by land for many years and south by sea thereafter, as shown on the map below.

The New Ones

The new silk roads[1] being planned by Chinese via their Belt and Road Initiative (BRI) will follow more or less the same itineraries from Xi’an but will split from Ürümqi in the north to either Kazan or Moscow via Teheran and Ankara. The south sea road will require building deep-sea ports in Haiphong, Jakarta, Singapore, Kolkata,Colombo, Mombasa, Djibouti, Piraeus and Venice, as shown on the map below.

[1] P. Frankopan, The New Silk Roads, Penguin Random House, 2018



But there is a 30-year old silk road born out of globalization that nobody ever mentions. Nevertheless, it exists, and as in the old days it runs from (1) China to Germany via (2) Volkswagen and (3) Deutsche bank.

(1) China

When China entered the WTO in 2001, its share of world exports jumped from 4.3% to 14%, while the size of its GDP increased twelvefold and its weight in the world economy jumped from a bare 2% to 15% today. Last year, its GDP was valued at $12,500 billion compared to $15,000 billion in Europe and $20,000 billion in the U.S. By 2025, that is, barely 6 years from now, China's GDP is likely to become the largest in the world.

As a result of China's emergence in the world of capitalism, 500 million people have emerged from poverty. Between 1990 and 2010, poverty declined from 80% to 12%.

(2) Volkswagen

Here is where Volkswagen enters the picture. In 1968, China had no highways for cars. Today it has 130,000 kilometers of highways going from North to South, West to East.

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In 2009, 13.64 million cars were sold in China. Ten years later, that figure stands at close to 28 million. The United States, Mexico and Canada combined barely reached 21 million. The major players in China are the established manufacturers of Europe, the U.S. and Japan. In 2016, Volkswagen sold close to 3 million cars in China, more than double its closest competitor, Buick, with 1.17 million cars. In 2018, the only manufacturer whose sales were not negatively impacted by the first pullback (-2,8%) in three decades was Volkswagen, thanks to its premium cars from Porsche and Audi. Not surprisingly, in this context its CIO Herbert Diess plans major development work for all three Chinese ventures, as trouble looms in Germany.

(3) *Deutsche Bank*

What does the business carried out by the Volkswagen Group in China has to do with Deutsche Bank? Most of the proceeds from three decades of car sales went into Deutsche Bank, although many other companies may have benefited as well, but to smaller extent. Unfortunately, Deutsche Bank is made up of bankers, and excess money in the hands of talented bankers always leads to one thing:

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the misallocation of capital, which only surfaced in 2007 when the financial crisis revealed that Deutsche Bank had invested €48,000 billion in derivative products, i.e., 24 times the German national debt! Starting precisely from that time, its share price began declining from €105.77 in 2007 to €7.75 today, i.e., -93%, as shown below.

It is nevertheless true that, in addition to the widespread misallocation of excessive cash, Deutsche Bank has loaded itself during the past decade with dubious business ventures, which appeared in the media under the headlines: "Paradis fiscaux", Danske Bank, Office raided, Trump, etc. The list at Deutsche Bank[2] is being upgraded continuously!

[2] The largest German financial institution is a counterparty to practically all other financial institutions in the world and has been recently found to have laundered hundreds of billion US dollars for Russian criminals and a miscellaneous of other illicit enterprises for years; in addition to that, even before 2008 the bank has been accumulating a derivative exposure to a number of markets so vast that it has not been possible to quantify precisely. CIO Team - Index & Cie – April 29, 2019

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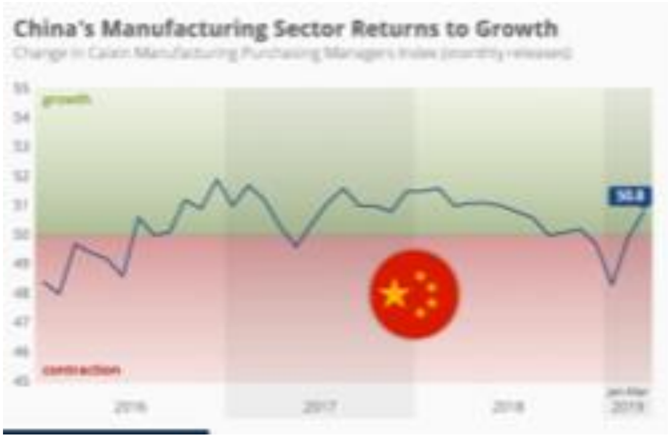
Conclusion

But at €7 per share Deutsche Bank is a Macro Buy. Perhaps it could also be so at €5, but I would definitely buy Deutsche Bank at these bottom levels for the following reasons:

- "La route de la soie": "China-Volkswagen-Deutsche Bank", which has been feeding Deutsche Bank with enormous cash flow, will continue to do so during the unfolding new decade. In the first quarter of this year, China has already started to recover. Not surprisingly, German investor confidence has just risen to 3.1, as concern over China's fades.



But there is much more to the story. Over the coming decade, another 160 million rural inhabitants in China are about to relocate to the urban community and rise out of poverty, just like the former hundred million did during the past decades. Rising household income along with spending will therefore continue to grow. The focus of the Chinese leadership resides precisely in this domestic migration. Their confidence in the future too[3].

[3] TIS Group, The Institutional Strategist, Global Market, April 2019

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- Deutsche Bank was founded in 1870 to become a steward for German industry, helping manufacturers finance their overseas trade. Unfortunately, it has strived to be more than just another lender and since 1990 it tried to go toe-to-toe with U.S. based powerhouses such as Goldman Sachs in global investment banking, the business of trading and underwriting securities, and in providing financial advice to large corporations. However, Deutsche Bank could not match these powerful U.S. investment banks on such a scale and, as a result, it is back to square one, downsizing to become a commercial bank. In this regard, it humbly follows several years later British Barclays Bank. Neither of these financial institutions can pretend any longer to become an investment bank "à la Wall Street". This marks the end of arrogance for Deutsche Bank and of its costly misallocation story, which triggered its downfall. Indeed, for investors this is the best piece of news since it clearly indicates that the Bank will focus on its main activity as a primary lender. Today, Deutsche Bank's capital ratio is 14%, well above any requirements, which almost guarantees it will not go bankrupt[4.] Its book value stands at €63 billion while its cash holding is a staggering €268 billion. That latter figure is doomed to grow substantially over the next decade despite multiple legal problems, courtesy of China's recovery, together with the end of the misallocation of excess cash.

- The merger of Deutsche Bank with Commerzbank at the cost of 30,000 jobs is already history. Opposition to such a deal had been increasing, particularly from the unions. Unicredito or ING would offer Germany a much better deal in terms of job loss and share price, since it would gain access in a big way to the German credit market. Of late, ING is entertaining the idea of acquiring Commerzbank.

PhC, PhD

[4] Deutsche Bank expects a global watchdog to loosen a key capital requirement as systemic role already wanes. Bloomberg – April 29, 2019 -

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