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Climbing the ‘Great Wall of Worry’

- Recent market moves have emphasised the fragility of markets now that liquidity has been driven out by regulation. Market mechanics are amplifying rather than dampening the momentum.
- Capitulation in China related trades including currencies commodities and emerging markets is being justified on the basis that Chinese fundamentals have changed. They haven't.
- We continue to see the emergence of long term structural change in China and the way it will interact with the rest of the world. Investors need to focus on these underlying trends to benefit from the upcoming phase of China's economic journey.

I spent last week meeting a variety of clients in Australia and the paper that follows is the basis of a speech I gave at a CIO conference on the Gold Coast. Prior to that I had spent two weeks touring various remote islands off Fiji, with (very) limited access to WiFi, which under the circumstances was probably a good place to be! Despite the gyrations in markets, I don't believe anything has actually changed in terms of the economics. The trends exhibited by China have been underway for several years now. The shift from production and export to consumption and import, the steady opening up of the capital account and the assembling of a financial sector capable of supporting one of the largest economies in the world.

The breakthrough, the bottom of the recently established 'floor' for the Shanghai Index may have been the catalyst on August 24, but the moves in global markets were a function of what I refer to as market mechanics. When equities move down sharply there are always issues with 'delta hedging' as the investment banks and other writers of put protection scramble to unwind their positions, while the moves in currencies such as the yen and euro suggest that carry trades that were short these currencies were being rapidly taken off. Much has also been written about the hit to strategies such as risk parity - essentially heavily leveraged bond portfolios claiming to offer equity like

returns with lower risk. Just because the risk measurement doesn't include leverage, doesn't mean it isn't there. Throw into the mix the important and increasingly evident realisation that the Volker Rule and Dodd Frank, far from making markets safer have actually made them more fragile by removing liquidity and you have a recipe for a very uncomfortable August. It is also worth noting that the Faustian pact between exchanges, regulators and high frequency traders (HFT) is also starting to be revealed, convincing themselves that shutting down the 'casino banks'' ability to make markets was not a problem since the role of providing liquidity would be taken by HFTs, they failed to recognise that you need a value investor to stabilise a momentum market. HFTs are momentum investors and thus will exaggerate volatility rather than offset it.

We also undoubtedly saw some more capitulation selling in emerging markets (EM), both debt and equity, undoubtedly egged on by the noise traders in the foreign exchange (FX) and commodity markets and I believe it is from here that the notion that China is suddenly slowing down emerges. The one, three and five year numbers on EM versus developed markets (DM) are truly terrible but advisors, institutional investors and others need some sort of fig leaf to cover up the decision to sell three years too late. We saw exactly the same thing with a capitulation in technology, media and telecoms in 2002/3. China suddenly slowing down or a claimed change in direction provides this excuse. Fine as far as it goes, but it is important to recognise that for future investment purposes the fundamentals being described as a justification for getting out of a bad old investment will not help anyone find a good new investment.

Over the last few weeks I have been discussing the two conflicting narratives on China. Essentially the consensual, negative one is that China is unstable and running out of control and that the worst is yet to come and the more contrarian, more positive one is that China is in fact a long way through a series of structural and particularly financial reforms that will alter the balance of winners and losers across other asset classes, stocks and sectors. To be clear, to pick the latter (which I do) is not to be outright bullish, but rather to set a frame of reference to try and understand what is happening and try and project what might happen next. I believe that China is in a bull market, but all bull markets have to climb a 'wall of worry'. It is instructive to remember that almost all the negatives being thrown at China were also thrown (mainly by the same people) at the US as it climbed a multiyear 'wall of worry' during the post dot com era, as well as post the global financial crisis (GFC). The list is similar, too much debt, lack of credibility in monetary policy, panic about inflation, followed by deflation and a belief that corporate earnings are all fake. Throw in a property bubble, in fact throw in constant talk of bubbles, a broad contempt for the ability of 'naive' equity investors and periodic panic about a weak currency and you have a pretty transferable template. Obviously there are differences and to point out that the US bears have been spectacularly wrong does not necessarily mean they will be wrong this time. But it should give us pause for thought.

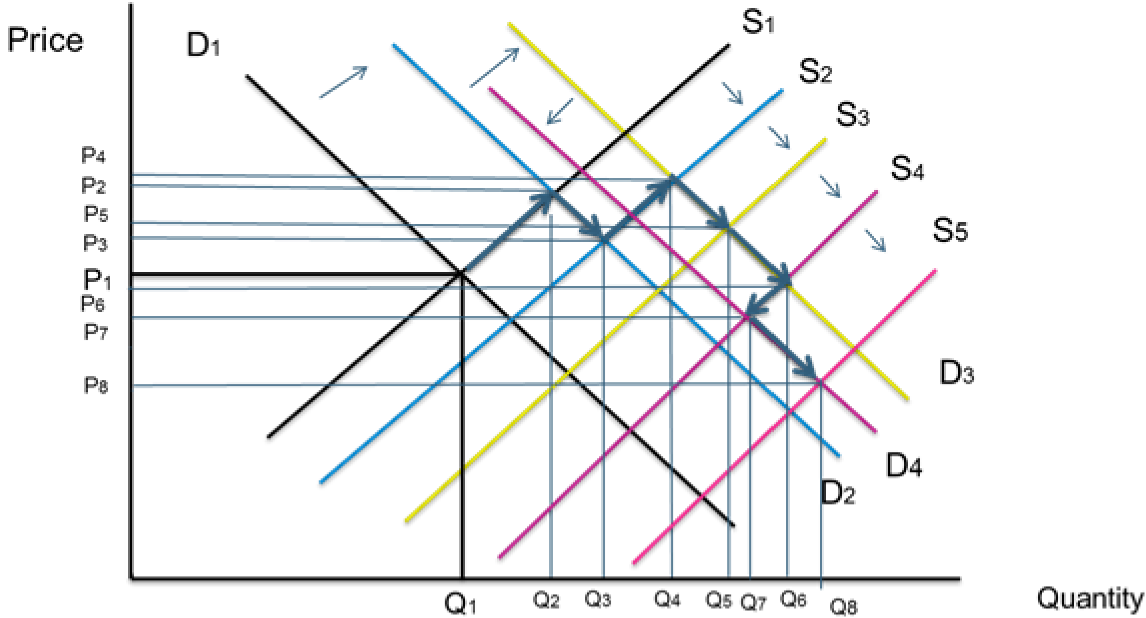
China has grown over the last 30 years through a policy mix initially focused on production and export, to one that has been moving towards consumption and import. This has involved a shift from consumer repression- low wages, low exchange rate and low return on capital to one that has higher wages, a stronger exchange rate and higher costs and returns on capital.

Let us consider the situation via different asset classes. Let's start with what I call the noise markets, essentially commodities and FX. These are really tradable prices, they have no underlying cash flows and as such are most prone to swings in received opinion. However they can, and do, have a profound effect on the underlying economies. Then we can look at other asset markets such as property, debt and equity as well as some of the overall economic data. For each of these I will consider some of the key worries and attempt to reframe them within a consistent picture of what I believe China is actually doing. This is not to dismiss the worries, although in many cases I do, rather it is to highlight what I would regard to be the more relevant risks and opportunities.

Commodities

When talking layman economics, I frequently default to the simple demand and supply curve framework, and find it very effective in almost all cases. Certainly it is for commodities. One derivative of this framework is found in agricultural markets and is known as the cobweb theory, where demand and supply fail to stabilise, creating an unstable equilibrium on price and volume. It seems clear to me at least that **China has introduced** such **an unstable equilibrium into almost every commodity market in the last 10 years, and a few other markets besides**. Consider diagram 1.

Diagram 1: Supply and demand



Source: AXA IM

The initial equilibrium is demand = D1 and supply =S1. This gives an equilibrium price of P1 and an equilibrium quantity of Q1. We then follow a series of steps.

Step 1: China's demand increases for commodity X, from D1 to D2. Price moves to P2 and quantity to Q2. Sales = area of the square under the lines, effectively increases by about 30%. Operational gearing makes this incredibly profitable.

Step 2: Supply increases to meet demand and price drops to P3, although this is still above P1, while quantity moves to Q3, greater than either Q1 or Q2, so sales and profitability increase. At this point pass through effects kick in, not least to manufacturers of capital equipment required to increase production and/or productivity of commodity X.

Step 3: Demand from China moves out to D3. This pushes prices up to P4, even higher than D2. Combined with higher quantity Q4, the area of sales is now two or three times the original level. Such super-normal profits stimulate yet more investment, boosting share prices of cap-ex companies as well as commodity companies. Profits hit highs, but free cash flow begins to decline due to cap-ex. Margins start to shrink, but volume is considered sufficient to offset this. Supply moves out to S3, as global supply picks up, and in many cases Chinese substitution start to compete. Prices fall to P5, but this is still above P1. Q5 is still considerably above previous levels. Suppliers start to gear up balance sheets to invest in increased production.

Step 4: Supply continues to increase to S4, causing prices to drop to P6, now below the original price and causing some panic among lenders to the producers. Around the same time it is realised that a significant proportion of the shift from D2 to D3 was actually speculation (mostly in China) and that this inventory is now coming onto the market, causing prices to fall to P7. This helps explain some of the increase in supply, but also makes us realise that real demand is not actually at D3, but lower, at D4. Operational gearing starts to work in reverse, profits start to collapse. Share prices head south rapidly.

Step 5. Despite lower prices, supply continues to increase. This is because of either a) actions by the lowest marginal cost producers to drive competitors out of the market or b) overleveraged producers being forced to increase output as price falls simply to maintain cash flow to meet interest payments. Supply moves to S5, output moves to Q8, but price falls to P8. In many cases this supply is now coming from China itself. China has moved from being the biggest customer to being the biggest competitor. Not only do the producers suffer, but so do those grown rich on providing the capital equipment.

The net result is **that China's boom, and the supply response to it has produced a situation in which almost every commodity is in excess supply.** This model most obviously applies to iron ore and coal and thus steel, but also cement, copper, aluminium, gold, silver, rubber, oil and gas, even

milk. With most of these (except copper) China has also significantly increased its own productive capacity and is in many cases moving to self-sufficiency, meaning demand from external suppliers is likely to fall. Even worse, China has emerged in some areas, cement for example, as the lowest cost producer in export markets and with the added problem of favoured nation status. With Chinese capital funding infrastructure across Asia, it is going to be built with Chinese cement and Chinese steel.

However, we can extend the analysis beyond plain commodities. As China has gone up the value added chain, we might argue that it has happened with smartphones and even cars. Also, arguably Macau gambling fits this model, as do luxury goods. In both cases, supply over-expanded and demand actually fell due to government action, in particular the crackdown on corruption. In this case the providers of capital equipment to the luxury goods companies might be seen to be the landlords. The luxury goods companies have a problem that the high spending Chinese tourists are no longer as plentiful as they were, but also they have moved location. Nowadays, they want to shop in Tokyo and Paris, rather than in Hong Kong and Macau, which has left the luxury goods companies and the landlords that accommodate them with an oversupply problem. Even worse, just as they rush to build out in these new areas it looks like the Chinese landlords have persuaded the government to start reducing the luxury goods tax in China, for many of the very same reasons why they were shopping abroad in the first place.

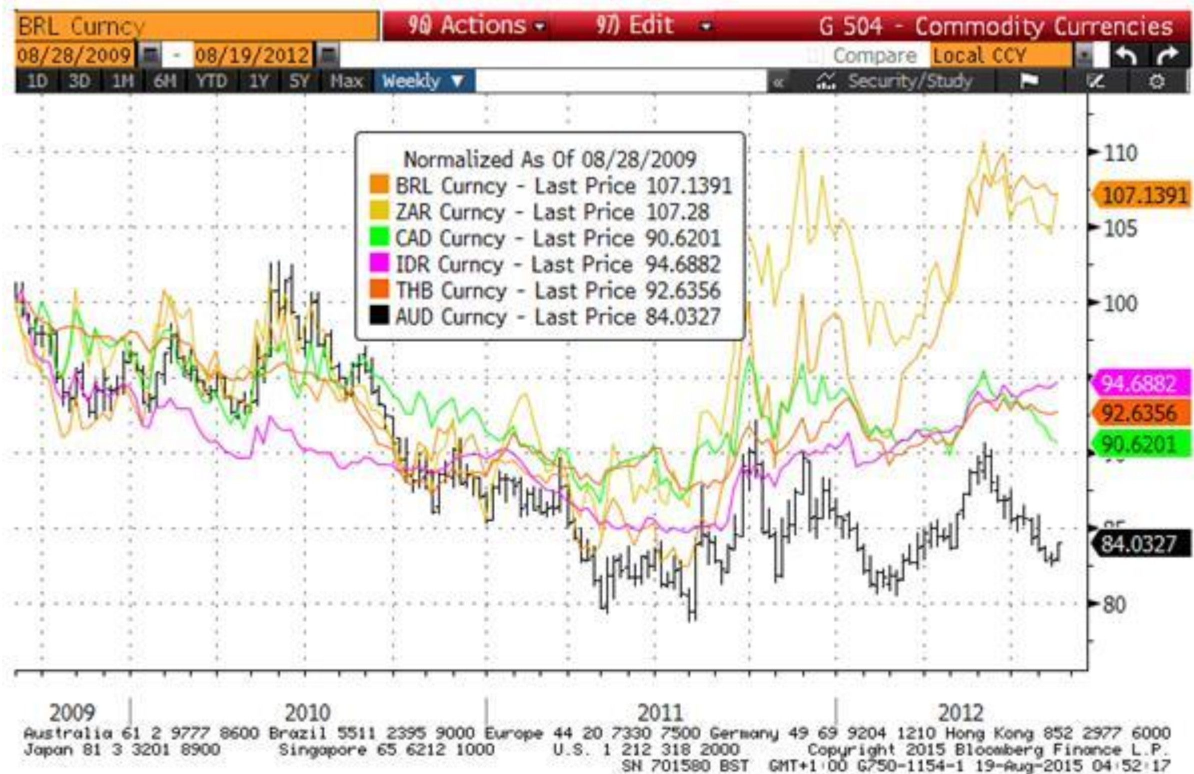
Worry number 1: China is slowing down rapidly and there is collapsing demand for global commodities.

Reality as I see it: Chinese demand remains robust, just not growing so fast. The real problem is that they have now created an excess supply of just about everything. China has gone from being the biggest consumer to the biggest competitor. **China set out to make China rich, not anyone else. The fact that for a few years the rest of the world got rich too in my view was a 'bug not a feature'.**

Currencies

The most visible reflection of the commodity cycle described above has been the performance of the currencies associated with the producers of the commodities, as the dollars earned were exchanged back into, Australian and Canadian dollars, Indonesian rupiah, Brazilian real, Thai baht and so on. If we look over the last six years since the GFC, we can see that **Chart 1 shows the gain in a range of commodity currencies against the US dollar,** the lower the better. In effect three years into the crisis, a US dollar would have only bought 84% of the number of Australian dollar it would have done three years earlier.

Chart 1: Commodity boom = commodity currency boom



Source: Bloomberg, 19 August 2015

Of course that all quickly reverses and as chart 2 shows, a US dollar now buys almost 30% more Australian dollars than it did three years ago, 53% more rand and 70% more real. Over the last week or so the hit to **EM currencies**, and by extension their asset markets has accelerated as China depreciation was seen as the final nail in the proverbial coffin. This is a **capitulation trade** in my view and the noise markets have well and truly caught hold of it. Much of the bearish noise on China is designed to drive this trade.

Chart 2. And commodity bust. One US dollar buys a lot more of these currencies now.

Source: Bloomberg, 19 August 2015

We could of course have included other oil and energy currencies such as the Nigerian naira (26% more), Norwegian krone (42% more), Malaysian ringgit (31% more) and Russian ruble (103%). Oil of course is down over 50% on a year as it captures almost all of the stages described earlier. These are all significant price moves, whether in commodities or the associated currencies and **put the 3% move in the renminbi (RMB) last week into context.**

The reform of the Chinese financial system is key to everything that is happening in China. China wants to open up the economy, but is (rightly) fearful of doing so too quickly. In particular it needs to ensure that its domestic money and banking system is robust enough to open up the capital account. Prior to the GFC, China was largely using the western banking infrastructure. When we broke that, the Chinese realised that their only alternative, the Chinese domestic banking system was not really up to the task. Since then, there has been a rapid move to build a 21st century financial system. Currently China has a largely closed capital account, so that companies earning foreign exchange, mainly dollars, will exchange them with the central bank for RMB and the central bank will in turn book them as reserves. Even before the 2008 crisis they were having difficulty in finding something to do with these dollars. The buying of US Treasuries was hitting its limits and the government set up institutions such as the Chinese Investment Corporation (CIC) to help manage the FX reserves. Encouraging the private sector to invest overseas was one angle and to this end former Premier Wen Jiabao allowed limited, quota

driven, investment overseas. In 2007 this led to a rapid inflow and short term bubble in the Hong Kong market, but little beyond that.

Post the crisis the situation became even harder as not only were Chinese corporates earning dollars overseas, but they were also borrowing them, meaning that the capital account deficit of the state sector was bigger than the overall current account deficit, giant as that already was. This is because **the private sector was not only running a current account surplus, but also a capital account deficit as they borrowed dollars**. Much of this was associated with the supply/demand model just described: companies borrowed dollars to invest in productive capabilities as well as to speculate on the commodities themselves. As a result of effectively selling of dollars to buy RMB, the Chinese currency appreciated by around 12% between 2010 and early 2014. This in turn stimulated more carry trades as the perception set in that the RMB would be rising so even more carry trades were put on. **For many dollar based investors, China became a high yield plus exchange rate gain story, so more money came in to do the arbitrage, flooding the markets with liquidity and causing fears of overheating**.

The Chinese authorities acted to slow this down early last year when **they let the RMB 'depreciate' a little, as we discussed at the time this was to take the certainty out of the carry trades**. At almost exactly this point the **collateral arbitrage trades started to unwind** and we discovered that large amounts of money had been borrowed in dollars to buy copper and then use that copper as collateral to borrow onshore RMB for 'investment' in China. This was the sort of collapse of (false) demand, spike of supply trade mentioned earlier and was clearly not limited to copper. There was also official stockpiling, such as for the strategic oil reserves, which seems to have also misled (admittedly already giddily bullish) analysts to overestimate long term demand, and effectively under-estimate potential supply.

Meanwhile the authorities were continuing to provide outlets for domestic savings and in particular domestic held foreign currency by encouraging the stock connect mechanisms. These are an advance on the strict quota systems and are designed to allow many more investors to participate – again subject to liquidity limits. Think of a large reservoir of domestic savings with a dam and a series of controlled sluice gates. Importantly the (controlled) flow operates in both directions, as China wants to get long term capital into the country to help price assets properly. This is key to the way they manage the currency regime; **they do not want a depreciating currency since it would deter long term capital, but neither do they want it appreciating too much, less for competitive reasons than to prevent carry trades being put on.** Hence the ideal is for a steady float with a narrow band.

However, a necessary part of obtaining long term global capital is convertibility, and a major step on that route is being included in the International Monetary Fund's Special Drawing Rights (IMF SDR) basket. Obviously simply being pegged to the US dollar would not be acceptable as it

would be, de facto, simply another version of the dollar. Last week the authorities adjusted the way they manage the band to hopefully maintain the Trinity of not too strong, not too weak **and sufficiently volatile to be regarded as a proper currency (but not too volatile).**

Much has been made recently of the drop in the official reserves, presented as evidence (as usual) of a collapsing economy, lack of control by central government, capital flight etc. To be fair, much of this came from the noise traders in FX using it as a stick to beat the above mentioned commodity currencies with. However, as explained in recent weeklies, of the $300 billion drop in reserves (out of $3.7 trillion total), a good $200 billion can be explained away as a translation effect. Not all of China's FX reserves are in US dollar assets and those in yen or euro will have dropped by around 20% over the last 12 months due to exchange rate effects. Second, we also know that around $60 billion was injected into the two policy banks in order to pump prime reform and specifically the One Belt, One Road infrastructure initiatives and third, encouraged by government, as mentioned above, **Chinese corporations have been paying down dollar debt.** Overseas debt is a serious 'Achilles heel' for any economy and is a key concern for most other emerging markets at the moment. The fact that over the last two quarters (Q4/Q1 latest statistics) the Bank of International Settlements (BIS) reports that net lending of BIS banks to China has dropped by $160 billion, which is actually an extremely positive sign. It also seems likely that the **deleveraging of private sector balance sheets will have been a major source of monetary tightening in China over recent quarters.** To the extent that this is near completion we might see positive surprises in economic activity.

Worry number 2: China is going to depreciate its currency and drive 'beggar my neighbour' policies throughout Asia and the rest of the world.

Reality as I see it: China's exchange rate is about the capital account not the current account. Chinese commodities, such as cement are so much cheaper than competitors, that a small exchange rate move makes little or no difference. The authorities are looking for a goldilocks exchange rate- not too weak to put off long term investors, but not so strong as to encourage carry trades and arbitrage; not too volatile to make hedging investments into China uneconomic, but volatile enough to count as a real currency in its own right and secure SDR status.

Worry Number 3: China is seeing capital flight as the economy stagnates

Reality as I see it: China's FX reserves reflect multiple effects, including currency adjustments and the use of FX reserves for other purposes such as capital injections into policy banks. Most importantly, they reflect a paying down of dollar debt by the private sector, which is a positive not a negative.

Debt and Fixed Income

The size of China's debt is seen as a near intractable problem, especially for economists brought up on Reinhart and Rogoff's work on debt to GDP, which suggests that government debt in excess of 90% of GDP 'inevitably' leads to slower economic growth. Accordingly there is much talk of 'massive debts' needing 'huge write downs' and competition to see who can have the lowest 'real' GDP forecast – implying, knowingly, that all the figures are fake and that they have a better insight. As a starting point it is perhaps worth noting, or rather questioning, an aggregate that combines debt rations of today's US economy and say Greece in 1932. Moreover, the difference in exchange rate regime, whether the debt was local or sovereign or whether it was in local or foreign currency is surely significant? A country, such as Greece or Argentina, with lots of foreign currency debt is vulnerable to both the price and availability of that loan, which obviously includes not just the interest rate but also the exchange rate. This has been the essence of emerging market debt crises over the years. Most, not all, of China's debt is domestically held. Yes, there are significant dollar debts as discussed earlier, currently a net figure with BIS banks at least of around $400 billion, but **the majority of the so called massive debt pile is domestic.**

This is not to be overly sanguine, rather as with the rest of these worries, to suggest that we are looking in the wrong place, both for our risk and our opportunity. For example, **the big worry appears to be local government debt, which some estimate to be as high as $3 trillion**. Like everything else in China, the numbers are big and suitably scary, but it is worth noting that much of this debt is a reflection of local government financing vehicles and is owned by local banks. The history is that these financing vehicles emerged because local government acted as the focus for investment in their region and provided tax incentives as well as building infrastructure, roads, airports, central business districts and so on. This left them with 80% of spending, but only 50% of revenue, meaning borrowing had to fill the gap. Undoubtedly there has been some (often significant) misallocation of capital, but **in contrast to most western local government debt, much of this can be backed by assets such as toll roads, airport levies and office rent.** So not only can it be backed by cash flows, the authorities have announced intention to package such assets and liabilities together and sell them as infrastructure bonds, corporate bonds, real estate investment trusts, etc. This is important, since it means that not only can the local banks be recapitalised (much of this debt is short term revolving loans), but the loans can be made long duration and provide assets for long term institutions such as pension funds and insurance. This will be vital to build domestic savings infrastructure, but is also likely to attract attention from overseas institutions, given the attractive yield relative to default risk. This is a prime area in which **the ability to hedge currency will be crucial.** Meanwhile, as discussed, now that the RMB is expected to go sideways to fluctuate against the dollar (rather than always go up) and corporates are starting to issue onshore debt rather than dollar debt, which **will broaden and deepen the corporate bond market.**

Worry number 4: China has very high levels of debt to GDP, especially in local government. Corporates have too much debt that needs restructuring.

Reality as I see it: debt to GDP matters far more if it is foreign currency, this isn't. Moreover, much local government debt is backed with high quality assets and can (and I believe will be) restructured to turn the debts into long term investable assets. Much of the dollar debt is being paid back or swapped into RMB, while much of the remaining corporate debt is within SoEs. This will need to be restructured, in the manner of UK privatisations and will be a long term project.

Property

Property has been the long term worry over China, not least because it has been the main 'asset class' for savers. The construction boom post GFC led not only to more infrastructure, but also to additional capacity in the residential market, much of it in areas already suffering from excess supply. This was particularly true in tier 3 cities, where the mechanics of the commodity cycle outlined earlier came into play, perceived demand bringing forth increased supply only to discover that much of the demand was speculative and was adding instead to supply and that underlying demand was actually falling not rising. Surveys show that the official levels of 3 years inventory in certain tier 3 cities are understating significantly, it is more like 8 years. This means that certain developers are almost certainly bust, but many continue to overtrade, as they get cash flow payments up front. We would normally expect the authorities to act to prevent this, but in the light of recent activity in the equity markets, we doubt they will. By contrast, tier 1 and tier 2 cities have little excess supply and surveys show a seller's not a buyer's market. Ironically, the same issues to do with the stock market that might prevent the authorities acting on tier 3 developers may actually lead to more investors switching from equities to 'safe, quality properties' in tier 1 and tier 2 cities.

Worry number 5: China has a housing bubble that will implode. There are lots of empty apartments and ghost cities meaning that there are lots of bad debts on banks' balance sheets.

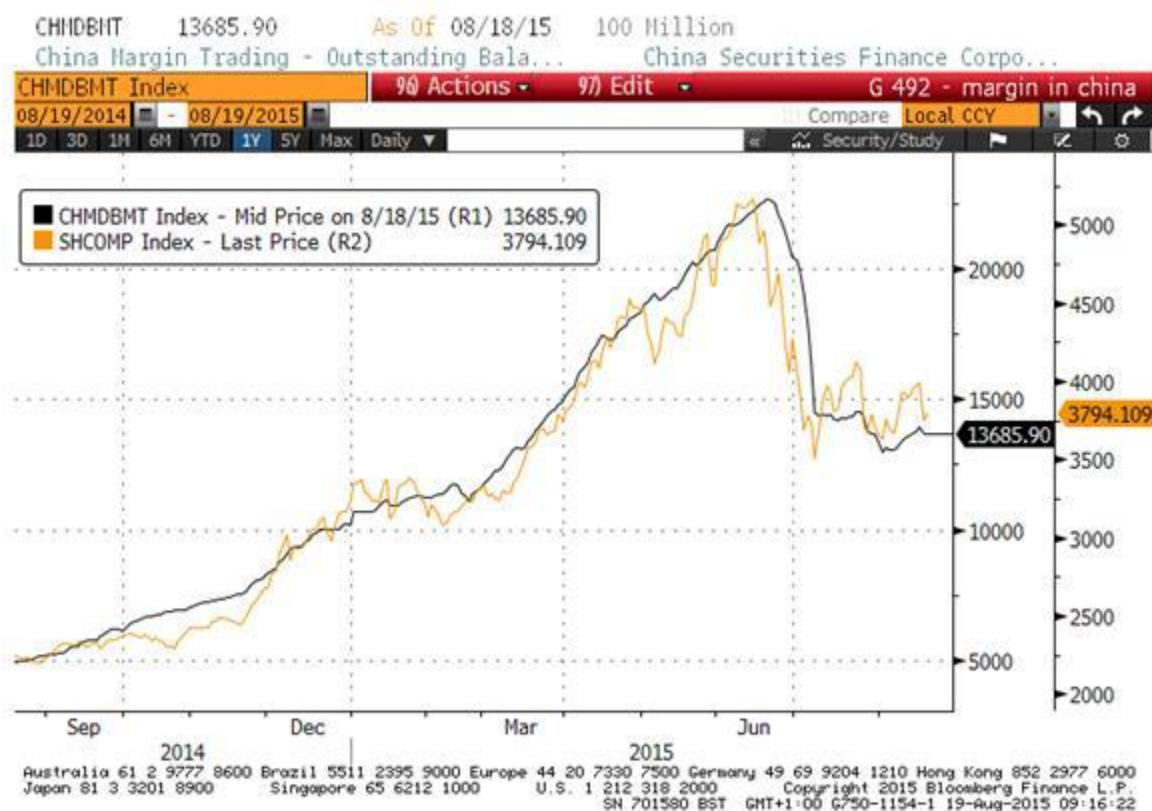
Reality as I see it: Tier 3 cities have excess supply, tier 1 and 2 do not. Personal leverage is low, this is trapped capital rather than lost capital. Prior to the equity market sell-off the risk was that authorities would force tier 3 developers to cease trading and that this would have a knock on effect on other tier 1 and tier 2 developers through investor behavior, capital flight, tighter lending, cross holdings etc. This actually looks less likely. Quality property will become more, not less attractive.

Equities

The rise, and particularly the fall, of the Shanghai Composite really

brought out the panda bears on China. The dramatic drop in June led to talk of trillions wiped off the value of equities from commentators who had never pointed out the trillions being added on. It also allowed the sinophobes to criticise the authorities over their handling of the events. The popular narrative is that the authorities deliberately encouraged a stock market bubble so as to allow them to embark on a 'massive debt for equity swap'. This is the obsession with debt again, but once again I would suggest that while this has a small kernel of truth, it is so distorted a view as to leave the observer blind to both the opportunity and the threat. The reality as chart 3 illustrates is that **margin debt started to take off in the autumn of last year**, almost certainly as the currency carry traders decided to borrow local and invest local, the trade weighted dollar started to rise around the same time. The moves by the authorities to persuade investors to look at assets other than property also contained encouragement in October to invest **through the newly announced Shanghai-Hong Kong Stock Connect system**. This worked in both directions, but undoubtedly the flow into Shanghai via Hong Kong was the stronger. I would interpret this as **part of the longer term plan to build a capital market rather than a short term desire to ramp up the equity market**. Interesting to note that there was also a value element – it wasn't until December 2014 that the Shanghai Composite regained the levels seen five years previously.

Chart 3: Shanghai Composite and margin debt



Source: Bloomberg, 19 August 2015

This interpretation is supported by the actions of the authorities**. Far from encouraging the use of margin accounts they attempted on several occasions to rein it in,** notably in January, where they banned new accounts for three months, then again in April where they acted to ban the umbrella trusts that appeared in their place. Both times they saw 6 or 7% falls in the index and both times they eased monetary conditions to compensate. They struggled to deal with the peer-to-peer lending structures that then appeared afterwards and to limit the run in margin lending during May and June (although much of this simply reflected the value of the underlying equities). As previously discussed**, much of the run up was in anticipation of a bigger fool arriving**, in this case index funds chasing MSCI inclusion such that there was a panic selloff in early June when the traders realised that there was no bigger fool to buy their positions. **The authorities then made things worse** by acting the very next day to clamp down further on margin lending by brokers, turning a trickle into a flood. The subsequent response attracted a lot of criticism, much of which came from the very same gurus on Wall Street who had applauded and in some cases demanded exactly the same type of intervention back in 2008. We need to remember that the Shanghai market is in its relative infancy and the authorities had just allowed both short selling and the launch of futures on the various benchmark indices. Both new sets of vehicles were then used to try and push the market down and the threat of triggering waterfall losses (which after all is the intention of the traders doing the selling) led to government intervention, and of course cries of foul play from those with vested interests. **As with much recent action, the response was arguably clumsy, but nevertheless understandable**, even acceptable and has established a trading band for now, between 3500 where the government buys and 4500 where brokers are allowed to sell – although 4000 appears to be a near term ceiling.

Worry number 6: The government tried and failed to engineer a leveraged bubble in the stock market. It has failed to rig the equity market and the economy will slow down because consumer spending will be hit.

Reality as I see it: The government is aiming to broaden and deepen the stock market, it wants long term investors, not day traders and the number of individuals participating in markets has certainly fallen sharply. This looks much more like 1987 than 1929. The run up was so quick that there was no time for a positive wealth effect, but the real concern is bad debts from individual leverage.

Shadow Banking

The shadow banking system is the bete noir of the Chinese authorities and equally of many investors. For one thing it makes it very difficult to measure economic activity and keep an eye on true credit creation within the economy. Secondly it has continuously produced unstable economic behaviour as leverage appears in the system distorting economic signals. We have already

discussed how unconventional lending led to distorted demand signals for raw materials that turned out to be for speculation and even to buy collateral for further leverage. However, we have also seen various ‘wealth management products’ lead to leverage appearing across a wide variety of markets . So far the most successful method of dealing with the shadow banks has been to allow them to deliver the product the market is calling out for but which the still not fit for purpose banking system has failed to provide and then make it official. Money market funds are a key example of this. After Alibaba was allowed to fast track a product the banks all suddenly discovered they could do it too.

Worry number 7: The shadow banking system is out of control and will lead to continued volatility and mis-pricing.

Reality as I see it: The shadow banks are being used to help identify areas of need/demand and, where suitable provide a solution and in doing so persuade traditional banks to follow them. The shadow banking system largely exists because there is not yet a developed capital market alternative. This is coming.

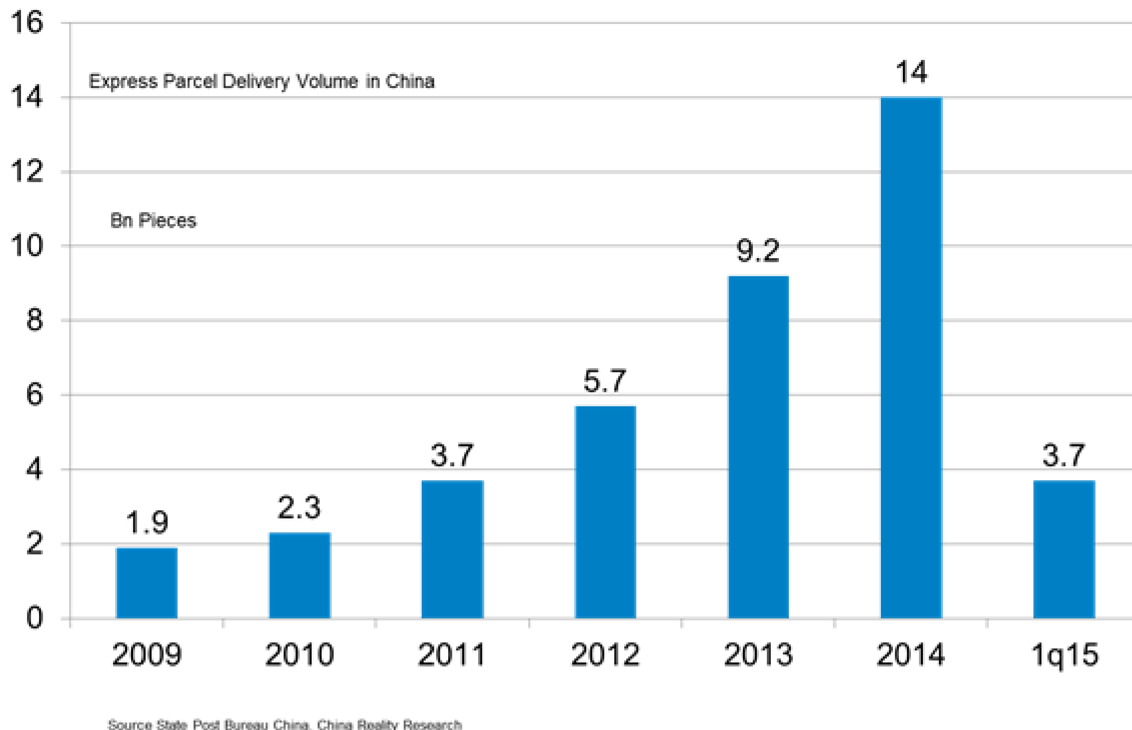
Overall Economy

Nobody believes China’s GDP growth numbers and they are probably right not to do so. Many quote the comment from Premier **Li Keqiang** not to look at the official index but instead look at other measures such as electricity consumption, railway cargo volume and bank lending. Currently all three are weak, leading to many economists competing for the lowest ‘real’ growth number. I would have a number of issues with this approach. First, the **comments came back in 2007 when China was a very different economy than it is now** and Li’s indicators very much reflect ‘old China’, not ‘new China’. As such, they are consistent with the slowdown in iron and steel, infrastructure and manufacturing, while the existence of shadow banking (the perpetual problem for regulators) makes the bank loan measure unreliable – especially if the loans are in dollars. Another, important issue is that **the old growth model of GDP targeting**, that led regional governments to maximise output regardless of utility (with echoes of the target driven Great Leap Forward) **has been abandoned,** so activity slowing may very well be exactly what is needed. Perhaps more pertinently, with **an economy of almost $11 trillion, bigger than Germany, France and the UK combined, why would we expect even 4% growth, let alone 5, 6 or 7%?** Given the base effect we should be happy with a sustainable 6% (as the IMF suggest they are) and focus on the shifting components.

Rather than look at the traditional and easy to measure variables such as GDP, industrial production, iron ore imports and electricity consumption, we might perhaps look at things **like retail sales, which are growing 10% in real terms** – hardly a slowdown**. A very interesting dataset is express parcel**

deliveries. These are a useful indicator of internet shopping and have grown from 2 billion to 14 billion in the last three years alone. There are **670 million people in China online** and most of them use their smartphones (not desktops or even tablets) to shop.

Chart 4. Express parcel delivery volume in China



Source: CLSA China Reality Research, May 2015

As we well know, overall sales growth is no guarantee of profitability, but it does re-inforce the message that catering to the tastes of the Chinese consumer, be it household goods, cosmetics, food and beverage, healthcare, holidays or financial services is to be operating in an area with economic tailwinds rather than headwinds.

Worry number 8: All the indicators show China slowing rapidly. This means global growth will slow and so called risk assets are expensive. There is no need to get involved in China as it's still not in benchmarks and it is too complicated.

Reality as I see it: You can ignore China but it won't ignore you. The economy is so big that even 4% growth would make it a significant contributor to overall world growth (currently it provides around a quarter of all growth). As well as becoming a dominant buyer of commodities it is now a major supplier and competitor. It runs a significant services deficit reflecting rapidly growing tourism, making China a major buyer of the western 'service sector'. As with commodities, we should not be complacent, where possible, China will produce a home grown substitute quite quickly.

Conclusion

Apologies for the long note! As I have said on many occasions, the further people are from China, the more certain they appear to be, and they are mostly negative. Sitting here in Hong Kong, I have to say that I am neither as certain, nor as bearish as the western consensus appears to be. More important perhaps, I think the questions that need addressing are not always the ones that are being raised as part of the 'great wall of worry'. Not particularly bullish, just looking at a different set of opportunities.

Regards,

Mark

Mark Tinker

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All data sourced by AXA IM as at Friday 4th September 2015.

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