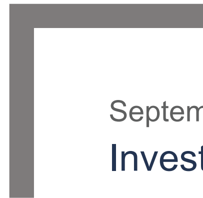

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Investment Publications Highlights

CAMBRIDGE ASSOCIATES LLC

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"China Investment Strategy Weekly Report: Approaching a Turning Point?"
Yan Wang, BCA Research Inc., September 12, 2012

While the years of double-digit economic growth may be over and concerns over too much government control of the economy are legitimate, much of the recent pressure on the Chinese economy is cyclical and ongoing urbanization remains a secular tailwind. Recent conversations with Chinese analysts, economists, and government employees suggest the outlook for China remains upbeat.

Perhaps no other topic in the global investment landscape divides opinion among strategists, economists, investors, and government officials as much as the outlook for the Chinese economy. The combination of tighter monetary policy, weak external demand for exports from Europe, and new structural headwinds for the Chinese economy makes the outlook for economic growth more difficult. However, while the years of double-digit economic growth may be over and government interference may have led to some excess capacity, some of the recent pressures are cyclical. Recent conversations with Chinese economists, analysts, and even government employees suggest the outlook for China remains upbeat.

China began tightening monetary policy in late 2010 in an effort to slow the flow of money within the economy and crack down on some of the excesses occurring in the property markets. The economic downturn in Europe, which is China's largest export market, made things worse, as has the appreciation of the renminbi. The cumulative effects are now being felt throughout China as slowing wage gains, increasing inventory-to-sales ratios, and declining activity within the construction industry indicate economic momentum has slowed.

Aside from cyclical factors, China has undergone some structural shifts in its economy that the recent bout of economic weakness has made more difficult. The labor-intensive growth model is not as viable as it once was given that rapid per-capita GDP growth in certain regions has reached $10,000 to $15,000. Government officials intend to help manufacturers as they adapt, but the cost of assistance is growing given the macro backdrop.

One option for the government is to increase or bring forward infrastructure spending. Planned spending is currently modest, and the government could easily afford to ramp it up dramatically. Critics charge that the infrastructure build-out has already been excessive, and point to unsustainable trends like fixed-asset investment having grown at 20% per year for decades; however, the reality is somewhat different. There has been some overdevelopment in eastern China, but less developed central and western China have significant transportation and power needs given increasing urbanization. The urbanization process may not even be half completed. Half of the population lives in the countryside, and currently only 40% of Chinese villages are even connected by paved roads. The contribution to overall GDP from the western region has already risen in recent years; this infrastructure should help boost growth further. The success of many businesses in eastern China should serve as proof of the value of solid infrastructure. Financing is readily available given government and consumer savings.

The government also could change its monetary policy to boost growth. Interest rates on bank loans are too low at 6%, as higher loan rates in the unofficial market suggest demand for credit exceeds supply. The government should allow the banks to loan to a wider range

of businesses and fund investments. Currently, China's households are rich in savings and perhaps save too much, but the idea that they are going to spend their way to posterity is misguided and lacks historical precedents. In a similar vein, China's population is indeed aging, but concerns about demographics becoming a drag on growth are also misguided. An ample supply of labor coming into the market through the urbanization process means there will be plenty of new entrants into the labor force in the coming years.

Critics of China do have some legitimate concerns. Labor market reforms would encourage entrepreneurs to grow businesses and unfunded liabilities are starting to mushroom. State monopolies are hurting productivity, and some businesses need to decouple from government organizations. However, the big picture is that China's leaders are aware of these problems and will soon need to address them.

Regardless of one's current view on the Chinese economy, its growth record over the last two decades has been incredible. It is unlikely that the economy will continue to grow at double-digit growth rates given the much larger base. However, with the central government in direct control of credit and lending, as well as infrastructure and investment projects, China's imminent demise may be overstated.

"China; No Quick Fix for the Beijing Model"

John-Paul Smith and Mehmet Beceren, Deutsche Bank, August 30, 2012

Slowing growth in the Chinese economy can be directly attributed to the close relationship between government and business. The links between the central and regional governments and the corporate entities they support have resulted in declining productivity, excess inventories, and a general lack of industrial consolidation. Cheap capital and excess leverage are only compounding these underlying problems, which until now were masked by positive aggregate economic data. As China attempts to muddle through economic reforms, investors should remain cautious of Chinese equities and emerging markets in general favoring developed markets.

Economic growth in China is slowing, as weakness in developed economies exacerbates longstanding structural issues that authorities have failed to address. At the root of these problems is the close relationship between government and business, and the resulting inefficiencies as businesses have been shielded from market discipline. Many top-down investors and economists have been caught off guard by these developments, as aggregate economic data have been strong and the consensus seemed to have been that businesses were becoming more market oriented. In fact, cheap capital and hidden subsidies for inputs like energy and land have led to declining productivity, excess inventories, and a looming bad loan crisis. Equity investors should remain cautious as China attempts to deal with these issues and rebalance toward more sustainable policies.

Different Chinese industries experience varying levels of government control and thus protection from market forces. The central government generally maintains at least a 50% ownership stake in the so-called strategic industries such as defense, power, and telecoms, and both investment and returns are made at its behest. Strategic objectives take place over commercial ones, and in practice this often

means returns to investors and productivity are weighed down. In "pillar industries" such as auto, construction, and technology, the state has a strategic interest but exerts less direct control. Large listed companies tend to be exposed to competitive forces and are thus somewhat efficient. However, investors still suffer because competition from unlisted competitors drives down profits, often because they are receiving subsidized inputs from local governments. The third category—the "true private sector"—is more efficient, but is much smaller than suggested by official data. While official figures claim otherwise, the state still exerts a high degree of influence even over the 20% of market capitalization that it does not control.

The build-up of substantial overcapacity in the Chinese economy was compounded by the post-Lehman stimulus. Other fiscal policies have also played a role. Local governments are accountable for a significant share of overall government spending but reliant for funding on local revenue sources (as opposed to national transfers) such as business taxes and property sales. This has led regional governments to overinvest in development, borrowing heavily but using special purpose vehicles and other tools to hide the debt from official leverage statistics. Excess leverage has also been facilitated by financial repression, as savers have had limited investment options and banks need to grow loan books to help mask nonperforming assets from previous cycles. In some respects the situation is reminiscent of post-soviet Russia, when large-scale privatization obscured the fact that many companies remained reliant on subsidized inputs and political patronage.

Some analysts argue that the Chinese government will not allow stagnation to persist, but the central government's lack of power is evident from its failure to follow through on targets to consolidate industrial capacity in key industries. The difficulty is that pushing through productivity-enhancing reform during an economic slowdown results in immediate pain but deferred benefits. However, inaction is not an option, as tensions are mounting. Local government revenues are under strain as revenues from land sales dry up; corporate tax takes are also under pressure. Financial repression also seems to be hitting its bounds, as nonperforming loans are growing and an increasing number of Chinese are attempting to get money out of the country. This could play out in a number of ways, but extreme outcomes such as external demand restoring growth or a financial crisis seem unlikely. Rather, it seems more likely that China will attempt to muddle through, gradually pushing through reforms as the recovery allows.

These developments create uncertainty for investors, and suggest a few takeaways. First, the risk premium for Chinese equities is set to remain high, given the likely continuing deterioration in the corporate sector and uncertainty over the direction of policy. Second, much of the apparent cheapness in Chinese equities comes from bank valuations, but these remain unattractive. The sector will likely be forced to absorb more bad loans as the slowdown plays out, adding to the pressure on profits and stunting future growth. For risk assets more broadly, China may be a source of future market volatility, as policy formation is not transparent and many investors may be caught unprepared for significant changes in policy. Slower growth should weigh on oil and metal markets. Finally, given that Chinese equities are the largest constituent in the emerging markets index, it seems likely that emerging markets will underperform their developed peers. ■