THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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China: It's Built, Now Will They Come?

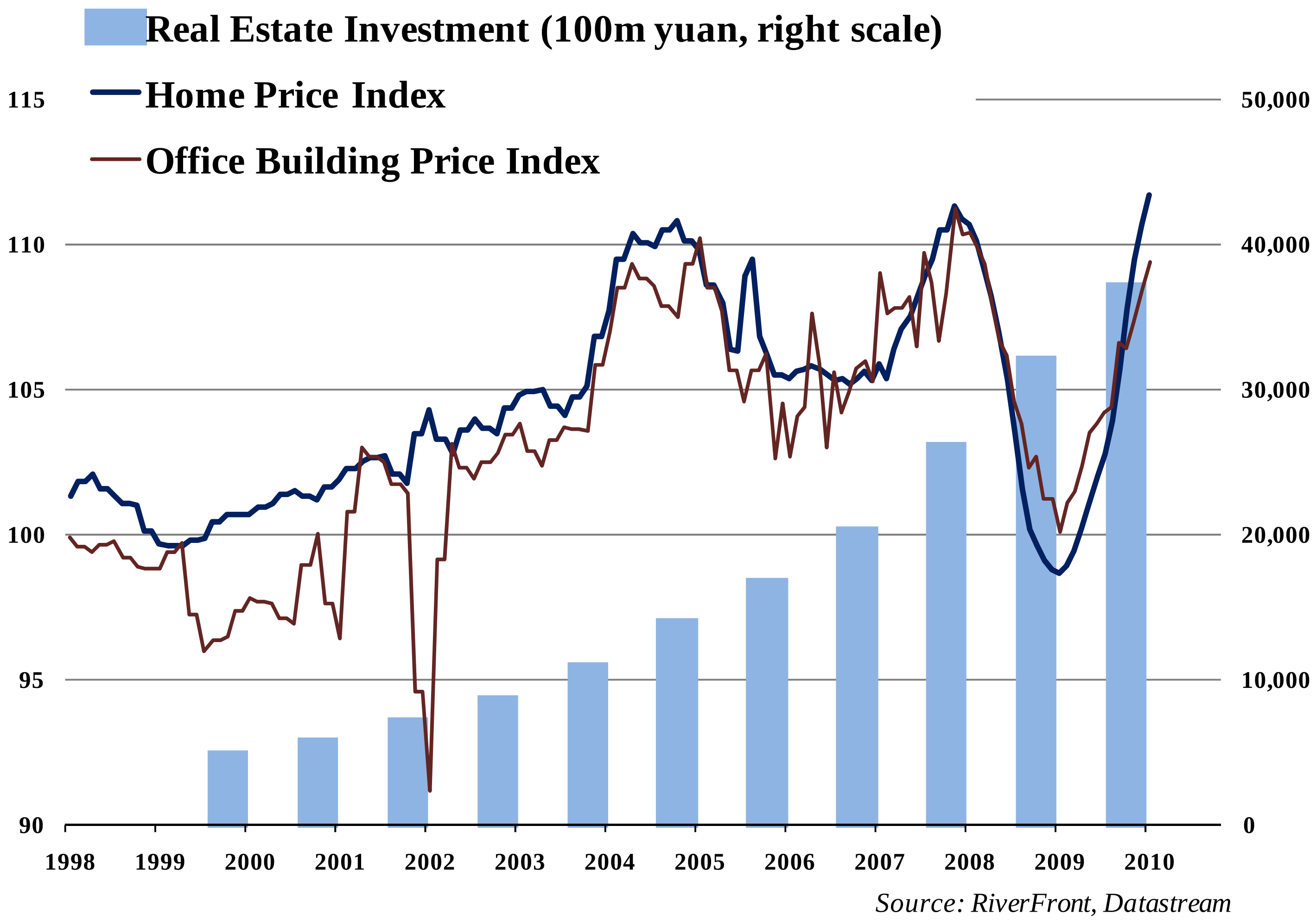
- There is a raging debate regarding China. The bears see the investment boom of the last decade creating a property bubble that will soon burst. They also see excess capacity that will cause significant profit declines leading to a bear market in stocks and a major speed bump for China's economic growth. The bulls acknowledge the need for more consumption and less investment during the next phase of China's growth, but say that most of the investment will be absorbed by the rise of the Chinese consumer. They point to strong growth in productivity and real incomes, China's high savings rate and healthy government finances. Relying on Chinese government statistics (a potential problem) we find evidence of overinvestment but not of an asset price bubble. We are therefore willing to conditionally side with the bulls as long as the economy successfully transitions towards domestic consumption and away from exports as the primary driver of growth. In our view there is not enough external demand to justify the investments that have been made. We think a decision to allow the yuan to resume rising against the dollar, which seems increasingly likely, will be an important step in the right direction.

- **The Bear Case:** GMO's Edward Chancellor, author of a seminal book on asset bubbles called *Devil take the Hindmost: A History of Financial Speculation*, has recently published a paper entitled *China's Red Flags* (which can be found at www.gmo.com). It concludes that, "China today exhibits many of the characteristics of great speculative manias." Neither the bulls nor bears dispute that China's nominal investment has grown at a trend rate of 18% per year for almost 40 years. The bear case is that overinvestment has led to unsustainable excess capacity and that property prices — both commercial and residential — cannot be supported by current income levels. The bears are especially exercised by China's response to the Great Recession, which led to a 30% increase in local government-sponsored fixed asset investment in 2009 and to investment spending representing a record 58% of GDP. Infrastructure accounted for more than two-thirds of this spending, despite low usage figures for roads and airports relative to world standards. We share the concern over China's excess capacity and also worry about the inflationary consequences of China's 2009 surge in bank lending.

- **The Bull Case:** BCA Research's China analyst Yan Wang recently tried to allay the bears' concerns. In his view, "the real problem in the housing market is insufficient supply being exaggerated by surging demand," and that, "the macro implications of a few localized housing bubbles should not be significant." This may be too sanguine in our view, given the 2009 surge in bank lending, but the fact that domestic credit as a percent of GDP is only now back to 2003 levels suggests no bubble. Furthermore, new bank lending was 70% lower this March than in March 2009, responding to new government directives, which are seeking to curb speculation. Even as investment growth has averaged 18% in the last 40 years, nominal consumption has grown at a trend rate of 15% over the same time period and consumers' balance sheets are scarcely leveraged at all. Low consumer leverage should help China, which has recently surpassed the US to become the largest buyer of new cars in the world, to sustainably expand domestic consumption. Finally, *The Economist* magazine has just updated its global house price survey and concludes that China's house prices are very close to fair value, whereas it finds many other markets such as Australia, Hong Kong and Spain to be significantly overvalued.

- **Our conclusions:** We find little evidence of overheating in house prices or commercial real estate, based on the published data. Prices fell sharply in 2008 and are only now recovering to levels seen in both early 2008 and 2004 — hardly a bubble in our view (see Weekly Chart). That said, the conditions are ripe for a bubble to build as interest rates are well below levels typical of a rapidly growing economy. It is possible that the government data is not accurate; we will seek other ways to corroborate our findings. A similar picture is evident in the domestic stock market. Shanghai's A-share market ('A' shares may only be traded by locals) is half the level of its 2007 highs. Evidence of overinvestment is easier to find. China has shown it can grow its economy on command by instructing banks and local governments to increase or decrease building projects, but these expenditures have been focused substantially on export capacity. In addition, we believe that the government is able and willing to finance any losses that result from overinvestment. With foreign demand much lower, it becomes critical for Chinese consumption to grow rapidly enough to prevent excess capacity from destroying profits and wealth. China continues to slow lending and thus investment, while consumption seems to be expanding more rapidly than ever. This is the right recipe, in our opinion, and therefore we are not yet ready to become bearish.

The Weekly Chart: Property prices — renewed strength but no bubble



Past performance is no guarantee of future results

Our chart compares Chinese real estate investment (blue bars, right scale) with indexes of home and office building prices. While the price indexes have recovered strongly, they are only about 10% above 1999 levels. In contrast real estate investment has risen to nine times its 1999 level.

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