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China: a Mid-Year Buying Opportunity

Why has the Chinese stock market performed so poorly over the past year when Wall Street has done well? Is the situation about to change?

The differing performance is because of very different circumstances.

US policymakers are struggling to re-establish an acceptable level of economic growth – creating enough jobs, raising incomes – in the aftermath of the debt crisis. Inflation sustained above 2 per cent a year would signal success.

But they are hampered in their efforts by conflict between two powerful and opposed political groups – the more-spenders and the tax-cutters. For the moment, compromise is unobtainable. So fiscal policy is paralyzed and public debt continues to rise.

The only actor with relative freedom to act is the Federal Reserve (the central bank), which drenches the system with abundant “printed” money and nearly-free credit.

But most of the easy money goes into bloated mega-banks, politically well-connected entities -- and investment markets. Its positive effect on stimulating economic activity is negligible.

China’s policymakers are struggling with the opposite problem.

Their economy is so strong – its manufacturing sector now the world’s largest, forex reserves of $3.2 trillion accumulated from huge foreign trade surpluses, high savings ratios, sound central government finances and moderate national debt – that it’s been growing too fast.

One consequence has been inflation that has been far too high – politically destabilizing and dangerous in a nation where roughly a third of personal spending is on food.

Inflation no greater than 2 per cent a year would signal success. China is on the way to achieving that, with the rate down to 3.2 per cent and continuing to fall.

The US is focused on raising growth, China on containing it. The policies are opposed, so no wonder their stock markets are performing differently.

There are early signs that this is about to change:

► The Shanghai A-share index bottomed at the turn of the year and rose strongly for two months. It has fallen back somewhat in recent weeks, but it’s close to its

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200-day average (an upside breach of that level would be regarded by most chartists as significant).

► All the Hong Kong-listed China shares that I monitor are now trading well above their lows of the past 12 months.

► Small businesses, which account for more than two-thirds of jobs in manufacturing, "have witnessed significant improvement in their operating environment" in recent months, Deutsche Bank reports. There are "falling accounts receivables, lower raw materials inflation, increasing profit margin and rising export orders."

► A start has been made on reversing the policy of discouraging economic growth. Since the beginning of the year the central bank has twice cut commercial banks' reserve requirements, which were raised 12 times in 2011 to slow credit growth.

Why the shares are neglected

International investors generally have very low holdings of Chinese stocks.

One reason is that the huge domestic market is largely closed to foreign investors, and completely closed to individual investors. The only avenues open to us are shares of Chinese companies listed outside the country (mainly in Hong Kong), depositary receipts of such firms listed overseas, or foreign multinationals whose profits are geared to business with China.

Another reason for low holdings is negative views towards China.

Some of those are based on prejudice, for example condemnation of the influence of the state over banks and other companies through holdings in their shares. This became clearly farcical when Western governments reversed their own long-declared policies to save their private-sector banks with huge injections of public capital.

Other negative views are soundly based, but their risks to economic growth, and particularly to the earnings of individual groups, are greatly exaggerated:

► There has been huge over-investment by speculators in residential properties, so there are whole "ghost towns" with completed dwellings but no occupants.

► Banks face a big non-performing-loan risk because of over-lending to local governments whose cash flows are under strain because of their over-dependence on revenue from land sales.

► Demand is dangerously focused on infrastructure projects (similar to the notorious "bridges to nowhere" of the US and Japan), and on exports. Consumer demand is far too low.

► Business is notoriously corrupt. Published accounts are unreliable and serious fraud is widespread.

Let's examine those risks…

Chinese invest heavily in real estate partly because of cultural bias. They tend to do so whether they live in China or anywhere else.

Another reason is that mainland Chinese have limited opportunities for investing their huge savings – typically a third of workers' income. Interest rates on bank deposits and state bonds are poor. Equities are highly volatile – in 2007-8 shares lost 70 per cent of their value. Because of government restrictions, it is practically impossible for ordinary middle-income folk to invest abroad.

So instead savers buy new residential properties – not for yield from rentals, but as a capital asset, one that need not be sold for a long time. Investors can afford to take the long view because they don't need to service a lot of mortgage finance, or any at all.

Unlike countries such as the US, the UK or Australia, households' leverage ratio is still quite low. Mortgage loans are only about 15 per cent of GDP, or less than one year's worth of average household savings. And past experience is that Chinese borrowers are among the least likely to default on mortgage loans.

It is true that the Beijing government regards speculation in residential property as a major distortion, and has taken a lot of policy action to suppress it. Policymakers seek to focus construction on social housing – simple but adequate accommodation for sale to, but especially rental to, urban populations that are growing through rural migration of 15 million people a year.

For the construction and property industries, that is a huge and continuing source of business. The official target is to build 10 million social housing units this year, and to provide homes for about 20 per cent of the urban population by 2015.

Another important point to remember is that if the planned slowdown in the Chinese economy seems to have gone too far, perhaps because events elsewhere, Beijing can easily press the buttons to restart speculative demand – not only in construction, but also in related sectors such as manufacture and sale of white goods, domestic electronics and furnishing.

Three reasons not to fear the bad debt risk

More likely than a panic is that speculators divert their attention from underperforming property to equities… or gold.

Banks' bad debt risk, which seems to have frightened investors so much late last year, is another bogeyman.

Firstly, because the general level of public debt is relatively low in China. *The Wall Street Journal* reported recently: "The range of analysts' estimates for the total of national, local and other debts that might end up on the Ministry of Finance's balance sheets is 60 to 85 per cent of 2010 GDP. That is far below public debt to GDP of 94 per cent in the US or 220 per cent in Japan."

Secondly, because when borrowers are in trouble, especially big or politically well-connected ones, banks usually don't push them into default, but delay and extend repayment terms. That's normal everywhere, not just in China.

Thirdly, there's no way that Beijing's rulers – able to deploy the enormous power of the Chinese state, including money printing, fiscal firepower and bureaucratic enforcement – would allow their seven huge state-controlled banks to fail because of defaults by local authorities.

In this, as in so many other things, analysts don't understand political prerogatives. Why should the Beijing authorities be less willing to stand by troubled mega-banks than governments in the US and Europe?

What about the imbalance in demand?

It is a problem, but not an immediate one.

Undue dependence on exports is a danger for any country. But China faces that risk with big advantages:

► As the lowest-cost producer in so many products, it is best equipped to safeguard market share where markets become even more competitive because of sluggish importing economies;

► It is moving rapidly up the levels of technological sophistication, encouraging manufacturers to shift to lower-cost labour elsewhere in Asia;

► It has a high level of control through the Communist state structure, and it has all those forex assets to cushion against setbacks.

There is excessive investment in infrastructure, as there often is with such politically-motivated programmes. But there are nevertheless huge needs in a country whose economy is still growing so fast, where so much of the interior needs to be developed, and where much of the construction is needed to accommodate improved social services – hospitals and schools, for example.

Chinese policymakers are highly aware of the need to increase the weighting of consumer demand in the economy. That would strengthen the popularity of the ruling party.

The most effective way to boost consumption would be to introduce free medical care, unemployment insurance and state pensions, so households would feel less of a need to save and accumulate personal capital.

Such changes are slow coming, with the in-built culture of thrift and the bias of the ruling class towards corruption-rich investment projects holding back progress.

Three reasons not to worry too much about corruption

Corruption is of course an unpleasant, negative reality for potential investors. But it needs to be considered in perspective.

Firstly, it has limited impact on economic growth – otherwise China would not be able to deliver performance that is astonishing even if you don't believe the statistics. (In any case, because of the scale of the informal economy, the figures may understate the case).

Secondly, the only figures in corporate accounts that can't be manipulated are those for dividends. They're paid out, not just entered in electronic or paper records.

Of course, due to corruption there may be less money available for paying out to shareholders. But judging by the figures for Chinese companies, and compared to those for firms listed in the West, there can't be much underperformance. The average annual rate of increase in dividends over the past five years paid by the Hong Kong-listed companies I monitor has been 25 per cent.

CHECK-LIST FOR THE BAD GUYS

If you are worried about investing in Chinese companies because of the risks of corporate crime, here are things to look out for, according to Violet Ho, Greater China MD of global risk consulting company Kroll:

► The first warning sign would be familiar to investors around the world: If it is too good to be true, then it probably is. Look for margins well above industry norms, rapid asset acquisitions after listing, related-party transactions.

► Most common fraud is using shell companies to process deals (often set up by key persons' family members or friends). The shell company is injected into the supply chain and used to create bogus revenues. This is very easy to fake, especially with services, as only people in the management team can say if they actually received services.

► While all sectors may contain companies which commit fraud, those where the supply chain has multiple entry points, particularly where the upstream is farmers or plantations, are most prone. A large supplier base transacting without formal contracts or receipts means you cannot cross-check with reported financials and thus risk increases. This is also true for companies where revenue comes from sales of things you cannot see (virtual businesses).

► Don't trust all-clears by auditors. If the fraud is perpetrated through collusion of multiple parties, both inside and outside the organization, it will be very hard for the auditor to detect.

► Compare statutory government filings with public disclosures. It is common practice for Chinese companies to under-report revenue to the local government by booking expenses in special ways to avoid taxes. This indicates they are corrupt on some level. And there's the risk they get found out.

Finally, I cherish this insight by *FT* commentator John Plender on accounting practice in Chinese business. He says family entrepreneurs tend to keep four sets of books:

► One for shareholders (lousy profits);

► One for the tax man (just over break-even);

► One for the bank providing credit (great profits);

► One for themselves (reality).

Thirdly, what matters to most investors is capital growth. Historic share prices are a matter of public record, so cannot be manipulated. If corruption has been a problem, it means capital growth would have been higher without it. But I would not complain about the average five-year share price increase for those same Hong Kong-listed firms -- 164 per cent.

Moving beyond the negatives, which are far less than they are often said to be, what should we now expect?

► Official policy is likely to continue moving cautiously towards easing.

This is a politically difficult time because of the periodic mass changeover in important government positions throughout the country. Retiring officials still in power won't want to make the mistake of easing up too soon on squeezing property speculation and damping down inflation. On the other hand, they wouldn't want to see too much of a slowdown, which would cost them serious loss of reputation.

So… steady as she goes, with the outgoing leadership probably declaring "victory" in the second or third quarters, ahead of the October changeover.

► If there is an economic setback, China "has plenty of ammunition in its monetary policy arsenal… to deploy," says former chairman of Morgan Stanley Asia Stephen Roach.

► With valuations now very attractive -- an average forecast earnings-per-share ratio of not much above nine times – and a reduced downside risk to earnings growth, Deutsche Bank says it has "a very positive outlook for China's equity markets."

Of course, there is historic evidence that strong investment returns don't correlate with strong economic growth. But rules based on history have a way of collapsing the moment they become well-known and investors base their decisions on them.

In this difficult new world of exploding public debt, what Roach describes as "untested and dubious" central bank policies, and mature economies struggling with poor growth and growing political disaffection, it surely makes sense to choose an economy growing at 8 per cent a year above those struggling to achieve 2 per cent? With retail sales, even in a slowdown, growing at 14 per cent a year? And to invest in companies whose earnings have been growing strongly, while most of those listed in the West haven't done better than recover lost ground?

Some shares to consider

If you're interested in investing directly in Chinese stocks, here are a dozen worth investigating. All are listed in Hong Kong; some are also listed in New York, Germany and London. The figures marked thus [1234] are their Hong Kong tickers.

Asian Citrus [73] is the largest orange plantation owner and distributor in China and is continuing to expand. It also owns the top supplier of tropical fruit juices. Its earnings-per-share growth has averaged 20 per cent a year over the past five, and its share price has started to recover strongly. Its dividend rate is below 3 per cent, but six times covered.

Beijing Enterprises Holdings [392] is a giant conglomerate, but an odd one – two-thirds public utilities distributing gas and water, and operating toll roads, in and around Beijing; one-third beer and infotech businesses. It has a $7 bn market cap and 41,000 employees. Its five-year annual EPS growth has averaged 26 per cent, but it has a low dividend yield of about 1½ per cent.

China National Building Material [3323] is another biggie, a main supplier to the ongoing construction boom – cement, lightweight composites, engineering services. Its yield is just 1 per cent, but that's 12 times covered. This is a major play on the prospect of policy easing.

China Oilfield Services [2883] operates in a booming global sector. Its services embrace every phase of oil and gas exploration, development and production. It's a

play on fossil fuels that's shielded from their price volatility. It has an excellent earnings and dividends growth record.

CNOOC [883], is one of China's three huge oil and gas companies, and has the best earnings-growth record. It's the one with a particular focus on offshore and international development, a strategic priority for this energy-thirsty nation. Its expansions include entries into US shale oil and Canadian oil sands production. Its yield of almost 3 per cent is nearly four times covered.

Evergrande [3333] is the second-largest property developer in China, with 27,000 employees and a market cap of more than $9 bn. It has been recovering strongly from its 2011 low, but still offers a div yield of 3½ per cent more than five times covered.

Haier Electronics [1169] is the world's largest maker and distributor of domestic appliances – airconditioners, washing machines, refrigerators, televisions. It has an annual turnover of $21 billion and 70,000 employees. Earnings-per-share have been growing at an average annual rate of 42 per cent over the past five years. But, like some other high-growth giants, it doesn't pay a dividend.

Huabao International [336] is a specialist in synthetic flavours, fragrances and cigarette components. It has an excellent earnings-per-share growth record and offers a dividend yield of around 2½ per cent thrice covered. The share is recovering strongly from last year's low.

ICBC [1398] is the world's largest bank, and enjoys the ultimate "insurance" of being 75 per cent owned by the Chinese government. It has an excellent record of growth in earnings and dividend payments, currently offering a yield above 4 per cent, three times covered. For years its share has been trapped, oscillating within a channel, but it's starting to look as if it could make a breakout on the upside.

Luk Fook [590] is a specialist manufacturer and marketer of gold jewellery in China, Hong Kong, Macau and North America, operating more than 580 retail outlets. It has an outstanding record of growth in earnings-per-share, averaging 54 per cent a year over the past five, and similarly high rate of increase in its dividends. It currently offers about 3½ per cent, 2½ times covered.

Shandong Weigao [1066] is an attractive healthcare play, as it makes and sells single-use medical products such as syringes, blood bags, orthopedic materials, blood purifiers and stents throughout China. It pays a low dividend, but has shown strong growth in earnings and payouts.

The Link REIT [823] is Hong Kong's largest listed property trust, with a portfolio of shopping malls and car parks. It offers the highly attractive yield of more than 4 per cent, six times covered, and has delivered excellent earnings growth.

The Debt Problem

Although financial policymakers are adept at shifting money around, or simply "printing" it – so foolishly-invested mega-banks and over-spending governments continue to dodge the bullets – none of this provides a long-term solution. It's simply shuffling around debt, even creating more, rather than reducing it.

According to Hoisington Investment Management, research shows that the US's massive fiscal deficits of recent years "will actually reduce economic growth" this year.

"Increased deficit spending does appear to provide a modest lift to GDP for three to five quarters… However, following this small, transitory gain, deficit spending actually retards GDP growth and the economy returns to its starting point at the end of about 12 quarters…

"All that is left is an economy saddled with a higher level of debt, with more of its productive resources diverted to paying the non-productive elevated level of interest rates."

Nassim Taleb – he of "black swan" fame – says quantitative easing, the pseudonym for money printing, "is a transfer of wealth from the poor to the rich.

"It floods banks with money, which they can use to pay themselves bonuses. The banks have money and assets, so they can borrow easily. The poor guy who is unemployed and can't borrow is not going to benefit from it."

Taleb also argues that money printing is a very dangerous course for central banks that indulge in it, because of the risk of the inflation explosion it can cause, down the tracks.

"It's like a ketchup bottle. You try to pour… out of the ketchup bottle. Nothing comes out. And then everything splashes. Inflation doesn't arrive in a nice, manageable way."

Ultimately, our troubled nations have to attract real cash to reduce the mountain of debt, and it's difficult to see where it's going to come from. Owners of capital understandably prefer the relative safety of real assets, such as gold, and low-leveraged investments offering yield, such as property and the soundest companies.

Alternatively, borrowers could attract such capital by offering interest rates commensurate with the risks. Higher ones.

That's started, and has a lot further to run.

Tailpieces

East trumps South: Latest developments tend to support my view that in the long-term contest between the two growth-economy giants, China is likely to retain its lead over India.

Both are slowing, but India more so than China.

The *FT* blames it on "inept economic management, falling investment and stubborn inflation."

Capital investment, the usual engine of growth in emerging Asia, has declined to 14 per cent of GDP. Bloated by subsidies and welfare costs, there's a fiscal deficit of 6 per cent of GDP.

"Given inertia-inducing graft, state meddling in business, and a confusing attitude to inward investment, it is harder still to see growth glimpsing the high-single-digit levels of the past decade again."

Cash piles: Companies in the US, Europe and the UK are now sitting on a cash pile of nearly $8 trillion.

Why are they holding on to so much rather than investing in new productive capacity?

One reason is that they want adequate resources to withstand another credit crisis. This is particularly true in Europe, where companies fear they can no longer depend on banks, traditionally their main source of credit.

Another reason is lack of confidence that demand for their products and services is going to grow much. Again, this is especially true in Europe, where government policies of austerity to curb the growth of public debt are depressing economic activity.

Threat to pensions: In some countries – Argentina, Hungary, Portugal – governments have already expropriated private-sector pension funds as a means of dealing with serious financial problems. There are "warning tremors" that such policies of seizure could spread to developed nations, warns *FT* commentator Tony Jackson.

In the UK governments have long regarded pension funds as an irritant: "pots of gold sitting passive in the economic landscape, when there are exciting policy uses to which they might be put."

Unfunded pension schemes, popular with governments because they hide the build-up of long-term liabilities, could also be hit "at the stroke of a ministerial pen" even though they have no assets to be seized, as benefits can be slashed, reducing their current financing costs.

Bonds: National debt defaults in the past have included forced conversions to extend maturity dates, which reduces their capital value. A different kind of "haircut".

There is intensifying argument over whether the bonds in the balance sheets of banks, pension funds and other funds should be "marked to market" – their value restated periodically to reflect the value at which they are currently traded on the open market.

Those in favour argue that this means balance sheets reflect current true value, taking into account the market's view on default and inflation risks.

Those who oppose it argue that the bonds will eventually repay their issue price when they mature.

Educational trap: The biggest projected increases in jobs in the US over the rest of this decade will be in occupations requiring relatively low levels of schooling, according to Philippa Dunne of *The Lisco Report* – nurses, salespeople, home health aides, personal care aides and office clerks.

Of projected job openings, fewer than 20 per cent will require a college degree, "almost three-quarters will require no more than brief on-the-job training, and 85 per cent will require relevant job experience," she says.

"All those politicians and pundits who love to talk about the need to educate the citizenry – along with the proponents of the job-skill mismatch theory of persistent unemployment – should check with these projections."

Formula investing: A simple approach giving equal weighting to each of the initial constituents of a share portfolio is likely to outperform approaches based on

weightings according to value or price, a new study based the S&P 500 index over the past 40 years has shown.

An equal-weighted portfolio outperformed one based on market-cap weightings by an average of 2.7 percentage points a year and one constructed using price weightings (like the Dow Jones Industrial Average) by 1.1 percentage points.

The researchers attributed the equal-weighting outperformance to resulting greater exposure to smaller and value stocks; and to the lift gained from monthly rebalancing (the contrarian strategy of selling winners and buying losers).

Wasteful handouts: American subsidies for "energy independence" paid for by taxpayers "have a miserable record of reducing reliance on foreign oil," says *The Wall Street Journal*.

Ethanol, the alcohol fuel made from corn and sugarcane, has received more than $40 bn, yet still can't compete with oil-based fuels. For two decades the federal government has poured tens of billions into solar, wind and other non-hydro renewables, yet they still provide less than 4 per cent of the nation's electricity.

"The history of energy subsidies is that they become an industrial and political addiction that is difficult to stop, no matter the results – and may even inhibit innovation and profitability by providing a crutch."

Bad choices: The main reason why most private client managers lost rather than made money last year was that so few of them were prepared to put a fair weighting of government bonds into their clients' portfolios, says Graham Harrison of Asset Risk Consultants.

Most followed the consensus path and overweighted emerging-market equities and underweighted the sovereign bonds, which turned out to be a serious timing error.

In all risk categories, from cautious to equity-rich portfolios, clients lost money on average. Hedge funds had their worst year since 2008.

But little potential: US Treasury bonds are now all risk, little upside potential. Essentially that's the message from Bill Gross, joint chief exec of the world's largest bond fund manager, Pimco.

Yields are so low, so close to what he calls the "zero bound," that there is little room for them to fall further, and therefore little if any chance of appreciation in the bonds' capital value.

In the Treasuries there are now "multiples of downside price risk" compared to appreciation potential.

Labour costs: One sign of how American workers are being forced by international competition to accept a reduction in their high living standards is that the latest labour contract by the Big Three automakers – GM, Ford and Chrysler – agrees a starting rate for new employees of only $20 an hour, way below levels labour unions insisted on in the past. At the new Toyota plant in Mississippi, the pay is only $15 an hour.

No bubble: Although there's now a lot of empty houses and other buildings in China, it's a situation "very different from what happened in the US, as the leveraging was not as high as in the US," says Mark Mobius of Templeton Emerging Markets. "They don't have credit-default swaps and there are no derivatives on housing. There is still a big demand for housing… it is a matter of price." He expects prices to continue to fall.

Risks in infrastructure: Although pension funds are increasingly attracted to investing in infrastructure projects such as toll roads and airports, because of their stable long-term income flows, such projects "are a lot more risky and cyclical than their supporters allow" and investing in them requires skills "that few fund managers possess," says *FT* commentator Tony Jackson.

The burden of childcare: The British government's crackdown on tax evasion has highlighted the huge cost faced by working parents who need to employ a fulltime child carer, without the tax breaks offered to such parents in many countries. The average cost in London – pay plus taxes – is now the equivalent of $58,000 a year.

European deadbeats: Many analysts argue that refinancing the huge debts of the Eurozone's troubled "peripherals" won't solve their fundamental economic problems because it won't solve their foreign trade deficits by boosting demand for their exports.

For the sake of their citizens, says commentator Rob Parenteu: "Pray there is life on Mars that exclusively consumes olives, red wine and Guinness beer."

Why predictions fail: All the mathematical models on which economic forecasts are based "make assumptions about variables that allow the models to work," but "what they end up showing is not related to the real world, which is composed of dynamic, and not static, variables," says John Mauldin in his new book *Endgame*.

Grounds for optimism: Three very important reasons for being long-term bullish, says leading technical analyst David Fuller, are the abundance of affordable energy (abundant shale reserves, nuclear power), an exponential rate of growth in technological development, and rapidly-expanding middle classes in the growth economies.

Banks: The assets of France's five largest are three times the size of the French economy. But those of the UK's biggest are close to five times GDP – and the nation's fiscal deficit is far worse than the average for the Eurozone.

Foreign earnings: Around 35 to 40 per cent of sales for the US's 500 biggest listed companies originate overseas, with some 40 to 45 per cent of those coming from Europe, according to Brewin Dolphin chief strategist Mike Lenhoff.

Benefits for ruling elites: Americans "increasingly realize that powerful government nearly always helps the powerful, whether the beneficiaries are a union that can carve a sweet deal as part of an auto bailout, or corporations that can hire lobbyists to write a tax loophole," comments *The Wall Street Journal.*

Wise words: *Extreme indebtedness is a deterrent to growth. It's not a positive for growth. What the classical economists said is true: What creates prosperity is the hard work, creativity and ingenuity of individuals and businesses. Your prosperity does not come from governmental financial transactions.* Dr Lacy Hunt.

Martin

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