Asian Economies and Investment Outlook

China did not save the world in 2009. It saved itself. When international investors effectively refused to further finance the Western economies, it became clear that the Western consumer would soon be the Western net saver.

This was potentially very damaging for nations built on selling cheap apparel and appliances to the West. It would represent a direct hit on China's GDP through depressed exports.

China's reaction was to use government expenditure, mainly on infrastructure, to plug the gap and then some. Some of this effort would manifest through investments made by quasi state controlled private enterprise. Consumption in China remains modest as average savings rates remain high. Despite a growing middle class, high income inequality leaves a large population below a threshold of income where discretionary consumption kicks in. The massive consumerism visible on luxury companies' cash flow statements represent a minute proportion of the massive population.

Not all the infrastructure spending was financed out of reserves. Credit creation at the municipality level has financed a substantial amount of infrastructure, some 2 trillion USD of which has been securitized in off balance sheet vehicles called Local Government Funding Vehicles not dissimilar to the familiar SIVs in the developed markets which met their demise in 2007.

Infrastructure investment (expenditure) has its limits and unfortunately the debt related troubles in the US and Europe have taken some 3 years to get nowhere and will require significantly more time for resolution.

With the large scale debt monetization of the Fed (QE2) at an end, it has become apparent that the US economy is struggling, and will struggle, absent any extraordinary stimulus policies.

The ECB's recent rate hike must be the most puzzling piece of policy in recent European economic history, given the state of the European economies.

The problems of Europe and the US are well known and have been analyzed ad nauseum. They will not be the engine of growth to carry the global economy for some time to come.

What of Japan? That economy, while important within the context of the global industrial supply chain, is in decline. While its economy languishes, per capita GDP growth remains healthy and is an acceptable state of affairs if one takes a more insular view. China’s ascendancy seems to have relieved Japan of the duty of exporter supreme in the global economy.

Debt allowed the global economy to grow and to consume more than it was able to without debt. It sounds tautological but the implication must be that as debt is slowly reduced through being paid down, which can only occur at a pace implied by economic growth, growth and consumption must either slow down for a protracted period, or fall in an abbreviated one.

At the terminal point of the consumption chain was the Western household. A new terminal consumer needs to be found and that hope has been pinned on the Asian consumer. In order for this to happen, not only must incomes rise, they have to do so broadly enough that sufficient numbers are taken above that uncertain threshold at which discretionary consumption becomes a reality. For China and India, being relatively poor countries when one looks at the number of poor people, this process is yet slow. It can be augmented if government spending and private investment can improve productivity and if the gains to productivity are equitably and evenly distributed across the population. Income inequality needs to be addressed. There are signs that the Chinese government is cognizant of this and has taken steps to improve wealth distribution, however, the Gini coefficient is still high and rising. In this Communist country, controllers, if not owners, of capital still manage to extract rents while the style of Chinese capitalism eclipses the Western kind for its unbridled nature. Left unchecked, Chinese Capitalism is likely to fulfill the Marxist prophecy leading ultimately to the proletariat strenuously challenging the legitimacy of the Chinese Capitalist. In the meantime the Party will do its utmost to maintain stable and robust economic growth while it buys time to address its raison d’etre.

For this reason, while Western economies struggle, and Chinese exports slow down, the government will likely continue or resume its infrastructure build. The softness in resource markets and resource driven economies like Australia are likely to be shortlived. While inflation is a major problem it is driven as much by international liquidity as domestic credit and fiscal expansion and is a serious constraint to policy. China’s solution to its own problems it would appear are of the same nature of the European’s and US’s to their respective problems, that of ‘kicking the can down the road.’

This makes an interesting a
rgument for an extension of the continued rise of gold. If Western and Asian households are all saving and not consuming, then the fundamental driver of economic growth is weak and needs to be supplemented with fiscal policy or investment. In weak growth environments corporates have hoarded cash and run conservative balance sheets. Governments are left to fill the gap. If therefore governments are borrowing, they need to either monetize their debt

or coerce or otherwise encourage private investors to purchase their debt, it is no surprise that inflation is persistently high and gold is rising.

The implications for Asian growth are less straightforward. Asia remains an area of robust growth. But asking the Chinese to continue to support US treasuries is a bit like asking the Germans to bailout the Greeks. The difference is that without a common currency, and with the US unable to default in their own currency, an effective default would come in either a much weaker USD/CNY or much higher USD interest rates. The Chinese reaction to weaker USD is clear to see. The analogy is further supported when one looks at the relative incomes between German versus Greek households, and between Chinese and US households. The relationships are not identical but they are similar. The similarities have simply been masked by the absence of a common currency between the US and China. There the analogy ends.

For where the European need to hold the Euro together for other than commercial reasons, such constraint does not bind the US and China. Eventually the CNY must appreciate relative to the USD. (This has implications for the HKD. Eventually the HKD is more than likely to have to hold with the CNY.) This is analogous to the Greeks being told that they should print their own Drachmas.

Before this happens, the Chinese have to address the imbalances in their own economy because a repricing of the CNY USD rate will affect the export sector adversely.

In the long run investing to take advantage of Chinese domestic consumption will reap returns. In the short run the same strategy will work albeit subject to volatility. The Chinese economy, however, will face headwinds as the West lurches into another recession. This will affect domestic consumption in China to be sure. But exposure to exporting China will be painful. In the short to medium term, it pays to be exposed to defensive sectors in the domestic Chinese economy. The time is not yet for cyclical sectors and the time has well past for exporters.

Trade will suffer.

The same analysis should apply to Asia ex China in terms of assessing the prospects for businesses exposed to Chinese industries.

Singapore is in an interesting position. Its trade and entrepot economy can be very exposed. Its size affords flexibility to position itself to take advantage or to take the blows. Singapore’s strength is likely to be in its financial sector where the barriers to entry protect it from Chinese competition and make it a valuable partner instead. The regulation and turmoil in Western financial systems is likely to favour Singapore, as it has already done. This is a long term theme, however, as long as regulation and governance maintain their current balance between ‘light touch’ and vigilance. The leisure sector is also likely to grow. Manufacturing is likely to struggle as other countries fight to rebuild manufacturing domestically.

In the short term, the commodity countries will resume their resource driven booms. The depth of the volatility in the coming months is hard to tell but resources have a nasty volatility sting.

The future is as always uncertain but we can summarize our best guesses:

– China will press ahead with infrastructure build until domestic consumption can drive the economy

– The USD will weaken significantly to the RMB.

– Trade will suffer as all countries fight to export.

– Domestic consumption is the best short term and long term China investment strategy.

– As trade protectionism rises, Western exporters will become a less effective way to express this theme…

– Asian exporters to China are more a more effective trade expression to the abo
ve.

– Domestic Chinese companies are also an effective trade expression.

– Indonesian and Australian resource plays are likely to benefit from continued infrastructure build.

In the short term, the problems in the West are likely to drive all market lower. The above is a best guess roadmap for building a shopping list for which to execute at lower levels in the next 12 months.