

China. A positive outlook at last.

The China A share market surged last week. It is time to reiterate my optimistic appraisal of the China market. It is not too late.

Back in July, we noted that

1. China equities were underowned.
2. China equities were trading cheap.
3. China equities had been in a 6 year bear market. This was most likely the consequence of the PBOC's tight monetary conditions.

We postulated that the PBOC's stance was driven by inflation concerns in the traded goods sector and the volatility in the commodities and food markets. 3 years ago food prices were rising at nearly 15% YOY and has since hovered between 2.5% to 5% since. It is likely that the PBOC views the US Fed's expansionary balance sheet policy as a source of inflation in the traded goods sector and felt it necessary to compensate. Another concern was the growth of the Shadow Banking system in the form of off balance sheet funding vehicles. This is a more complicated topic but one which I believe has less of an impact on PBOC policy. The reason is that credit can be isolated in a semi closed economy whereas traded goods are sufficiently open to be impacted by international flows.

The trigger for the buy recommendation was the impending end to the US Fed's expansionary balance sheet policy. With the end of QE, while the Fed's balance sheet will not likely shrink quickly, or at all in the short term, it is at least static. The latitude that this provides the PBOC in expanding liquidity to support a slowing economy is important. China's inflation has slowed to 1.6% with food inflation down to 2.3%. Widespread global disinflation will impact the traded goods markets in China providing further room for expansionary policy. The impact on semi closed markets, whether by nature or regulation, such as services and asset markets, is inflationary.

I previously held that China had a long term innovation deficit and that it had to buy or otherwise acquire technology. I am still of this view, but there are nuances to that view. The cutting edge of technology remains in the developed Western

economies, but **China** is catching up. There is a chance that this long term trajectory can be reversed. For investors and traders, a shorter time frame is more relevant.

One of the more important developments in **China** took place last week. The Fourth Plenum produced a number of interesting and constructive signals. The Central Committee chose to reduce the influence of local level officials over the legal system, establishing circuit courts with greater independence from local Party officials. There was some woolly announcement about accountability and transparency of government but details were scant. The most important announcement was the elevation of the constitution within the rule of law. The consensus is that the Party's authority would not be weakened by constitutionalism but an optimist would hope that while the Party might not be compelled to work within the constitution, it might work with the constitution to more efficiently and fairly govern the country. Certainly this focus on the constitution places the anti corruption efforts in a less cynical perspective.

Bottom line: We are likely to have an expansionary PBOC and we are hopeful that concrete legislative reform is underway. At the same time we have cheap stocks and healthy growth at a time when developed markets face deflation risks and other emerging markets like LatAm face stagflationary risks, China is a good place to invest.