China In Transition. Outlook for the Chinese Economy.

Despite strong economic growth, Chinese equities have been derating over the past few years. There are technical reasons for the underperformance, mostly due to regulation and the nature of the investor base, which are mostly domestic retail investors. Still, this does not explain the cheap valuations in offshore listings of Chinese companies.

The current structure of the Chinese economy is unbalanced with an over reliance on investment and exports. These features are not bad in and of themselves, however, when globalization is being slowed down or rolled back, when capital is scarce and when trade policy becomes more contentious, such over reliance becomes a weakness.

China is embarking on a rational if unpopular and short-term painful reorganization of its economy. Some of this reform is being forced upon it but it is in line with the long-term objectives of Chinese. Fortunately, China is in many respects still a centrally planned economy, the sovereign balance sheet is healthy, the workforce is diligent and productive, households are thrifty, and the urbanization cycle still has far to run. Standing against China is rampant corruption, domination of State Owned Enterprise in industry, and complexity of regulation and administration. These issues are currently being addressed by the government. Still, there is much left to do.

1. Urban and rural land reforms.

2. Environmental protection. Take a walk down any street in Beijing and see for yourself. Or not see, as the case may be.

3. Red tape and uncertainty of administration and regulation are a drag on growth as well as provide fertile ground for corruption. Administration needs to be simplified and trimmed down.

4. Reform of the Hukou system. It can be argued that the hukou or huji system limits labour mobility and thus efficiency in the labour market, among other things. It is also a highly discriminatory policy. Reform is not so easy as social and community issues need to be simultaneously addressed.

5. As part of a longer term plan, China will need to address its demographics. Policies such as the 1 child limit may need to be re-examined.

6. As China matures it will inevitably face heavier burdens on its welfare systems. Issues surrounding unemployment benefits, healthcare and pensions will need to be addressed.

7. Fiscal and taxation reforms will have to undertaken. Current systems are not only inefficient, they are not well-defined leading to much uncertainty, always a breeding ground for rent extraction and creative reporting/accounting.

8. A move towards full liberalization of markets and the abolition or moderation of price controls. This is particularly important in resource and energy markets.

9. Liberalization of the financial system, (interest and exchange rate reforms). Current price controls disrupt the signaling value of prices and oppress savers to the benefit of borrowers.

Not all of the above are issues specific to China. Indeed China has the luxury of being a few steps behind and learning from the experience of other countries. What is clear is that, not all of the above will be addressed, and even when they are, opposition will come from interest groups, however, change is at hand. If the crisis of 2008 was useful in one respect it was to shake the world out of its stupor. The West was over-consuming and over-borrowing while the emerging markets were happy to provide vendor financing to them in return for strong economic growth. It also challenged established wisdoms, though some fallacies survived unscathed. The danger is that only half the lesson is learnt.

China’s efforts to diversify its sources of growth are laudable. There will, however, be winners and losers, as in any reorganization and this makes Chinese asset markets a fertile ground for alpha generation through stock selection. An index or passive exposure strategy to investing in China will be less useful, perhaps even counterproductive. The index is replete with banks, big exporters and resources. Financial and resource sector reform will likely remove the crutch of state support for these sectors, causing them to underperform and drag the index with them. Exporters will face increased competition. Over time, the success of domestic and consumer stocks will gain them entry to the index. It pays to cast the search for tomorrow’s market leaders today among the small and mid caps and companies less covered by sell side research.