China Revisited. Investment Prospects In The Middle Kingdom.

To understand the Chinese economy it is necessary to understand the collective Chinese psyche. it is one of great insecurity, feeling hard done by from all quarters, still harbouring an inferiority complex, and thinking that the world sees it as weak, backward and belligerent. As a result, it comes across precisely as insecure and belligerent. Even as China engages more openly in the international arena, China’s neuroses require it to behave more aggressively than it has to, for a local domestic audience, to address and belie perceived weaknesses. Most of China’s external behavior becomes more explainable in this context.

At home, China’s people have grown comfortable and confident in their economic success. Economic policy, however, is no surer, no more confident, certainly no more confident than the US Fed for example. China’s reform efforts to instill rule of law, market discipline and strength of institutions, have introduced more uncertainty into policy. It is this uncertainty that complicates much of China’s policymaking in recent times. In a centrally planned economy, policy was decree and there was a clear separation between target and measure, between state variable and control variable. As markets become more open and price driven, the effects Goodhart’s Law assert themselves. Policy cannot be made without considering the reaction of the economic agents and without risk of triggering unintended consequences. Legacy cultural tendencies to report success and suppress failure lead to noisy macroeconomic data exacerbating the problem of effective policymaking.

China’s ministry of finance, central bank and market and banking regulators are intelligent but are also inexperienced in operating under such conditions where policy is no longer simple or linear. Policy under open markets with all the feedback loops introduced by expectations mean a lot more than policy but include skillful communications and management of expectations. Recent policy missteps by the regulators have not so much been a failure of policy than a failure to manage expectations and communication.

In China, the state has interfered extensively and directly in allocating resources through administrative and price controls, guarantees, credit guidelines, pervasive ownership of financial institutions and regulatory policies, and it has done this with the SOE as principal accomplice. Recognizing the inefficiency of SOEs, China is in the midst of reforming the sector. Foreign investment will be introduced into state-owned firms via restructurings and joint ventures, as well as overseas mergers and acquisitions, the State Council said in new guidelines on SOE reforms. While welcome, the statement was deemed insufficient and vague. Notwithstanding the size and influence of SOEs, some believe that the driver of growth in China has been private businesses. According to the Economist: “Average growth in output for industrial private firms since 2008 has been 18%, twice as much as for industrial SOEs.” Private enterprise is heavily disadvantaged in particular in terms of access to credit. SOE’s still consume more credit and at lower cost than private enterprise and therefore represent unfair competition to the private sector.

China has a history of enterprise and innovation. The current centrally planned economy is in many ways the last ripples from the anomaly that was Communism which gripped China in 1949. China’s rehabilitation began with Deng XiaoPing who a reformer and rolled back some of the less sensible Maoist policies and principles. After him, Jiang ZeMin was the pragmatist, slowing reform where it threatened to rupture the economy or society but maintaining the general principle of Socialism with Chinese characteristics, Jiang’s own slogan was “socialist market economy”. Jiang’s leadership saw the demise of many SOEs as market reform exposed their un-competitiveness. It also coincided with a increase in corruption and cronyism and in the emergence of an oligarchy with penetrating interests in government and business. The next 10 years under Hu JinTao saw a maturing of the Chinese economy with all the associated social frictions that come from a growing middle class. In many ways, the Hu leadership set the stage for the current leadership under Xi as it sought to address some of the inequality and excesses of wealth and influence in China. Notably Hu’s government began to address corruption and lack of transparency in government and sought to narrow the gap between rich and poor as well as development between coastal areas and the interior. It was also a period where China began to more actively integrate itself into the global community beyond a purely commercial context and to assume more of the social and political norms of developed nations. Navigating this evolving political landscape was a vibrant private sector full of innovation and enterprise, saddled with the burden or task of working around market distorting policy, but profiting from the surge in investment in infrastructure both physical and institutional.

The image of China as a backward, reverse-engineering, IP stealing, technological laggard is persistent but mistaken. In 2014, the top and third most prolific patent filers were Huawei and ZTE, both Chinese companies. China’s annual R&D spend as a percentage of GDP, at 2%, has now exceeded Europe’s and is catching up with the US’s 2.8%. The numbers belie another trend, which is that private sector innovation is driving growth. Total factor productivity is growing 3X faster at private firms than at SOEs, according to the World Bank. A report by the

McKinsey Global Institute finds that Chinese firms are particularly adept at innovation in a number of industries, in consumer facing indu
stries such as e-commerce, in efficiency driven ones, such as manufacturing but lag in science and technology. Over regulation in developed countries may also provide China’s pragmatic model with an advantage. The same heavy hand of the state that meddles may also turn a blind eye to less ecologically or ethically ambiguous pursuits where more conservative western regulators would have acted.

China under Xi JinPing is facing the continuing issues of a growing middle class and a slowing economy, slowing naturally under the weight of its own size, the consequence of prior growth. Slowing growth is to be expected; economist sometimes forget that constant growth is exponential growth and unsustainable. The burden of central planning sitting alongside private enterprise is that price signals are attenuated leading to misallocation of capital and in China’s case, over investment and over capacity. Other areas such as consumer credit and mortgage credit are undersupplied. Recognizing these imbalances, the Chinese government has engaged macro prudential policies to redirect the flow of credit and lower the cost of credit for particular segments. Specifically, they intend to prevent excess credit in speculative markets, local government white elephants and SOEs while improving the access to credit for SMEs, private enterprise, consumer loans and mortgages.

At a more fundamental level, the Communist Party is trying to reform itself. This may appear mainly cosmetic but there are good reasons why the reform may be in earnest. A growing middle class, a better educated people, the proliferation of social media, have created an environment of de facto transparency which the government cannot reverse. To stave off an existential threat, the Communist Party has to embrace greater transparency, the rule of law, reliance on institutions, and other international norms as its new pillars. If you cannot hide, you should not try, is the principle. Transparency also places a greater responsibility back upon the people to play their part and to respond appropriately to policy. The new ideal is, however, in its own way, difficult to manage, especially for a government unused to intransigence and criticism. The rapid development of China, the size of her economy and the massive forces at play can be intimidating to the government and can and has led to policy miscalculations and hesitations. The handling of the sharp downturn in the domestic A share markets are an example.

From 2010, the PBOC the central bank has kept monetary conditions fairly tight with interest rates rising from 5.31% to 6.56% and the RRR rising from 15.50% to 21.50% as inflation accelerated from 2009 through 2011. Despite cheap valuations and decent earnings growth

Chinese equities performed dismally, locked in a bear trend from late 2009 to mid-2014. It was only when the PBOC embarked on expansionary policy as US QE was tapered off and inflation receded that Chinese equity markets were ignited. From mid 2014 to mid 2015, the Shanghai Composite Index rose 148% in a liquidity accelerated ascent that defied reasonable valuations. Latecomers to the equity rally used leverage and margin accounts to boost returns and drove valuations further out of line with fundamentals.

Note that the motivation for the PBOC's expansion was falling inflation and slowing growth, both incompatible with accelerating earnings growth. The market was driven by liquidity and sentiment alone. This is not to say that the astute investor recognizing the dynamics of the market could not participate profitably but it did mean that at the end the exit cost would be high. Ultimately the rally was ended by the confluence of an accelerated IPO pipeline, weakening company fundamentals, and the regulators themselves removing the punchbowl by regulating the growth of margin trading accounts.

Having burst the equity bubble the PBOC, alarmed by the pace and extent of the correction acted to slow the descent and limit the downside with a series of clumsy regulations including short sale bans, selling bans, market support funds and moral suasion. For all of September, the Shanghai Composite Index traded in a narrow band between 3000 and 3300. A 148% bull market had ended in a -44% bear market and although the market remains some 50% higher than when the stock frenzy began, sentiment has been damaged and the China market has become both the centre of attention for global investors and the alleged culprit for every market disappointment from the US to emerging markets.

In June 2015 the Shanghai Composite traded at a PE of 21X, still shy of the 27X seen in 2008; it currently trades at 13X, closer to levels seen in 2011. While growth is slowing, earnings growth rates remain high at over 20%. H shares in HK currently trade at a PE of 7 albeit with lower earnings growth potential, well below the recent peak of 11X in June 2015. These are aggregates of course and hide a rich detail. But even so, Chinese stocks which were acutely over-valued in the summer are now cheap.