Understanding China and How To Invest There.

China’s growth is evidently slowing and investors are concerned. China is the second largest economy in the world, and it is a manufacturing hub importing commodities and intermediate goods and exporting finished goods. More recently, China has extended its connectivity beyond trade in material goods but has sought participation in and sometimes led the establishment of significant clubs in the international arena. The establishment of the Asian Infrastructure Investment Bank, and the inclusion of the RMB in the IMF Special Drawing Rights are examples of how China seeks to engage and be part of the world. However, it is feared that its current and future position makes it a nexus for economic and financial contagion. To understand the potential for this it is useful to understand why China is slowing and if that rate of deceleration is a cause of concern or not.

Since 2008, the world has been in a Cold War in trade. As countries exhausted domestic consumption, their financial markets stopped funding business investment and their governments exhausted reserves in rescuing their banking and financial systems, trade became the only viable source of growth. A currency war was fought under the cover of financial system desperation’ it continues in fits and starts today. Weak economic data has become a relief as it justifies more monetary analgesic and currency debasement. New battlefronts have opened in the form of re-shoring in the case of Western economies previously happy to outsource manufacturing to foreign shores. The evidence lies in the stagnation of global trade since 2012. For an economy designed to export like China, a trade war is damaging. Exports as a share of GDP have fallen from 36% in 2006 to 22.6% at the end of 2014.

A related theme is the balance between manufacturing and services in the economy. Globally, services are growing whereas manufacturing is in decline. This is another consequence of the Cold War in trade. Manufacturing is more export sensitive than services so as global trade slows more than global growth, manufacturing must slow relative to services. This is a phenomenon measured from Asia to Europe to the US. As manufacturing capacity is re-shored, countries like China must experience a surge in excess capacity, even if GDP does not actually shrink. In the case of China, because manufacturing was the larger contributor to output, its relative weakness translates into weakness in aggregate growth.

It is illuminating of the culture that the shift from investment and exports to consumption and services is portrayed as an intentional strategy when fact it is a phenomenon which China cannot avoid.

Then there is the matter of simple mathematics. Economies are expected to grow exponentially even though this is not realistic. Economists expect constant growth rates or use this as the basis of their calculations even when they don’t expect constant growth rates. When growth rates are high, the path of nominal GDP levels, not growth, is exponential. When growth rates are lower, constant growth rates approximate linear growth in the level of nominal GDP. Technically, the higher powers of the polynomial can be ignored when the growth rate is small, and the linear component is sufficient to capture the growth. When China’s GDP was 3.5 trillion USD, it was easy to grow at 10% per annum. China’s GDP is some 11 trillion USD in nominal terms. If China adds 700 billion USD of nominal output every year, that is it grows linearly, growth this year, 2016, would be 6.4% and growth in 2017 would be 6.0%.

While China’s slowdown is understandable, it cannot and will not simply passively accept its fate. China recognizes that as the world evolves it too needs to keep up with it. It has to address a number of issues.

As China opens up as it evolves it has to adopt international standards and norms consistent with a free and enlightened society. The complexity of managing an economy without arbitrary control over the populace is risky both economically as well as socially. To diversify its risk, the Chinese Communist Party recognizes that rule of party poses to itself an existential risk, a risk which can be mitigated by embracing rule of law. This is already well underway as evidenced by the focus on the constitution and the anti-corruption campaign.

China is engaging the world by joining and creating economic and political coalitions such as the AIIB. It continues to engage in trade as buyer even if its export competitiveness has been eroded. China’s adventures in the South China Sea are most probably a device to appease the nationalists at home who tend to have a bit of a persecution complex and see China’s engagement in the context of weakness.

China is spending more on R&D than ever before and has overtaken the US, Japan and Germany in terms of patents filed. Not all of this frantic patent filing will be productive but China is reacting to the charge that it has a poor record of generating intellectual property and is more adept at stealing it or buying it.

Change has direct monetary as well as opportunity cost. Rebalancing an investment and industrial heavy economy to consumption and services is costs in growth. China has stated that it wishes to maintain growth near current levels, impossible without central bank largesse. The PBOC has been busy providing liquidity to the economy to compensate for the slowdown associated with restructuring costs. We have seen the debt accumulation post 2008 as China first reacted to the new reality in international trade. This will continue. The PBOC, however, knows it can only deal with one problem at a time and it has chosen to allow debt to pile up, as it must, but tackle the more immediate issue of debt service. Enter targeted open market operations and debt restructurings, particularly of local government debt, to reduce the debt burden on the more indebted corners of the economy, the local governments and SOEs. At the same time it is directing credit towards SMEs and households. Unlike developed world central banks who pull 2, maybe 3 levers, interest rates, size of balance sheet and maturity schedule of balance sheet assets, the PBOC has many more levers and behaves like a creditor committee working to maintain the going concern of its massive economy.

China is full of opportunity but it has never rewarded the macro investor who buys equity index exposure, not for long anyway. Investing in China requires an understanding of businesses, their prospects, the behavior of management and of the government who continues to direct capital where it is needed and siphon it away from where it isn’t. China is a stock pickers market but fundamentals are but one small part of the analysis. Policy, frustratingly opaque and seemingly arbitrary, play an important part also, in determining price discovery in this fascinating market.