GUINNESS ATKINSON FUNDS

China brief


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Commentary and Review by Portfolio Manager Edmund Harriss & Analyst Mark Hammonds

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China's economy continues to undergo reform as the government presses ahead with its transformation plan and at the same time tackles corruption within its ranks. The effect is to place a drag on economic growth, but this is a price that has to be paid. However, this has also led to (more) warnings of an economic crisis prompted by an over-inflated real estate market and a too-rapid increase in debt. We argue that China is pursuing a more intelligent and prudent approach to tackle these issues than they are given credit for and from a position of greater strength than is often appreciated. For investors this might suggest that Chinese stocks trading on valuations at multi-year lows present a very attractive risk/reward profile.

China – Stronger than you think?

For the last three years there has been a steady drum beat warning of a Chinese economy overwhelmed, sinking into a mire of corruption, overcapacity and debt. Economic data are scrutinized each month with weaker numbers prompting calls that China 'must' provide stimulus, followed by relief the next month when signs don't look so bad. The actions of policy-makers tell a rather different story. While stock markets and their commentators respond to each fluctuation the government appears to be operating to a more long term plan. For long term investors, we must decide who is right, the government or the market commentators?

Government policy direction has been well-signposted both prior and subsequent to the change in leadership. The substantial report China 2030 laid out six new directions for the economy. This highlighted the need and provided a roadmap to transform China's economy away from its dependence on investment to a more sustainable long term path. The importance of that report and the proposals it made may be gauged by the heated debate it generated inside China. The reformers are still out in front and their commitment should provide long term investors with confidence in a key decision: With Chinese stocks trading on low single digit Price to Earnings multiples and at multi-year lows, do I feel confident that if I buy now I can look back in five years' time with satisfaction that I made the right call?

Regardless of the cries from analysts, the government has proceeded steadily to tackle the issues facing it with a constancy that puts our own governments to shame. On the matter of debt, credit expansion has tightened 6% and shadow banking activities have dropped by a fifth (-20.25%) this year. We are not seeing a crunching effort to deleverage the entire system in a short period of time, which would cause a collapse if done too quickly, but to a change in the sources and direction of credit from the obscurity of off-balance sheet special vehicles towards greater openness. At the same time, the overall availability of funds is being tightened gradually with specific central bank and policy operations to target liquidity where it is needed. This is a far more sophisticated approach than many have appreciated.

In respect of local government financing, the government made its first change to its budget law in over 20 years when approval was made explicit to local governments to issue municipal bonds and to take responsibility for their servicing. Previously all debt issuance and financing of government has been done centrally by the Ministry of Finance. A difference has been drawn between bonds issued to fund public projects and those issued by local government to fund commercial related projects such as those where local government provides subsidies to projects in the form of a public-private partnership arrangement. The new framework now links bond issuance to budgetary evaluations; it sets a principal of no central government guarantee; and it firmly separates government liabilities from corporate debt obligations.

[1] China 2030: Building a Modern, Harmonious, and Creative Society. The World Bank, Development Research Center of the State Council, the People's Republic of China. (2012)
http://www.worldbank.org/content/dam/Worldbank/document/China-2030-complete.pdf

Other macro data released in the past three months have showed gradually declining real estate prices. Purchasing Managers indices have held steady with the data from the National Bureau of Statistics, which favors the state sector, around neutral and HSBC/Markit indices, which favor smaller companies and the private sector pointing weaker. The government's response has been to continue to tackle industry overcapacity, provide liquidity into the interbank market to keep short term rates steady and ease lending restrictions to support mortgage lending. But notably there has been no knee-jerk response to provide stimulus.

Less well understood but probably even more important have been government moves to tackle corruption and introduce reform into the State Owned Enterprise sector. China's new leader Xi Jinping has made tackling corruption a centerpiece of his leadership. Unlike past leaders who have paid lip service to this issue, Xi Jinping has been pushing this for over twenty years, since he was a provincial government official in Fujian. Following his elevation in 2013, the anti-corruption drive has gathered momentum covering officials in government through to leaders in the powerful oil and banking sectors. The nature of links between government and key sectors and the networks that thrive on patronage present, in Xi Jinping's own eyes, a threat to the long term survival of the political system. So this campaign will not let up and is another factor for investors to consider.

When we consider the robustness or otherwise of China's economy and its ability to manage transformation there are some things worth bearing in mind. Reform takes priority over high growth, and economic growth of 7% - 7.5% is acceptable. The government will continually trim course with regard to liquidity, overcapacity, investment and administrative reform to preserve stability in transition, but investors should not look for stimulus anywhere close to that seen in 2009. China is working against a backdrop of a current account surplus estimated at 2.8% of Gross Domestic Product (GDP) in 2014 compared to 2.0% in 2013 and a fiscal deficit at -2.1% of GDP. The US by comparison is running a current account deficit at 2.3% and a fiscal deficit of 2.8% of GDP. The point here is not that the US is bad – its national account metrics are improving rapidly and are the main drivers of dollar strength – but that China is operating and maintaining a prudent economic policy also.

China & Hong Kong stock markets

In the past quarter the stocks markets performed strongly, well ahead of the MSCI World Index in July and August before falling back in September amidst a broader market sell-off. The market rally was driven by improved macro data from China, stronger than expected earnings growth and cheap valuations. September saw a marked change in tone that saw China and Hong Kong give back most of the gains of the prior two months but still left those markets above the broader MSCI Emerging Markets Index.

Pro-democracy demonstrations in Hong Kong drew world headlines and the stock market in Hong Kong sold down initially, but the reasons for weakness lie elsewhere. First, a comment on the demonstrations in Hong Kong. The trigger was the interpretation by the National People's Congress (NPC) on the sections of Hong Kong's Basic Law, which governs the One Country-Two Systems arrangement agreed at the handover, concerning the election of Hong Kong's leader. The NPC agreed the principle of universal suffrage (one person, one vote) that exists nowhere else in China, but required that any candidate be approved by a 1,200 strong council in Hong Kong believed to be largely full of pro-Beijing representatives.

This move resulted in demonstrations which, with the aid of some particularly inept policing, soon swelled into hundreds of thousands. The demands by the demonstrators' leaders for the immediate resignation of Hong Kong's current Chief Executive, CY Leung and for the reversal of the NPCs decision simply cannot and will not be met. The departure of CY Leung will no doubt occur after some time has elapsed, but a solution to the second problem is not in sight.

A better solution is for a leader who is more active on local issues and less in thrall to Beijing's biggest backers, the property tycoons. Hong Kong's income inequality is substantial with the richest 10% having 18x the incomes of poorest 10%. Real estate prices are sky high and for a new graduate from Hong Kong's universities the prospect of owning an apartment is a distant one. There is a strong feeling that the field is tilted heavily in favor of the richest, backed by Beijing. Solve this, and have Hong Kong's leader make a stand for the have-nots, and pressure by Hong Kongers to select their own candidate outside Beijing's say so will likely recede.

In terms of what is driving markets we need to look at the rest of the world. We are presently in the midst of another 'growth crisis' with concerns centering on Europe. Weaker growth from Germany and near atrophy in France has prompted bickering within the Eurozone. The European Central Bank argues for more stimulus, the Germans for budgetary discipline and the French argue for continuing deficit spending to protect their already generous welfare system. The Germans are now losing patience with France for their lack of budgetary restraint and sluggish reform of labor markets; they have signaled they may vote with the Commission against France to bring the French deficit in line with currency treaty obligations. A triple dip recession in Europe looms.

Against such a backdrop the improving economic metrics from the US referred to earlier look like a beacon. The dollar has strengthened and markets are preparing themselves for a prolonged period of dollar strength. This is not necessarily a good thing for emerging markets which have in the past struggled to out-perform during such periods. While this current state of affairs may not persist, and the dollar may weaken if the Eurozone gets its act together (a big If, certainly) it helps explain broader market weakness.

However, underlying company performance has been good. Commodity stocks have of course been hurt by falling prices, but the technology sector has been bubbling. Internet businesses, PCs and smartphones have been doing well. Competition in the Chinese smartphone space has been intensifying, but local manufacturers have been looking to markets such as India which has a potential 650 million strong handset upgrade market. China's car market is still growing, although a loss of momentum among local manufacturers has prompted renewed government support for small fuel-efficient vehicles. Stocks exposed to urban redevelopment and urban water/gas distribution also did well.

China Renminbi Yuan (RMB) & Bond markets

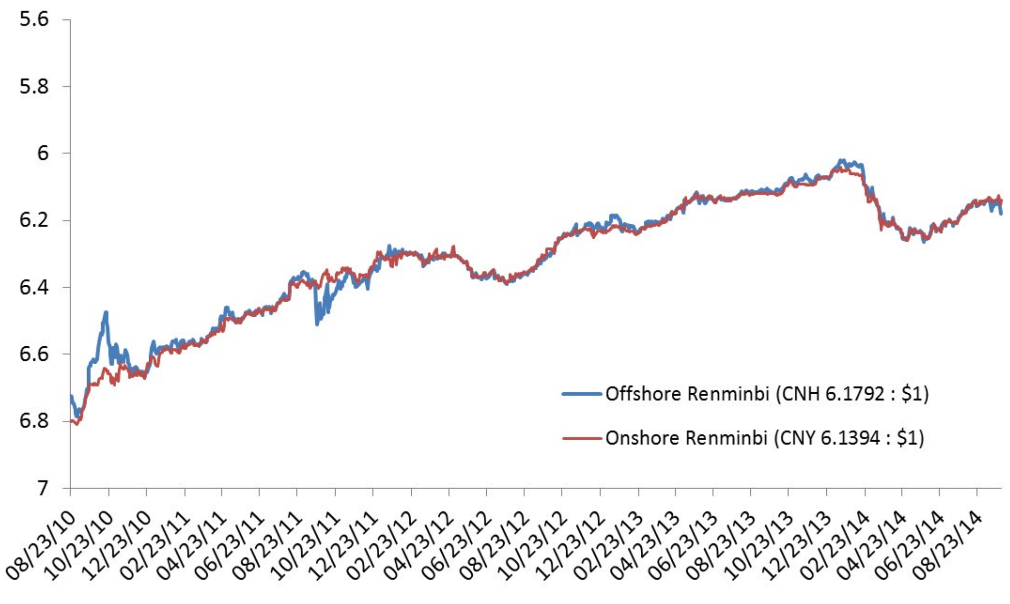
The RMB continued its recovery after the sell-off earlier in the year. The offshore RMB rate fell at the end of the month as the Hong Kong demonstrations reached their zenith but has since moved back into line with the onshore spot rate.

Recent Chinese trade stat has continued to be stronger than expected with the trade surplus at the end of September over $230 billion for the year, some 36% above the same period last year. This, with the resulting flows, is supportive of continuing currency strength against the dollar in spite of the latter's recent strength.

RMB denominated bond issuance picked up in September following a relatively quiet July and August, to $9.5 billion. The market capitalization of RMB denominated bonds and certificates of deposit now stands at $120 billion.

The process of RMB internationalization continues apace. A major development in this area took place in London on October 14 2014 with the issue of a UK Government bond denominated in renminbi. This is the first RMB bond issued by a western government and signals its aim to be a substantial player in what will very likely become one of the world's leading currencies.
The chart below shows the exchange rate of the Renminbi Yuan in the onshore and offshore markets to September 30, 2014.

Exchange rate of the Renminbi Yuan in the onshore and offshore markets to June 30, 2014



Source: Bloomberg

Commentary for our views on Asia, Dividends and Energy markets is available on our website. Please click here to view.

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The Purchasing Manager's Index is an indicator of the economic health of the manufacturing sector. The PMI Index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

MSCI World Index is a capitalization weighted index that monitors the performance of stocks from around the world.

MSCI Emerging markets index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

The Price to Earnings multiple reflects the multiple of earnings at which a stock or group of stocks in an index, sells. It is equal to the market capitalization of a stock, or group of stocks in an index, divided by the after tax earnings for that stock or index.

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