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MARKET INSIGHT

CHINA: OLDER, SLOWER, WISER

A longer-term pragmatic view on China

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Summary

- Talk of the Chinese economy collapsing appears overdone.
- The recent devaluation of the renminbi seems more closely associated with a desire for the currency to become part of the International Monetary Fund's Special Drawing Rights basket than it does an attempt to stimulate growth.
- Multiple indicators suggest that Chinese growth is slowing. A part of this reflects a natural slowdown in the trend rate of growth and a part is cyclical.
- The Chinese authorities retain plenty of firepower, both fiscal and monetary, for stimulating growth. There is some tentative evidence that measures taken earlier this year are starting to take effect.
- Trade linkages indicate Asia is the region most directly affected by slower Chinese growth. The US and Europe are the least affected.
- We expect the margin trading overhang to remain a headwind to domestically listed Chinese A-shares but that the H-share index looks much more attractively valued.

It is a truism that investor sentiment is fickle. For anyone who may have doubted this or who believes short term market movements are inextricably tied to fundamentals, events of the past few weeks should have convinced them otherwise. Having enjoyed a reasonably robust first half to the year in terms of the performance of risk assets and with investors seemingly shrugging off yet another bout of uncertainty associated with the third Greek bailout, markets took a decided turn for the worse around the middle of August.

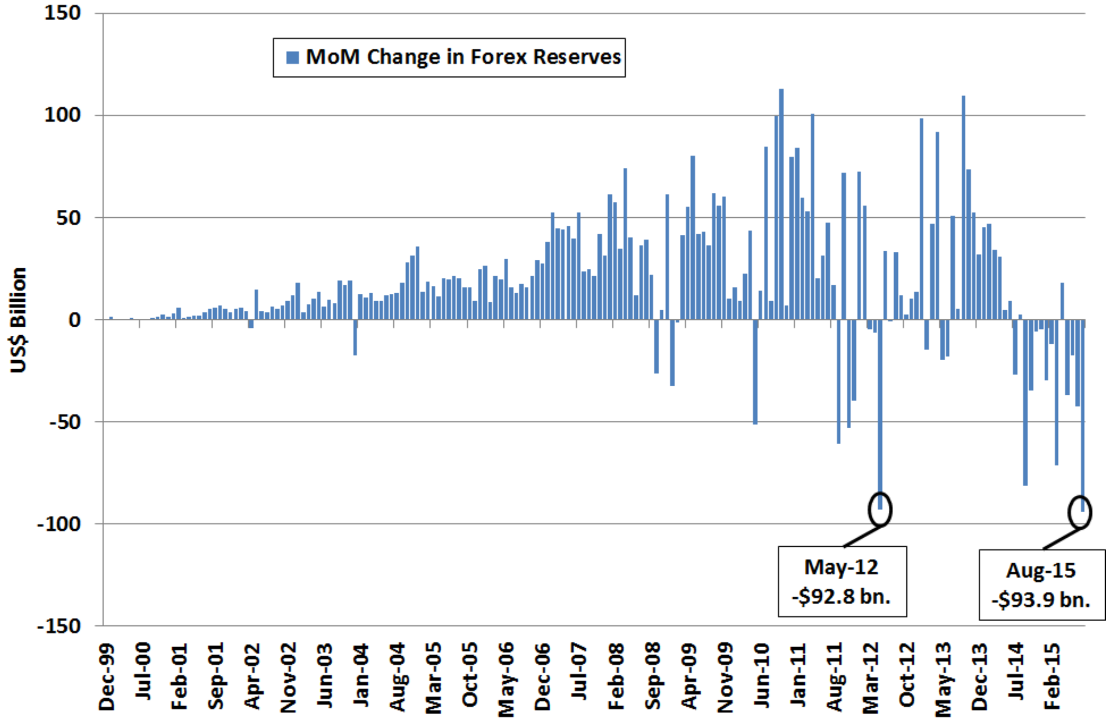
The Renminbi

The catalyst was the surprise announcement by the Chinese authorities that the daily central fixing rate for the renminbi would in the future be determined according to a process that took market forces into greater consideration[1]. The central fixing rate for the renminbi

[1] See http://www.pbc.gov.cn/english/130721/2941603/index.html

against the US dollar was devalued by about 4.5% over the following three days, leading to fears that China would engage in an ongoing process of competitive devaluation. Since then the Chinese authorities have reassured markets regarding their desire for a stable currency[2] and have intervened to ensure the renminbi does not depreciate further. Evidence of this intervention can be found in the record monthly decline in foreign exchange reserves that took place in August, as shown in Chart 1. From a high of just under 6.41 yuan per US dollar on 27 August, the central fixing rate has appreciated by around 0.5% since then.

Chart 1. Month-on-Month Change in China's Foreign Exchange Reserves



Source: Bloomberg, EFG calculations

This is hardly the behaviour of a regime that is keen to see its currency devalue aggressively. Our interpretation is rather that the Chinese authorities are eager for the renminbi to be included in the International Monetary Fund's (IMF) Special Drawing Rights (SDR) basket, a precursor to which is that a currency is declared "freely usable"[3]. In a further sign of financial market liberalisation, the People's Bank of China (PBoC) recently removed the cap on interest rates paid on deposits with maturity of more than one year[4]. This follows the 2013 removal of the floor on lending rates[5].

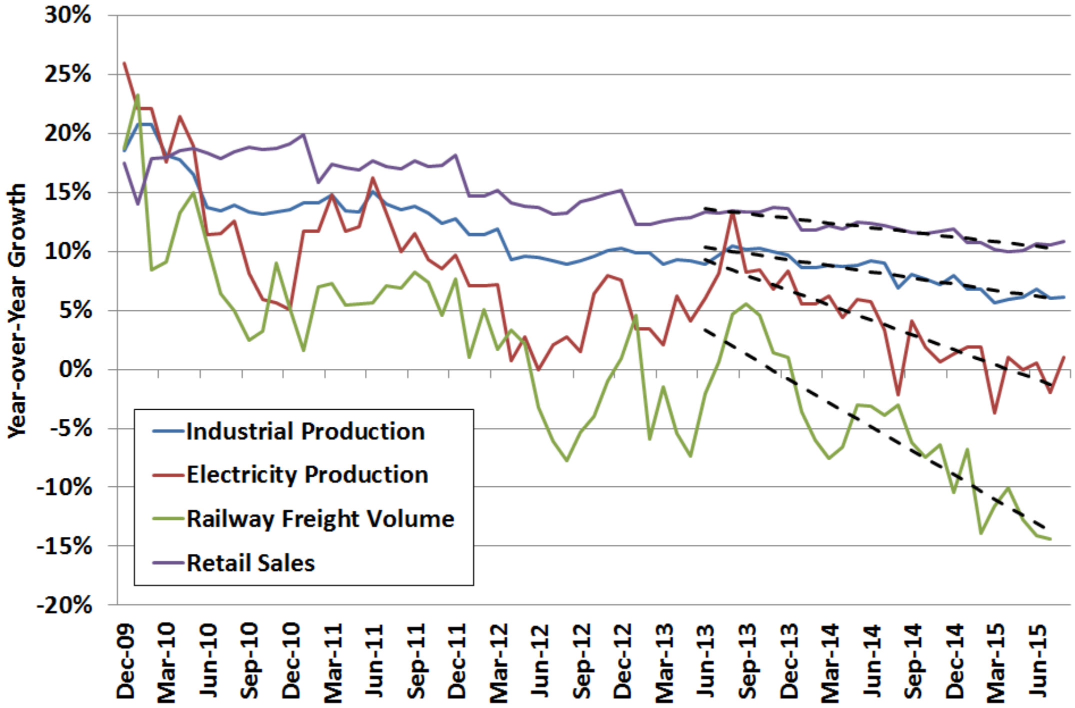
The Economy

The fact that the daily fixing arrangements were changed only a few days after the release of weak export data is cited by some as evidence China wants to see the renminbi much weaker to support growth. However, relative to other Asian currencies the renminbi remains

[2] See, for example, "China's Stock-Market Rout is Almost Over, Says PBOC Governor" Bloomberg news, 6-Sep-15.
[3] See https://www.imf.org/external/np/exr/facts/sdrcb.htm for a fuller description.
[4] See http://www.pbc.gov.cn/english/130721/2941752/index.html
[5] See http://www.frbsf.org/banking/files/Asia-Focus-China-Interest-Rate-Liberalization.pdf

much stronger on a 12-month or year-to-date view[6] even after having taken into account recent moves. Whilst a small depreciation of the renminbi relative to other Asian currencies may make a very minor contribution to Chinese exports in the months ahead, it is unlikely to provide much stimulus to the economy in general.

Chart 2. Weaker Chinese Growth: Cross Sector Slowdown



Source: Bloomberg, EFG calculations

Nonetheless, it is certainly true that the evidence across a broad range of data indicates that Chinese growth is slowing. Chart 2 shows how metrics such as industrial production, electricity production, railway freight volume and retail sales have all been growing at progressively slower rates for several years. These indicators are often used as cross checks on the Chinese economy because they provide a semi-independent way of establishing the validity of the headline gross domestic product (GDP) numbers. The chart also shows how the rate of slowdown has remained fairly constant over the past few years – the black dotted trend lines describe well the path of each series. This is important because, in contrast with investor sentiment, it demonstrates there has not been a sudden deterioration in the data – the series are slowing at a similar pace to that experienced over the past few years.

An interesting observation from the chart is that retail sales growth has been persistently above that of industrial production. This suggests the rebalancing of the Chinese economy away from investment expenditure and towards household consumption is underway, although it is likely to take many years before it is complete.

The Longer Term Perspective: Trend versus Cycle

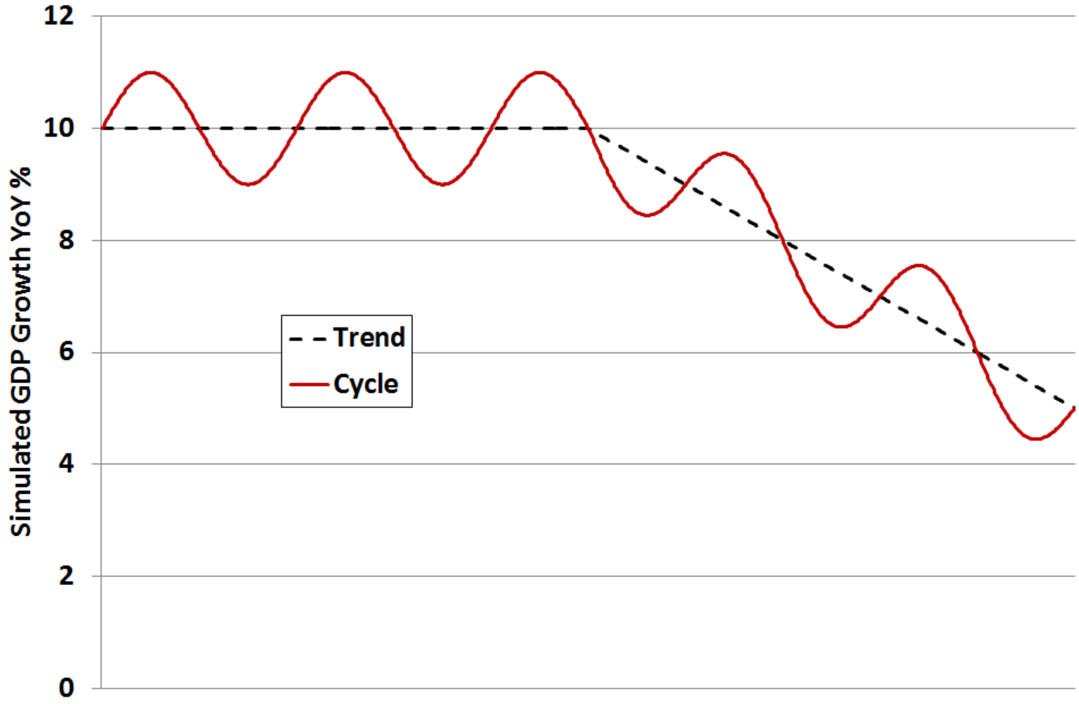
For some time we have been promoting a model of the Chinese economy whereby it was able to grow at 10% or more per annum over a prolonged period of time – 30 years or so – because productivity gains were easy to come by. It was relatively easy to achieve high

[6] As noted in a our Market Update 21-Aug-15.

rates of growth because it was possible to move workers from low productivity rural agricultural endeavours to higher productivity urban manufacturing jobs.

At the same time, the Chinese economy was starting from a position in which infrastructure and other forms of productive capital were relatively underdeveloped, providing a glut of investment opportunities. The Chinese economy is now at a point where these productivity gains are much harder to come by. Hence it is natural to expect the trend rate of growth to slow[7].

Chart 3. China Trend Growth and the Economic Cycle



Source: EFG calculations

The crude rule of thumb we use is that we expect the trend rate of growth roughly to halve every ten years. So if the Chinese had been growing at a trend rate of growth of say 10%-12% in the ten years to 2010, a starting point would be to anticipate trend growth of around 5%-6% for the ten years to 2020. Of course, we will only be able to observe with hindsight what the actual rates of growth turned out to be.

Chart 3 provides a simplified graphical representation of how we view the path of Chinese growth. The black dotted line represents the trend. On top of the trend it is necessary to overlay the economic cycle – the red line - and China is also facing some cyclical challenges. For example, it is natural to experience an increase in non-performing loans following a period of rapid credit expansion. This is what is currently happening in China. Fortunately policy can be used to help offset cyclical weakness and, in contrast with much of the developed world, China has plenty of policy options available to it.

One monetary policy tool the People's Bank of China (PBoC) uses to help control the economy is the Reserve Requirement Ratio (RRR). The RRR can be lowered to encourage lending and support growth and vice versa. Even after being lowered by 1.5% for the year-to-date, the RRR stands at 18% implying that there is plenty more room for it to be reduced

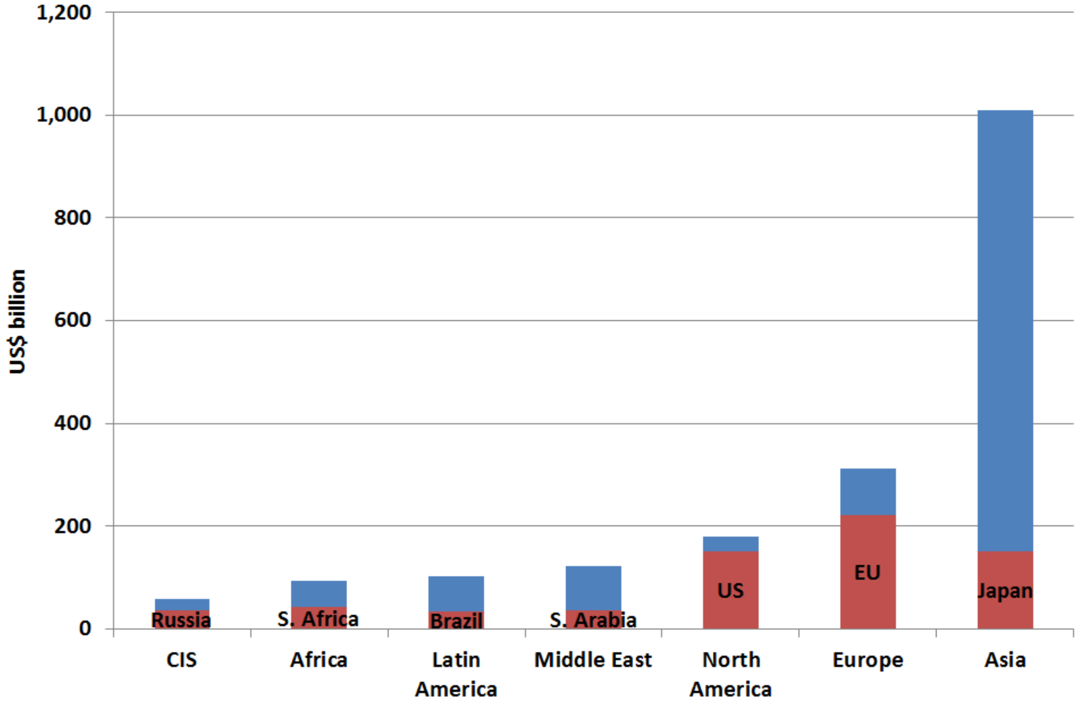
[7] The point at which a developing economy has exploited easy productivity gains achieved via the redistribution of labour is sometimes referred to as the Lewis turning point.

further. For reference, we estimate that each 0.50% cut in the RRR adds about CNY 600 billion ($95 billion) in liquidity to the banking system[8].

The External Impact

Given the large size of the Chinese economy, a slowdown has important ramifications for the rest of the world. International trade is the transmission mechanism. Chart 4 illustrates the value of goods and services China imports from the rest of the world by region and also by major country within each region.

Chart 4. Chinese Imports by Region (12 months to Aug-15)



Source: World Trade Organisation, EFG calculations

The chart clearly shows the region from which China imports the most in US$ terms is Asia; in the 12 months to end August 2015 China imported about $1 trillion worth of goods and services from other Asian countries of which over $850 billion was from non-Japan Asia. It's also important to quantify the impact in terms of each region's GDP since a small amount in US$ terms could have a meaningful impact on the GDP of an individual country or region. The data is shown in Table 1.

[8] The RRR is the proportion of deposits that a bank must keep in reserves, usually on deposit at the central bank.

Table 1. Exports to China as % of GDP

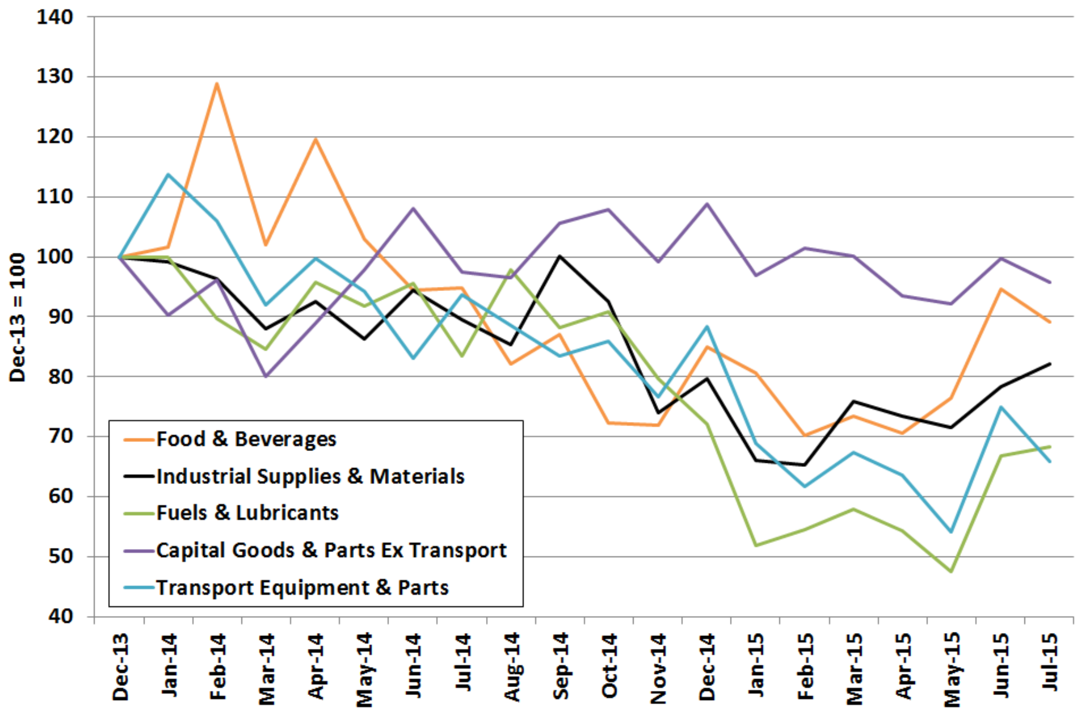
	Exports to China as % of own GDP		Exports to China as % of own GDP		Exports to China as % of own GDP
Russia	1.9%	**Other CIS**	5.2%	**Total CIS**	2.6%
Brazil	2.3%	**Other Latin America**	2.8%	**Total Latin America**	2.5%
South Africa	13.2%	**Other Africa**	4.1%	**Total Africa**	5.7%
Saudi Arabia	5.0%	**Other Middle East**	3.1%	**Middle East**	3.5%
United States	0.9%	**Other North America**	1.1%	**Total North America**	1.0%
European Union	1.2%	**Other Europe**	3.0%	**Total Europe**	1.4%
Japan	3.3%	**Other Asia**	10.2%	**Total Asia**	7.6%

Source: World Trade Organisation, IMF, Bloomberg, EFG calculations

At 7.6%, Asia remains the top region in terms of the share of GDP that is made up of exports to China, with the share for non-Japan Asia rising to over 10%. The next largest by share of GDP is Africa with the Middle East in third place. North America and Europe are the regions with the smallest share of GDP in exports to China.

Another interesting dimension of the trade data relates to the type of goods that are exported to China. Chart 5 provides such a breakdown. There are several interesting things to note. First, most categories have experienced a sharp decline over the past couple of years with Chinese imports of Transport Equipment & Parts and Fuels & Lubricants both down about one third (the decline in the latter category has no doubt been exaggerated by the sharp fall in the oil price). Secondly, the decline in Capital Goods & Parts Ex-Transport has been modest, which perhaps helps explain why the German economy has not been that badly affected by the slowing Chinese economy.

Chart 5. Chinese Imports by Broad Economic Category.



Source: Bloomberg, EFG calculations

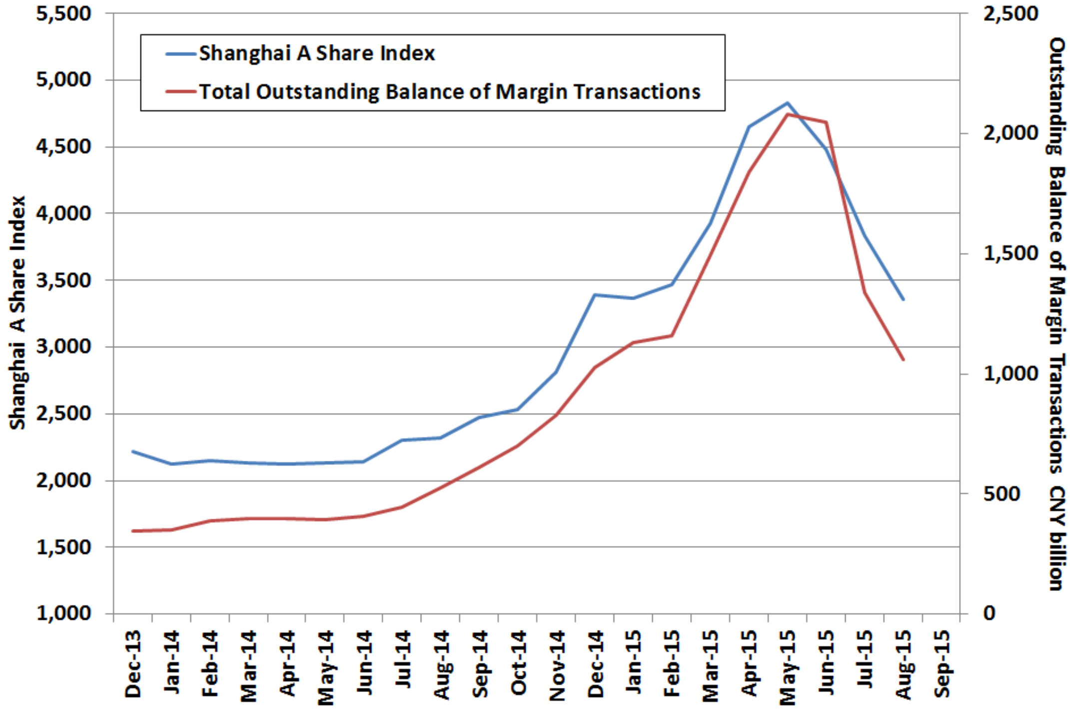
The third point to note is that most categories have experienced an uptick recently. It is hard to know precisely what has brought this about but we can speculate that the stimulus applied earlier this year is beginning to take effect and is helping to stabilise the Chinese economy.

The Markets

If recent market action were a guide to the outlook for the Chinese economy, one would naturally be concerned about growth prospects. The Shanghai A-share index is down over 40% from its June peak and the Hang Seng China Enterprises index (H-shares) has fallen by about a third over a similar period. However, whereas in developed economies stock market behaviour often leads economic activity, the relationship is much weaker in most developing countries. Moreover, the extent of the decline in the A-share index would portend a decline of gargantuan proportions for the Chinese economy, something we consider unlikely.

Why then have Chinese equities fallen so precipitously? To answer this question it is necessary to understand why the market went up so quickly in the 12 months preceding the June peak. This occurred alongside a rapid increase in margin transactions, as shown in Chart 6.

Chart 6. Shanghai A-Share Index and Margin Transactions

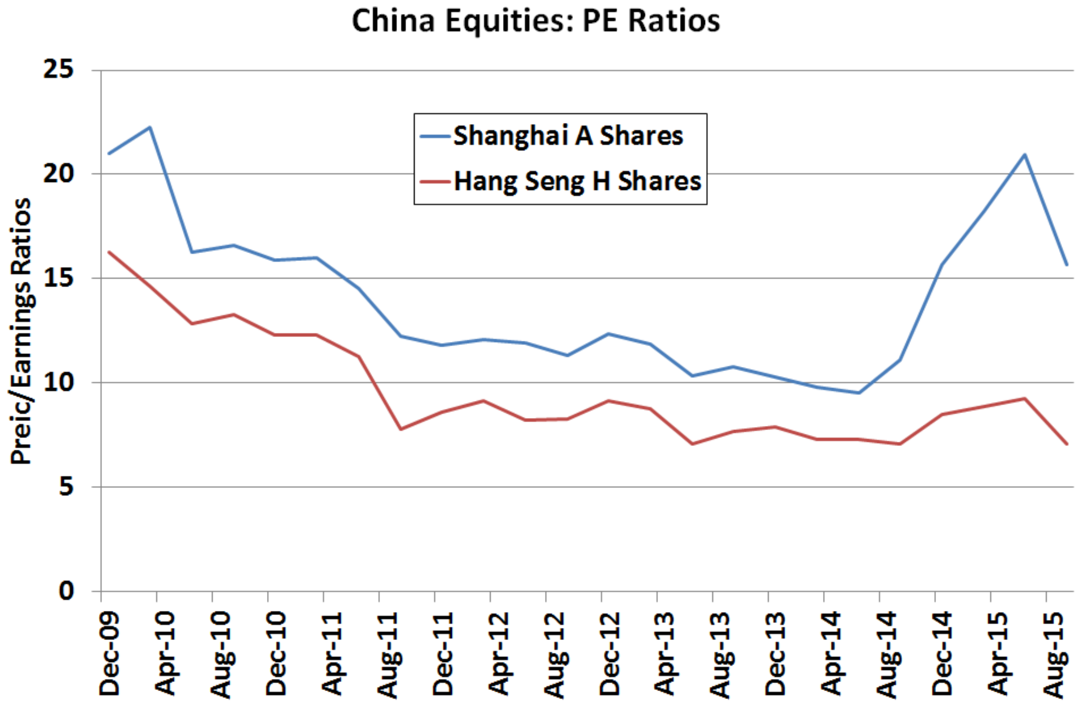


Source: Bloomberg, EFG calculations

The chart shows that as the A-share index declined sharply, so too did the outstanding balance of margin transactions. Margin balances are down about 50% from their peak earlier this year but remain about three times greater than their end 2013 value. This suggests there is room for these balances to unwind further, which will remain a headwind for Chinese A-shares.

The H-share index is a different proposition[9]. Our view is that the index and shares in it have been sold off recently as a proxy for Chinese equities more generally. For example, some investors may have been unable to sell or hedge their A-share exposure and could therefore have sold or shorted H-shares instead. The H-share index has traded not on fundamentals but on A-share induced panic. The result is that H-share valuations now look attractive; the price-to-earnings ratio and price-to-book ratio for the H-share index are now around 7x and 1x respectively compared to around 15x and 1.75x for the A-share index – see Chart 7.

Chart 7. A-Share and H-Share Valuations



Source: Bloomberg, EFG calculations

A further point relates to relative GDP and equity weights. There is no law of finance specifying that the weight of country's equity market capitalisation in the world should be proportionate to its GDP weight and it is true that large discrepancies between the two can exist for prolonged periods of time. However, for long-term asset allocators seeking to achieve investment exposure in rough proportion to economic risk, it makes sense to pay attention to differences in these weights. In this context it is notable that China's GDP weight is significantly higher than its MSCI equity market weight, as shown in Table 2. Of the 50 or so countries listed in the MSCI All Country World Equity index, the difference between the capitalisation share of world markets and GDP share of the global economy is by far and away the largest for China.

[9] For a fuller discussion of the attractiveness of investing in H-shares see the EFG Market Update "Panic Selling in China's Equity Markets" 25-Aug-15 or the New Capital update "China Equity: Beyond the Headlines" Sep-15.

Table 2. GDP and Equity Market Weights.

	MSCI Index Weight (%)	GDP Weight %
United States (608 members)	51.3%	25.5%
Japan (314 members)	7.9%	8.2%
United Kingdom (112 members)	6.7%	4.6%
Switzerland (47 members)	3.7%	0.8%
France (71 members)	3.4%	4.1%
Germany (53 members)	3.2%	5.5%
Canada (92 members)	2.8%	2.3%
Australia (69 members)	2.2%	1.5%
China (107 members)	1.7%	9.1%
Hong Kong (75 members)	1.5%	0.4%
South Korea (107 members)	1.5%	2.1%
TOTAL	**85.9%**	**64.2%**

Source: MSCI, Bloomberg, EFG calculations

Conclusions

Concerns that China is about to enter into a period of competitive devaluation seem overblown and inconsistent with the facts. Nonetheless, there is a broad body of evidence that indicates Chinese economic growth is slowing. A part of this relates to the natural process of slowdown as an economy matures and a part is cyclical. With regard to the cyclical dimension, the Chinese authorities have a range of tools available to them to help offset any weakness in activity. There is some tentative evidence that policy measures enacted earlier this year are starting to take effect.

Trade is the direct channel via which a slowdown in China’s rate of growth impacts the rest of the world. In this regard, the region that looks the most vulnerable – both in US$ terms and also as a proportion of GDP – is the rest of Asia. The relatively modest slowdown in Chinese imports of capital goods helps explain why European exports have held up reasonably well.

From a market perspective, the continued unwind of margin trading may weigh on the domestic Chinese A-share market. However, the associated sharp sell-off in H-shares has resulted in valuations that are now more attractive.

Note: Past performance is not necessarily a guide to the future. Returns may increase or decrease as a result of currency fluctuations. Performance is net of fees. Please refer to the Prospectus for further information on this Fund and prior to any subscription.
Sources: New Capital Fund Management, Bloomberg. Unless otherwise stated all data as of 25 August 2015.

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2. where no consideration is or will be given for the transfer; or
3. where the transfer is by operation of law.

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