China: Risks, Misconceptions and Opportunities

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"May you live in interesting times." **– ancient Chinese curse, possibly apocryphal**

Things have gotten very 'interesting' indeed for China and the global equity markets. One of the risk factors most often cited for the recent market volatility is confusion and concern over Chinese currency policy and the direction of its economy.

Having spent time in China recently, we share investors' uneasiness with policy and the economy in China (see our *Strategic View*, dated October 7, 2015, for more of our thoughts on the Chinese economy). However, we also believe that the current rhetoric surrounding China's place in the world economy should be placed in the proper context. The purpose of today's Weekly View is to lay out our view of the risks, misconceptions and opportunities for the world as it relates to China.

LEGITIMATE RISKS:

1. **We believe the Chinese economy is growing meaningfully slower than official government estimates suggest**. This is primarily due to the weakness in heavy industry, as evidenced by consistently weak data in areas such as rail tonnage and container shipments. Despite an "official" GDP growth rate in 2015 of 6.9%, we suspect the manufacturing part is growing by several percentage points lower than this. The overbuilding glut in Chinese infrastructure over the last decade is having profound negative effects on any region which relies on commodity sales to China as a significant export. This includes most of Latin America, Africa, and Russia, as well as Canada and Australia. Unfortunately, we expect this dynamic to continue, and thus remain underweight these regions' equities relative to our strategic benchmarks.
2. **We expect the Chinese yuan to continue to weaken relative to the US Dollar, forcing action from the rest of Asia**. Further de-pegging of the yuan from the USD makes sense to us, because it's costly for Beijing to maintain its support of the yuan in the face of capital outflows, and because further stimulus for the economy is likely needed. While we believe the Chinese are keen to move incrementally, we cannot entirely rule out another snap devaluation. Whether it happens slowly or quickly, we believe yuan devaluation will most likely remain a risk for any region or country whose economy hinges on significant direct competition with China for non-differentiated exports. This includes Korea, Taiwan, and most of Southeast Asia. Consequently, we remain underweight these regions relative to our strategic benchmarks as well.
3. **Real reform not happening yet**. In our opinion, structural reform of China's inefficient state-owned enterprise (SOE) sector is a key to long-term growth potential. While not surprised, we are nonetheless disappointed to see little meaningful progress here yet. Given the stresses on their economy and currency, we expect the status quo to remain for now.

POTENTIAL MISCONCEPTIONS:

1. **"The Chinese economy continues to deteriorate markedly."** While ongoing deterioration in manufacturing has been well documented, China's economy overall doesn't appear to be in meaningfully worse shape than it was 6 or 12 months ago, in our view. This is in part because the Chinese economy appears to still be growing solidly within services and consumer-facing industries. Data such as house prices, services Purchasing Managers' Indexes and passenger vehicle sales all suggest recent improvement. We think this is important because services and consumer-facing industries represent a much larger portion of the economy than they did in the past – roughly half of the entire economy by some estimations.
2. **"A Chinese slowdown means recession for the rest of the world."** While China's status as the world's 2nd largest economy provokes panic, perspective is important here; according to a recent report by Ned Davis Research, the size of China's economy has more than doubled from the end of 2009 to the end of 2014. In practical terms, we believe this suggests that today's slower-growing but larger China still can contribute as much to global GDP as it did back when it was growing roughly 2 times as fast. We think it is also instructive to remember the parallels of another Asian nation which was once the world's 2nd largest economy: Japan in 1990. While Japan's peak was followed by almost two decades of zero growth, the world economy was able to grow at a solid rate for most of the 1990s and early 2000s. Finally, regarding China's debt issues: while there is

legitimate concern about overheated municipal debt, shadow banking and housing markets, it is worth noting that China is a relatively closed financial loop. This suggests that the implications of contagion from a debt implosion in China are likely less far-reaching than those related to the banking systems of the US and Europe during the 2008 Global Financial Crisis.

3. **"Lower oil is a harbinger of global recession."** It is our belief that China's economic slowdown has been a partial cause of the global commodity price correction; and, when combined with technological advances, a fractured response from traditional energy producers, and a developed world still recovering from a debt crisis, oil and commodities are likely to stay lower for longer. If true, this is negative for commodity net exporting nations, but potentially positive for most G7 nations like Japan, Germany, Italy and even the US, who are mostly commodity net importers. When viewed as a bloc, commodity net importers make up over 70% of the world's GDP on a purchasing power parity basis, dwarfing the contribution from commodity net exporters. Put simply, low oil helps much more of the world than it hurts, in our view. Additionally, recent analysis by Ned Davis Research suggests that, for G7 nations as a whole, crude oil prices historically tend to be negatively correlated with G7 GDP growth with about a year lag. This suggests to us that the extended period of low oil prices should start positively affecting G7 economic growth soon, if not already.

Finally, we also see opportunities in some of the misconceptions surrounding China. For instance, G7 stocks have experienced similar downside as emerging markets like China in the most recent market selloff. We believe that this will eventually prove to be short-sighted, as the economies and stock markets such as the eurozone and Japan could eventually be net beneficiaries of the outsized China slowdown concerns. Central to our thesis is our view that prolonged weakness in the economy or inflation in either area will likely force additional monetary accommodation from the Bank of Japan and/or European Central Bank, which should serve to reflate asset prices and place downward pressure on the euro and yen. **Thus we have used the recent market weakness to opportunistically increase our exposure to both Japan and the eurozone, as well as reduce exposure to the euro and yen via currency hedging.**