Creative Global Investments

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Objectivity
Integrity
Creativity

Patience Is A Chinese Virtue

Back on May 28th we noted that the Shanghai composite index had hit CGI's target of 4,900 and was vulnerable to a pullback. In fact, technical work by our colleague, Carlo Besenius, showed that the index could fall to as low as 3,250. But as we said at that time, we believe that the 'A' shares can still push higher after a period of consolidation. There are many reasons to support such a view. **We reiterate that we believe the greater risk for long-term investors is one of not participating and missing out on China's continued bull run.**

The infallibility of the communist party and by extension its leadership is a core tenet of the mantra that the Chinese people have intoned as truth for decades. So the meltdown of China's stock market over the past three weeks must have been viewed with consternation by Chinese investors as well as the average Chinese citizen watching from the sidelines since the populace was encouraged by Beijing to invest in the country's own brand of capitalism. Implicitly, most Chinese undoubtedly believed that Beijing would—to borrow a phrase from Mario Draghi—do "whatever it takes" to keep the party going. To stem the downhill slide, Beijing intervened by unleashing new support mechanisms designed to stabilize the market by limiting selling and forcing corporate buy-ins in many instances. Beijing really had no choice since the legitimacy of the party was potentially at stake. **Failure to stop the sell-off would lead to a broad-based loss of confidence that could undermine the leadership's reform efforts, the economy and potentially lead to social unrest—the biggest fear of the leadership. Consequently, the rest of the world's angst over Beijing's direct market intervention rather than allowing free market forces to clear markets is relegated to a far distant secondary concern by the country's leaders.**

The Chinese authorities are still learning. Critics have come out of the woodwork since the sell-off began with zero tolerance for any mistakes or missteps made by regulators or the leadership. Their commentary is all about the failure of the system, yet it's a system with little history. We'd take the other side of this intellectual argument with a couple of pragmatic observations. We believe that China is still "finding its way" but nevertheless is demonstrating its commitment to financial reform and liberalization. Should it surprise anyone that Beijing would move toward implementation of free markets in stages? While it's disappointing that Beijing chose not to let price discovery work to clear markets, it's understandable given the perceived risks involved and lack of prior experience. **Where is the utopia elsewhere in the world where free markets developed without at least some form of government intervention along the way?**

Investors should still not be naïve to believe that Beijing will blithely acknowledge that it somehow might have contributed (or even been the catalyst) to the market's sell-off and subsequent $3.2 trillion loss. Expect scapegoats, both real and imagined, to surface. These will receive significant attention in the press to demonstrate the government's commitment to the welfare of its people.

The last phase of the recent market surge was driven by neophyte investors, many of whom were using margin for the first time. It's reasonable to assume that few of them fully comprehended the magnitude of risk that they were assuming. As margin calls arrived, those investors without additional liquidity sold whatever they could to meet margin requirements (as is the norm in any market downturn) so that the selling spilled over into H-shares (many of them high-quality stocks that hadn't been driven up to extreme valuations in the rally), bonds, gold and anything else of value that could be liquidated.

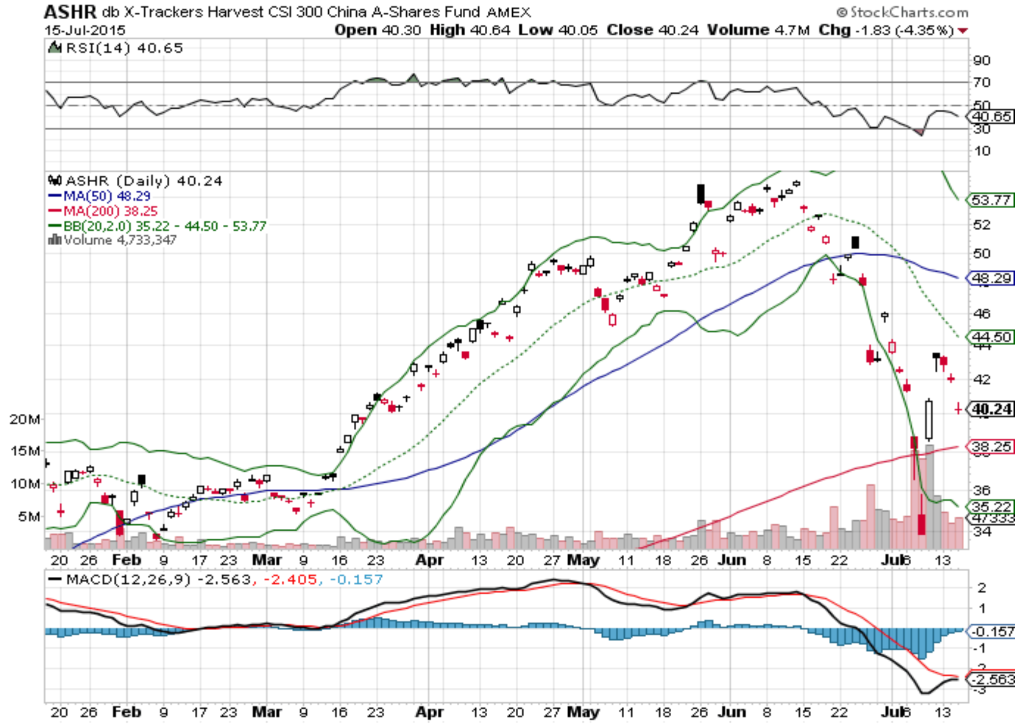
Media pundits have tried to outdo one another as they use descriptions such as "stunning stock market crash" to describe the $3.2 trillion decline in stock market value during the recent sell-off. Impending doom must surely hover over all investors' heads. They conveniently ignore the fact that the Shanghai composite index is still up 84% in the past year and 17.6% y-t-d. In our judgement, only the speed of the run-up and subsequent correction was unusual. The magnitude of the correction, which equaled roughly one-third of the market's gains (see chart below), was completely proportional to the market's upward climb over the preceding year and defines what technicians typically view as a healthy correction capable of sustaining upward bull-market momentum. Meanwhile, self-serving observations abound from newly minted China "experts" that anyone could have predicted the collapse of China's stock market because economic fundamentals didn't support higher stock valuations. But as we've observed over our investment career and have often reminded others: the economy and the stock market are not the same thing and often don't move in unison.

The fundamental rationale for investing in China remains intact. Beijing continues to transition the economy away from an investment-led economy to one that's consumption driven. The leadership's commitment to reform appears ironclad as does its adherence to further accommodative monetary policy and fiscal stimulus. Perhaps that's why Chinese stocks have found renewed buying interest since last Thursday (+13.2% in three days) once the market traded down to major technical support levels that held. (We view last Wednesday's disproportionate drop in the CSI 300 (see ASHR chart) as capitulation selling to meet margin requirements). Of course, this coincided with the government's imposition of various measures designed to help support the market. **These measures will doubtless be supplemented with additional confidence-boosting initiatives aimed at counteracting any potential lingering negative wealth-effect influences from the correction.**

Second quarter real GDP growth of 7% exceeded consensus forecasts of 6.9%. Manufacturing surprised to the upside (+6.1%) as did retail (+10.6%). Services grew faster than forecast (+8.4%), which provides further tangible evidence that the government's rebalancing efforts are meeting with some success. According to the official data from the National Bureau of Statistics, higher earnings (per capita disposable income rose 9% through June) coupled with the creation of 7.2 million new jobs contributed to consumption rising to 60% of GDP in the first half, which is 5.7 points higher than a year ago.

The Shanghai composite index sold off by 3% after the release of the stronger than expected economic data, echoing our earlier observations about the market and economy. We attribute the decline to profit taking after the earlier three-day gain of better than 13% (see chart below) and concern that the stronger numbers could cause Beijing to be less forthcoming with additional stimulus. In our judgment, investors shouldn't worry as we're confident that more stimulus is on the way—probably two more quarter point interest rate cuts and another full point reduction in the reserve requirement ratio for banks before year end. In the meantime, we wouldn't be surprised if stocks remain under intermittent pressure with sideways consolidation for another week or two before resuming their upward ascent to new highs. Investor confidence will have to be restored that China's stock exchanges have stabilized and this will surely include that all listed stocks are open for trading (25% still remain halted), which likely initially adds to volatility. Beijing wants [and needs] a vibrant stock market to achieve its plan. Rising wealth spurs consumption while a growing appetite for stocks enables debt-laden companies to recapitalize themselves. In our view, betting against China has been and still remains a losing proposition.

Our preferred vehicle for gaining exposure to the China-A shares continues to be the db X-trackers Harvest China ETF (ASHR) that tracks the CSI 300 index and is comprised of the 300 largest capitalization listed A-shares. All index constituents are large cap. The average weighted price/earnings ratio is 18.1x while the forward p/e is 17.2x. This compares to the average price/earnings ratio for A-shares listed on the Shanghai Exchange is currently 19x while those A-shares listed on the Shenzhen Exchange have an average p/e of 45.5x (the latter are overwhelmingly small and microcap stocks that are considered highly speculative). All segments of the economy are represented in the index with the financial services sector comprising about 32% of the total. Valuations are obviously much lower than the aggregate A-share universe—not unlike one would see when dissecting the NASDAQ listings. **Although the forward p/e of 16.5x is modestly above the long-term average, we find little cause for concern given that benchmark interest rates in China are already below historical levels even as Beijing enacts increasingly accommodative monetary policy.**



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