



Creative Global Investments

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Beijing Continues To Deliver; Don't Buy The Avoid China Argument—Buy The Shares Instead

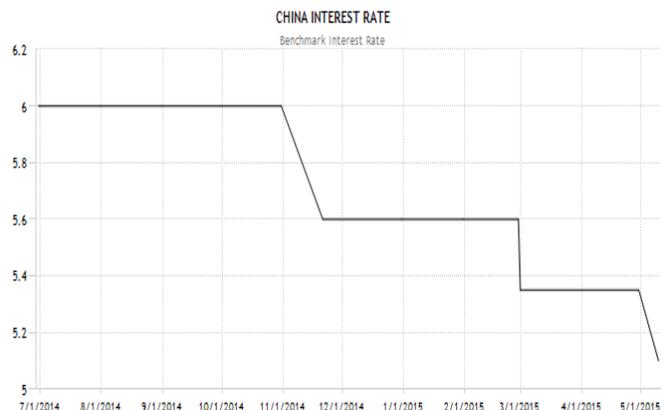
It's no surprise that many commentators perpetually warn off potential investors in China shares. Those warnings have become even more strident after the 104% run up in the Shanghai Exchange over the past twelve months. For years we've been told that burgeoning financial stresses from the real estate bubble and skyrocketing corporate and local government debt will contribute to a wave of defaults leading to a meltdown of the country's financial system. And for much of the time since the initial recovery in 2009 from the global financial panic, one would have been correct to avoid or underweight China as it underperformed most other markets. That is until last year, as the reforms from the Third Plenum, including liberalization of the financial markets began to be implemented.

Beijing is managing the impact of economic reform by selectively implementing additional monetary stimulus. In our April 21st update we wrote that "next on Beijing's agenda is a cut in the benchmark interest rate." Yesterday, the People's Bank of China (PBoC) delivered with a 25 basis point cut to 5.1% for the benchmark rate that follows

last month's reduction in the reserve requirement ratio. This is the third rate cut by the central bank since November. We don't believe that this 25 basis point cut will do much by itself. China's real interest rate still remains among the highest in the world for a major economy, which means that ample room exists for further cuts with the 5.1% benchmark lending rate far above

China's current annual inflation rate of 1.5%. Beijing will stay the course and the PBoC will continue to lower rates—down to 2% if it believes it necessary and, in our judgment it very likely will. Additionally, we believe that more reserve requirement ratio (RRR) cuts are coming to further expand credit.

Few countries have an RRR anywhere near that of China's current 18.5%. For comparison, the U.S. has an RRR of 10% and India 4% while Eurozone countries have an RRR of 1%. The U.K., Canada, Australia and Hong Kong have none.

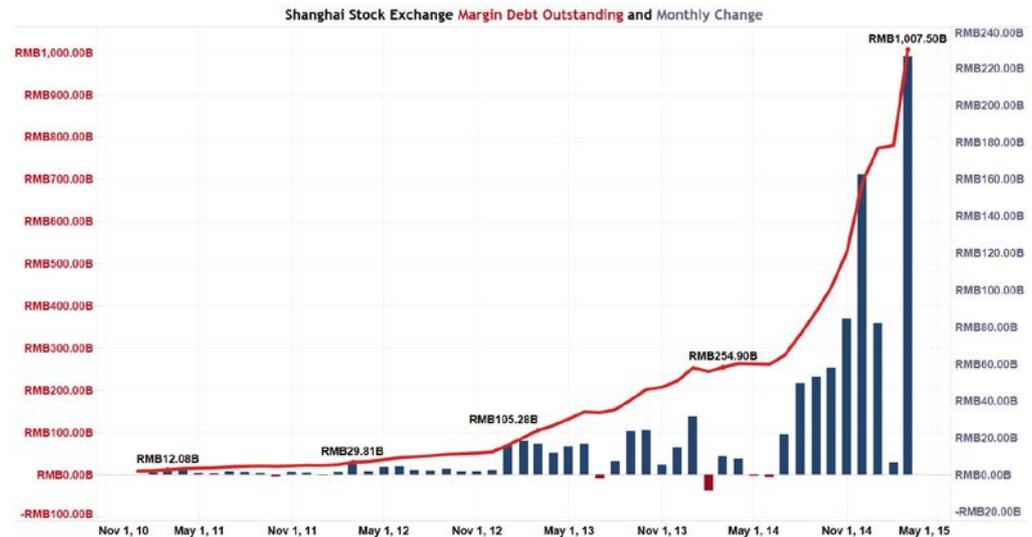


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As financial doom failed to materialize, China's critics have subsequently focused on new concerns to set investors' hair on fire. The latest effort highlights the skyrocketing margin debt on the Shanghai and Shenzhen exchanges. Margin debt has tripled in the past three years to approximately 1.7 trillion renminbi (\$275 billion). This equates to roughly twice the New York Stock Exchange margin debt to market capitalization. Margin trading is believed to typically comprise about 25% of daily trading volume while margin debt is thought to equal slightly more than 8% of the free float—the highest in the world. Of course there's ample cause for concern.



Equity margin trading is a fairly new product, introduced only five years ago and fully implemented only in 2011. We believe that it's reasonable to assume that many of the individual Chinese investors trading on margin don't understand the inherent risks or fully appreciate the consequences of falling share prices triggering margin calls.

China skeptics say to continue avoiding China's stock market and await a materially better entry point. In their scenario, the market will swoon at the first misstep with margin calls creating a self-reinforcing cascading downward spiral. According to them, it's better to wait another year or two as China's stock market will certainly experience a substantial pullback or even crash. We're troubled by the "certainty" of this often touted "intellectually superior" view. **In contrast, we see the world awash in rising central bank driven liquidity and, as we pointed out earlier: China is capable of unleashing substantially greater stimulus.**

We'd argue that the greater risk for investors is one of not participating and missing out on a continued bull run. After all, most foreign money has fled. Global portfolio managers remain underweight. Who's going to sell? For many of the mainland individual investors of more modest means, the stock market is one of the few accessible paths to wealth creation. Critics highlight the high level of retail share ownership as another reason for caution due to the potential for greater volatility. We can't argue against the notion that greater institutional ownership would lend stability to the market. However, it's a matter of evolution and institutional ownership has been rising since the turn of the century. **Bottom line: China has more room for further accommodative monetary policy and stimulus than any other G-8 nation.**

Government efforts to slow the market's advance in order to prevent it from overheating into a meltdown, such as recent restrictions on margin lending, are likely to be no more than a temporary restraint against the market's irrepressible rise near term. China's capital controls limit the investment options for the average Chinese investor. **Stimulus enacted by The People's Bank of China will continue pushing investors into riskier assets just as it has for central banks elsewhere.**

The Peoples Bank of China can't determine or direct where the additional liquidity created by its monetary policy will go. The central government was forced to act to wring out [perceived] excessively rapid asset price gains because its implementation of

monetary policy is such a broad-based tool. Historically, one would assume that much of it would find its way into the property market. Although there have been signs of rising housing prices in cities such as Shanghai in recent weeks, supply still exceeds demand and many developers remain trapped in difficult financial predicaments. Rather than flowing into the real economy, we believe that much of the additional liquidity from this [and future rate cuts] will find its way into the stock market—especially as the emergent middle class increasingly views the stock market as the path to quick riches. **We see little that Beijing can do to halt this growing speculative excess without unwanted social repercussions. The best that it can do is the occasional peripheral move to let a little air out of the balloon and hope that the wealth effect contributes to rising consumption as part of its plan to rebalance the economy.**

The International Monetary Fund now believes that China’s currency, the renminbi, is fairly valued—opening the door for inclusion in the IMF’s supplementary foreign exchange reserves for Special Drawing Rights. Lack of convertibility has been the principal impediment for inclusion. While the issue of whether the renminbi is “freely usable” remains, it has nonetheless become one of the top five currencies traded in the world. Should China succeed in its lobbying efforts with the IMF this year, the enhanced convertibility of the renminbi could swell demand for renminbi-denominated assets and expand China’s weight in various global indices. For example, if the A shares were added to the 2.5% weighting of the H shares, China could be pushed to a 10% weighting in the MSCI All Country World Index. In our judgment, given the relative size of China’s economy and capital markets, such an upward-revised weighting is justified and needs only currency convertibility to remove the final barrier. **If successful, asset managers indexed to global indices would rush to increase China exposure in order to match allocations to index weightings.**

Adherents of the “don’t buy China” argument sound all too similar to those who cautioned against buying the U.S. stocks after the market’s huge rally off the bottom in 2009. Further accommodative monetary policy and quantitative easing would lead the United States to financial ruin in the aftermath of inescapable rampant inflation. Those who heeded those warnings missed out on five more years (and still counting) of rising share prices in what may yet go down as the biggest bull market in history—unless of course it is eventually eclipsed by China.

We reiterate our April 21st call to add to ‘A’ Share exposure, particularly on pullbacks from current levels. Our preferred vehicle has been the Deutsche X-trackers Harvest CSI 300 China A-Shares ETF (ASHR), which consists of the 300 largest and most liquid China A shares. There’s much more room to run.



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