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Batterymarch: The China story we never hear

Ray Prasad, a director and senior portfolio manager on Batterymarch's Emerging Markets team, shares insights gained through on-the-ground research in China and other Asian countries.

Each time I return to China, I gain a view of this country that's often at odds with what we see in the press. I have made two trips to Asia in the last four months, both during the course of major global economic developments. The first, focusing on China, took place at the beginning of May as the Greek crisis was boiling over and the possibility of a hard economic landing in China worried investors. In August, I traveled again to China as part of a swing through Southeast Asia. At that point, Mario Draghi, president of the European Central Bank (ECB),[1] was putting the finishing touches on his plan to keep the Eurozone intact.

Plenty of power to spur economic growth

My trips have yielded a number of insights. First and foremost, Chinese company senior managements and think-tank members were unanimous in their opinion that China will not have a hard landing. While liquidity has not been easy to come by and business growth has slowed, everyone emphasized that China is still a policy-driven economy and that government officials can modify policy as needed to catalyze growth, just as they engineered their recent slowdown. For Chinese officials, keeping an eye on the liquidity in the system has been critical. Importantly, China can act very quickly to implement necessary measures.

[1] The **European Central Bank (ECB)** is responsible for the monetary system of the European Union (EU) and the euro currency.

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While none of my contacts question the imbalances and overcapacity in certain segments of the economy, the consensus is that much of the growth shortfall has resulted from government tightening to avoid economic bubbles, particularly in the real estate sector. As one executive put it, "When you take the buyer away, to whom do you sell?" As part of their policies, officials had done exactly that, at least in the housing sector. Now we are hearing chatter about pent-up demand and rising volumes despite the government's restrictive policies. The view is that the government is keen not to repeat the policy mistakes made during the global financial crisis, and therefore they are treading carefully in terms of the magnitude and scope of any growth-oriented policies.

Meanwhile, selective easing has begun. Credit is flowing, especially to small and mid-sized enterprises, which have been disproportionately affected by the global economic slowdown. In fact, the Wenzhou rate of interest — the rate paid on loans outside normal channels, which sheds light on the likely level of interest rates without government regulation — has declined dramatically. So far we have seen only limited use by the Chinese officials of blunt financial instruments such as interest-rate changes, with just two moderate rate cuts in mid-2012.

On the other hand, areas with few restrictions, such as retail sales, have remained robust. In addition, the government has already announced targeted measures to support first-time home purchases and transportation infrastructure development. China has the will as well as ample fiscal capacity to continue to invest in infrastructure, and anecdotally, we can expect to see more such policies once the new government is in place. Public spending may be the preferred tool for fiscal easing.

China's stance has clearly changed from trying to slow down an overheating economy to engineering a soft landing. The size of the economy means that it takes a bit longer for the effect to be felt. Plans to engineer a soft landing have also been complicated by economic data flowing from Europe and the US — key trading partners for China and the rest of Asia. This has dampened the impact of China's piecemeal policy announcements. However, as US and European economies gain traction, we expect further Chinese stimulus measures to have more impact in jumpstarting growth.

Markets and investors tend to underestimate how much can be brought to bear to stimulate the Chinese economy. Required reserve ratios, currently at 20%, can be eased by at least 400 basis points[2] if necessary. These ratios are already expected to come down by another 50 to 100 basis points before the year is out. In addition, interest rates are nowhere near the zero level that we see in the US or Europe, and China's fiscal budget deficit is less than 2%, with the flexibility for expansion.

[2] A **basis point** is one one-hundredth of one percent (1/100% or 0.01%).

Weakening bear case

In our view, the bear case for China is becoming stale. Banks are trading below price-to-book[3] having priced in an increase in non-performing loans from 275 to 400 basis points. Property stocks are trading at half their net asset values[4] in a country where owning property is everyone's goal. Corporate profits are at all-time lows relative to GDP.[5] The market itself is now at 8x forward price-to-earnings;[6] we are fairly close to pricing in a disaster scenario. Eighty-three percent of respondents in a recent Morgan Stanley survey believe that China's growth will come in below 7.5% even though the economy has expanded 8.1% and 7.6%, respectively, in the first two quarters of 2012.

Over the last few months, we have seen some of the most bullish China strategists capitulate. All of the company executives and members of the investment community I met in Singapore were negative on China, believing that a hard landing is a foregone conclusion. During the last six quarters, the Chinese stock market has seen significant divergence in relative returns between companies with solid balance sheets and visible cash flows and those with leverage and either actual or expected revenue declines. Some strategists have dubbed the winners the "Nifty Fifty" — a select group of defensively oriented stocks with very visible cash flows. These are must-own names where valuations do not matter at this point. This is true across Asia as a whole. The bulk of flows into India, Indonesia and other Asian markets has also gone into this limited set of stocks.

Today valuation spreads have increased dramatically between defensive sectors and more cyclical areas, beyond levels that have led to past reversals in relative performance between the two groups. More importantly, current valuations for the "safe-haven" names are difficult to justify on an absolute basis. There is also limited participation among retail investors, with the opening of new stock-market accounts in China at a new low. Projections are bleak even for best-in-class cyclical names.

Experience has shown us that such forecasts, along with extreme sentiment and complete avoidance of out-of-favor names, have historically characterized market troughs and inflections.

Additional notes on Southeast Asia

China's economic situation is echoed in the Southeast Asian economies, where domestic policies are as influential in their slowdowns as external elements. On September 13, 2012 the Indian government introduced a series of reforms — virtually overnight — that had been pending for over three years. Steps in Indonesia to increase the domestic valued added for commodity exports have instead created uncertainty, and the award and clearance of infrastructure-related projects continue to proceed at a glacial pace. In Thailand, which has implemented business-friendly policies, the economy is thriving despite global cross-currents due to robust loan growth and increasing domestic consumption.

Overall, the existing underlying resilience in growth for Southeast Asia is clouded by sentiment amid a disproportionate focus on global macroeconomic issues — yet this resilience is tangible.

[3] The **price-to-book ratio (P/B)** is a stock's price divided by the stock's per share book value.

[4] **Net Asset Value (NAV)** is a price that reflects the value of the fund's underlying portfolio plus other assets, less the fund's liabilities divided by the number of shares outstanding. However, the market price at which an investor may buy or sell common shares of the fund is determined by supply of and demand for the fund's common shares, which may be more or less than the fund's NAV.

[5] **Gross Domestic Product ("GDP")** is an economic statistic which measures the market value of all final goods and services produced within a country in a given period of time.

[6] The **price-to-earnings (P/E) ratio** is a stock's price divided by its earnings per share.

Our investment viewpoint

We believe that China has reached a turning point. In terms of global influences, the ECB has unveiled its plan to buy the debt of peripheral Europe, and policymakers appear to be uniting behind Mr. Draghi. In the US, the economic trend is improving slowly, with housing stocks at new highs. The US Federal Reserve[7] just announced QE3,[8] which will inject liquidity into the markets, with the objective of spurring asset reflation.

In China, the most recent results for property stocks, a leading growth indicator, point to improving year-on-year growth, not just in transaction volume but also in land purchases and new project start-ups. The feel-good effect from rising property values in China cannot be understated. Every Chinese CEO has an interest in property, and the impact of stabilizing prices gives them the confidence to make capital expenditures for their firms. Transaction volumes picked up in June and July, and we saw price stability in August. Furthermore, inflation — good inflation, not the kind associated with overheating — is starting to climb slightly, providing another sign of improving growth. Purchasing manager surveys and other leading indicators from peripheral European countries are beginning to turn up as well: Greece has a trade surplus!

Valuations in China are very attractive even after the dramatic downward revision of earnings estimates over the last 12 months. For now, investors are obviously not enthusiastic about anything in the Chinese market. Being negative on China is the attitude du jour. Yet all the ingredients for a turnaround are there: valuation, sentiment and liquidity. We believe that as prices stabilize in the property market, new bank loans continue to flow steadily to fund government initiatives and the once-in-a-decade change in the country's leadership occurs in October, the perception about China and, by corollary, cyclical names, will become favorable. In our opinion, the rubber band has been stretched too far in one direction and is ready to snap back.

[7] The **Federal Reserve Board ("Fed")** is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

[8] **Quantitative easing (QE)** refers to a monetary policy implemented by a central bank in which it increases the excess reserves of the banking system through the direct purchase of debt securities. With QE3, announced 9/13/12, the Fed will buy $40 billion of mortgage-backed securities per month for an open-ended period of time.

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