The Chinese dragon

Don't make too much of the recent drop in China's growth rate, writes JONATHAN WU. This is the result of a shock to confidence, not fundamentals.

As the turbulent and volatile market conditions of 2008 have drawn to a close, both advisers and funds managers have started looking to 2009 where new investment opportunities lie.

The traditional saying of "where crises exist, opportunities arise" is no different this time around.

As we take a close look at the reawakening of the dragon, namely Greater China, we see some interesting investment themes arising in the New Year.

When focusing on Greater China, a long-term view must be taken. Traditional growth style investment philosophies are generating returns that are too volatile given that China is already a volatile market.

Having said this, let us first revisit the fundamentals of the economy as a whole.

There have been many conflicting reports in mainstream media in recent months questioning China's growth prospects going into 2009 and beyond.

Some have argued Chinese GDP growth will drop below 8 per cent and we tend to agree.

But the fuss over China's growth dropping from 10 per cent to below 8 per cent seems overblown. Context is the most important fact investors need to take away from this. Based on December World Bank forecasts, estimated global growth is set to drop from 2.5 per cent in 2008 to 0.9 per cent in 2009, with emerging markets still estimated to grow 4.5 per cent in 2009.

If China can maintain its own growth in excess of 6 to 7 per cent, it will be a large contributor to the growth in emerging markets.

Additionally, developed countries are forecast to go into negative growth. Therefore, China seems, on the surface, a worthwhile investment opportunity to consider.

Another factor working for China is the country's inflation rate, which dropped below 4 per cent for November 2008 and hence presented the Chinese Government with an opportunity it did not have during the Asian financial crisis: the ability to undertake aggressive stimulus packages to the extent of 4 trillion RMB (renminbi).

China's packages provided direct stimulus to the economy,

unlike the offerings of other countries trying to deal with the global financial crisis. While China is not facing the same problems because of its tight credit regulations (a strong positive), this has not, however, created the opportunity for China to come out in 2009 as a shining star.

Summarising China's main achievements in the past 20 years sheds much light on what can be expected in the next 20 years and beyond.

The evolution of the average Chinese worker is a prime example.

Until recently, half of Chinese workers were farmers. And as these farmers leave the farmlands to the cities, they move from primary industry to secondary and tertiary.

This creates two separate, but still related, consequences.

Firstly, these workers' productivity would increase and hence produce more GDP. As a point of measure, in 2004, the average annual returns of a labourer in agriculture was US$300, compared against US$900 for services and US$3,000 in industry.

Secondly, saving patterns will shift. The average farmer, for example, has income that rests solely upon the good harvest in a particular season, not a constant level of income, and therefore making the farmer save

reawakens

more for that 'non-rainy' day. But an industry or services worker has a more or less stable job with a more stable level of income, making them more prone to save less and spend more. As the number of these workers increases in the coming years, GDP will increase and so will the collective spending power of the Chinese.

Another achievement has been the movement of large numbers of people from rural to urban areas.

In the past decade, 100 million Chinese have moved to cities. Over that period, 200 new cities have been added to the Chinese map, and China now has over 100 cities with a population of one million and above.

Each new city requires infrastructure: schools, sewer systems, roads, law enforcement and power generators just to name a few. This has created what we refer to as the 'resources boom'.

No matter what people say about Rio Tinto's or BHP's share prices, China will continue in the long-term to import iron ore, coal and the like, be it from Australia or digging its own mines.

This is why we have never believed Australian miners to be an adequate play or proxy for China.

What we have seen in China now, and moving into the next 20 years, is no different to the US in the 1950s. President Eisenhower started the multi-billion dollar interstate highway system, interlinking cities, which have led to major efficiency gains in logistics.

China is now underway in its new '7-9-18' system (already 40 per cent complete) with seven ring roads leading out of Beijing, nine expressways linking the north to south, and 18 expressways linking east to west, bringing the total size of the national expressway system to 85,000 km. This in itself will replicate the benefits that the US has reaped over the past half century, but with a population more than five times the US.

Moving to the short term, what immediate investment opportunities lie in China and which sectors will benefit from China's short to medium-term stimulus packages?

The first discussion point is from a valuation perspective. It seems that a deep and long recession has been priced in. We all understand that the share market is a forward looking indicator. Given that the Chinese stimulus package has begun to make an impact, the market trend in the last two months of 2008 seems to be pointing to the beginning of a recovery.

But the preceding 12 months must also be taken into account, with the Chinese CSI300 benchmark falling 70 per cent and the Hang Seng 65 per cent. This was all prior to the stimulus packages. P/Es are now below 15x both in China (from highs of 50x +) and below 10x (from highs of 25x +) in Hong Kong on historical earnings, and are at similar levels to previous crises (the Asian Financial Crisis, Third World Debt Crisis, and Oil Crisis) and returns post these crises were strong.

The sector looking most attractive is banking because of banks' current valuations and stability in the wake of the subprime crisis.

The important point here is that China has room to move in terms of further interest rate cuts, reserve ratio requirements, strong FX reserves and increases in loan quotas, in contrast to some of its western counterparts.

This will aid banks in their recovery. History has also shown that, after a crisis, banks in China have averaged a 49 per cent rise in the three months following.

Consumer staples and discretionary companies are also set to benefit given the slowdown in global growth.

Retail sales leading up to the end of 2008 remained strong with October still posting a 22 per cent increase over the PCP. This has been due to the slowdown in exports.

Instead of selling these high quality goods offshore, they are now being made available to local consumers, and since they are currently sitting on high levels of disposable income and cash, retail sales moving into 2009 look strong.

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Another beneficiary of the current government plans and environment is infrastructure. With the 4 trillion RMB stimulus plan, the government is targeting stronger employment and creation of new positions. To fulfil the country's infrastructure plans, infrastructure companies will benefit from new mandates awarded by the Chinese government.

The third clear beneficiary looking into 2009 is the property market.

In the fourth quarter of 2008, the government has boosted the property market with six separate policies, of which the strongest is the minimal mortgage rate cut.

Consequently, banks can now charge below 4 per cent. Cuts to stamp duty, land appreciation tax and the like have been auxiliary to this.

With the movement of 15 to 20 million people a year, to building new and expanding existing cities, there is no doubt low cost and luxury properties will be in great demand. Developers involved with constructions in new cities will benefit the most.

The property sector has been severely battered by the global financial crisis as well as continuous government policy to raise interest rates leading up to the middle of 2008.

Hence, a great opportunity now exists for investors to join in the recovery.

It should be noted that in the lead-up to the end of 2008, institutions were starting to make their tactical asset allocation calls. A trend can be seen already, with JP Morgan and Credit Suisse allocating an overweight position in China, and Goldman Sachs calling for long China A Shares.

The main driver for the serious 2008 drawback of Greater China shares (China, Hong Kong, Taiwan) has been a shock to confidence rather than fundamentals.

When shocks are apparent in an inefficient market, investors can take advantage of this value. Hence, the reawakening of the dragon will come.

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