

Investing in China. 2015 and Beyond.

Discretion is the better part of valor. I began the year still bullish on China domestic equity markets. The thesis was founded on a number of factors.

1. Low inflation and slowing but still positive growth had led the PBOC to significantly expansionary policy. This policy was widespread including
 - a. Cutting the RRR.
 - b. Cutting interest rates.
 - c. Various open market operations to increase liquidity and cut real borrowing costs across the board including short and medium term lending facilities, pledged supplementary lending and a local government debt swap which manufactured qualifying collateral for cheap repo.
2. Valuations on Shanghai Composite and H Shares were not demanding, at 15X and 8X respectively coming into the year.

But we overstayed our welcome, missing a number of things.

1. The level of retail margin trading was apparent and we saw that. What was less apparent was the level of corporate share financing whereby corporates used their equity as collateral for loans.
2. Corporate borrowing to invest in the stock market instead of operating assets. This created a feedback loop whereby falling prices triggered LTV covenants and thus margin calls on corporate investors.

And we revised our outlook for a number of reasons.

1. Corporate investments in the stock market implied A) company management not seeing investment opportunities in their core competencies, B) corporate balance sheets were more volatile than represented and therefore of poorer quality.
2. Given the signals from corporates' investment patterns, we have a less optimistic view of Chinese corporate earnings prospects. Indeed the economy appears to be slowing faster than we expected. Despite the fact that our investment thesis relied on a slowing economy, it relied on a moderate decline. The current decline appears to be more serious.

We expect that the Chinese equity markets will trade in a range.

1. We expect the Chinese government will not tolerate much weaker equity markets as this will threaten the solvency of corporate China. Hence there is an implicit support, a sort of PBOC put. We think the strike may be around 3500-3700 if we use the Shanghai

Comp as a guide.

2. We expect the Chinese government will not tolerate strong equity markets either. The 18 month bull market in Chinese equities was not driven by earnings growth but by a massive liquidity operation of the PBOC resulting in multiple rerating. This encourage leveraged, speculative activity which destabilized the market. China values stability and will likely to allow the market to rise too quickly. We think there is a sort of PBOC call, with a strike somewhere between 4300-4500.

What about structural reform?

1. We think that the structural reform in China will continue. We do not see the anti-corruption campaign and the emphasis on rule of law and the constitution as cosmetic but rather as a genuine effort to create a socially and politically durable regime. We think that to not do so is to present an existential threat to the Party in the face of a growing middle class and greater information mobility.
2. Economic reform goes hand in hand with political reform. As the government is moving towards rule of law, it is pushing its economy to rule of market. The intervention in the equity markets during the recent volatility is no more interventionist than the Fed, or the ECB during the credit crisis of 2008. The recent turbulence surrounding the new RMB rate determination is also, when examined closely, a move towards more market price discovery, but was unfortunately miscommunicated, and misunderstood, as a competitive devaluation.

What are the long term prospects?

1. China continues to grow in size and importance. Even at 6% GDP growth, China will add more nominal output than the US economy growing at 3%.
1. China's to do list includes the following
 - a. Rule of Law.
 - b. Rule of Market.
 - c. Rebalance the economy.
 - d. Hold society together.

Holding society together is the most important agenda item as it gives the Party legitimacy and thus a *raison d'être*. Rule of Law is simply a means to this end. Corruption needs to be addressed in order to present a fair and even playing field in a country where inequality has been rising even as the country has become richer. Rule of Law is also important in presenting the government as an impartial and disinterested arbiter. Most importantly, laws and principles are far more durable than persons or parties. By embracing the constitution instead of subordinating it as in the past, the Party gains legitimacy and longevity.

Rule of market is necessary to integrate China into the global economy even more. When China was simply a factory, integration is not important. The relationship between China and the

rest of the world was sufficiently simple that it could be controlled through closed channels. If China rebalances its economy successfully, it will no longer be just a factory to the world but will be a source of capital as much as a destination, a source of intellectual property creation as much as a consumer of it, an importer as much as an exporter. Only an open economy guided by market forces, even if with some soft direction, can facilitate China's future intended relationship with the rest of the world.

In the long term, investing in China will be more like investing in the US. Today we buy US business and companies, not USA. In future, we will also be able to buy Chinese businesses and companies and not just China beta.