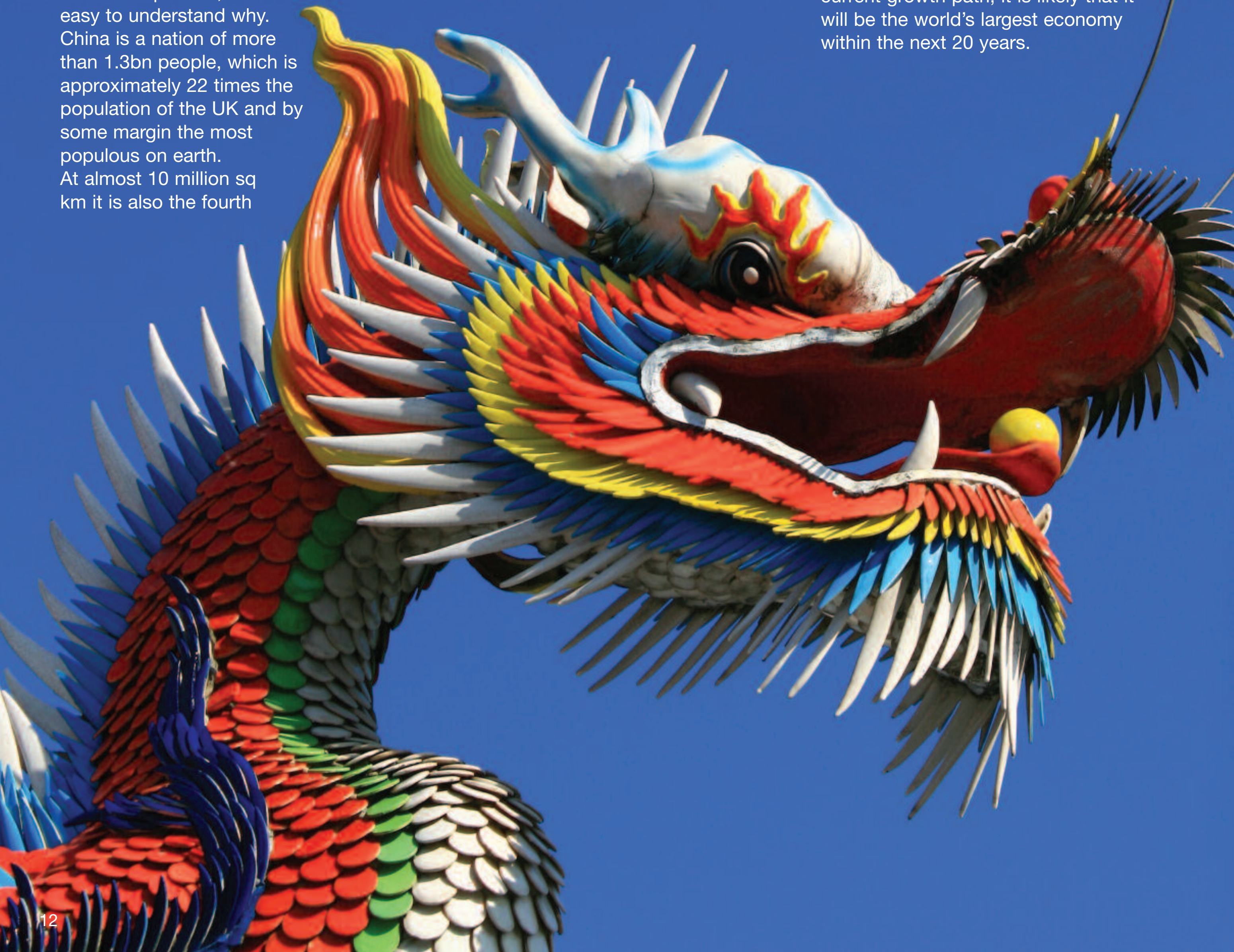
Year of the Tiger, Century of the Chinese

Christopher Sexton, Investment Director with Saunderson House, examines the temptations and turn-offs of investing in China

If the 19th century represented the peak of Great Britain's global influence and the 20th the rise of the United States to the position of dominant super-power, will the 21st century belong to China?

Certainly a great deal has been spoken and written about the Chinese development story recently, nowhere more so than with regard to the opportunity China presents for investors. On first inspection, it is easy to understand why. China is a nation of more than 1.3bn people, which is approximately 22 times the population of the UK and by some margin the most populous on earth. At almost 10 million sq km it is also the fourth largest country by geographic area. More importantly, it is undergoing rapid economic expansion, achieving growth in output of close to 9% in 2009, despite the global financial crisis, as migration from the countryside to cities drives what is effectively China's industrial revolution.

Such rapid growth provides a mouth-watering prospect for investors. Strong economic expansion should support rapid corporate earnings growth and thereby, at least potentially, strong stock market returns. At a time when economic growth is pedestrian at best in developed countries, this growth is still more appealing. What is more, there is clearly a long way to go. Despite already being the third largest in the world, China's economy is only slightly more than twice the size of the UK economy, and output per head is barely one-sixth of that of the UK. Yet on its current growth path, it is likely that it will be the world's largest economy within the next 20 years.



China is also an exporting powerhouse, and this, together with a policy of keeping its currency cheap relative to western currencies, has allowed it to amass the world's largest reserves of foreign currency. At a mind-boggling $2,400bn, a figure close to the UK's 2009 annual output, this means China, itself, is now a very serious investor in overseas assets in its own right. In particular it is seeking to utilise these reserves to secure sources of energy and raw materials, thereby ensuring that its rapid development does not stall for lack of such resources.

The opportunity for investors then is to provide capital to Chinese companies as they drive the modernisation of China, bringing more and more export goods to world markets and bringing modern goods and services to its enormous population. This opportunity has not been lost on fund management group Fidelity, which is looking to raise $1bn for a Chinese Special Situations Investment Trust to be managed by their star fund manager, Anthony Bolton. Indeed, such is the attraction of the China story for Bolton that he has reversed his decision to retire from fund management and is relocating to Hong Kong to take on the challenge, having gone on the record as saying that he firmly believes China to be the investment opportunity of the next decade.

However, there is another side to the story. China is, of course, a communist state and a command economy with centralised planning and controls. It has censorship, a questionable record on human rights and, importantly for investors, its corporate governance and even property rights are not what we take for granted in the West.

Further, it has only managed to maintain strong economic growth through the global financial crisis by embarking on a massive government investment programme and instructing its banks to go on an enormous lending spree. Thus, while China's 8.7% economic growth in 2009 was hugely impressive in the face of falling output elsewhere, more than nine-tenths of this, according to the *Financial Times*, came from investment in fixed assets. While it can be argued that there is a clear need for such investment, particularly in infrastructure, there is some evidence that this is happening too quickly. For example, despite having at present one sixth the number of passenger vehicles as the US, China's high-speed road network is only fractionally smaller. More to the point, upon the completion of proposed construction, China's road network will be 60% larger than the US.

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Chinese money supply data also give cause for concern. At close to 30%, growth in China's monetary aggregates is far in excess of economic growth. This is clearly inflationary and the People's Bank of China, the Chinese central bank, is now taking steps to slow this growth by raising bank reserve ratios. Whether they can effect a slowdown before inflation takes hold is a moot point. Chinese banks made loans of 1,390bn renminbi ($203bn) in January. This was more than the sum of the three previous months combined. Worryingly for investors, the performance of China's stock market is, according to JP Morgan, closely correlated with money supply growth. This implies that last year's strong stock market performance might have had more to do with excess liquidity spilling over into the stock market rather than more fundamental factors such as earnings growth.

It also implies that stock market returns this year might not be spectacular, despite the continued strong economic growth. Indeed, so far this year the Shanghai A shares market has fallen by 9% as investors look to lock in profits from last year amid signs of increasingly hawkish actions from the Chinese authorities to deal with potential asset price bubbles before they become too extended.

A degree of profit taking is understandable. The Shanghai A shares market rose by 97% from the low point in November 2008 up to the end of 2009. This is far more than its developed market counterparts and leaves Chinese shares looking by no means cheap. Chinese shares currently trade at 3.4x book value (the UK's FTSE All Share is currently at 1.7x book). Analysts might argue that high valuations are warranted by the strong profits growth. However, while growth is clearly superior, the risks are also greater. Traditionally, stocks trading on emerging equity markets have traded at a discount to those on developed ones - to compensate for weaker corporate governance and greater political risks. These risks have not disappeared.

International risks are also significant. The Sino-American relationship is one of tense mutual inter-dependence. Chinese exporters are hugely reliant on demand from the US, while the Americans need the Chinese to recycle their trade surplus into the US Treasury market to fund their budget deficit. Furthermore, the US government would like the Chinese currency to appreciate against the US dollar to allow their enormous trade deficit to correct. The Chinese have resisted this since the onset of the credit crisis as to do so would damage Chinese growth and slow their transition from a predominantly agrarian society. Too little growth or too much inflation in China could lead to social unrest. As Angus Tulloch of First State Investment highlighted recently, the 1989 Tiananmen Square uprising took place amid a bout of inflation that was threatening the living standards of the population.

In summary, many, many factors need careful weighing in the minds of those considering investing in the China story. The growth potential is clearly huge, and the profits for investors could be considerable. However, the risks should not be underestimated. It is entirely possible that China emerges as a great world power in the next two decades without international investors benefiting. It may well prove to be China's century but, for investors, caution is likely to remain the most valuable commodity.

Contact details:

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Tony Scott-Clarke, Director
on 020 7315 6638

Gareth Parsons, Chartered Financial Planner
on 020 7315 6521

Christopher Sexton, Investment Director
on 020 7315 6506

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