CERNO CAPITAL

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At the end of May, Joe Zhang and Geoff Yu came for lunch in our offices to debate the economic and financial risks facing China in the next few years. Geoff was born in Beijing, educated in China, the US and the UK and is a senior foreign exchange strategist at UBS. Joe was born in Guangdong province, worked, variously in the past 30 years, at China's central bank, a Chinese property company, a micro finance company and various international banks and brokerages before setting up his own consultancy. Joe sits on the boards of several Chinese companies and is a Communist party member. Geoff has no formal China analytical role at UBS but is an avowed sceptic about China's ability to fully open its capital account without incident. Joe and Geoff had never met before: their backgrounds, influences and views are markedly different and different in ways that allowed a wide spectrum of expert opinion to be surveyed in one debate.

James Mackintosh of the FT, also present at the lunch, skewered the problem from an investment management point of view, as follows: we can all agree that China matters. Even if you do not invest in Chinese financial markets, China has a preponderant influence on global economic activity. What is less clear is how to deal with the possible outcomes in portfolios. The unknown zone dominates investors' minds, although there are some exceptions. Jim Chanos is remembered as the fund manager who told Bloomberg that China was "on a treadmill to hell" as a consequence of overinvestment and an over bloated property market. However, he delivered this augury in 2010, so if he is right, he has not yet been right. Edward Chancellor has recently left the asset management firm GMO to write a book on China. It will certainly foretell disaster (unless it is not completed in time in which case it will chronicle it). In 2013, Edward predicted that the various isolated financial blow ups and scandals would conflagrate into a wider financial problem. Although Edward is spot-on in respect of the thorough toxicity of these quasi Ponzi-schemes, the wider blow-up has not yet happened.

What these reveal is that there is a debate to be had about factors and there is also a debate to be had about timing.

At the risk of introducing too many personalities, a mention should be made of Russell Napier who, as a young man, joined a rowdy brokerage owned by a French bank and now, through acquisition, finds himself working for a unit of the Chinese financial apparatus. Russell has also written recently on China and his prediction is that the large trade and current account surpluses of recent years will evaporate as a consequence of declining competitiveness and increasing capital flight and this, like the proverbial ebbed tide, will leave the economy unclothed and ultimately result in a significant devaluation of the RMB.

His new employers have yet to comment.

In the early 1990s, this writer, then based in Hong Kong, made several trips with investors visiting the then new stock exchanges of Shenzhen and Shanghai, investors on those exchanges and some of the companies listed. It wasn't long before the avid new speculator class had ramped the shares of the first listed 'A' shares to unsustainably high valuation ratings. Almost a quarter of a century later, the jagged de-rating of 'A' shares is approaching an area of basing out. Since then, other classes of security have become available, first 'B's, a form of foreign board script on those stock exchanges, the 'red chips' in Hong Kong and then 'H' shares, also in Hong Kong.

What manifestly has not developed is any general sense that Chinese equities might be a good store of wealth. There has been some substantial wealth created outside the state sector, notably in derivative technology and internet offerings (e.g. Baidu, Tencent with Alibaba to follow soon) but these have tended to serve the founders, some venture capitalists, the underwriters and a short list of institutions able to access their stock at IPO.

With the new stock exchanges came brokerages, asset management firms and a fruity argot: falling stock prices are nothing less than death (跌）. The concept of *tao zhu* (套住) is to be stuck in a position. To *qingcang* (清仓) is to clear out stocks, a further step is *shuaimai* (甩卖) dumping stocks. *Dimaigaomai* (低买高卖) is the nefarious practice of pumping and dumping.

The backdrop of a falling 'A' share market has not been conducive to the proliferation of a mutual funds culture and something much more pernicious has grown up in its stead. In China, "wealth management products" have been pushed by ironically termed trust company intermediaries offering rates of return that cannot be obtained without great risk. The underlying investments are junk debt, not equity. Trust company assets have been growing at an annual compound rate of 71% over the past nine years and now stand at RMB11.7tn (£1.2tn). Remember the 1980s? This is China's Savings and Loan Crisis in the making.

Nonetheless 'H' share market capitalisation now sums to £343bn and represents 40% of total Hong Kong capitalisation. The investible Chinese universe of stocks carries a current weight of 18% in MSCI's Emerging Market universe and is now the largest country universe (South Korea comes second), but a mere 1.9% in MSCI's All Country World Index. This means that, for the global investor, a Chinese allocation is an off-benchmark bet but for the Emerging Market (EM) investor, the Chinese conundrum must be taken on.

The puzzle for the dedicated EM investor deepens when you further consider that Financials represents 37% of the Chinese index, a full 2.5x larger than the next largest sector: Energy at 14.3%.

At face, Chinese banks appear to be a profitable sector on a low rating. The sector has achieved compound growth in earnings per share of 16% in the past four years, its return on equity stands at 19.4% and price to stated book ratio is just 0.8x. The earnings multiple is a mere 4.6x, which inverts to a earnings yield of nearly 22%. If the lid on the growing keg in debt within the Chinese economy can be kept on for a few years more, Chinese banks are beguiling speculations that have begun to draw some investors in.

Domestically in China, one of the consequences of growth and surpluses in the context of a largely closed capital account has been the *de facto* financial suppression that has lasted for many years. This matters less when there was little money to go around, as was the case under Maoism. What has filled the gap since 1991, and filled it with dumper trucks, has been residential property.

Since young Jimmy went to Shanghai in 1991, the Chinese have been moving into cities at the rate of 20 million people per annum, in what remains a partly state controlled process. Not all have required new housing but the newly affluent have bought apartments and the sustained rise in capital values has encouraged those with savings to follow on with further investment purchases. Amongst the relatively wealthy classes, it is not unusual to own three, four, five or more apartments. Officially, property ownership already stands at over 1 unit per household nationally. Migration levels, though are on the wane and the ratio of urban housing (in sqm) to head of population is now higher than that of the US and UK and shy only of the French who seemingly rattle around in their apartments like *pois dans leurs cosses*.

Tao Wang, China economist at UBS, estimates that replacement and migration requirement sums to underlying demand of perhaps 8-9 million units per annum, a few million shy of the 11mn units that were completed last year. Floor space under construction stands at 57mn units and the construction level to sales ratio is at a level that has only been seen in other countries prior to a major downturn: comparable with Japan in the 80s and Spain and the US in the 00s.

Although mortgage lending is now available, many purchases are cash financed so you do not have in China quite the same linkages between bank, homeowner and property sector as prevail in the US, the UK and most of the Western world.

This leads many analysts, Joe Zhang being one, to suggest that a downturn will not deliver the pain in the way we would anticipate from Western booms turned sour.

And indeed, were sourness to spread, there is scope to provide official support the sector: by pushing the mortgage sector further, by relaxing the *hukou* (residency permit) system further.

The suspicion, though, remains that the nefarious trust company structure will deliver a dose of bad-credit poison sub-cutaneously.

Tao Wang represents the sanguine viewpoint: although a downturn will have some bearing on China’s overall economic growth which might register at below 6% (compared with IMF forecasts of 7%). The means of transmission are clear. Property accounts for over 30% of of Fixed Asset Investment (FAI) in China and FAI accounts for 84% of GDP.

To our minds, there is therefore a highish probability that a slowdown in the housing sector will set in train two chain reactions: externally the demand for construction related goods will be stayed with collateral effects fanning out via the commodity complex (for example toward the Australian property and financial sectors). Within China, debt problems are likely to erupt like pustules, at greater frequency than in the past.

If so, this is going to be more than a shudder on the rudder. A few weeks ago, we approved a China specialist investor for investment, the first China only fund to be approved in our history. Post shudder, and timing is not known, we may look for an opportune moment to add capital. At that point in the future, value will be apparent and risks diminished.

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