# The China Sell-Off: Implications & Opportunities

## Manager Call with Canterbury Consulting and Matthews Asia's Andy Rothman

*On September 29, 2015, Andy Rothman, China Investment Strategist at Matthews Asia, presented his outlook on China. He discussed post sell-off valuations, devaluation of the Renminbi currency, misconceptions of bearish sentiments, and the government's recent missteps. While sentiment is currently negative on the region, Mr. Rothman is encouraged by the long-term growth prospects as domestic consumption continues to rise from the evolution of the middle class.*

### THE CHINESE STOCK MARKET AND POST SELL-OFF VALUATIONS

— The recent downturn in the Chinese stock market is significant, however it has been largely overdramatized

— The Shanghai Composite is down 40% since June 12th, however the market is outperforming the S&P 500 by 30% on a one year basis

— There is clear evidence that the correction has not impacted Chinese consumers. For instance, new home sales are rising, SUV automobile sales are higher, and retail sales are higher

— Chinese citizens are well aware that their local stock market is new and susceptible to volatility. 73% of active accounts have less than $15,000 and only 4% of the population is invested. Moreover, 80% of the turnover is retail and not 'research-based'

### THE DEVALUATION OF THE RENMINBI (RMB) CURRENCY

— The Chinese Government did not devalue their currency in order to increase exports. The RMB only devalued 3% vs. the USD and is still higher than the dollar on a YTD basis. Moreover, Chinese exports are doing well compared to the rest of the world. Exports have actually grown 1% YoY

— China has a desire to be added to the International Monetary Fund's ('IMF') Special Drawing Rights ('SDR') basket which is composed of four key international currencies. China wants to be included on the exclusive list since SDRs are used as an international reserve asset by many nations associated with the IMF. By devaluing their currency and effectively 'de-pegging' it from the U.S. dollar, China is one step closer to monetary independence which could be interpreted favorably by the IMF

— The risk in the devaluation stems from the government's poor implementation and communication. Economic policy-making may become more political and less efficient which could negatively affect the population's perception

### MISCONCEPTIONS OF BEARISH SENTIMENTS

— Many have had negative views on the rebalancing or restructuring of the Chinese economy as it moves away from export dependence to consumption dependence. Contrary to this belief, China has done a good job and the process is well underway:

- The nation has moved beyond its dependence on exports. Exports contribute a very small percentage to GDP and only 10% of factory production is sent overseas
- Consumption has outpaced structural investment. 2015 marks the third consecutive year where this has occurred

- Retail and entertainment growth is higher. Movie theatre sales, SUV automobile sales, Apple sales, and Nike sales are all up. This shows a shift in preferences due to higher wealth creation and the evolution of the middle class

— While many manufacturing indicators have been weak, PMI for services have been better than expected. The market should be focused on consumer and service industries as they are the largest part of the economy

— State-owned Enterprises ('SOE's') are a much smaller part of the economy than what is initially thought. Entrepreneurialism is at an all-time high and 80% of jobs are now created by small, private companies

— ETFs tracking companies in China are out-of-date as they are primarily concentrated in manufacturing and SOEs

— While the property market has caused uncertainty, only 10% of property sales are made by investors while the other 90% are made by homeowners. The median cash down-payment for a house in China is 30% (compared to 2% in the U.S. pre-financial crisis) and banks only deal with 'plain vanilla' mortgage lending

— The emergence of 'Ghost Cities' is largely due to how new home deals are formulated. 80% of new homes are sold on a 'pre-sale' basis where the contract is agreed upon 1-2 years before the house is complete. Many of these new cities will soon be populated once construction is finished

## CHINESE GOVERNMENT MISSTEPS

— Absence of the rule of law will hurt the reputation of the government. China encourages private property, however there is no transparency or fair protection of such. This will not be sustainable in the long-term and the nation will suffer a real recession within the next few decades as it becomes more market driven. The government will need to be held accountable by a private judicial system

— The government's handling of the environment has been poor thus far. However, there is recent evidence that they are recognizing the significance of taking care of the environment and have recently begun several associated initiatives

— Geopolitics in the South and East China Seas are too aggressive, however they have become more aware of their aggressive actions in the last six months

## Q&A WITH ANDY ROTHMAN

What are your thoughts on the banking system?

— Every bank in China is controlled by the government, however the majority of the loan creation is made to the private sector

— The risk of bad loans or a pending banking crisis is small. $8.5 trillion is held in Chinese consumer bank accounts

What are your views on the accuracy of macroeconomic data out of China?

— Don't obsess on the GDP number as investments shouldn't be made on it. The government hasn't been falsifying the number on a large scale

— Growth in the property market and sales in retail is far more important

What is the effect of the recent crackdown on corruption?

- The crackdown has been longer and more thorough than expected. Many high level officials have been exposed
- The government runs the risk of pursing too many political threats rather than focusing solely on corruption. This may hurt the government's reputation
- The crackdown has not had a significant impact on the Chinese economy, but has hurt luxury goods

What is your assessment of China's competitiveness and foreign direct investment?

- China is pushing companies to move up the value chain by trying to make them more productive. Automation growth is apparent
- Cheap textiles and goods are contracting. China is diversifying away from just producing affordable clothes and toys

What is China's demand for commodities?

- The 'Super cycle' is over as the growth rate of fixed asset investment peaked in 2009. The nine consecutive years of 25% YoY growth was equivalent to the U.S. infrastructure boom in the 1950's
- Commodity growth will continue to decelerate, but demand wont collapse

What is your outlook on Macau?

- The anticorruption campaign has had a significant impact on the VIP casino consumer
- The highest margin for the Macau casinos is in the mass-market gambler
- The government is pro-gambling in Macau and there is no chance in them ending it

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**Andy Rothman**

*Matthews Asia, China Investment Strategist*

Andy Rothman is an Investment Strategist at Matthews Asia. He is principally responsible for developing research focused on China's ongoing economic and political developments while also complementing the broader investment team with in-depth analysis on Asia. In addition, Andy plays a key role in communicating to clients and the media the firm's perspectives and latest insights into China and the greater Asia region. Prior to joining Matthews Asia in 2014, Andy spent 14 years as CLSA's China macroeconomic strategist where he conducted analysis into China and delivered his insights to their clients. Previously, Andy spent 17 years in the U.S. Foreign Service, with a diplomatic career focused on China, including as head of the macroeconomics and domestic policy office of the U.S. embassy in Beijing. In total, Andy has lived and worked in China for more than 20 years. He earned an M.A. in public administration from the Lyndon B. Johnson School of Public Affairs and a B.A. from Colgate University. He is a proficient Mandarin speaker.

**Loren Asmus**

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Mr. Asmus is part of Canterbury's Research Group and is responsible for the sourcing, due diligence, and monitoring of public market investment managers. He joined Canterbury in 2013 as an analyst where he served institutional and taxable clients. Prior to Canterbury, Mr. Asmus was an Institutional Fixed Income Representative for Mutual Securities, LLC where he provided fixed income solutions for county and city municipalities. Mr. Asmus graduated from California State University, Fullerton where he double-majored in Business Administration, Finance and Music Performance, Jazz Studies.

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