COMMENTARY

July 6th, 2010

Benign slowdown, live from China

Dear clients and colleagues,

This is Tuesday in Hong Kong, the mid-stop of my one-month trip in China. Outside the hotel the heat of air is usual for the summer, but the heat of shopping crowd from mainland tourists is unusually overwhelming. What is certain is that the Chinese economy is still booming. What is uncertain is how the slowdown, initiated by the government and beneficial for the long term, will play out in the coming year. Such concern has dragged down China's stock market by 27% in 1H2010. Last Friday Shanghai Composite Index dropped to a 15-month intraday low.

It is an important time to study the direction of the Chinese economy. I started the journey by attending the Credit Suisse China Investment Conference in Shanghai. About 50 companies and 200 investors were present. Although everyone was optimistic about the mid-term growth of China, there was simply no consensus on the short-term outlook. After the conference I conducted company visits in 4 cities: Shanghai, Hangzhou, Nanjing and Hong Kong, and talked to more institutional investors. These companies were related to sectors of consumers, infrastructure, e-commerce and telecom. They believed that revenue growth in their own companies might be slower than last year but still at double digits. However, fund managers were more cautious and their opinions ranged widely. Some expected the housing price to correct 10%, others 30-40%. Some saw the sluggish stock market to last 6 months, others 2 years. You get the idea.

There are many moving pieces in the China game. I try not to confuse myself with too many controversies, but put them in one big picture, step back and take a look.

1. Is the economy going towards hard landing?

Unlikely. The concern of the government right now is the contrary – overheating.

Current slowdown is an active policy-driven initiative, not a passive last-resort reaction.
China recently revised its GDP growth in 2009 to 9.15% from 8.7%. This leaves more room for the government to slow down the economic growth, and return it to the healthier level of 7%-8%. Chinese leaders still have lots of ammunition to adjust the economy which are proven to be effective. This government has probably the best balance sheet in the world. State-owned enterprises dominate the economy. And both are cash rich.

The overall policy is still pro-stability and pro-targeted-growth.
The announced policy is sector-specific, not one for all. Restrictive measures are applied on bank lending, housing market, and mature industries with overcapacity, while expansionary policies continue to encourage consumption, infrastructure and emerging industries such as alternative energy.

Key GDP components are driving the economy forward.
Investment and government spending are massive. The impact of the RMB 4 trillion stimulus packages is still on-going; Private consumption gets stronger following the contribution of rural areas and overall rising disposable income. Retail sales growth of around 17% is the consensus; Net export is the only weak factor, but is expected to be offset by the other three.

2. Is the stock market over-reacting?

Not really.

Visibility is very low.
This is mainly due to three reasons: slower domestic growth, weak recovery in the US and EU, and unclear effectiveness of recent policies. Unlike the trend of economic growth, the move of stock market is all about expectations. Investors who have not forgotten the market turbulence since 2007 have good reasons to be prudent. I think the cautious sentiment may cloud the stock market for at least 6 months till some investors sense the end of policy tightening.

The big question mark is the real estate market.
It is hard to estimate investors' tolerance on price slump. -20% or -40%? The current housing market is a mixture of strong demand, limited supply and rich speculators. On one hand, the anti-speculation measures should be able to push price down, by completely restricting non-resident purchase and limit resident purchase in some cities, not to mention the increase to 40%-50% down payment requirement. On the other hand, there is real demand created by accelerating urbanization. Rent in big cities, which has increased over 20% in the past few months, may also provide certain price cushion.

3. How to play the China game in the coming year?

Stock picking rather than indexing.

In the Shanghai composite, financials and commodities sectors represent over 60% of the total index. With the concern on debt delinquency and weaker economic growth, both sectors may be under pressure and drag the index down. On top of fundamental analysis, more attention may be paid to sectors which are driven by urbanization such as Consumers, Healthcare, and Infrastructure, as well as green industries encouraged by the macro policy.

During this trip I visited two of three H-share companies held in our portfolio. The update was positive.
Hongkong and Shanghai Hotels (45 HK)
The company operates one of the most luxury hotel chains in the world, under the brand of Peninsula. Worldwide it has 9 Peninsula hotels, with the latest opened in Shanghai and a new one under construction in Paris. The CFO told me that the recovery has been strong in Asia, especially China. The performance of

Shanghai Peninsula exceeded expectation. On the growth strategy, the company is looking for opportunities in gateway cities in Europe and Asia, such as London and Mumbai. The management emphasized quality over quantity in creating its hotel portfolio.

Citic 1616 (1883 HK)
Citic 1616 is a telecom service provider with a leading position in inter-operator connectivity in Asia, particularly focusing on China & HK. It provides hubbing services to over 300 telecom operators in 53 countries. It is the No. 3 carrier in the world and No. 1 in Asia for voice hubbing services, ranked by international minutes. The CFO foresees lower revenue growth in 2010, but the bottom line is expected to be boosted by new investment in Macao Telecom. The growth strategy is to continue gaining market share in Asia as well as entering more markets in South America and Africa.

4. What impressed me the most?

People's growing confidence in the Chinese leaders.

It's my 4th trip to China since Feb 2009. This time everyone I met told me that despite corruptions if the central government wants to do something, they will succeed. We might take it with a grain of salt, but you get the idea of the popularity of the government and its strong influence on the economy.

The backbone of China's economic growth is urbanization led by the Communist Party of China (CPC). In short, Mao liberated the poor, and Deng made them rich. Last week, the Party celebrated its 89th anniversary on July 1st. Total number of membership increased to 78 million from 66 million in 2002.

While reckoning the power of the CPC, we should also view it as an evolving Party instead of a purely-red dictatorship. During the economic reform, the Party has transformed from an anti-capitalism regime to a some-called "State Capitalism". Its leaders are no longer a group of revolutionary farmers, but economy-savvy cadres rising from corporate level. They are more sophisticated and flexible.

Of course, the one-party leadership has created many structural deficiencies which it tries to correct, such as corruption, lack of democracy, and weak private sectors. The general public seems to feel realistic about the complexity of the country, and believes the CPC has done a good job.

Lastly…
I still have two more weeks to feel the pulse of this big economy. Will keep you updated.

Regards

Qing Ji, Partner
On behalf of the Global Alpha Team