

# M&CO Newsletter

## A Short History Comparative of East Asian Investment History

From history we can observe how mercantilist policies inevitably results in massive domestic asset bubbles. Significantly, the greater an economy's exposure to exports, the greater seems to have been the resultant bubble. The best example of this Taiwan in 1986 when the trade surplus reached over 20% of GDP and even though the currency appreciated by some 30%, money supply went out of control by over 20%, fuelling a supreme bubble. From September 1985 to April 1990 the stock market exploded upwards 12 fold. This was accompanied by two significant retracements of 50%, (associated with the 1987 world crunch), and 35% respectively. As the currency rose it entrained a self fulfilling expectation of further rises and locals brought more funds on shore to participate in the boom even though the authorities did their best to encourage outflows. In an attempt to diminish speculation, capital gains tax was introduced along with dire warnings of impending trouble.

The surprising feature of the bubble was that the banks prospered in this environment inflation, but mainly because of asset growth. Most significantly, the cauterizing of their balance sheets which involved special reserve requirements that peaked at 40% of deposits, caused them to amplify risk-taking with the residual funds at their disposal... yet investors kept chasing bank shares. They rose on average by 20 fold in three years! The other beneficiaries were companies that were domestically orientated, while exporters languished. The same pattern applied in Korea and Japan but the bubble was much more modest with their respective indices rising by ten fold and by two and a half fold in four years from 1985.

The position of China today suggests a similar paradigm. We can expect all manner of policies to be introduced to alleviate the pressure on the yuan. Though, rather like sitting on a water bed, pressure in one part will be felt elsewhere. Outward flows are likely to be encouraged, initially to the likes of better regulated and far more accessible (from Australia) Hong Kong and Singapore, with the consequential impact on values. It is unlikely to be a smooth trajectory as investors respond to the phalanx of measures introduced to try and calm them, yet past patterns suggest the market will rise well beyond sustainable value. That the bank of China will have learned from these past patterns we do not doubt, so it will be intriguing to see what innovations they foster.

The remarkable feature of the industrialization of China is that while factor input costs have been distorted, the growth of productivity has been colossal. This has been assisted by the investment by government in infrastructure (the World Bank unofficially puts this figure at 9% of GDP) with the results that growth has been accomplished without the normal bottlenecks that cause inflation. Of course, it is necessary for there to be willing consumers abroad to absorb this additional output, because home consumption is growing slower than industrial output; or as economists would say, the structural bias in the economy tends to favor savings.

At present the US economy is seen to be reaccelerating but should it falter, the fact that it absorbs some 20% of Chinese exports (China accounts for 14% of total US imports) will raise concern. Fortunately China's export dependency on the USA is diminishing as new markets take up the running. Notably, trade is increasing with large countries such as India, and commodity rich regions like Latin America, Africa, Russia and its former satellites. Markets other than the US, Europe and Japan now account for 50% of Chinese exports. Unlike Japan during its growth spurt in the 70s, where exports accounted for around 15% of GNP, China's economy derives a full third of its activity from exports. This exposes the country to external economic risk. The internal risk lies with inflation. Publicity has been given to food prices rise more generally, this will impinge on the cost of monetary intervention and make it all the more difficult.

While the Chinese economy is vulnerable to slowing exports, the structural imperative to save and the profitability of the corporate sector are such that surpluses will continue to mount. Even if domestic rates are raised to attempt to slow the economy, and bank lending is restricted, the system seems able to circumvent these traditional channels. The escape valve of the exchange rate will have to play a part as the internal bloating continues to find expression in the value of assets, namely property and shares.

The bull market in the Shanghai stock market continued this quarter, with the index now standing at levels almost four times higher than the low reached two years ago. An interesting phenomenon of the bull market is how shares of the same company typically trade at significantly higher prices in the Chinese domestic stock market (the A share market) than they do when listed in offshore

markets such as Hong Kong (H shares). On dual listed stocks the A share premium has increased from an average of around 40% to over 70% in the last two years. The reason occurs is that the stocks listed in China are predominately bought and sold by Chinese investors who are precluded from trading in the Hong Kong market. Thus while the domestic share prices are set by domestic investors, the offshore prices are set by foreigners, with the two groups having different economic variables (e.g. domestic Chinese interest rates versus global interest rates). The result is a very different price in the two markets for an almost identical claim over the same business.

However there has been considerable discussion amongst commentators about whether this gap might be closed, with the H shares rising to the level of the A shares, due to an expansion of the Qualifying Domestic Institutional Investor (QDII) system. QDII allows Chinese financial institutions to offer portfolios of offshore assets to their domestic customers. Until recently, the program has been restricted to fixed interest type investments and was only offered by banks. This has been changed to allow access to some foreign stock markets, with the product now available from a wider range of financial institutions including stock brokers and fund managers. Chinese companies are trading in Hong Kong at much more attractive valuations. Moreover, many of the blue chip Chinese companies such as China Mobile, are not listed domestically, thus giving Chinese investors access to some of the country's best companies for the first time.

How enthusiastically Chinese individuals take up the opportunity to invest offshore may be tempered by many of the restrictions placed around the products that can be offered (e.g. products can only have a 50% equity weighting) and indeed the size of the quota available will limit the impact of Chinese money coming into Hong Kong. Longer term though, the moves would appear to be part of an ongoing loosening of capital controls and ultimately it is hard to see how this will not boost the prices paid for not only Chinese companies listed in Hong Kong, but also for the broader market. Certainly this has been a major part of the enthusiasm shown for Hong Kong listed stocks during the last month or so. Although the possibility of Chinese money spilling into the Hong Kong market is an interesting question, it is perhaps more important to examine whether the Chinese bull market has further to run. Although

making such a prediction is fraught with danger, history has many bull markets that we can look to for guidance. An undervalued exchange rate driving a large and growing trade surplus, together with strong capital inflows, and limited opportunities for domestic investors to move money offshore, would proffer the Taiwan bull market of 1985 to '90 as a reasonable case study. Once that bull market was underway, even though the exchange rate started to appreciate halting the rise in trade surpluses, and the authorities' unveiled measures such as capital gains tax to slow down the market, and allowed some flow of funds offshore, it wasn't until interest rates increased substantially that the market lost its momentum. Despite these attempts to halt the rise of the Taiwanese market, it appreciated 12 fold before the bull run came to an end. There is an uncannily similar situation in China today, where not only have we seen the introduction of QDII but also increase in stamp duty on stock trading and talk of imposing capital gains taxes. The Chinese yuan is also appreciating but yet to make an impact on the trade account.

Before one extrapolates the Taiwanese experience to the current market in China it needs to be recognized that the Chinese authorities are highly likely to have a good understanding of the forces at work (and of the subsequent damage to the economy that can result). Their policy decisions may well result in different outcomes. In particular the communist party still has strong control over the major banks in China and thus further credit controls could slow down the rapid increase in money supply that is fuelling the bull market. The other point to note from history is that during the Taiwanese bull market, the market suffered to major setbacks of 50% and 35%. It is highly likely that the Chinese market will suffer similar setbacks, possibly as a result of policy measures aimed at doing just that, or external events such as higher global interest rates. China's economic development in recent years, the ongoing investment opportunities that are arising for Chinese companies, together with the fact that we can still purchase them at sensible prices, leads us to conclude that the bull run in China is far from over. Nevertheless, one should expect a wild ride.

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