Global Connections

Itaú BBA

May 2, 2014

# China – Don't Drop the Ball

Year IV
Issue #146

Itaú's Global Connections presents independent perspectives on economic issues and market forces that affect your current investments and strategies for the future.

I have followed China closely for many years, but a recent trip provided my first on-the-ground experience there in well over a decade. From Beijing to Shanghai and on to Hong Kong, in meetings with government agencies, foreign embassies, academics, auto manufacturers, property developers, public and private market participants alike – over more than 25 meetings, there was much to absorb.

China is an economy and society that is early in its transition from export- and investment-led growth to domestic demand-, service sector-led growth. The easy years are over and rationalization is needed across the board, together with a focus on efficient capital allocation. Growth drivers are hard to identify, with exports, infrastructure and property all exhausted. China will not boom again for years, but neither is it likely to go bust. Think Japan-style workout rather than U.S./EU crisis. From rise to normalize, from quantity to quality, from manufacturing to services, from state-directed lending to moral hazard, China is changing.

Change is in the air, but a reform "Big Bang" is highly unlikely. Many of China's problems and solutions are well known internally, yet almost all the solutions beget more problems. Hence the system is severely limited in its ability to act swiftly and significantly. The main question has been and remains political will and capacity, both of which are in turn being severely affected by the ongoing anti-corruption campaign which threatens to absorb the top leadership's attention for the next several years.

The downside risks are large, yet catalysts are hard to identify. Foreign investors who view China through a post-Great Financial Crisis (GFC) lens and think that the property bubble and debt boom must be the epicenter of a crisis may well be mistaken. In my view, the tail risk lies in the environmental and corruption spaces where the potential for the government to lose control and face popular uprising is large and unquantifiable. China has run up against the laws of nature as well as finance.

Finally, it seems clear that the West's near-hero-worship of Chinese economic management capacity is misplaced; the factors that allowed China to move so swiftly and surely in years past – huge amounts of low-cost labor and capital, endless Western demand, blue skies and fresh water – are gone, never to return. China is moving to a market-based economy, but very slowly, and with great trepidation around the critical issues of governance, openness and moral hazard.

## Three Surprises

Three surprises stand out from over 50 pages of meeting notes. First, China's 2009 stimulus package is seen internally as a major strategic mistake, the negative ramifications of which will be felt for years to come. Second, pollution and corruption have become principal limiting factors in China's macroeconomic adjustment process. Third, the number of fracture lines running through China's society and economy are almost too many to count, let alone manage; China is far from monolithic.

Four factors help explain why the 2009 stimulus package is seen as such a mistake. First and foremost, it is seen as a missed golden opportunity to have begun the rebalancing process with a scapegoat, the U.S. financial crash, to blame if things went wrong. If the reform/rebalance project fails today, there is no one to blame but the current leadership. This alone is a huge brake on the pace of reform. Second, the stimulus resulted in a massive misallocation of capital, the ramifications of which will be felt for years to come as projects come on stream to a demand profile far short of what was forecasted. Third, corruption exploded during this period, as too much money came too easily to too many people. Fourth and finally, even if the current leadership wanted to engage in massive stimulus they couldn't, because they would then be just like the prior leaders; one thing politicians everywhere have in common is they don't want to do what's already been done. Thus, if there is a massive stimulus package in the years ahead, one should duck and cover because it will mean things are really, really, really bad.

Jay Pelosky is Principal of J2Z Advisory, LLC.



**Read this report in:**
**5 min:** Front Page
**17 min:** Full Report

Pollution and corruption represent the limits to modern China's flexibility and thus are also critical to consider. The pollution was a real eye-opener; one reads about it affecting Beijing and, to a lesser extent, Shanghai, but one tip is to take the high-speed train between these two cities. This train covers the 800-mile distance in less than five hours at a speed approaching 200 mph. That's impressive – what is sad and depressing is that the entire 800 miles is also covered in a layer of smog that would be unacceptable in the West. The PM2.5 reading (a key air pollution reading) hit 276 on one of our days in Beijing; this compares with the World Health Organization's acceptable level of 100. Anecdotally, our driver referred to this day as a 6 on a scale of 10, with 10 being the worst.

Pollution demonstrates the China condition writ large: it is a known and highly visible problem with known solutions, and yet it remains unfixed. Now, yes, there are steps being taken – new car sales are rationed in Beijing; coal and steel firms are being shut out of the triangle of Beijing, Hebei and Tianjin; environmental regulators have just been empowered to shut down firms that don't comply with new anti-pollution mandates. Yet shutting down factories in the midst of a slowing economy is suboptimal and reflects China's current syndrome of solutions begetting more problems. The rising cost of environmental compliance is one of the factors that will ensure that the China of the future is not your kid's China – the Pearl River Delta is rapidly being priced out of the low-cost, low-margin production business.

The current anti-corruption campaign is unprecedented in scope and consequently is having a very visible effect on confidence within the upper echelons of Chinese society. What was a reasonable response to the corruption emanating from the 2009 stimulus package has broadened out into something much greater, with implications for the society at large. Political patronage networks that run from top to bottom and include many sectors and segments of the society are being wound up. Our meetings included constant references to feelings of being on edge, of not knowing how safe one was, of business disappearing as these networks are rolled up. The anti-corruption campaign is much more popular on the street than in the boardroom, where the focus has shifted from business strategy to self-preservation. How it is playing out is very hard to quantify, though it is clearly a major limiting factor to the process of reforming the state-owned enterprises (SOEs).

The fault lines cutting across and through China's economy and society were equally impossible to ignore. Society seems split between young and old, rich and poor, with the young, much like the young anywhere, interested in technology and the service economy and the old and poor completely divorced from both. Politically, the fault line between Beijing and the local governments was visible through the prism of debt, fiscal reform, land reform and urban migration. Geographically, the split between the more developed East and North of the country and the underdeveloped West and South came across in discussions of future growth drivers – the Go West solution seems difficult to square with the much lower levels of wealth in the outer regions.

Economically, the split between the pro-growth and pro-reform camps exists in virtually every major government entity, so what you hear depends very much on where you sit. Alongside lies the divide between the centrally planned economy and a market-based one; China today is a hybrid economy. The state-directed, overly indebted, SOE-led economy has run out of gas, but the service-centered, tech-driven, private sector economy is not yet ready for prime time.

Opening up to full market forces entails giving up control, which helps one understand China's go-slow approach to reform. This is most evident in the financial sector, which is itself riven between an excess debt camp on one side and a tight money camp on the other. In essence, those who get capital shouldn't have it and those who need it can't get it. This, of course, helps explain the shadow banking and Alibaba deposit-taking stories.

## The Juggler

Thus, it is a tale of two economies: the up-and-coming service sector and the slumping SOEs. One of the favored analogies during this trip was that of a juggler: China is juggling at least six key domestic economic issues, bookended by the two issues of pollution and corruption. Keeping eight balls in the air is a challenge for even an expert juggler.

The six main issues are:

1. Foreign exchange liberalization. China views the closed capital account as a major source of protection, and control and will not be relinquished easily or quickly – the United States' new-found predilection for financial sanctions will only reinforce this view. Investors can stop obsessing over every twitch in the RMB rate.
2. Interest rate liberalization. Freeing up the deposit rate would lead to a collapse in bank profitability and a spike in SOE loan rates – neither of which is desirable. Thus, this too will take considerable time to unfold, notwithstanding the Alibaba deposit success story (90 million depositors depositing over USD 100 billion in a matter of months).
3. SOE reform. This is a political issue adversely affected by the anti-corruption campaign, and reform will take years. The often-mooted idea that SOEs and local governments have great assets to sell to help them offset their debts is a pipe dream: private equity buyers are concerned about industry concentration, control issues and corruption before even getting to price.
4. Real estate. Residential and retail real estate is in a bubble, and commercial real estate comes close. It takes three to four wage-earners/savings to afford the down payment for a house, so housing is socially explosive. Accordingly, the government is on top of it and has the tools to soften the already very visible decline in transactions and the incipient decline in prices.
5. Jobs. Jobs are job one, but as in the West it is difficult to come up with big solutions, and there are growing concerns about a mismatch between migrant labor and service sector jobs. Tech sounds plausible but does not employ great numbers of people.
6. Social issues. Health, education, the social safety net – problems with all three help explain the high savings rate, which is now being diverted into property. A real estate bust would thus kill the domestic demand story, as savings would have to be rebuilt.

Net-net, the pace of reform will be very much in line with the old Chinese saying,"crossing the river by feeling the stones."

## Global Implications

China's credit boom and the Fed's QE program represent the two wellsprings of global liquidity that have buffered the GFC fall out. The fact that both are pulling back at the same time in the absence of any new global or regional growth model is deeply worrisome. The barriers to a policy reversal (i.e., a return to massive stimulus) in China are very high, as outlined above, which has negative growth connotations for the global economy.

In turn, weak global demand means that China cannot export its way out. There is also a strong feeling within China that the Fed's QE policy makes it more difficult for China to open its financial sector, given fears that near-zero interest rates in the West will trigger a flood of capital into China to take advantage of the 3%-4% short-term rates.

China will not be a global growth locomotive for years to come. We should think of China, instead, as a global growth dampener whose growth path will continue to slow in the years ahead. This will help us consider the likely global growth, inflation, currency and financial asset price outlooks. A China that merely slows rather than crashes is no small thing, given the lack of Western policy tools for responding to a China crash.

The good news is that the oft-expressed fear of China adopting pure mercantilist policies, weakening the RMB and flooding the world with cheap Chinese products in order to work off its excess capacity, is also highly unlikely. Given what would happen to China's USD corporate borrowers and all the others who are long the carry trade, a collapse of the RMB would be devastating and is thus highly unlikely.

## Regional Impact

Several embassy visits confirm that China's regional economic impact continues to grow. China's raw-material demand profile is changing (think from iron ore to milk formula), but it is in China's capital outflows that its neighbors can expect to see the most change in the years ahead. External property investment is expected to double in the next year, while a constant refrain heard from companies is the desire to go abroad to make money. Not being able to make money in a 7%-GDP-growth economy is an interesting concept. It suggests a challenging business environment in terms of the access to and cost of capital, rising wage costs, expensive anti-pollution requirements, etc.

From a geopolitical perspective, the Washington-DC-based view that the U.S. can cut China out of regional economic integration via the Trans-Pacific Partnership (TPP), which China has not been invited to join, is laughable when contemplated from Beijing or Shanghai. China is simply too big an economic engine and too important to its neighbors as an export market and source of capital for this idea to make sense.

## Investment Conclusions

For such a large economy, there were surprisingly few investment ideas that stood out on either the long or short side. Stocks are close to multi-year lows, while domestic fixed income is being introduced to moral hazard, can expect lots of defaults, is hard to access and requires a lot of internal expertise. From a private market perspective, concerns about control, industrial concentration within the SOE/local government space and corruption risk limit the appetite, while the tech sector has had money thrown at it.

The decision to pull the WH Foods IPO in Hong Kong is very interesting in this regard. The deal was cut in half and is ready to be priced at the bottom of the range, suggesting that investor appetite is not what one would have expected even a few weeks ago. Of course, pork and social media are two different animals, but the upcoming Alibaba listing in New York should be approached very carefully.

The undeveloped nature of China's capital markets combined with the unbalanced nature of its economy are two good explanations for the broad lack of investment options. Clean energy has room to grow in China, but ways to invest in it are not immediately visible, though uranium/nuclear power may be one path worth investigating.

Thus, one comes back to the trusted idea of investing in China via an external focus. In the past this has meant the commodity super-cycle; today's commodity of choice may well be physical gold, which continues to see rising demand. Another option might be the currencies of some of China's neighbors, such as the New Zealand and Australian dollars. Recently, both currencies have rallied strongly as their central banks became more hawkish and, in the case of New Zealand, actually raised rates. Yields are attractive, and the prospect of a multi-year re-rating driven by Chinese (and Japanese) capital outflows seems quite reasonable. Buy on pullbacks.

Jay Pelosky is Principal of J2Z Advisory, LLC, a global asset allocation and portfolio strategy consultancy for institutional investors. Jay advises clients and invests personally based on insights gained from 30 years of financial market experience in over 45 countries. For the past decade, he has invested his own capital in a global, multi-asset, ETF-based Asset Allocation strategy. He sits on the board of Franklin Holdings (Bermuda) Ltd. and serves on the advisory board of Carmel Asset Management. Jay teaches a graduate level course, The Art and Practice of Global Investing, at The George Washington University and is a founding member of the New America Foundation's World Economic Roundtable. His formal Wall Street career spanned twenty years and included positions on both the buy-side and sell-side. At Morgan Stanley, he launched the Firm's global asset allocation and global equity strategy research products. He also formed and co-chaired the research department's asset allocation committee. Jay created the firm's Global Emerging Market Strategy (GEMS) product and initiated its equity investment, research, and strategy efforts in Latin America.

jaypelosky@pelosky.com

## Itaú Global Connections – Recent Issues

| Date | | |
|---|---|---|
| 4/25/14 | Issue # 145, by Stephen L. Jen | China: No Pain, No Gain |
| 4/15/14 | Issue # 144, by Stephen L. Jen | External and Internal Rebalancing in EM |
| 4/8/14 | Issue # 143, by Felix W. Zulauf | Political Chess in Ukraine |
| 3/20/14 | Issue # 142, by Jay Pelosky | The Sound and the Fury |
| 3/14/14 | Issue # 141, by Stephen L. Jen | Weak JPY, Stagnant Exports and Abenomics |
| 2/27/14 | Issue # 140, by Jay Pelosky | READY, WEATHER OR NOT |
| 2/25/14 | Issue # 139, by Felix W. Zulauf | Increasing Selectivity |
| 2/14/14 | Issue # 138, by Stephen L. Jen | How Much Further Could EM Currencies Fall? |
| 2/4/14 | Issue # 137, by Felix W. Zulauf | Another Deflationary Episode |
| 1/28/14 | Issue # 136, by Jay Pelosky | Walking the Knife Edge |

# DISCLAIMER

**Itaú BBA is a brand name of Itaú Corretora de Valores S.A.**

## Ratings: Definitions, Dispersion and Banking Relationships

| Ratings (1) | Definition (2) | Coverage (3) | Banking Relationship (4) |
|---|---|---|---|
| Outperform | The analyst expects the stock to perform better than the market average. | 55% | 50% |
| Market Perform | The analyst expects the stock to perform in line with the market average. | 32% | 29% |
| Underperform | The analyst expects the stock to perform below the market average. | 13% | 12% |

1. The ratings used herein (Outperform, Market Perform and Underperform), for purposes of the ratings distribution disclosure requirements of FINRA and the NYSE, correspond most closely, respectively, to Buy, Hold and Sell.

2. Ratings reflect the analyst's assessment of the stock price performance in the medium term compared with the market average. Recommendations will be valid until the analyst changes the rating, which may happen as a result of news or simply due to a change in the stock price (there is not a defined time horizon). Companies are grouped, according to their similarities, into sectors. The sectors are: (i) Banking & Financial Services, (ii) Consumer Goods & Retail + Food & Beverage, (iii) Healthcare + Education, (iv) Steel & Mining + Pulp & Paper, (v) Oil, Gas & Petrochemicals + Agribusiness, (vi) Real Estate, (vii) Telecommunications, Media and Technology, (viii) Transportation, Industrials and Logistics, (ix) Utilities, and (x) Equity Strategy.

3. Percentage of companies under coverage by Itaú Corretora de Valores S.A. within this rating category.

4. Percentage of companies within this rating category for which Itaú Unibanco S.A. or any of its affiliated companies provided investment banking services within the past 12 (twelve) months, or may provide investment banking services during the next 3 (three) months.

### Relevant Information

1. This report has been prepared by Mr. Jay Pelosky as a consultant to Itaú Corretora de Valores S.A ("Itaú BBA"), a subsidiary of Itaú Unibanco S.A., and distributed by Itaú BBA or one of its affiliates (altogether, "Itaú Unibanco Group"). Itaú BBA is the brand name used by Itaú Corretora de Valores S.A., by its affiliated or by other companies of the Itaú Unibanco Group. . This report is being distributed (i) in the United States by Itaú BBA USA Securities Inc., a FINRA/SIPC member firm; (ii) in the United Kingdom and Europe by Itau BBA UK Securities Limited, regulated by the Financial Services Authority (FSA). Details about the extent of its authorization and regulation by the FSA are available on request; and (iii) in Hong Kong by Itaú Asia Securities Limited, licensed in Hong Kong by the Securities and Futures Commission for Type 1 (dealing in securities) regulated activity (altogether, "Itaú Group"). This report is provided for informational purposes only and does not constitute or should not be construed as an offer to buy or sell or solicitation of an offer to buy or sell any financial instrument or to participate in any particular trading strategy in any jurisdiction. The information herein is believed to be reliable as of the date in which this report was issued and has been obtained from public sources believed to be reliable. Itaú Group does not make any representation or warranty, express or implied, as to the completeness, reliability or accuracy of such information, nor is this report intended to be a complete statement or summary of the securities, markets or developments referred to herein. Opinions, estimates, and projections expressed herein constitute the current judgment of the analyst responsible for the substance of this report as of the date in which it report was issued and are therefore subject to change without notice. Prices and availability of financial instruments are indicative only and subject to change without notice. Itaú Group has no obligation to update, modify or amend this report and inform the reader accordingly, except when terminating coverage of the issuer of the securities discussed in this report.

2. This report has been prepared by Mr. Jay Pelosky, who hereby certifies that the views expressed herein accurately and exclusively reflect his personal views and opinions about any and all of the subject matter discussed and that this report was prepared by Mr. Pelosky independently and autonomously, including from Itaú BBA. The views expressed herein do not necessarily reflect the views of Itaú BBA, its subsidiaries and affiliates. Because personal views of analysts may differ from one another, Itaú BBA, its subsidiaries and affiliates may have issued or may issue reports that are inconsistent with, and/or reach different conclusions from, the information presented herein. Mr. Pelosky is not registered and/or qualified as a research analyst with the NYSE or FINRA, and is not associated with Itaú BBA USA Securities Inc. and, therefore, may not be subject to Rule 2711 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account.

3. The financial instruments discussed in this report may not be suitable for all investors. This report does not take into account the investment objectives, financial situation or particular needs of any particular investor. Investors should obtain independent financial advice based on their own particular circumstances before making an investment decision based on the information contained herein. If a financial instrument is denominated in a currency other than an investor's currency, a change in exchange rates may adversely affect the price or value of, or the income derived from, the financial instrument, and the reader of this report assumes any currency risk. Income from financial instruments may vary and its price or value, either directly or indirectly, may rise or fall. Past performance is not necessarily indicative of future results, and no representation or warranty, express or implied, is made herein regarding future performances. Itaú Group does not accept any liability whatsoever for any direct or consequential loss arising from any use of this report or its content.

4. This report may not be reproduced or redistributed to any other person, in whole or in part, for any purpose, without the prior written consent of Itaú Corretora de Valores S.A. ("Itaú BBA"). Additional information relative to the financial instruments discussed in this report is available upon request.

5. This report may contain links to third-party websites. Itaú Corretora de Valores S.A. ("Itaú BBA") is not responsible for the content of any third-party website or any linked content contained in a third-party website. Content contained on such third-party websites is not part of this report and is not incorporated by reference into this report. The inclusion of a link in this report does not imply any endorsement by or any affiliation with Itaú Corretora de Valores S.A. ("Itaú BBA"). Access to any third-party website is at your own risk, and you should always review the terms and privacy policies at third-party websites before submitting any personal information to them. Itaú Corretora de Valores S.A. ("Itaú BBA") is not responsible for such terms and privacy policies and expressly disclaims any liability for them.