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MARKET COMMENTARY

Ashmore

China roadmap

By Jan Dehn

All change

For several decades China's growth model relied on exports. Taking advantage of strong external consumer demand fuelled by debt in the Western world and gaining market share at the expense of competitors in Emerging Markets (EM) by managing its currency, China was able to become the world's greatest export-led economy. China tapped its enormous reserves of rural labour to increase output with only a marginal impact on the cost of labour. Every decade or so when the economy ran into capacity constraints, China would engage in huge waves of investment and then resume exporting with renewed vigour.

This model of growth worked well, but has now become obsolete. Debt fuelled demand in the West is over. The ability to weaken the RMB versus other EM currencies is exhausted. The economy is running out of cheap labour.

Without adjustment China risks stagnation, a hard landing due to resource misallocation issues and loss of its ability to control the economy if RMB becomes an endogenous variable.

The good news is that China's leaders have understood for the better part of ten years that change is needed. They understand – as do most EM leaders – that economic stagnation poses a major risk to their ability to hold on to power. Poor but increasingly well-informed EM populations, including China's, demand stability and growth. There is very little tolerance of recessions, loss of macroeconomic control and other types of instability.

Adjustment is therefore not a choice, it is a political imperative. Some investors are still too backwards looking when it comes to China. Too many still only see China as a quarterly GDP print with ramifications mainly for the prices of iron ore and other commodities. In fact, the actions China is taking now are decisive and forward-looking, aimed to ensure that the economy and its leaders have a future. Those that do not see this risk missing one of the largest economic events of recent times.

China's leaders recognise that economic stagnation poses a major risk to their ability to hold on to power. Adjustment is therefore not just a priority, it is a political imperative

The Biggest Bang

The changes taking places in China now and over the next few years will utterly transform the world as we know it. China has already been a major force for change in the global economy, but so far this was achieved with China as a closed economy. Now China – the world's largest economy in PPP terms – is opening up for the first time. This is perhaps the 'biggest bang' the world has ever seen. But what does it mean for investors?

Roadmap for change

China's export led growth model is obsolete and China is turning to domestic demand-led growth. This transformation has far-reaching consequences stretching from the realm of domestic politics via capital account liberalisation and to the rise of the RMB as a global reserve currency.

All of these developments inter-related, indeed they are interdependent. The purpose of the following seven point road map is to pull together the various strands of China's reform program to help investors grasp the full scale and implications of China's transformation.

China's transformation began with a political decision – to reform in order to ensure continued prosperity. This decision had immediate domestic political consequences as the government immediately faced opposition to change from very entrenched vested interests that had grown rich and powerful on the back of the export-led growth model. Naturally, their instinct was to strongly oppose change. So far, the government has dealt with these opponents decisively in two purges. The first was the very public denouncement of Bo Xilai. More recently a determined anti-corruption drive has targeted senior members of both the military and the party. Investors should expect more purges in the future, but at this point the government is very much in control and the commitment to reform is not under threat. If anything, the reform program is moving faster than expected.

Once the political case for reform has been established, the government's next priority is to develop a new set of policy tools appropriate for controlling the domestic demand led economy. China's leaders are, understandably, obsessed with their ability to control the business cycle. When China was an export-led economy, the government would regulate the temperature of the economy by targeting the exchange rate and adjusting credit directed towards investment. But these tools are not suitable for

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a consumption-led economy. It is likely that savings and investment will decline going forward as consumption rises and consumers in a largely closed economy, such as China's, tend to be unresponsive to FX rates.

Managing consumer demand therefore requires the use of interest rates. This is why interest rates liberalisation and the development of the bond market in China are now among the top priorities of the reform program. The establishment of free interest rates and a well-functioning liquid bond market will enable the PBOC's policy decisions to be transmitted into the wider economy.

The on-going effort to convert the loans of local governments into tradable municipal bonds is a major part of the effort to establish a bond market in China. Municipal bonds will be particularly important in transmitting monetary policy signals down to local government level.

The significance of the municipal bond market should not be under-estimated. The market could eventually exceed RMB 10trn, which would make China's municipal bond market larger than the entire EM corporate Dollar bond market.

In addition to transmitting monetary policy signals to local governments, the municipal bond market will reduce the refinancing risks for local governments, extend the maturity of their debt and impose market discipline on local governments by forcing them to borrow at market determined interest rates.

The significance of the municipal bond market should not be under-estimated. It could eventually exceed RMB 10trn, larger than the entire EM corporate bond market

When it feels that it can control consumer demand, the government is likely to take specific steps to stimulate private consumption in an orderly manner. The scope for consumption to rise in China is enormous, because China's savings rate is 49%, according to the IMF World Economic Outlook from April 2015.

It is therefore not a question of whether, but rather how China can induce greater consumption. It will be critical to reduce the level of precautionary savings. A typical Chinese saver can either put money in the bank and earn nothing, or put money into stocks or property. But stocks and property are notoriously volatile and often pro-cyclical. Missing from the typical Chinese savings portfolio is fixed income. Bonds have the wonderful quality that they tend to go up when everything else goes down. The introduction of bonds into Chinese savings portfolios will therefore have the effect of stabilising the overall savings pool and therefore reduce precautionary incentives to save.

In other words, the development of China's bond market is not just about macroeconomic control – it will also directly contribute to higher consumption by reducing precautionary savings rates in China.

The key will be to get bonds into the typical Chinese saver's portfolio. This is going to happen via the rise of the mutual fund industry in China.

The technical in the fixed income market are mind blowing – the markets are so under-owned by international investors that this could prompt USD 1trn flowing into Chinese fixed income in the next few years

China's mutual fund industry is already developing extremely rapidly. The recent announcement that Hong Kong and China mainland funds will now become available for sale in both territories is just one expression of this trend. But there will be more to come. Four of the ten largest banks in the world are Chinese, including the top two. In the next few years, these and other financial institutions will emerge as some of the largest mutual fund businesses in the world, in our view. They will not just offer access to Hong Kong funds; over time capital account liberalisation means that they will be able to tap into a global menu of investment opportunities.

Consumption will also be stimulated through much publicised social measures, such as broader provision of social security, stimulation of low income housing, establishment of pensions, education reform, land reform, greater labour market flexibility (including hukou reform) and other initiatives.

Since China cannot increase consumption without eroding its current account the government has decided to open its capital account. The rationale for capital account liberalisation is straight-forward: As China becomes a consumer-led economy it will necessarily import more goods and services from abroad. China does not want the resulting erosion of the current account balance to jeopardise the overall balance of payments. So the decision to liberalise the capital account reflects a desire to offset the expected outflows from the current account with inflows via the capital account.

Capital account liberalisation is notoriously challenging. For example, locals are likely to be more ready to take money out of China than foreigners are willing to enter China's markets, at least in the early stages of capital account liberalisation. For example, many foreign investors will wait for China's inclusion in benchmark indices before they commit and even when they do so China will have to cope with the usual 'herd dynamics' of the more fickle types of investors. China will try to manage these cross-currents by selectively opening up its markets. Teething problems are inevitable.

But these teething problems should not obscure the bigger picture. China's capital account liberalisation is, quite simply, one of the largest Big Bangs. China's combined equity and fixed income markets are today valued at roughly USD 15trn, equivalent roughly to the size of US GDP.

One third is fixed income. China's government bond market should not be compared with conventional EM local bond markets – in both size and quality it is better seen as an alternative to developed bond markets. Except that the Chinese Government bond market pays a much higher real yield (about 200bps at 5yrs), is backed by substantially stronger fundamentals and therefore is 'less risky'. It is not just that China's central government has less debt. The government also has much greater FX reserves and the economy is growing faster.

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The technicals in the fixed income market are mind-blowing; global investors have barely any exposure to these markets yet. We estimate that on a simple market cap basis investors ought to have at least 4% in Chinese fixed income. And even if investors only allocated a quarter of this amount they would still have to channel USD 1trn into Chinese fixed income over the next few years.

Chinese A-shares have had a recent good run; much of it driven by anticipation of the money flows to come. At 22x, the A share market's 2016 forward PEs are now higher than those of US stocks (16x). This is fair, but some individual stocks are undoubtedly valued too highly and substantial buying has been done on margin. On the other hand, the policy environment is likely to be supportive. Net-net, prices will go up as well as down, but we believe that, longer-term, the only direction is up.

Index provider, MSCI, announced recently that it plans to include China A-shares in its benchmark index after a few remaining issues are ironed out. A working group comprising MSCI and Chinese regulators has been set up specifically to address these issues, which could be solved within months or longer depending on the outcome of negotiations; MSCI allows for the A-share market's inclusion in the MSCI index in between the regular scheduled meetings. The message is therefore clear: A-shares are now positioned soon to be integrated into MSCI's index universe, probably in a staggered fashion at first. Eventually, China's markets will operate without quotas at all. Between now and then China's capital account liberalisation is likely to continue to serve up market-moving events as global investors continue to lack behind developments.

The greatest risk facing countries that open their capital account is that fickle portfolio investors create instability. Specifically to counter this risk but also for other important reasons China is now making its currency the world's next major reserve currency. The IMF recently announced that China's currency is valued fairly, a key pre-requisite for entry into Special Drawings Rights (SDR). It seems extremely likely that the RMB will now be included either this year or sometime next year. This will mean that RMB will now attract more stable investors, such as central banks.

But China is also pushing for global reserve currency status for other important reasons. China recognises that the RMB will increasingly become an endogenous variable – meaning that China will not be able to control the value of its own currency. For example, if the value of the RMB increasingly gets determined by the fate of QE currencies (USD, JPY, GBP and EUR) then China wants to ensure that it derives the maximum benefit in exchange from giving up its own control.

What are those benefits?

- Firstly, having a global reserve currency means that China will be able to trade and financially transact with other countries in its own currency as overseas demand for RMB to settle cross-border transactions rises.

This also means that China will no longer need reserves for international transactions. Or at least not as many as before. Remember that the US has almost no reserves at all. That in turn means that China can consume more, because it no longer needs to suppress domestic demand in order to run the large external surpluses required to maintain high levels of reserves.

- Secondly, China's enormous existing stocks of reserves will genuinely become 'excess reserves' over time, i.e. surplus to requirements. China is starting out with nearly USD 4trn in reserves. These 'excess reserves' become a de facto windfall to the government – that is, funds that can be considered similar to Sovereign Wealth Fund assets. They can therefore be invested in return seeking assets rather than sitting in US treasuries and other non-yielding conventional reserve assets.

The recent establishment of the Asian Infrastructure Investment Bank (AIIB) has to be understood in this light. In the last two years alone China has increased the volume of its total trade settling in RMB from 10% to 31%. If China continues on this path and manages to settle half of its international trade in RMB within the next few years then as much as half of China's reserves will eventually become 'excess reserves'. Given the magnitude of potential excess reserves it is likely that the AIIB is only a dummy run for a much greater Chinese engagement in infrastructure on a global scale in the years to come.

- Thirdly, it will be extremely positive for China to be able to reduce its enormous – and very risky – exposure to the US dollar and US treasuries. As one of the largest holders of Treasuries in the world, China is likely to become a steady seller of US treasuries over the next few years at a speed that will be a function of the pace at which the RMB is adopted as a reserve currency by other central banks.

Moreover, looking ahead, when inflation returns to the QE economies the world is likely to find itself short of healthy reserve currencies – at that point demand for RMB could become explosive as investors become desperate to preserve capital.

It seems extremely likely that China will become the world's next major reserve currency – attracting more stable investors such as central banks

This suggests that China's currency will appreciate over time. Appreciation will hurt exporters and therefore growth. To prevent excessive loss of momentum, China must increase its productivity. The challenge facing China is that it is not possible to replace lost export-led growth with higher domestic spending. Without also increasing domestic supply, higher spending will merely create excess domestic demand, which will soon translate into inflation and an unsustainable current account imbalance.

The only way to square this circle is to also raise domestic supply – that is, increase productivity. Raising productivity will have the added advantage of shielding exporters somewhat from a stronger currency.

China is currently experiencing a revolution in terms of home grown innovation and research and development – for further details see *"China's R&D revolution"*, The Emerging View, May 2015. But productivity in China is also going to rise for two reasons directly related to government reform efforts. The first is more efficient resource allocation. China is aggressively pursuing labour market reforms, land reforms and allowing for a much greater role of market forces in the allocation of resources. SOE reforms, forcing local governments to face market discipline, interest rate liberalisation and freeing up the capital account and the currency are also part of that story.

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The other reason is that China is building more efficient institutions. Anti-corruption campaigns grab the headlines, but judicial reforms are particularly important in ensuring better contract enforcement and more agnostic dispute resolution. Intellectual property rights enforcement is also moving up the agenda with the establishment of several courts in China that specialise in intellectual property.

Due to the large number of interlocking reforms taking place at the same time in China, the economy is likely to continue to slow for the next couple of years. Reforms create massive uncertainty – political as well as economic. Many investors – domestic and foreign – will sit on the sidelines until the outlook becomes a bit more predictable. It will also take time for domestic sectors to develop the capacity to invest and consume in the size that we saw in the export sectors in recent years.

China is clearly slowing for the right reasons. The country is preparing for the future, not fixing problems of the past. The current reforms will enable China to grow when many other countries with far less foresight get stuck. A hard landing is unlikely – China has plenty of levers to sustain momentum during the transition, including fiscal room, monetary room and even room to weaken the currency.

The road ahead

Investors are likely to be rewarded for taking the long view.

Government bonds continue to offer value. The economy is slowing, inflation is falling and the currency will appreciate.

The PBOC is likely to cut rates and the bonds pay much higher real yields than developed market bonds. The technicals are strong, because hardly any foreigners are in the market yet. As with credit and stocks, it is important to be selective and to be aware of valuations. Bottom-up stock picking with a bias towards the consumer space, notably in third tier cities and lower income groups could be a good opportunity, given the direction of reform in China.

Finally, the RMB will benefit from China's own diversification out of USD, inflows to the domestic market from private and official sector players abroad and increasingly as a way for investors to hedge themselves from future depreciation of QE currencies.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Beijing
T: +86 10 5764 2601

Bogota
T: +57 1 347 0649

Jakarta
T: +6221 2953 9000

Istanbul
T: +90 212 349 40 00

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Sao Paulo
T: +55 11 3556 8900

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

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