Summary

We often say to clients that there are many similarities between modern China and Victorian Britain; enormous disparities of wealth, rapid industrialisation, infrastructure investment, almost complete disregard for ecological standards – currently the biggest cause of social unrest in China bar none - shady capitalism and a considerable amount of securities fraud.

Victorian Britain turned out ok, however China faces great challenges and as its importance in the world economy grows we should all take notice of how these challenges are dealt with. President Xi Jingping and Premier Li Keqiang have the mandate opportunity to radically change the structure of Chinese economy but there are many vested interests and it won't be easy by any means. It seems the Chinese proverb, or curse, – "may you live in interesting times" – is truly upon us.

Look East, not West

Over the last few months the Republican orchestrated pantomime in Washington was the focus of many investors' attention. Egged on by the Tea party, and, at times, exacerbated by the President Obama, the political classes caused excessive disruption to the markets. Whilst on my recent fact finding tour of Asia, I had the opportunity to ponder the goings on Capitol Hill from a different perspective; China in particular provided an interesting context. An economic powerhouse of global importance held back by political folly: the similarities are obvious.

China's seemingly insatiable demand for raw materials, its huge significance in international trade (both in exports and imports), and its continued accretion of foreign exchange reserves means its effect on the turbulence we, as investors, experience in global financial markets is on some measure, on a par with America too. It is now widely recognised that the previous 10 years under the rule of Wen Jiabao and Hu Jintao was a fallow period in China's development; both economically and politically. The installation of a new leader, President Xi Jinping, should set a more progressive course. Most commentators agree that Xi has reasserted the primacy of the Communist Party in Chinese affairs, while others are suggesting he is the most powerful leader since Deng. Whilst his political direction remains, as yet, undefined, his primary task will be to solve the misallocation of resources under the current dual communist-mercantilist system.

Xi must promote and control the required changes or risk a wave of protest and discontent. The Chinese population are right to be angry, not least at the pervasive corruption in their country. The recent show trail of Bo Xilai gave the articulate and charismatic former Politburo member a stage from which to highlight the issue. The proliferation of social media in China suggests the Party will find it increasingly difficult to control dissenting voices. The recent 'incident' in Tiananmen Square, although yet to be fully explained, suggested potentially explosive social tension is not far from the surface.

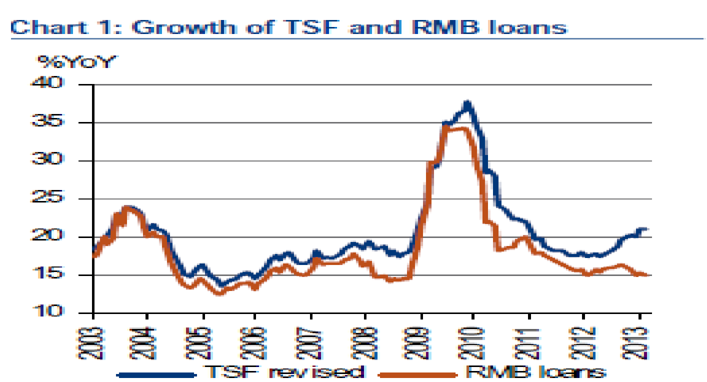
President Xi Jinping is supported in facing the challenges that lie ahead by Premier Li Keqiang, who is known to favour reform. Informed observers in Beijing report that in fact many policy makers appreciate the need and scale of reforms required to address the political, social and economic issues facing the country.

From my own recent trip and research I believe from an investor's perspective some of China's most pressing concerns are as follows:

- *The system for apportioning credit is under great strain*. The Peoples Bank of China (PBOC) has tightened its credit controls recently with credit growth having been reduced from 22.4% in April to 20.2% by July. But PBOC has in the past been too enthusiastic on this front; over the summer it caused the inter-bank lending rates to soar to over 8% (from the usual 3% level) and a resulting notable drop in economic activity. The attempts to curb the expansion of money supply were rightly scaled back substantially as the liquidity gulf was revealed; the right balance remains to be found.

This chart shows the difference between M2, a measure of cash that includes some types of "quasi-money," and bank deposits.

- *The lack of liquidity, particularly for small business and individuals, has stimulated the growth of the shadow banking system* (where interest rates can often be in the mid-teens, and the penalties for repayment are sometimes physical as well as financial). The shadow banking system has, in effect, become the faulty safety valve for the Chinese economy, but there remains an absence of any official recognition about the size of the this hidden economy.



Source: CEIC, PBoC, BofA Merrill Lynch Global Research.

- *China has traditionally exerted strong control over short-term interest rates*. Investors have therefore not been able to make a real return on their cash deposits for much of the last 10 years. In their search for assets with a reasonable prospect of future capital appreciation Chinese investors have turned to property, particularly in the 'tier one' cities. This has inevitably led to a (continuing) bubble in property prices. Deflating this bubble, without causing a financial crisis remains a top priority for the Chinese leadership, not least since these elevated prices act as an unpopular barrier to many aspiring property owners. The Hukou system of residency further exacerbates problems in the property market as those without residency permits for the area where they live are banned from buying property, and are therefore condemned to rent where they work. They do have the opportunity to buy property back home, but the price dynamics of Western and inner China is often vastly inferior to the cities on the Eastern coast.

- *The Hukou system* also unfairly curtails the Chinese worker's right to a pension, as claiming a state pension is dependent on the individual returning to the territory to which their Hukou relates. For migrant workers this provision causes considerable hardship, and forces many retirees back into the countryside. China also provides no safety net for itinerant and poor residents. "Foreign" residents are not entitled to free health care and this has magnified their attempts to save since they do not know when they will need to use their private resources due to illness. Indeed, if migrant's consumption matched that of city dwellers, Chinese consumption share of GDP would increase 2-3%.

- *Local government enjoys too much authority and too little scrutiny*. Their collection of taxes, much of which is meant but fails to be remitted to Beijing, is symptomatic of wider problems. Fraud is endemic, with many local government agencies using off-balance sheet entities to circumvent the lending curbs. These entities then invest in nepotistic local 'pet' projects. This situation could be ameliorated by a large-scale privatisation programme of assets (both at a local and government level) but there has been a recent cessation of IPO activity due to poor results from a number of recent flotations. This triggered a major review of the IPO process, which informed observers claim has led to the authorities almost formulating a new code for flotations.

- *Auditing and corporate governance standards in China are generally very poor* and most believe the new code will not halt the flow of recent scandals. This is a great shame as it means a workable and vibrant new issue market, which is key to the flotation or privatising state owned assets, is still some way off. The authorities might choose to float most of the listings through Hong Kong rather than Shanghai in order to increase confidence in the process. Theoretically there would be very little loss of face for the Government since Hong Kong is now well integrated into the mainland both politically and psychologically. However this would mean that the former boom in Shanghai stocks is unlikely to be repeated to the same extent.

- *The judiciary urgently requires greater freedom from political control*. We do not believe that the necessary reforms will be progressed with any vigour in the short term as Jinping will be intent on consolidating his power (and that of the Party).

- *China is experiencing a clear deterioration in its competitive edge in terms of its cost of labour advantage as it becomes a higher wage economy*. Furthermore the lack of determination by authorities to slow the rise of the Renminbi is exacerbating the price advantage of goods produced in China. Many foreign companies are moving more sophisticated production facilities offshore and nearer home as the supply lines are shorter and there is no necessity to deal with continued corruption and crude controls.

These issues require urgent attention; and powerful interest groups within China (such as "the Princelings" and the army) are likely to resist rapid or radical change. It is unclear whether the leadership are powerful, or indeed willing, enough to force the necessary reforms. Many people already feel that Xi is not prepared to diminish the authority of the current power brokers, so reform will never be radical enough. Throughout history the attempts by ruling elites to retain political power whilst seeking to satisfy the masses with a considerable improvement in living standards have usually floundered once prosperity reached a certain tipping point. Even in Russia the normal docile populous have now begun to complain about the excesses of the system, whilst in China there is an increasing wave of discontent related to excessive opulence and the corruption which feeds it.