China moving cautiously to avoid earlier stimulus mistakes

Members of the Signature Global Advisors team have been visiting China to take the pulse of the world's second-largest economy. Eric Bushell, Signature's Chief Investment Officer, was the most recent visitor. He was in the country in September to hear from economists, securities regulators, officials from the ministry of finance, the housing bureau, the People's Bank of China and academics. His key findings and insights are summarized here.

Highlights

- Since December 2011, when China's economic and export data started to weaken, the world's market participants have anticipated the government would launch a stimulus response – such as interest rate cuts, fiscal spending and projects, tax cuts or subsidies to consumers – to support growth.
- The Chinese government has the fiscal ability to achieve a safe economic landing and will act, but unless a significant employment problem develops, we believe a large stimulus program is unlikely.
- China will try to backstop a growth rate that, by developed world standards, will continue to be quite high. But the days of supercharged growth in China are over.
- The Western world's confidence in China's capital markets has taken a beating because the country has a veneer of a market economy in which investors often have difficulty believing what their business partners tell them. Also, there is the issue of whether state-controlled enterprises are more instruments of government policy as opposed to commercial entities.
- Business confidence of China's private sector is low, partly because of weak demand for Chinese goods in Europe and uncertainty stemming from the transfer of power to China's new leaders.
- Uncertainty also characterizes the situation in the U.S., which faces the "fiscal cliff" of tax increases and government spending cuts in the new year, and in Europe, where economic and fiscal issues remain unresolved.
- Signature expects weak global growth.

Chinese officials remember their mistakes of 2009 – including the inflation that followed

- China's 2009 stimulus program, which was the turning point for confidence globally in the wake of the 2008 Lehman Brothers bankruptcy, continued through 2010 and into 2011 and has provided 4 trillion renminbi in financing, primarily by banks lending money to local governments for infrastructure projects.
- But the stimulus is now viewed as having been overkill – the spending included a lot of waste, corruption and over-investment. There's widespread concern that the bank loans are now becoming non-performing. The government does not want to repeat what are viewed by the population as bad decisions, and is reluctant to unveil any knee-jerk reaction to the current slowdown.
- China is in the midst of a transfer of power to new leaders who take their seats in March 2013. The transition may create some paralysis on the policy side. Various

factions are vying for power within the government, state-controlled enterprises, and within the private sector. For example, conservatives in government feel threatened by rising economic elites.

- A key obstacle to responding with stimulus is the belief in China that there is a lot of inflationary pressure, which is linked to the U.S. Federal Reserve's launch of a second round of quantitative easing in September 2010. QE2 saw the U.S. dollar fall and hot money flow into emerging economies such as China, and into hard assets and resources. This drove inflation almost to double digits. At the same time, banks were paying 3% on deposits – so savers looked for alternatives and poured money into assets including housing. The 2010-11 spike in housing prices was a consequence of China's negative real (after-inflation) interest rates. The government has responded by restricting purchases of second or third homes to try to cut demand to keep the property market from ramping higher. Despite the current slowdown, China's central bank is worried about inflation. It fears that if the property cap comes off, housing prices would skyrocket.

Chinese companies feeling profit margin squeeze

- Because wages and rents jumped higher in China, input costs for raw materials rose. Many Chinese companies asked their customers in the U.S. and Europe to pay higher prices to address these pressures – and the customers said no. Adding to the profit squeeze has been the rise in China's currency.
- Also, to address environmental concerns, the government started to force corporations to invest in water treatment and air pollution equipment. These were capital costs that ate into profitability.
- The profit margin problems have been compounded by the drop in Chinese exports.
- Private businesses in China are uncertain about future prospects. They are avoiding reinvesting in their operations. That's bad news for German capital equipment manufacturers, who had assumed Chinese companies would invest a lot in robotics and other productivity-enhancing initiatives to deal with China's tight labour supply.
- Chinese citizens are also moving capital offshore as a hedge. They know that any individual can be accused of corruption or have their assets seized. There is no real rule of law.

China needs to transition to consumption-led growth and maintain the social bargain

- China's easy export days, thanks in part to once-cheap labour and an undervalued currency are over. The shift to growth based on domestic consumption will take the new leaders years to accomplish.
- The basic social bargain has been that the government would give the people economic liberty and advance their economic conditions and the political side was left to the Communist Party. But if the pace at which standards of living rise slows or there's a disruption, how does the government maintain that bargain and what other apparatus can be used to bind people to the state? Chinese cable TV broadcasts of anti-Japanese programming are being used to deflect people's

attention from the fact that the social bargain is being stressed by the economic slowdown.

- Japan won't put more capital into China as the two countries squabble over territorial claims, and as anti-Japanese rhetoric damages Japanese brands in China.
- China is coming to better understand that to compete and to advance, better innovation and productivity is needed. The country must better use its human potential, and provide more freedom to its people. Political change may be needed.

How are Signature strategies positioned in this period of uncertainty?

- With much uncertainty in key markets and expectation of weak growth, we believe that this is a time to be cautious. Cash levels in the strategies may go back up.
- There is a short-termism in the market, with investors focused on two or three months at a time. An example is the relief rally generated by the European Central Bank's announcement in September that it would purchase government bonds. We used this opportunity to help reposition our funds.
- Our focus is on quality, stable businesses with strong balance sheets and good free cash flows. An example is Shoppers Drug Mart.
- We have added significant value through our holdings in the health care sector.
- Signature has maintained its positions in energy stocks, but has an underweight allocation to the materials sector.
- We have modest exposure to China through our emerging markets strategy, through property holdings, and stocks in the industrials and consumer discretionary sectors. We have avoided financials in China. We've done fine with our consumer staples holdings, in areas such as snacks. Our consumer discretionary holdings have been hurt on weakness in the luxury retail area.

This commentary is provided as a general source of information and should not be considered personal investment advice or an offer or solicitation to buy or sell securities.