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Trend reversal in China

Does the slowdown of economic growth in China mark the beginning of a major downturn or the generally hoped-for soft landing? This was the big question that economists, investors – and we – faced in 2011. When we travelled to Hong Kong last November, our itinerary included talks with a number of economists covering China. Their concerns about the debt crisis in Europe – China’s top trading partner – were palpable. Nonetheless, forecasts for 2012 economic growth ranged quite surprisingly, and quite uniformly, between 8 and 9 percent (provided the crisis in Europe will not escalate). The reason for this positive outlook – and on this point the economists were pretty sure – is subsiding inflationary pressure. In the years ahead, inflation is expected to run at only 5 percent on average.

The sharp rise in prices was the Chinese economy’s principal problem last year. China’s central bank tightened the reins of monetary policy to combat inflation; last July, the inflation rate was still as high as 6.5 percent. Worries about a slowdown in growth

“For those of us based here in Hong Kong, 2011 was a year that saw soaring office rents, restaurants booked out, taxis hard to hail, airplanes and subway trains packed, and even bouncer-controlled queues at designer handbag shops. In other words, from the ground, it felt very much like a roaring bull market. The problem for investors, however, is that it did not trade like one. [...] Last year’s pain could turn out to be this year’s gain in Asia.”
Julien Guillaume, GaveKal Research

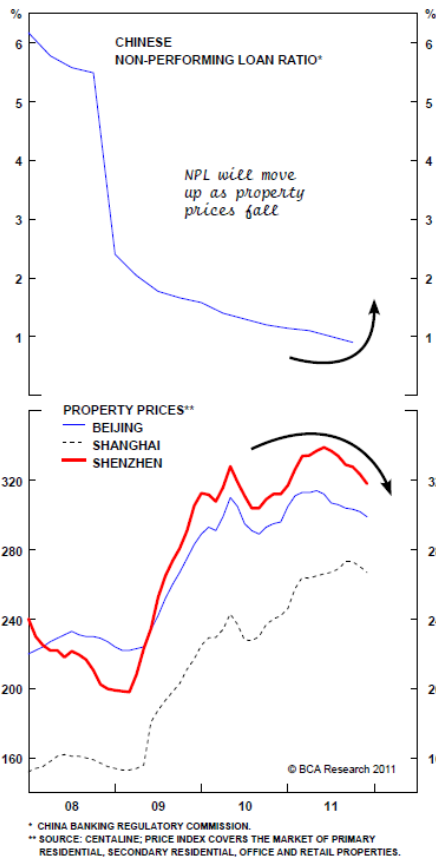
caused investors to withdraw their funds again from the stock markets. Based on earnings estimates for the next 12 months, the Hang Seng Index is currently valued at a price-earnings ratio of 9. This compares with its high of 16 in 2010.

The tightening measures proved effective: in November 2011, consumer prices were only 4.2 percent higher than the year before. This has increased the scope for measures designed to stimulate the economy. The Chinese central bank has meanwhile eased the reserve requirement ratio for banks a little, which may also be interpreted as a sign that China is loosening its grip on the currency.

“We are inclined to be positive because the authorities are well aware of the risks and have begun to respond accordingly. Reserve requirements have been cut, and further measures will be taken if economic conditions continue to worsen. Unlike the U.S. and Europe, China has plenty of fiscal and monetary ammunition to offset any decline in external demand.”
BCA Research

Other segments of the Chinese economy are likewise pointing to a soft landing. While softening a little, they did so at a high level. Last November, exports were up 13.8 percent while imports

rose 22.1 percent year-on-year, which is clear evidence of robust domestic consumption (despite a savings ratio of more than 50 percent!). Industrial production expanded by 12.4 percent and retail sales increased by 17.3 percent. Current purchasing managers’ indexes for the manufacturing and non-manufacturing industries surprised on the positive side: they rose more sharply than expected and clearly rebounded into expansionary territory.



One of the main risks is still the real estate market. Prices have been falling not only for new properties but also in the secondary market. In this context, one must not forget, however, that the Chinese government took tough measures last year to cool the real estate market and that a mild slow-down is desirable. The increase in non-performing loans, on the other hand, is one consequence that the government may be less comfortable with. This involves not only loans that were granted by the banks themselves but also loans extended outside the banking sector.

To contain the damage to the economy, the government may inject fresh liquidity. However, the real economy will respond to monetary policy measures only with a time lag of about six months.

These trends have to be watched carefully, but we believe that the strategic opportunities outweigh the risks. Stock market performance was weak last year not only in China but throughout Asia. In view of reversing trends we consider the investors' anxiety exaggerated. We have increased our exposure to Asia and added to the Gutmann Asien Portfolio. The fund pursues an active bottom-up approach with a focus on stocks with top dividend yields and top dividend growth, healthy balance

sheets and strong cash flows.

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