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A NEED TO DISCOUNT CHINA'S LONG-TERM GROWTH POTENTIAL

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Mr. Robert Rountree, Head of Investment Services, at Prudential Asset Management (Hong Kong), shares his views on China and more specifically, on whether China related stocks remain a good investment.

Yes, we all know the growth story. We are bombarded with it, virtually every day, with evermore impressive figures. China is consuming more commodities, pushing prices higher. China signs a new oil supply agreement. China establishes trading links with yet another African country. A mainland company attempts another global take-over. Recently, China burnished its growth credentials further by publishing another set of sizzling economic figures, recording an average 10.8% growth for the first half year.

But discernible concerns can be identified within this welter of good and, undoubtedly, impressive economic data. The most apparent is the extent to which China's economy is overheating. Is it growing so fast that domestic demand will outstrip the economy's capacity to deliver, despite those impressive growth figures? Will the overheating sections of the economy trigger additional official attempts to slow growth to more sustainable levels? If the authorities are tempted to do this, will they miscalculate and inadvertently push the economy into recession?

And then there is the issue of returns on investment. While investors may focus on the authorities' attempts to slow growth, many easily overlook the impact that over-investment can have on potential investment returns. If there is "excessive" investment, then returns on investment can be low. One has only to see the role that overinvestment played in the Korean economy during the Asian crisis to realise that over-investment can old significant consequences for investors. In truth, China's potential over-investment remains a major concern to many of Prudential's funds.

So where does the truth lie? Growth yes, but has this been discounted? Perhaps, more to the point, how much should be discounted? It is easy to make the case that China will see several decades of economic growth, but it would take a brave (and foolhardy) investor to discount prices that far ahead. More significantly, how does one value a market such as this? Price- earnings multiples that look high today may look cheap in several years.

There are no simple answers. When an economy emerges, and often well into the advanced stages of its development, many rules of investment may no longer apply, or they may "bend" at the very least. Take monetary growth, for example.

In an advanced economy, monetary growth that consistently outstrips day-to-day economic growth is often a fair indicator that inflation is in the pipeline; this is the "too much money, chasing too few goods" kind of argument. Within a developing economy, however, high levels of monetary growth will more than likely feed production than it will push prices higher.

This has certainly been the case for emerging Asia. Even Singapore has seen extended periods during which money growth has been very high and yet inflation remaining low. When looking at the long-term charts, it is apparent that high monetary growth fed production more than prices throughout most of the 1980s and early 1990s. This situation is quite common in developing economies as they "monetize". In short, the "normal" investment rules may be "bent" such that investors are left grappling in a new environment. The emergence of China (and India) has certainly changed the investment rules, at least temporarily.

As a result, investors are left wondering what all that growth is worth, knowing full well that the path to growth will likely contain potholes, and some deep ones at that. This caution can often be seen in the path of the stock market as investors fluctuate between greed and fear. This has been evident within the China stocks.

Between 1999 and mid-2003, for example, the "H" share index (comprising China stocks listed on the Hong Kong exchange) remained virtually flat, and fluctuated around that trend. The concerns were not so different from those of today – involving, for instance, the clarity of earnings and valuations. The effect of deregulation on certain industries, especially the electric utilities, was a major stumbling block. Equity prices rose once investors became more comfortable that China's economy was embarked on the road of reform, that the legal framework was being strengthened and that strong economic growth was being reflected in rising company profits.

In May 2003, China stocks were caught up in the burst of enthusiasm that swept global markets. This was partially due to relief that fallout from the US invasion of Iraq was not as bad as feared, but also investors' worst-case SARS epidemic fears were not met.



Perhaps more significantly, investors realised that they had been too cautious; their China concerns had been more than adequately discounted. Between May 2003 and March 2004, Hong Kong's "H" share index rose more than 130% and led similar rises in both India and Indonesia.

In general, as investors' confidence rises and they become more familiar with an emerging market, history shows that they become less aggressive in discounting their concerns, which stands to reason. This rising confidence is reflected in market pricing, which currently seems to be the case in China. Following the April 2004 sell-off, for example, China's equities again fluctuated around a trend, but this time a rising one. Over the nineteen months to last November, the index rose 20%. But then, take-off!

Investors became more confident that global growth was intact given the perception of a less hawkish stance by the US Federal Reserve Board on US interest rates. Investors concluded, once again, that they had been too cautious, that China stocks were too cheap. They drove them sharply higher. In the rallies that peaked in early May this year, China again led the region, rising over 30%. Despite resurgent global growth fears, which reappeared in late July as the US announced lower than forecast growth, China stocks bounced back rapidly.

To put all of this into one figure, despite all the worries over growth, oil prices, clarity of earnings, China's still emerging legal and compliance framework, two sharp sell-offs and a host of other concerns, the China stock index has more than doubled since May 2003.

Is there more to come? There has to be, in our view. The clincher is that prospective valuations, taking into account forecast earnings growth, are not significantly higher than they were when the market first started rallying more than two years ago. Put another way, investors still seem to be discounting their concerns about China rather than placing any premium on China's long-term growth potential.

Let us put this into further perspective. On today's consensus profits forecasts, China is valued lower than Singapore – and recent profits forecasts in China have been rising. When investors were valuing Singapore as a growth market in the late 1980's and early 1990s, they valued the market at around 17~18x, rising to as high as 24x. The former valuation is some 40% higher than today's China valuation.

The message is clear – investors are not discounting China's full long-term potential even if current valuations are at cyclical highs. Many financial stocks, for example, look expensive today on growth forecasts that go out three years, but what about subsequent years?

Major concerns undoubtedly remain, but equally, historical evidence suggests that investors tend to err on the side of caution in the early days of an emerging market's development. This all suggests that there is plenty of upside to come – but it will take time, and it will be volatile. An investor's key attributes should be patience and the nerve to withstand some volatile periods. But, nevertheless, the longer-term outlook looks very attractive.

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