China - Where The Bears and Bulls Agree

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By **Jason Van Steenwyk**
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The bullish case for China is straightforward: Most analysts still predict growth rates in the high single digits over the next few years. Yes, the coastal areas have undergone a tremendous boom, attracting hundreds of millions of migrant workers. The coastal areas seem to have overdeveloped, and real estate prices have undergone a short, sharp correction in recent months.

But move inland 100 miles, say bulls, and the rest of the country is still a truly emerging market, with loads of room for the expansion of the Chinese middle class and affluence, and lots of land available for development.

Meanwhile, the bulls point out, valuations in Chinese equities are still cheaper than in the U.S. and Europe, with P/E ratios of ______, as of late November 2011, compared with _____ for the S&P and ______ for the MSCE, representing European stocks.

Furthermore, China's high personal savings rate has generated a flood of liquidity even as asset prices in the West declined - enabling Chinese firms to make substantial investments all over the world, from oil fields in Libya to casinos in the Caribbean - all at bargain basement prices. The vast Chinese sovereign wealth fund balance sheets - three times that of the closest runner up (Japan) - mean that there is more cash available where that came from. If anything, China is having trouble finding investment opportunities abroad for its vast store of government controlled liquidity.

From a macroeconomic perspective, China will have at least one key advantage that could last for years: Having successfully (for the time being) engineered a soft landing for the Chinese economy following the great boom of the 1990s and 2000s, China will likely be putting its foot on the accelerator soon - goosing the money supply through lending, even while the west must recover from the current rounds of stimulus and profligacy by tightening

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monetary and fiscal policy. In short, the Chinese economy will soon have a monetary tailwind, even as the west must commence sailing against the wind, as central banks will eventually be forced to hike interest rates. The world bankers are going to take the proverbial punchbowl away from the west and bring it to Asia, according to Agnes Deng, portfolio manager of the Greater China Fund, a value-oriented closed-end fund focusing on equities in China, Hong Kong and Taiwan.

The bearish take

Lately, however, the bears have been scoring some points for their own point of view in China. They point to the recent decline in some urban real estate markets (as much as 60 percent in some areas, over the last year) as the inevitable result of overbuilding in major urban areas, even to the point of building "ghost cities." - investments which will probably bear fruit eventually, but which are generating negative cash flow for investors now.

Sociologically, the bears point out that China's immense so-called "shadow population" of migrant workers who have come to the cities from farming communities all over China have no long-term connection or commitment to their adopted homes along the coasts. This population of 220 million, which has been supporting Chinese real estate prices in the cities and driving much demand for middle-class goods and services like cell phones and television sets could pack up and leave as quickly as they came.

These days, the most prominent of the bears is Carson Block, a 35 year old attorney-turned stock researcher and analyst and author of the book "Doing Business in China for Dummies." Today, as principal of Muddy Waters Research, Carson has been shorting Chinese companies he suspects of fraud or misrepresentation, while publishing reports highly critical of targeted companies' business practices.

For example, earlier this year, Block went after Sino-Forest, the Chinese-owned timber company and then the largest timber company listed in the Canadian stock exchange, publishing a research report accusing Sino-Forest of massive fraud and operating a Ponzi scheme. Sino-Forest's CEO denies the charge, calling Block a "shock jock" who doesn't understand the industry, but the damage was done: By the end of the day, Block had turned over $3 billion of shareholder value into mulch - trading on his report the whole way.

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Block has attained such notoriety that the mere suspicion in the trading and investment community that Block has taken a short position in a company can negatively affect stock prices.

At best, Block is providing the investment community with a valuable service: Putting the fear of God into Chinese companies and giving managers an incentive to avoid his attention by keeping conservative books; at worst, Block is effectively managing the short-sellers' equivalent of a massive "pump-and-dump" scheme.

We're naturally suspicious of any analyst/investor that seeks to make their research reports a self-fulfilling prophecy. Which is all too easy to do when a single analyst achieves great notoriety writing about a relatively small corner of the global equity markets. We're especially skeptical when that individual is trading on them.

But Block is certainly correct on one issue: China's investment markets do not have the same transparency that western analysts are used to. (The name "Muddy Waters" does not refer to the great American blues guitarist, but to a Chinese proverb that says "muddy waters make easy fishing").

In the long run, though, it doesn't matter what short-sellers like Block, or perennial China bulls, or anyone else says. In the end, value will win out. And there is ample room for short-sellers and long investors in a healthy market.

How do you know if the shorts are right? Don't pay attention to what the company says. Follow the money. Look to see if their managers are net buyers in the days following a short hit. Look for share repurchase programs. Look to see if the company uses stock or debt to fund purchases. Their actions will tell you whether the short sellers are on the right track or not.

In the meantime, the lower levels of transparency in China give the edge to local investors: Men and women who have spent their whole lives in China, making contacts and learning the subtleties of the Chinese ways of doing business. Agnes Deng believes this is a key advantage for her team: Her staff of analysts has long experience and deep contacts in China, and they employ an up close, personal style of active management that cannot be easily replicated from abroad. "Our Hong Kong China team has seven people, and we conduct on-the-ground due diligence and channel checks by ourselves by meeting with corporate managements, conducting field trips and talking to stakeholders of the companies in order to get the firsthand information about the operation of each of the companies."

China Report: Demographics Predicts a Coming Boom in Health Care

December 12, 2011
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The old saying goes that demographics is destiny. That's very nearly true - absent a truly cataclysmic event, or a huge population influx, China's demographic picture for the next 70 years or so is pretty much a known quantity.

At first glance, we see a country entering its premium years for productivity - with the a large percentage of their working years, with comparatively few of the very old and young depending on them for support.

According to research by the United Nations Population division, China is in the middle of its most prosperous demographic phase - one in which overall dependency by both elderly people and children on workers is declining. Furthermore, China still has some years to go before that situation reverses itself

In contrast, the United States has just emerged from its long period of prosperity - lasting roughly as long as the working careers of the Baby Boomer generation - and is just now following Europe into a challenging period of increasing dependency on the work force.i

Even when the percentage of retired workers in China does begin to rise, however, their circumstances will be quite a bit different from their Western cohorts: China's significant savings rate means that many Chinese families will be assisting their older relatives with cash in the bank and relatively little debt, compared to the West. China's massive sovereign wealth stores -- $3 trillion and counting -- are waiting in the wings to pick up any slack, if the Chinese people demand it - which they may.

Modernization Paying Huge Dividends in Productivity

Meanwhile, even though the total number of Chinese employed on farms is declining as they move to the cities, productivity and output has exploded. Consider: The number of small trucks on Chinese farms exploded from 74,000 in 1978 to 874,000 just 20 years later - and the number continues to rise. Farmers increased their use of chemical fertilizers from 0.6 kilograms per hectare to about 213 kg between 1952 and 1993, while organic fertilization increased from about 41 to 120 kg per hectare during the same period. Grain yields nearly doubled between 1978 and 1993, though the rate of increase has leveled off somewhat in recent years. ii Absolute production continues to increase, though - even as the percentage of labor utilization consumed by the Chinese agricultural sector plummeted as a result of adopting modern methods. It simply doesn't take as many farmers to feed the Chinese population as it used to.

The increase in agricultural output per worker, though, unleashed a tidal wave of immigration from the rural communities to the cities - a mass migration dwarfing any immigration influx the United States has ever seen.

No one knows for sure how many people have migrated to the cities, but China estimates its floating population to be as much as 250 million people - greater than the sum total of every U.S. migration combined, and nearly as great as the total population of the United States.

It's as if nearly everyone in the United States packed up and moved to the 50 biggest cities in Canada.

Today, 47 percent of the population of China is urban, rather than rural - and the population is urbanizing at an astonishing rate of 2-3 percent per year. iii

Increase in China's Industrial Output

The increase in China's urban population has been mirrored by dramatic increases in worker productivity outside of agriculture, as well. Agnes Deng, portfolio manager of the Greater China Fund, explains: "Two years ago one textile exporter company - every production line worker probably produced 10 pieces of Ralph Lauren (RL) clothes in the production," says Deng. But now, with the help of the technology, as well as equipment, they will able to produce 20 for each of their workers."

Her prediction is that these kinds of productivity improvements will continue as Chinese workers move up ▶

the manufacturing value chain - with each worker able to add more and more value to Chinese manufacturing output.

The result - The massive numbers of workers first freed up by China's agricultural modernization program from 1978 through the 1990s are making a huge push in output possible, which has transformed China into the largest exporter in the world,iv while dramatically boosting the wealth of ordinary workers. In turn, this has resulted in a cultural transformation, as a new Chinese middle class begins to demand more and more of the fruits of their labor for themselves.

The Clock is Ticking

Meanwhile, China's massive population is shortly to undergo another transformation. While China's 1.3 billion people make it easily the most populous country on the plant, China's birth rate is actually 151st in the world. China's long-standing "one child" policy has resulted in a birth rate that is well below China's actual replacement rate.

How big a change? Currently, only 8.5 percent of the population is over age 65. But The United Nations is estimating that China's elderly (above the age of 60) will make up over 30 percent of the population. By contrast, the proportion of children and young adults (below age 20) will be only 21 percent.

You can see an animated version of the Chinese baby bulge currently snaking its way through the population here.

The Coming Health Care Boom

What does this mean? In the years to come, China is going to have to make some adjustments. To keep up the sheer economic output, Chinese workers will need to modernize a great deal to increase the productivity of future workers to compensate for so many reaching their retirement years. This they appear to be working hard to do.

The explosion of older workers is also going to require a massive increase in health care expenditure, predicts Deng, who has been overweight in the health care sector for some time[u1].

Currently, China spends just 4.6 percent of its gross domestic product on health care, according to the CIA World Fact Book - 14th in the world. And despite a strong 92 percent literacy rate - nearly unheard of for a society that was mostly agrarian just a generation ago - China ranks 86rh in the world for the number of physicians per 1,000 people, with 1.415 doctors.v

It won't stay that way for long. The percentage of Chinese in their golden years will more than double over the next 40 years. But an increasingly middle class Chinese population will demand radically more in health care than their rural forebears did. Demand for Chinese health care is set to explode.

(INSERT PITHY QUITE FROM MS. DENG OR OTHER MEMBER OF HER TEAM HERE.)

At the same time, China's central government has been taking steps specifically to boost domestic demand - loosening monetary policy to stimulate lending, decoupling the Chinese currency from a falling dollar to preserve the purchasing power of the Chinese people. Overall, this bodes well for all manner of businesses catering to Chinese consumers, Deng argues. Health care is just one example of a sector that will benefit both from increased Chinese consumer demand.

The Active Management Advantage

This is where the active managers have a chance to outstrip the ETFs: Where ETFs can only add to their health care exposure in hindsight, after the run-up begins, actively-managed funds have an opportunity to read the tea leaves and get out in front of it.

Overall, Deng remains optimistic on China because of the compelling valuation, both compared with the west and compared with robust expected economic growth rate of 9 percent, according to projections by the International Monetary Fund - more than double the 4 percent predicted growth for global markets as a whole.

But economic cycles come and go and are notoriously difficult to predict. Demographics is a much better window into the future. Barring a truly massive demographic event, demographics is destiny, and all indicators are pointing to a massive increase in demand for health care spending - no matter what the economic cycles do.

Deng plans to be out in front of it when it happens.

i See, for example, the excellent research at http://www.strategy-business.com/media/file/00091-Demographics-Are-Not-Destiny.pdf, and especially the telling infographic on page 5.

ii International Association for Applied Systems Analysis: Can China Feed Itself? http://www.iiasa.ac.at/Research/SRD/ChinaFood/iiasa_1.htm

iii CIA World Fact Book

iv Ibid.

v Ibid.

[u1]Any current portfolio information from the fund? ■