



WILL CHINA OVERTAKE THE U.S. NEXT YEAR?

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Do you recall the interview given by China's President Hu Jintao on the eve of his visit to the United States, in which he called the international currency system dominated by the US dollar a "product of the past", and noted that China was taking steps to replace it with the Yuan, its own currency, although he acknowledged that this would be a "fairly long process"? These were words that clearly surprised many in their boldness. More recently however, they seem to just have been outdone by the Chinese central bank stating this month that the country aims to allow all exporters and importers to settle their cross-border trades in yuan by this year, as part of plans to grow the currency's international role, and that China would "respond to overseas demand

for the yuan to be used as a reserve currency."

While these words and actions may at first appear overly assertive, when looking at the actual realities of China's recent development versus the West, then we must admit that there is a good deal of truth in it, and there is a good reason for China to become an increasingly important voice in world affairs: While much of the West is scrambling to emerge from the last financial crisis, China's economy/economic growth remains incredibly strong - despite an onslaught of doomsayers who have continuously been claiming that China was Dubai times 1000 and nothing more than a cheap labour factory for the United States inevitably tied to the fate of that

export destination. In reality, the numbers show that China is actually becoming less export dependent, and increasingly turning into an economy and market in its own right. Trade data released last month shows that China's exports reached \$1,578.5 billion for the year of 2010, up 31% versus 2009, while imports jumped up by a considerably stronger 39% versus 2009, growing to a total of \$1,393.9 billion, a reflection of the country's rapidly growing domestic market and consumption power.

One should also note that it seems to be largely ignored by the majority of analysts, that China has recently even been projected to overtake the United States as the world's No. 1 economy as soon as next year (as measured in real output/PPP-



adjusted terms), according to 'the Conference Board', a highly respected US-based global economic research association. The actual true size of the Chinese economy generally tends to be vastly underestimated by most market participants, simply because it is the 'nominal' GDP figures that are mostly being looked at, yet these do not account for the fact that the prices of identical goods and services in China are considerably lower than those in the US (or Europe), and that accordingly any reasonable comparison of economic sizes should be concerned more with the volume of actual physical production, as reflected in the purchasing power adjusted GDP numbers, rather than only with the USD prices of such items.

So, having established China's economic might, as well as its currency's undervaluation and growing global status, it seems to be the right choice for investors to at least gain some exposure here - not least since most Western countries, burdened with escalating sovereign debt and ever increasing taxes, do no longer

seem neither to be the areas of the most growth/upside potential nor those of the most reliability and security.

While there are still good value stocks to be found across many different sectors in China, based on stock-specific bottom-up research, it should also be noted that, from a general sector specific point of view, the Chinese banks (particularly those listed on the mainland A-Share market) do appear to offer a particularly good risk/return potential trade-off at this moment, because:

- a) It is a sector which has largely been shunned by investors recently on the back of fears about property/bad loan exposures, as well as fears of lending restrictions and monetary tightening of various forms, yet these fears may be overdone considering that the recent weakness of bank stocks has reduced them to relatively good value again based on P/E ratios, while bad loans have been reducing and profits are growing.

- b) Chinese banks may increasingly profit going forwards from the internationalization and liberalization of the RMB, in line with the growth of these banks' RMB related corporate as well as personal RMB transactions.

- c) Currently banks listed on the China A-Share market are mostly trading at discounts as compared to the same stocks traded on the H-Share (Hong Kong) market, which is unusual, since A-Shares mostly tend to trade at a premium over their Hong Kong counterparts, and it may indicate an overselling of the sector.

However, having said all this, as with all investments, there are also specific risks involved in any China investments, as there certainly are some bubbles in some areas, and then there is always the risk of sudden government market interventions of one form or another (i.e. not only common tightening measures and bank lending or property purchase restrictions, but also official fixing of prices that can be charged for various commodities, goods and services), with the timing and implications of such measures on the various sectors always hard to predict. Moreover, there can also be no doubt that the seriousness of the sovereign debt crisis in the West does continue to pose severe risks to all economies and markets around the world.

Therefore, caution should remain the priority when investing, and it is advised to enter positions of relatively high volatility (such as Chinese banks, or any other 'emerging market' equity or commodity sectors, for that matter) only if the invested capital can be spared for the medium-long term, and if one does not employ any form of leverage or engage in short term speculative gambling.

Moreover, in today's uncertain times, it is recommended to hold a solid exposure to gold and silver as well as some energy and general commodity exposure for the purpose of protection from the ongoing Western debt crisis as well as geo-political and global inflation risks. One should also generally avoid overexposure to any one particular asset/asset class even if it appears outstandingly attractive, and to be positioned in a portfolio that is diversified across a basket of different asset classes, different geographical regions, as well as different investment tools used. **TD**