What a wonderful world

Jonathan Pain| The Pain Report | 28 January 2014

After an impressive performance in 2013, stock markets have stumbled in January and the culprits for this unseemly conduct are, in no particular order, Argentina, Turkey, Thailand, Ukraine and the eminently memorable '2010 China Credit/Credit Equals Gold#1 Collective Trust Product'. We can also throw in the tapering debate if you wish, although I am of the view that this is fully priced in markets.

So which of this motley crew do I fear the most? To be perfectly honest, none of them! I'm not going to spend any time on Argentina, other than noting they have the world's best polo players and I'm told it's a great place to visit. Other than that, it's been in a mess for a long time and I don't see it as the Thai Baht Butterfly of 1997 fame. The problems in Turkey, Thailand and Ukraine, however, serve as a timely reminder that political risk should never be ignored when investing.

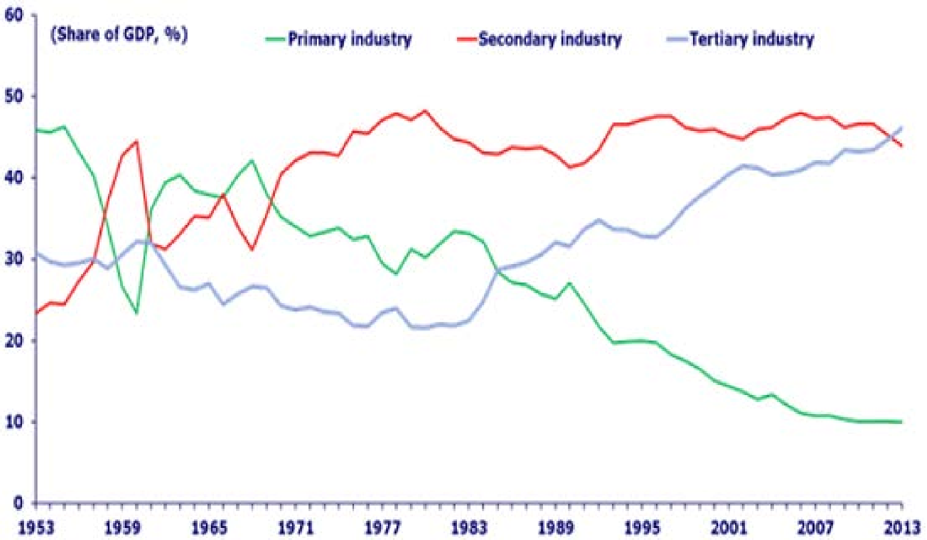
That leaves the 3 billion yuan ($496 million) WMP (Wealth Management Product), which, if said quickly, does sound like WMD. Is this the tip of the iceberg, or the proverbial canary in the Chinese coal mine? As many of you will know, the aforementioned product was backed by loans to a coal company which has since collapsed. So, is this China's subprime moment? My answer to this question may well surprise many of you as it is, yes. There is no doubt that China has seen a rapid build up of debt, particularly at the local government and corporate levels. There is no hiding from this as the recent audit of local government debt told us that there had been a 70% increase from 2010. Long time readers of *The Pain Report* may well recall that I wrote about China's local government debt problem in 2010 and said at the time it was a problem, but not a crisis. Fast forward to 2014 and it is still a problem, but still not a crisis, as the authorities have the financial capacity to deal with it, with the important caveat that growth exceeds 6% per annum over the next five years.

In this regard, this is very much China's subprime moment as we now have a much better understanding of the scale of the problem, and where it is hidden. The difference, however, between America in 2007 and China in 2014 is that the Chinese authorities have the authoritarian means with which to deal with it – and, moreover, the financial wherewithal. In this fundamental regard, economic growth is very much the defining and dependant variable. This 28 January 2014 Issue #57 What a Wonderful World brings us conveniently to the issue of the outlook for the Chinese economy, which is far more important than Argentina, Turkey, Ukraine and Thailand combined. And talking of Turkey, the Chinese economy grew by more than a Turkey in 2013.

The great thing about Chinese economic statistics is that they are usually easy to remember and the latest numbers did not disappoint. In the fourth quarter of 2013, the Chinese economy grew 7.7%. In 2013, the economy grew 7.7% and in 2012, it also grew 7.7%. The growth rate of 7.7% in 2013 generated an increase in GDP equivalent to US$818.5, which is slightly larger than the Turkish economy. In fact, as *The Financial Times* reported, if China grows at the same rate in 2014, it will have created an economy roughly equivalent to the Australian economy and in just two years.

But let's put size to one side for a moment and concentrate on the quality and composition of growth. Figure 1 below tells us that a very important milestone was achieved in China last year. As you can see, the tertiary sector, which includes retail sales, real estate and services, is now larger as a share of GDP than the secondary industry, which includes industry and construction businesses. In the spirit that a picture paints a thousand words, Figure 1 tells us that the rebalancing of the Chinese economy is a reality and that it is accelerating.

Figure 1: China's primary, secondary and tertiary industry share of GDP (%)



Sources: CLSA, Financial Times

The other point to make about the Chinese economic outlook is that, given my optimistic view on global growth, we are likely to see a significant contribution from a pickup in Chinese exports in 2014. Very few analysts are currently anticipating this, as we have all been fixated on the domestic demand story over the last several years.

At the end of last year, I put my neck on the line with my prediction that the Chinese equity market would be one of the best performing markets in 2014. So far, so bad as we've seen a very disappointing start to the New Year. At the risk of repeating myself, I continue to believe that the reform package announced at The Third Plenum last November represents a watershed moment in the modern history of China. (Refer the November 2013 Pain Report for further discussion.) Valuations are very attractive and sentiment is horrible, all of which makes a compelling investment case.

Through the latter part of 2012 and throughout 2013, I made the case for a significant recovery in the US economy, but even I was surprised by the strength in the second half. The third quarter saw growth of 4.1% and the fourth quarter is likely to be about 3%. My growth forecast for 2014 is 3% which, I admit, is nothing special as it is in line with the consensus. With regard to the tapering schedule, my economic view suggests a reasonably linear and orderly US$10 billion a month and I do not feel that the recent turbulence in markets will prevent a tapering of such a magnitude at Bernanke's final FOMC meeting this week. My own view is that 2014 will be more about forward guidance rather than tapering and that the qualitative message might be more important than the quantitative. Hopefully, this makes sense! This reminds me of one of my favourite Greenspan statements, when he said, "I know you believe you understand what you think I said, but I am not sure you realise that what you heard is not what I meant." Let’s hope we get some plain speaking from Janet Yellen.

In closing, I need to tell you how difficult it has been to write this month's report. I have raised my pen many times over the past several days, only to walk away from my desk and wander around the garden. In recent days, I have taken to watching the sunrise in my quest for inspiration, only for the kookaburras to cackle and laugh at me as I struggle to fashion my thoughts into a coherent narrative.

This brings me to the bit I have found so hard to get my head around. I remain of the view that the majority of the world will see an improvement in economic growth this year. In addition, I continue to believe that equities remain, by far and away, the most attractive asset class in 2014. All things being equal, you should remain overweight equities versus bonds as the global economy continues to gain traction. But – and I wish so much that there was no but – the equity markets in the so-called developed world are already priced for such an outcome, and have not seen a correction of any meaningful significance since mid 2011. This leads me to believe that the current sell-off could lead to our largest decline in more than two years.

After a lengthy and linear rise, equity markets will see much greater volatility this year which will require a more tactical and nimble approach to asset allocation. This will be somewhat ironic given the macro backdrop will see less volatility and greater certainty, but that is the nature of markets and why we love what we do!

Jonathan Pain is Editor of The Pain Report, an independent and global perspective of financial markets and world economy, free of Wall Street spin. He is a regular key note presenter at PortfolioConstruction Forum's professional development programs. Over the years, he has debuted new investment theses and challenged delegates about how to build better quality investor portfolios.

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