

3 AUGUST 2009

So far the Chinese year of the ox has not disappointed investors. The Chinese share market has risen 79% year to date, while the International Monetary Fund estimates that China may account for 74% of worldwide GDP growth in the three years to 2010.

A number of local and international fund managers have come out in support of the emerging economy. But Michael Lang, Chief Investment Officer at New Zealand Funds Management Ltd (NZ Funds), is happy to watch from the sidelines. "We are long-term bulls but short-term bears," says Lang.

Lang believes that it is always better to have a vivid imagination of what could go wrong tomorrow and use it to shape investment thinking today. That's how to protect investors, and investors may need protection from China, according to Lang. China has the potential to be the biggest credit collapse yet, claims Lang. In his support he points to Societe Generale's equity strategy team which was rated by Thomson Reuters Extel as Europe's top Global Strategy team in 2009 and which dismisses "the Chinese economic miracle as the sickest joke yet played on investors".

Lang believes that the Chinese economy is being artificially supported by a combination of excessive lending and government-driven fiscal stimulus. Over the past six months, research from David Rosenberg, Chief Economist & Strategist at Gluskin Sheff, shows that public sector capex has accounted for 88% of Chinese GDP growth (double the contribution over the past decade).<sup>2</sup> "This has been financed by bank lending – as measured using rolling 12-month sums – which has soared from 4 trillion renminbi per year in late 2008 to 8.62 trillion renminbi in May 2009," says Lang (the renminbi is the official Chinese currency).

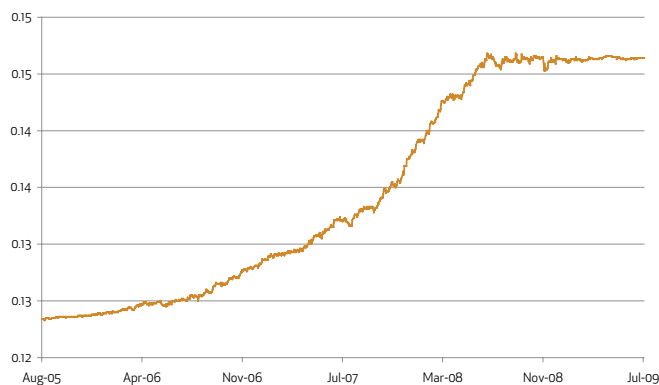
In the short term, non-performing loans are unlikely to be a problem. Lang points out "it is hard to default if the People's Bank keeps rolling the loan over and offering you more money". However, Lang believes that eventually

the loans will have to be repaid. Unless private sector investment and personal consumption begin to take off, bad loan ratios are likely to rise.

"It's hard to put a time frame on the situation but the Chinese government cannot go on lending and spending indefinitely. Either global demand will resume enough to maintain China's momentum, or China will slow. There cannot be a permanent decoupling. If China slows first, there will be a formidable price correction," says Lang. Because of this Lang believes investors should be cautious. "There are plenty of oversold growth companies that are not dependent on China and corporate bonds still offer high returns by historic standards despite the improved global outlook," says Lang.

One measure NZ Funds is using to monitor China's progress is the Chinese currency. The renminbi exchange rate is set by the Chinese government. Until June 2007 it had been appreciating against the US dollar, which helped slow China's economic growth. However, since the advent of the global financial crisis the Chinese government has held it constant against the US dollar to ensure that China's exports remain competitive. Lang says that, when Chinese authorities are confident that economic growth is sustainable they will let the renminbi appreciate again. Until then, he is happy to watch from the sidelines.

### RENMINBI/US DOLLAR EXCHANGE RATE (1 August 2005 1969 to 30 July 2009)



Source: Bloomberg.

(1) Societe Generale: Global Strategy Weekly, 16 June 2009.

(2) Gluskin Sheff: Breakfast with Dave, 29 July 2009.

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