

August 2009



**“If you can keep your head, when all about you are losing theirs...”**

My mother often told me that there would be days like this. However I think not even my dear old mum can sum it up as succinctly as the late Rudyard Kipling’s famous quote: “If you can keep your head, when all about you are losing theirs and blaming it on you...”

Now before you think that we have completely lost the plot in this traditionally most testing period for equity markets, we thought a brief comment on what is happening in China would be appropriate.

For those of you lucky enough not to be stuck in front of computer screens at this time of year, Chinese and China related equity markets have been falling since the start of August. The Shanghai A Share Index has lost over 18% over this period, closely followed by Hong Kong’s H Share Index down nearly 10%. So what is spooking markets in supposedly rapidly recovering China?

This is where it gets contentious. The bears would have you believe that with the rapid recovery witnessed so far in China, the Chinese authorities are now firmly in “tightening” mode to stop the economy and real assets (stock markets, property etc) from overheating. The proof for this is the rapid decline in bank lending in July and the reintroduction of restrictions on residential property investment in certain cities. The argument goes that with falling liquidity in the economy asset prices will decline.

Our view is slightly different. We believe Beijing is simply beginning the process of “normalising” policy from an extremely loose stance. Micro adjustment (less bank lending) with macro assurance (the leaders are continually stating policy has not changed) seems the way forward. Bank lending was running at unsustainable levels, and anyone out there who couldn’t see a drop off in lending figures must be living on a different planet. Lending will likely slow into the second half of the year, as is usual, but there is still plenty of money in the economy.

History shows us that there is simply no way that China will start tightening without a better growth outlook than we currently have. The economy has after-all only just started recovering! There will also need to be some proof of a sustainable G3 recovery. Only then do we believe policy will move to the next “normalisation” stage.

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So what to do? Don't panic! Chinese shares have run hard and fast and it is only natural that we have a bout of profit taking. But as valuations in Shanghai and Hong Kong contract we anticipate the entry of investors who have been looking for exactly this consolidation to jump in. We will.

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