Episode 32: Commentary on the Recent Market Volatility in the Chinese Stock Market

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Hello, I'm James Fletcher, Co-Portfolio Manager of the Emerging Markets Small Cap Portfolio at Kayne Anderson Rudnick.

As the global equity markets have contracted sharply during the first weeks of 2016, concerns about China are at the top of investors' minds. One of the critical questions that investors have is whether China is headed for a hard landing. We would like to take the opportunity to address the recent developments in China, provide our perspective, and summarize the approach we take to investing at Kayne Anderson Rudnick.

First, let's take a step back and put the country into perspective. China is the world's second largest economy and has been the primary engine of global growth for the past decade. Its importance on the global economy is undeniable, being the largest consumer of everything from cars to commodities to luxury goods. It's also one of the least transparent markets in the world and is showing signs of stress. There are four primary factors that are currently worrying investors: declines in the Shanghai Stock Exchange, depreciation of the Chinese currency (the yuan), slowing growth, and the rising debt levels.

Let's start with the Shanghai Stock Market decline. In our podcast on China in September, we highlighted how the meteoric rise and subsequent fall of the Shanghai Stock Exchange has little if any linkage to the actual economic fundamentals in China. This is still an important consideration. China is not your typical equity market, and its sharp rise in the beginning of the fall of 2014 and subsequent declines have been manipulated by unprecedented measures taken by the Chinese government to encourage investing and prop up the market. Despite these efforts, only about 10 percent of total Chinese wealth is invested in the Exchange (much lower than other countries) and only about seven percent of the total Chinese population holds a brokerage account.

So while the Chinese Stock Exchange is probably still overvalued (and we highlight that the stocks in Shanghai trade at an average a 40 percent premium to the same listings in Hong Kong) and may decline further. We believe that any link between the Shanghai Stock Exchange and economic fundamentals in China is tenuous at best.

Second, the depreciation of the Chinese yuan. The Chinese yuan has depreciated slightly since the beginning of the year and has depreciated by a little more than six percent since this time last year. In general, this decline in value is very small in context of the massive currency depreciations seen throughout emerging markets during the past 18 months. Brazil, Columbia, South Africa, and Malaysia, for example, have seen their currency values against the U.S. dollar nearly cut in half over this period. Additionally, China still has substantial foreign-exchange reserves as a safeguard. And currency depreciation, while negative for Chinese consumers, would represent a tailwind for the slowing manufacturing sector.

The concern is that the cost to hold the currency at this level is increasing. China already spent 108 billion dollars to defend its currency during the month of December, and since June 2015, its stockpile of foreign-currency reserves has declined by 513 billion dollars, from 3.8 trillion to 3.3 trillion. If China pulls back on this level of support and the currency continues to decline, this would put pressure on other emerging markets to further devalue their currencies, stoking additional fears in the market. So while trying to predict currencies is almost always a fruitless exercise, we cannot rule out further yuan depreciation.

The third factor is slowing growth in China. China is undergoing a transition from an investment-led economy to a consumer-driven economy. This is a necessary move for a country's economy, but the transition will be a bumpy one. It is likely to continue to put pressure on short-term growth rates in China (Exhibit 1). Our expectation is that growth in China should continue to slow to somewhere in the range of four-to-six percent in the coming year. It is likely to continue to be a "tale of two economies" with the industrial, material, and property sectors remaining weak, while consumer-oriented retailers, internet, and health care continue to show growth. Still, fundamental data has not changed materially over the past six months and Chinese authorities have many fiscal and monetary options they can deploy if necessary.

The last concern is perhaps the most pertinent, which is China's rising debt levels. China has seen its debt level balloon to 28 trillion dollars in recent years to more than 280 percent of GDP. The ratio of debt to GDP increased in most advanced economies since 2007, however, China has increased leverage more than any other developing nation (Exhibit 2). From our perspective, China's rising debt is a cause for concern and is something that we are watching. If the economy continues to slow more than expected, China may have to balance efforts to support the yuan and keep the market growing with repayment of debt obligations. Certain indebted sectors of the economy may come under financial stress.

In light of all of this information, it may help to revisit the two primary factors that have driven China's extraordinary growth over the past decades: large-scale urbanization and a high domestic savings rate.

Large-scale urbanization is significant. Each time a low-productivity farmer immigrates to a high-productivity urban manufacturing job, the income of that worker triples and becomes an important growth multiplier. China's urbanization rate, which rose from 20 percent in 1980 to 54 percent in 2014, still has many years of growth remaining before it reaches the 80 percent level at which markets usually begin to peak (Exhibit 3).

Finally, perhaps the most important asset China possesses is an unusually high domestic savings rate at nearly 50 percent of GDP. This enables the funding of large scale investment without relying on external financing. The high savings rate drives the current account surplus, which has allowed China to expand its massive reserve stockpile. When evaluating China's debt levels, it is important to recognize that only six percent of outstanding debt is foreign external debt, which continues to be significantly below China's 3.3 trillion foreign-exchange reserve buffer.

Both of these drivers, rising urbanization and a high savings rates, continue to be in place in China, which gives it a distinct advantage relative to other countries around the world.

At Kayne Anderson Rudnick, our investment approach is not dictated by movements in the market. While we cannot rule out a scenario in which the market conditions in China worsen or head for a hard landing, our key criteria for owning a stock has always been and continues to be the quality of the underlying business, bought at attractive prices, which we believe is the best way to mitigate risk in the long run. We don't own Chinese banks, for example, because they are heavily influenced by the government and have proved to be inefficient allocators of capital. We also avoid investment in companies with state influence or those with high debt levels. And in China, this precludes us from investing in large swaths of the market, particularly in the sectors of financials, materials, telecom, and energy.

Despite market conditions, we still find terrific companies in China to invest in. Take for example one of our holdings, Autohome, the leading Chinese auto-information website. Autohome's website contains professional car reviews and user-generated content including discussion forums and user reviews, and draws daily user traffic that's more than three times that of their nearest competitor. We believe that the company is protected by powerful "network effect" economics: as new users access and contribute to the site, the value of the information grows for everyone, which increases the barrier of entry for a potential competitor. The company also benefits from [a] strong secular tailwind of advertising moving more online from traditional channels. This allows the company to maintain healthy growth despite the overall slowing growth in China. For example, in the first reported nine months of 2015, even as auto sales in China grew only 5.6 percent, Autohome's revenues grew by more than 75 percent and earnings grew by more than 50 percent, as both automakers and dealers continued to pay to advertise more online and to favor Autohome's website over other online sites because of its strong traffic. Additionally, due to the asset-light nature of the business, Autohome is able to grow with very minimal capital required, and they maintain cash on the balance sheet with no debt. Corporate governance risk is minimized due to the fact that the company is listed in the United States and publishes results in US GAAP, and its controlling shareholder is Telstra, a listed telecom company from Australia. Of course, no matter how good a business is, the price must be sensible in order to earn an attractive return, but in the case of Autohome, due to investors fleeing anything with China exposure, the stock trades at very attractive levels compared to similar businesses in other markets.

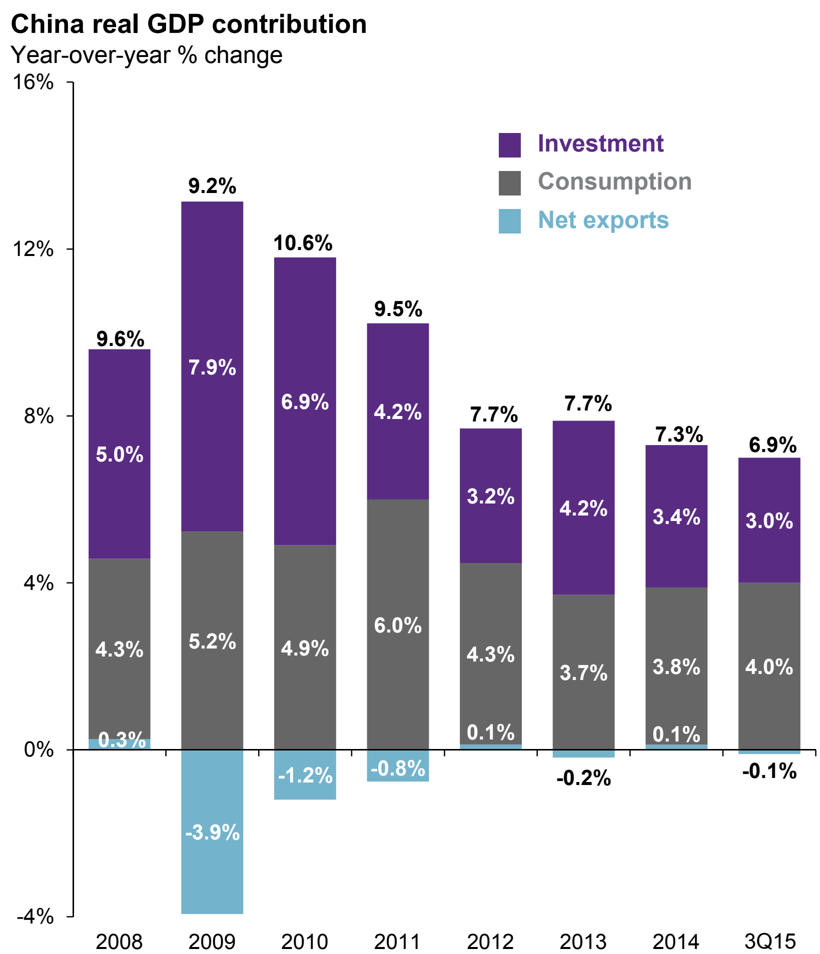
In short, we have strong confidence that five years from now Autohome will make a lot more money than it does today and generate exceptional returns for investors.

We believe that without having to predict the level of the Shanghai Stock Exchange, the value of the yuan, or the probability of a hard landing in China, we can be reasonably sure that in the case of Autohome, we are buying a protected company with significant growth potential. Our investment in Autohome does not depend on correctly predicting what will happen in the next 12 months in China. Frankly, we don't invest in companies where we need to get that right to make meaningful returns.

In conclusion, is China headed for an imminent hard landing this year? Probably not, but at the same time we can't rule it out. Our view is that whatever the macroeconomic outcome, there are still opportunities to find quality businesses with consistent earnings growth, strong balance sheets, sustainable competitive advantages, away from government involvement. We strongly believe that to invest in markets like China, where economic uncertainty is high, corporate governance standards are low, and large swaths of the market are dominated by state-owned enterprises, demands a high-quality active approach like we adhere to at Kayne Anderson Rudnick.

Thank you for your time, interest and continued trust and confidence, and please do not hesitate to contact us with any further questions that you may have.

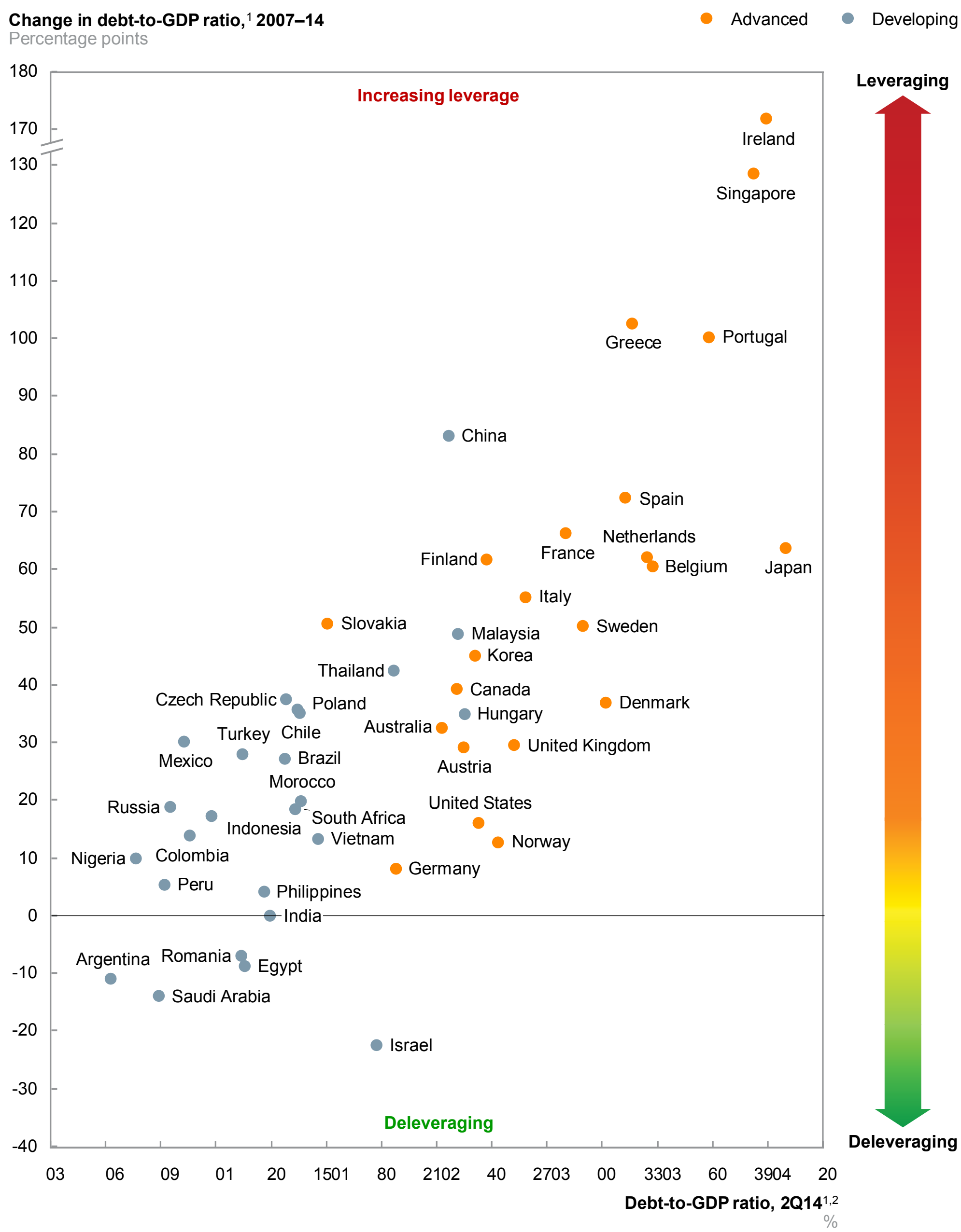
Exhibit 1



Source: FactSet, J.P. Morgan Asset Management, and CEIC
Guide to the Markets – U.S. Data are as of December 31, 2015.

Exhibit 2

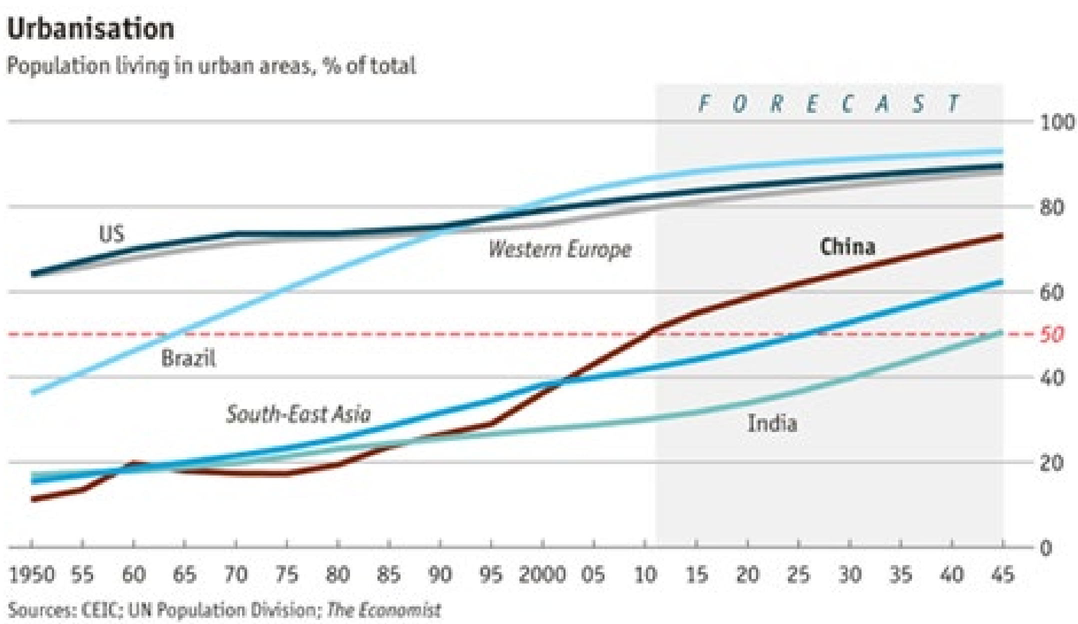
The ratio of debt to GDP has increased in all advanced economies since 2007



1D ebt owed by households, non-financial corporates, and governments.
22 Q14 data for advanced economies and China; 4Q13 data for other developing economies.

SOURCE: HaverA nalytics; national sources; McKinsey Global Institute analysis

Exhibit 3


Urbanisation
Population living in urban areas, % of total
FORECAST
100
80
60
50
40
20
0
US
Western Europe
China
Brazil
South-East Asia
India
1950 55 60 65 70 75 80 85 90 95 2000 05 10 15 20 25 30 35 40 45
Sources: CEIC; UN Population Division; The Economist