ASIA'S "GREAT MODERATION" HOLDS PROMISE FOR EQUITIES

September 2017

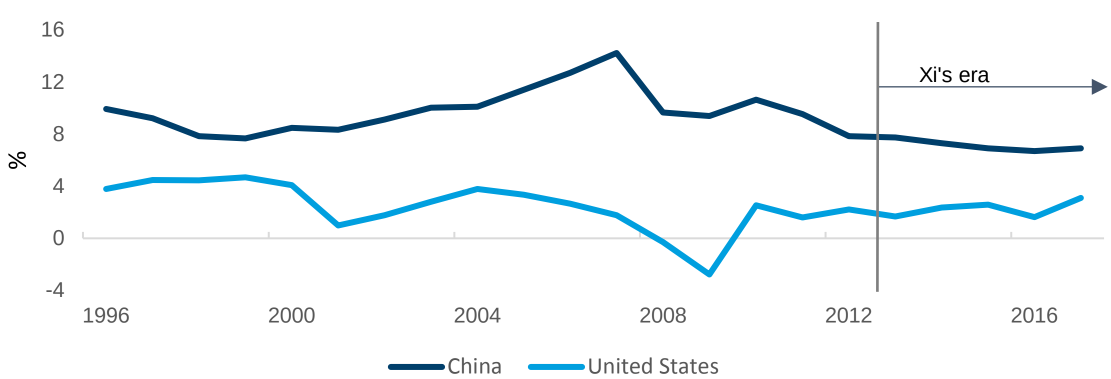
Soo Nam Ng
Head of Asian Equities

- China's economy is entering a more moderate and stable period, which will benefit Chinese and Asian equity markets.
- President Xi Jinping has introduced a mindset of sustainable, rather than fast, growth.
- As China leads regional integration, stocks across Asia may be beneficiaries.
- This "great moderation" concept offers a framework for understanding the region's economies and equity markets.

Asia ex-Japan's entrepreneurs, rapid urbanization and young population have long made it a subject of envy among many developed economies. Led by China, the region has generated strong economic growth for many years, yet its equity market performance has lagged the United States over the last 10 years. A key reason is that rapid macroeconomic growth has not necessarily translated into superior earnings growth, not least because there had been a growth deceleration in China that had caught many companies unprepared.

Things may be changing. Since President Xi Jinping assumed office in 2012, he has presided over a shift in the country's mindset, from fast growth to sustainable growth. The new policy focus has brought about growth stabilization in the last four to five years – from more than 10% in 2010 to 6.7-7.0% over the last 10 quarters. It appears corporations are beginning to leverage the more predictable and levelheaded environment to focus on profitability rather than market share, given the pick-up in positive earnings surprises that we have seen in the last 12 months.

Figure 1: Year on Year GDP of US and China



Source: World Bank 1996-2016; Bureau of Economic Analysis, 2017 (US); National Bureau of Statistics 2017 (China)

Is China entering a period of low macroeconomic volatility that economists have dubbed the "Great Moderation" in the U.S.? Since the 1980s, the U.S. has had stretches of slow but sustained growth over prolonged periods of time, albeit punctuated by a few severe downturns. These periods of growth were generally accompanied by sustained equity upside, including the current post-financial crisis period.

If similar "great moderation" dynamics are already taking hold in China (and Asia for that matter), a multi-year rally for Asia ex-Japan equities could be a result, especially if it evolves into a period of sustained value creation by the corporate sector – made more likely by the current improving corporate governance environment.

Former Chair of the U.S. Federal Reserve, Ben Bernanke, in a speech in 2004, highlighted three broad arguments that had been put forth to explain "great moderation" growth in the U.S., namely structural change, improved macroeconomic policies, and good luck.[1] Structural change includes changes in economic institutions, technology, business practices, or other structural features of the economy that have improved the ability of the economy to absorb shocks. The increased depth and sophistication of financial markets, deregulation in many industries, the shift away from manufacturing toward services, and increased openness to trade and international capital flows are other examples of structural changes that may have increased macroeconomic flexibility and stability. These are certainly the types of changes that are ongoing in China, in particular, the use of technology and modernization in management practices, the shift in economic structure towards services and the improvement in policy and regulatory sophistication in the last four to five years under the Xi administration.

On the contribution of macroeconomic policies, Bernanke observed that "few disagree that monetary policy has played a large part in stabilizing inflation, and so the fact that output volatility has declined in parallel with inflation volatility, both in the United States and abroad, suggests that monetary policy may have helped moderate the variability of output as well." In the context of China, I would argue that fiscal policies would also have a large role to play, especially in the government's ability to drive such stimulus through the administrative apparatus.

To understand the changes that have been taking place and to determine whether transformation has taken hold, one needs to understand the psyche of the Chinese policymaker and how that may have changed. For decades, Chinese policymakers feared that a deceleration in growth would lead to massive unemployment and subsequent social upheaval. This may help to explain why the Hu Jintao administration embarked on a massive fiscal stimulus in the aftermath of the financial crisis. The stimulus proved disastrous, as it created excess capacity in various sectors, and was poorly executed, with large amounts of money going into projects that were not commercially viable – not to mention the leakages due to corruption. The lack of sustainability in such forms of fiscal intervention ultimately led to the rapid growth deceleration over the course of 2010-2012.

[1] Remarks by Governor Ben S. Bernanke at the meetings of the Eastern Economic Association, Washington, DC; February 20, 2004.

It appears to me that Xi Jinping and Li Keqiang (the current Premier) have a different understanding of the role of fiscal policy. They have consistently emphasized sustainability of growth over the pace of growth, perhaps after the hard lessons of 2010-2012. They also took on the important but difficult task of eradicating corruption, which is absolutely critical to plugging fiscal leakage and to ensure spending is done in a way that will mean future returns for the economy. Further, the progress that they have made in terms of supply-side reforms and a successful transition to a more balanced economy bode well for the future if these policies reduce the propensity for economic shocks.

Lastly, I would not place too much significance on good luck, but as luck goes, two items of relevance are important enough to mention. First, the Chinese population proved to be extremely capable of taking on the e-economy (or the "new" economy, so to speak). The e-commerce lift-off in China has helped to drive a new wave of consumption, as well as entrepreneurial energy, even as the entire system confronted the growth slowdown. Importantly, new employment opportunities were created not just for skilled jobs but also for lower-skilled ones, such as in logistical delivery. As it stands, unemployment in China remains at healthy levels despite the economy trending at below 7% growth. This frees China's policymakers from the paranoia around "insufficient" growth to create employment, and keeps the focus on the pursuit of sustainability. Second, the clampdown on corruption did not come without risks, but Xi prevailed. The positive trickle down of discipline should not be underestimated, including its impact on corporate governance among listed state-owned companies. It has also put Xi on a much stronger footing to continue pursuing his economic agenda.

China's willingness to take a leadership role in regional economic integration, via the One Belt One Road and Asian Infrastructure Investment Bank (AIIB) initiatives may mean two things. First, given its size, "great moderation" dynamics from China may rub off on the region at large. Secondly, it may add to the sustainability of regional growth, given the complementary strengths of the region's different countries as they leverage each other's comparative advantages.

China is now five years into what is traditionally a 10-year leadership cycle and Xi is politically stronger than ever. I anticipate the next five years will continue to be very stable, as the country follows the path of "great moderation". Anchored by a more stable operating environment, I expect companies to create value for shareholders as they begin to plan and execute more effectively. Risk perceptions should also start to improve, thereby helping to drive positive re-ratings for the region.

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