Sankala Group

The Pot & Zé Kettle

The word *zé* means “to pick,” in Mandarin. This year we are glad we picked China equity to overweight versus other emerging markets because the recent bull market in China has been spectacular. The mainland Shanghai Composite Index gained 111% over the last 12 months ended in May. The Xinhua 25 Index, which we invest in due to the more stringent listing requirements and direct foreign access in Hong Kong, returned 38.5% over the same period. Those returns outpaced U.S. stock returns by a sizable margin:

		YTD	1 Year
Xinhua 25 TR Index	(China)	19.1%	38.5%
S&P 500 TR Index	(United States)	1.0%	12.7%
Spread		18.2%	25.8%

In the United States when you see such strong returns after a period of stagnation, Wall Street, the media, and investors typically rejoice about the birth of a new bull market. When the same results occur in China, rather than celebrating, sinophobia seems to overtake the English-speaking world and analysts search far and wide for reasons to delegitimize the rally. Below are three recent headlines from Bloomberg:

When Will China's Stock Market Bubble Burst?
China's Economy Is Not in Very Good Health
Chinese Stocks Tumble as Morgan Stanley Says Don't Buy the Dip

Despite that, with a little digging you might also find these less prominent articles that reference Chinese analysts, as well as recent IMF data:

China Stocks Not Expensive, Atlantis's Liu Says
Room for Optimism in China's Housing and Equities: Jin
Slower China Will Still Grow by Four Greeces This Year

Anytime I have the good fortune of identifying investors making decisions based on emotional bias, I get very excited. It means we can gain an edge simply by dispelling our ignorance, which is a wonderful result both financially and intellectually. In this letter, rather than simply rehashing data on the undervaluation in parts of the Chinese stock market, I want to share some research I've done that shows why China bears' main arguments are misleading, factually incorrect, or merely good examples of "the pot calling the zé kettle black."

Margin Debt

The most popular argument against China stocks, referenced in nearly every article on the subject in 2015, suggests the recent rally was driven by investors borrowing heavily on margin, and therefore will end in catastrophe. Below are recent facts about margin loans on the Shanghai Stock Exchange and the New York Stock Exchange:

USD (Billions) - May 2015	**Margin Debt**	**Total Capitalization**	**Margin %**	**GDP %**
SSE ***(Shanghai)***	163	5,500	2.96%	2.4%
NYSE ***(U.S.A)***	507	20,373	2.49%	3.0%

Sources: Shanghai Stock Exchange, New York Stock Exchange, IMF

While the SSE has ~0.5% more of its total capitalization financed on margin, there wasn't any material difference from the situation on the NYSE. More notable is the fact that the NYSE had *three times* more total margin debt, and it's also a larger amount relative to GDP. The NYSE now has more than a half trillion dollars worth of margin debt, up from ~200 billion in 2008. The NYSE's margin growth alone since 2008 is more than double the total balance of SSE margin debt. NYSE margin debt equates to 3% of total U.S. GDP, versus margin debt in China at the lower level of 2.4% of total GDP.

In short, if you're worried about margin lending the pie lives in New York while the slice lives in Shanghai. While these figures can't help us conclude that either exchange is a riskier place, they certainly demonstrate that the constant discussion of margin levels in China is overblown. These analysts are engaged in some pot calling zé kettle black.

Drunk on Liquidity

Another leading argument by China bears suggests the market is being driven by liquidity not underlying fundamentals. This argument is specious for the same reasons as the margin argument. Too much liquidity relative to what?

Liquidity is fueled by the price of money, which we popularly know as *interest rates*. Since 2007, The Peoples Bank of China *Base Rate* has dropped from 6.00% to 4.85% after four (4) rate cuts. The Federal Reserve's *Fed Funds Rate* has dropped from 5.25% to 0.25% after eight (8) rate cuts—a number of which were unprecedented in steepness and pace. That means China's benchmark rate was reduced by **19%** during a period when the U.S. rates were dropped an astounding **96%.**

Further, because investment returns happen in the future, the future direction of interest rates is more relevant to us than the past direction of rates. In this regard, China has wide scope to continue lowering rates and adding liquidity. (Ironically, they did exactly that as I was working on this letter on Friday 6/26.) Moreover, China also has space to further reduce *reserve requirement ratios* (RRR) which is the amount of money banks need to keep on hand to back their deposits. Currently set above global norms, plenty of space remains for China to reduce reserve requirements while still keeping a conservative profile relative to other nations.

The Federal Reserve, on the other hand, is now considering rate increases after officially ending three major rounds of quantitative easing. Quantitative easing, which is basically money printing, is the last ditch in liquidity creation. They conducted these operations because they had essentially reached the "zero bound" in terms of interest rates. The Fed's traditional

methods of liquid creation are now stretched to the limit. As a result, probabilities strongly suggest that from here liquidity will increase in China and decrease in the United States. If we take a clear-eyed look at so-called liquidity drunkenness, we can see that the Federal Reserve is passed out on the floor in front of the Baijiu cabinet, while the People's Bank is drinking tea with the Puritans.

The Middle Class is Making Money – What is wrong!?

The last popular argument being made by the uninformed is that there are simply too many people enjoying the bull market in China. Perhaps because they missed the rally in New York, analysts now suggest that too many smaller Chinese investors are making profits in the stock market, so it must be doomed. This argument not only fails on the basis of data, it also smacks of extreme arrogance by essentially suggesting only rich people deserve profits in equity markets.

Est. May 2015	**Account Holders**	**Total Population**	**% People Investing**
USA	172,000,000	319,000,000	54%
China	90,000,000	1,357,000,000	7%

Source: China Securities Depository and Clearing Co., Gallup Polling

In China 7% of the population owns investment accounts, versus 54% in the United States. When you see headlines like ***"Chinese Retail Investors Open Enough Brokerage Accounts In March For Every Man, Woman, and Child In LA,"*** your thought process should not be, wow, that sounds like a bubble. Rather it should be, amazing, China's rising middle class still has a long way to go. L.A. isn't a global-tier city at 3.8 million people. You could squeeze L.A. into a corner of Guangzhou, a city in China most people haven't heard of with 12.3 million residents. In fact, that seems like a pretty reasonable pace of account opening given recent stock performance and the fact that *640 million* more account owners will be needed for China to reach United States levels of market penetration.

According to the World Bank, China has the highest savings rate in the world and yet only 20% of financial assets in Chinese households are invested in equities. That statistic is also skewed upward by the ultra-wealthy who have much higher percentages in the stock market. 45% of household wealth remains in cash and bank deposits according to Charles Schwab Corp. Clearly

there is wide scope for Chinese market participation to continue to rise both rapidly and sustainably.

Reporters and analysts like to paint Chinese small investors as uneducated country-bumpkins who don't have any business in the stock market. I offer a different view. Perhaps they are more like your parents or grandparents, who had the clarity of vision to buy shares of General Electric, Exxon Mobile and Boeing in the 1970s? Maybe they see that they are in the rarefied 7% of the Chinese population that currently invests in equities, and that long-term growth of the investor class is basically assured in China. The more relevant discussion is not about if Chinese saver's migration into capital markets will lift Chinese firms, but rather to what extent these capital flows will influence the direction and development of the entire world's capital markets.

Needless to say, for all the reasons I covered, combined with previous work I've shared on the attractiveness of valuations in Hong Kong, we will be betting against Morgan Stanley's analysts who say not to buy the dip in China. All the observations that attracted me to that market in 2012 remain in place or have improved, and many of the milestones we expected have been reached or are in sight. We should take advantage of the current price correction. It will be far easier for us to beat a couple Morgan Stanley analysts than hundreds of millions of people hungry for middle-class life who want to open their first retirement account or college savings fund.

One a similar note, last Friday as China announced its interest rate cut and Greece edged closer to default, Vietnam's central government quietly lifted foreign ownership limits for national firms. These new rules go into effect starting in September 2015, and are supportive of our long-term investment thesis in Vietnam as well. These moves add to my confidence that politics across Asia remains very conducive to financial liberalization, which I believe will be *the* defining force in globalization over the coming decade.

Best,

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