The Crash of China is a Myth

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My Recent Trip to China

Tuesday I returned to San Francisco after spending eight days in the Chinese cities of Shanghai, Hangzhou and Nanjing. From the headlines in US newspapers prior to my departure, I might have expected to find a country in turmoil and crisis. Indeed this expectation was reinforced in the week prior to my trip as no less than five "non-investment" people – including my mother - asked me about the "crash" of China. The sensational media coverage seemed to reach a peak the day before my departure as the Wall Street Journal reported that President Xi himself had "botched" the stock market and a CNBC reporter made the quite extraordinary claim that Premier Li Keqiang may "lose his job" because of the stock market declines. Was it possible that the 30 year secular trend of growth in China had reversed since I last visited in April?

Here is what I saw:

- Shanghai. The city was as frenetic as ever. Tens of thousands crowded the Bund, perhaps hundreds of thousands packed the shopping street Nanjing Road. Restaurants were packed. No signs of a crisis.

- Hangzhou. Scenic West Lake, a top tourist attraction in Zhejinag province, welcomed throngs of tourists. Tour buses packed with tourists from around the country clogged the roads and parking lots around the lake. Families strolled the shores, young people took picturesque selfies to post on WeChat. No signs of turmoil.

- Nanjing. The city wall and Xuan Wu Gate were also packed with families and tour groups. The constant thumping of construction equipment could be heard in the background constantly as the city continues the work of adding lines to the metro system that serves its 8 million inhabitants. No signs of a collapse.

My last day in China I had breakfast with a Shanghai-based Partner at of one of the world's leading consulting firms. This person has lived in China for 30 years and knows more about the Chinese economy, its businesses and its people than nearly any other expert you can find. While he acknowledged that China continues to struggle with its transitions from a state dominated economy to a private sector economy and from an economy based on manufacturing to an economy based on consumption, his comments reinforced my belief that the "crisis" that populates the headlines of U.S. media is a mirage. It's not real, it's not there.

The Chinese economy is slowing, but this is not news. The slowing of China's GDP growth rate has been a fact of life since I first became immersed in China 10 years ago. It's part of China Economics 101 and is simply the law of large numbers. China will continue to "slow" for the foreseeable future but will still likely grow at a pace 2-3 times that of the developed world for years. Furthermore, should it be required, the Chinese Government has significant tools and resources at its disposal to combat weakness in the "real economy".

The China Stock Market Correction

To be sure, China's stock markets have had a very volatile and negative 12 weeks. The Chinese domestic A Share stock market has undergone a significant correction at best and "crash" at worst. The awkward and clumsy market intervention by the Chinese government was, for good reason, widely criticized and seen as a step backwards in China liberalizing their markets and economy. However, such interventions are not unique to China. In fact, U.S. markets – and many ETFs in particular – were whipsawed only two weeks ago, as regulations and trading curbs instituted by our government in response to the 2010 "flash crash" went awry leaving many ETFs trading at significant discounts to their Net Asset Values (NAVs).

And let's not forget, the China A share market remains up over 30% in the past 12 months vs. a loss for the S&P 500. Even those with a short rearview mirror should see that while the drop was dramatic, it was preceded by a similarly dramatic speculative bubble and is still in positive territory over past year. And let us also acknowledge that there were parties in China warning against the type of

speculation that resulted in the spectacular fall. Indeed, the China Securities Regulatory Commission (CSRC) warned investors in December of 2014 that they should "invest rationally, respect the market, fear the market, and bear in mind the risks present."

Buy Fear

Most of my friends and colleagues know that while I am active in the ETF marketplace, I am a Warren Buffett groupie at heart. I "pray towards Omaha". One of my favorite Buffett lines is that "you pay a high price for a cheery consensus". The opposite of that is that you get your best buys when there is "blood in the streets". Buy Fear. Sell Greed. Corny yes, but true. By all accounts, fear of China has never been higher.

Buy What?

One of the major problems with investing in China and Emerging Markets is that the major indexes and the ETFs that track them are dominated by state owned, legacy, inefficient and often corrupt companies. And it's now just China that has this problem. Anyone that has followed the PetroBras disaster in Brazil should understand why these companies should be avoided. Yet, a full 30% of the largest Emerging Markets ETFs (VWO &EEM) are invested in State Owned Enterprises ("SOEs"). Many of the Chinese SOEs were part and parcel of the "botched" efforts to prop of the market and instructed to buy their shares or those of other SOEs.

Investors seeking to take advantage of the fear that permeates the China investment landscape should look for the parts of the equity markets that will benefit from the long term secular increase in consumption. These sectors include traditional consumer sectors and also the ecommerce and internet sectors that are benefiting both from the increase in consumption and from the spread of smartphones and mobile broadband. While the legacy manufacturing economy is slowing, retail sales posted 10% growth in the most recent quarter. The growth in the internet and ecommerce sector remains over 35% today and should remain high even if the broader economy in China slows further.

While a year ago investors were clamoring for Alibaba (BABA) it has been kicked to the curb and is, as I write this, trading at near all-time lows. Other ecommerce names haven't fared much better as BIDU, JD, WUBA and others have all seen dramatic declines in their share prices. These are the types of companies that investors should be buying now. Unlike the stocks that dominate the indexes, these stocks trade in the U.S. and are not subject to Chinese market interventions or the erratic behavior of mainland China's retail investors. These companies are also entrepreneurial and much more focused on shareholder returns than SOEs are. In fact, many of these companies including BABA, JD and YY have announced share repurchase programs to take advantage of the dramatic decline in share prices.

This may not be the bottom. These stocks could go much lower. However, long term investors seeking exposure to Emerging Markets equities ought to consider these companies or ETFs that track these sectors.

Please note that I am conflicted. I am the founder of The Emerging Markets Internet & Ecommerce Index, which has been licensed as the basis for an ETF (NYSE: EMQQ) from which I receive a licensing fee.

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