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China 'only game in town' for iron ore, gold



Montgomery Investments' Andrew Macken, Simon Ho from Triple3, Charlie Jamieson from Jamieson Coote Bonds, Perpetual's Garry Laurence and Tim Carleton from AusCap Asset Management speaking on a panel at trading firm Optiver. Daniel Munoz



by Jonathan Shapiro

Australia's top emerging fund managers are divided on the fate of China's out of control sharemarket and whether it will lead to catastrophe or opportunity.

But all agree we are at a historic juncture that will set the Australian market's course for years to come and determine the fate of our own fortunes.

"There's a risk that the Chinese sharemarket continues to unwind. If that's the case it's going to have ramifications for their economy. We may well look back at this period as a key moment in time for markets and our economy," Auscap Asset Management's Tim Carleton said at options trading firm Optiver's inaugural Investor Day held last week.

Mr Carleton warned that as China's enormous consumption of steel, currently close to 800 million tonnes a year, inevitably slows, Australia faces a slowdown and potential recession.



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Montgomery Investments' Andrew Macken, Simon Ho from Triple3, Charlie Jamieson from Jamieson Coote Bonds, Perpetual's Garry Laurence and Tim Carleton from AusCap Asset Management speaking on a panel hosted by the Financial Review's Jonathan Shapiro. **Daniel Munoz**

"There is no other game in town in relation to **commodities**. If China stops consuming so much in the way of commodities, which we think has to happen – there's no reason that a country, which has circa 14 per cent of global GDP and 19 per cent of the world's population, should be continually consuming 50 per cent of the world's resources – it has big implications for our own economy."

China, which accounts for 30 per cent of global economic growth, remains the **main game** in town not just for Australia but the world, Montgomery Investments' Andrew Macken told the panel.

The middle kingdom's growth model of suppressing interesting rates, holding down consumption to push up savings and investment is reaching its natural end, he said.

'SOURCE GROWTH FROM CONSUMPTION'



Montgomery Investments' Andrew Macken: the common thinking that low interest rates drive growth does not hold for China. **Daniel Munoz**

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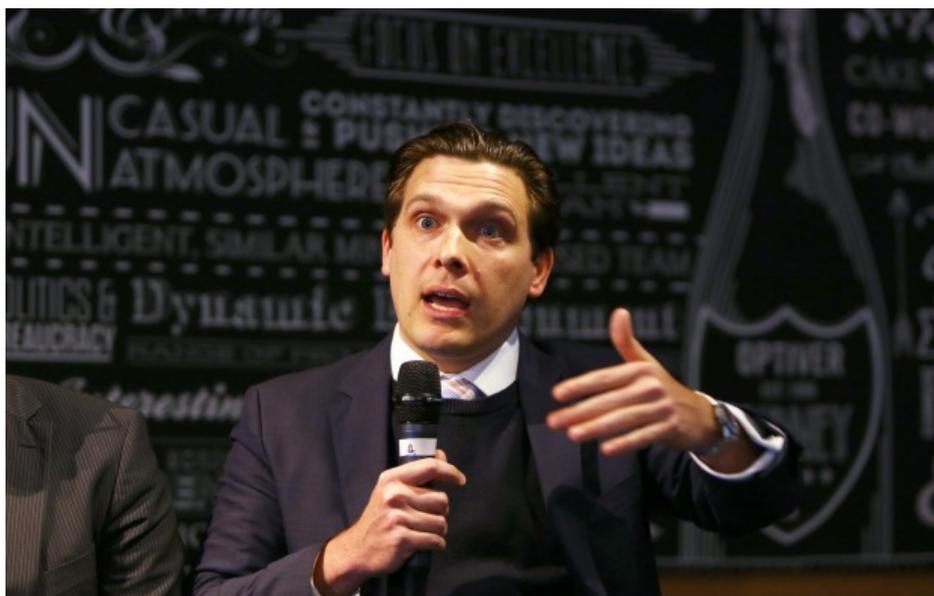
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to service the debt that is funding it, which is where we are now. The government needs to rebalance the economy and source growth from consumption rather than investment; everyone agrees that needs to happen."

Policymakers could achieve this much-desired rebalancing by allowing aggregate growth to slow and by jacking up interest rates to increase incomes of a population of savers.

"We are hardwired that low interest rates are good for growth and high interest rates are bad for growth. In China it's different: higher rates means I earn more on [my] savings, so as a household I am richer and start to consume more."

But lower growth, he said, "sends the fear of God into every country in the world" while higher rates would bankrupt much of the Chinese corporate sector.



Auscap Asset Management's Tim Carleton: China's property sector is worse than the US in 2007-08. Daniel Munoz

"They are highly indebted and the return on assets is not enough to service a lot of the debt they have used to fund the assets. So the Chinese government is really stuck between a rock and a hard place."

Mr Carleton said over 100 hours spent travelling on trains and buses throughout China led him to conclude that the country's overbuild of property is on a much larger scale than he saw in the US in 2007 and 2008.

The property boom of the past five years has now been replaced by a sharemarket whose rise was fuelled by a volatile combination of uninformed investors and margin debt, not seen for almost a century.

'UNCANNY' PARALLELS

"There hasn't been a situation that's more similar to the [late 1920s in the US](#) in the intervening period. The parallels are uncanny," he said.

"Our observation is that they are making many classic [policy] announcements that were similar to those made in the 20s that led the US into a depression."

But Garry Laurence of Perpetual Investments tempered the bearish outlook for China.

Mr Laurence has invested in several Chinese companies including China Life Insurance and says most Chinese stock indices are still showing strong gains over the past year and trail most other markets, including the S&P 500 over a five-year period.

"I've owned [Chinese A-shares] for about five years thinking, 'why are they going sideways?' They are much cheaper than the rest of the world and have better growth prospects."

Mr Laurence also pointed out that while China's ration of debt to GDP has gone up from 150 per cent in 2008 to 250 per cent, it has been limited to governments and corporations not households, and is still low compared with major Western economies.

"China has moved from being undergeared to the same level of gearing as Western countries. Now what they are doing is that they can't go above this; we can't keep building infrastructure and fuelling this part of the economy. So for the next 10 years we need to grow at more normal levels and begin to shift to services and consumer sector. Consumption to GDP in China is about 40 per cent versus 67 per cent in the US."

Mr Laurence said the main concern among Chinese policymakers is to ensure there is employment and wage growth. There's evidence they're achieving this, based on the companies he owns, he said.

EVIDENCE OF SHIFT IN COMPOSITION

China Life, for instance, has increased its workforce over the past year from about 600,000 to 900,000 – early evidence of a shift in the composition of the labour force.

"Think about that in the context of other economies and how many people actually have been employed by one company in one particular industry. So that is happening in China.

"The government is focused on shifting their work force. They are concerned with keeping these people employed and raising their wage levels and you are seeing a shift from people working in construction and heavy industry to life insurance and retail."

But that does not mean the world is without problems. Mr Laurence's biggest worry is an increase in debt globally from \$US34 trillion (\$46.6 trillion) to more than \$US185 trillion.

"That has increased the amount of liquidity, which has driven asset prices, and you're starting to see property bubbles [and] bubbles in bond markets as a result of surplus liquidity in the financial system."

Charlie Jamieson of bond fund Jamieson Coote Bonds agreed that the world's enormous debt burden will constrain central banks contemplating rate rises from restoring bond markets to normal.

That the US Federal Reserve is likely to be the first major central bank to hike rates is a major juncture; "knowing we have an enormous amount of debt in the world after the GFC, most of which has been created at record low interest rates, all of which needs to be rolled and serviced," he said.

'PATIENCE' REMOVAL HUGELY SIGNIFICANT

"Servicing simply requires a low term structure and to think we can materially step away from that gives me great concern about what would happen in all markets – not just the bond markets – but we know every market has enjoyed the benefit of very cheap and accessible money, so it needs to be watched carefully."

Mr Jamieson said the removal of the word "patience" from the Federal Open Market Committee's April statement was hugely significant for markets.

"It was the first time we didn't have forward guidance from the world's major central bank since the GFC and that forward guidance allows you to walk through the hallway in the dark and know exactly where the boundary is, as an investor," he said.

But for all the "hawkish talk", the Fed under Janet Yellen is doing its best to neutralise the market's fears through "dovish dot plots" or forecasts of future rate rises.

"We feel if they do hike, it will be by a small amount, which will soothe the investor community and assure them there's still a reasonable amount of sugar in the punchbowl," Mr Jamieson said.

Uncertainty around China and the Federal Reserve may be weighing on the minds of Australian investors, but Mr Carleton of Auscap said while he's concerned about the challenges facing the economy, its long-term strengths remain intact.

"The main drivers of household expenditure are the number of people, influenced by population growth, and the price they pay for the goods – governed by what's happening to inflation. We have an economy that creates an environment for incredibly steady numbers on both of those fronts. So we may be short-term cautious, but we are long-term bullish. You won't find many people more bullish on Australia's long-term prospects."

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