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Monthly Commentary - May 2013

Visiting Toronto last week, one was impressed by the visible construction boom, which means there are 147 cranes actively working, almost as many, if not more, than there were in Shanghai and Beijing in recent years. Why is there so much construction activity in Canada? Apparently, much is driven by the massive inflow of Chinese money, to buy apartments (for around C$1 million) and also for office buildings. This is the same phenomenon which we have seen in Hong Kong and Singapore recently, as well as in London and Sydney.

The key point to note is that we have seen this trend peaking out in Hong Kong and Singapore with the imposition of tough capital gains taxes and other restrictions on foreign ownership through company names. Also, the anti-corruption drive in China has sharply curtailed purchases of luxury goods; and the flow of capital out of China is being much more carefully monitored by officials. Nevertheless, we hear from our informants in Beijing that many higher income young couples with children have foreign passports and plans to emigrate, and buy property overseas, bearing testimony to the severe health risks from the continuing pollution problem in the capital.

There are very clear signs that the 10 year boom in the Chinese economy is gradually tailing off, and growth rates, instead of reaching 10%, are now trending down towards 5/6%. Both foreign direct investment and fixed asset investment, and industrial production, are slowing down and the growth of consumer spending is not yet strong enough to offset these declines. We are told that the new government under Xi Jinping and Li Keqiang is firmly in charge, and has appointed many new officials, but is going slow on the much needed reforms, such as changes to the "Hukou" system, in case of unintended consequences, including rising municipal debt, and rising interest rates, in the shadow banking system. We do not anticipate any crash in China, but we are aware of the mounting social and economic risks which confront the new administration. The internationalization of the RMB will continue, but at a very slow and managed pace.

One of the consequences of this China slowdown is the recent sharp fall in commodity prices including oil, gold and industrial metals, such as copper and iron ore. We believe that the 10 year catch-up phase, since China joined the WTO in 2001 is now complete, and looking forward, (as is confirmed by BHP's Chairman expecting 5% rather than 12% annual growth in mineral demand) the long commodity boom is now petering out.

The only exception to this is in food, water and agricultural items, notably potash and fertilizer. The Chinese middle class is raising its living standards (as in the whole of Asia) and eating better, so the major agricultural producers, and seed companies, can expect another few decades of expansion.

The other major development in the Asia Pacific region is the dramatic change in economic policy in Japan. Since Mr. Abe's administration took office in last autumn, the Yen has fallen by over 30% against the US$ and is now standing at ¥102 at the time of writing. The Nikkei has rebounded by almost 50% and the Bank of Japan has pledged to double the Yen money supply by the end of 2014. This dramatic reflation has altered the global investment landscape: much of these newly printed Yen will find the way overseas, and will drive up asset prices in Asia and beyond. "Mrs. Watanabe", who is often epitimized as the Japanese saver, is, above all, searching for yield and income. Hence the low yields on sovereign bonds, and the growing capital flows into good dividend paying stocks, especially in the USA, Canada and even Europe. In Asia, the two countries which we see benefitting from these Japanese capital flows are Thailand and India, especially in the form of direct foreign investment.

As the Japanese car companies have been shut out of the Chinese market, they are looking for new markets to expand in and the greater Bangkok area has long been their favourite location for auto parts and assembly production to supply the South-East Asian market. In India, Maruti Suzuki is one the success stories of Indian-Japanese joint ventures. Both Hong Kong and Singapore will also benefit from this inflow of Japanese investment, especially in real estate investment trusts and high yield shares.

We therefore remain quite positive on the outlook although there are as always clouds on the horizon. This autumn, Mr. Abe, having presumably won a large majority in the upper house will confidently present the Diet in Tokyo (for the first time since 1950), with his revision of the US-dictated constitution, which made Japan into a non-militaristic state, with self-defense forces, costing no more than 1% of GNP. With a newly assertive China across the Yellow Sea, Japan feels the need to defend itself, and re-build its navy and air force, particularly as Obama's foreign policy is increasingly hands off and non-interventionist. All of these factors will alter the geo-strategic balance in Asia, and increase the possibility of military conflict in 2014 and beyond. Both Taiwan and the Korean peninsula will be involved in this struggle for domination, in north Asia.

Robert Lloyd George
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