

China: Alone in Its Confidence

By Douglas Clark Johnson

In an inaugural week, you would expect the international news weeklies to carry a cover story on the incoming US president. *Time* ran a feature on President Obama entitled, “Great Expectations.” *The Economist* did the same, but called it, “Renewing America.” *Newsweek*? Well, their editorial board decided to publish a special issue, labeled “Why China Works.”

Maybe that says two things: that the world does not revolve around Washington and that the global economy may be a bigger issue than who is in the White House. The subhead to the *Newsweek* cover story certainly had a sobering message for many US-focused economists: “Inside the command-capitalism model that will outrun all rivals.”

One reason why China works is that it has lots of cash. At maybe \$2 trillion, its central-bank reserves—the world’s biggest—are staggering. This means that the US-China bilateral relationship may well prove to be the most important anywhere over the years ahead, as China recycles its cash into US Treasuries to prop up a deflated American economy.

The world’s biggest saver and most profligate spender are rather stuck with each other. While tradition would have President Obama head to Europe for his first overseas trip as the new face of America, it would say a lot more about concern for US economic wherewithal if he were to head to Beijing. Presumably his economic policy team should be in tow.

China is having its cyclical problems like everyone else. Real GDP growth for 2008 was recently announced at 9%, the lowest since 2001, but still above the generally accepted rate of 8% required to preserve some semblance of social stability. The slowdown was expected, given that exports may account for as much as one-third of China’s output. But, as a lagging indicator, the data are not surprising.

What may be more interesting is anecdotal corporate information. Just recently, Swatch Group (the watchmaker) announced intentions to open 15 stores across China. Alibaba (the online marketplace) said it intended to move beyond its China-centric model and pursue multilateral opportunities. Lurking in the details are the notions that China remains a buoyant market and that Chinese companies are likely to use their cash hoards to expand in ways that companies elsewhere simply cannot.

So why does China work? It may have much to do with its oft-derided government intervention in the economy. The great irony here is that economists have been arguing for decades that an open-market model is more advanced than a state-controlled model. In a bit of a turnabout, the opposite now seems to be true. Who would have imagined that the US would effectively nationalize its banking and auto industries?

To quote the *Newsweek* article, “Once seen as the bad habit of an immature economy, China’s state meddling is now seen as a bulwark of stability.” The piece goes on to conclude that the real key may simply be command capitalism’s ability

to sustain confidence. And that is something sorely missing just about everywhere else in the world right now.

For the global investor, there is a certain strategic logic to exploring China-related ideas. China equals confidence, which in turn equals investment opportunities—all the more as the speculative money leaves Shanghai and Beijing. What is left is a playing field devoid of exuberance, on which one might actually have some true clarity on the investment prognosis.

Does that mean we should all run out a buy a Chinese equity fund? Maybe. But putting your money to work in such a product likely has an opportunity cost, until we see a whiff of global inflation and some sign of a worldwide recovery. In our view, better to invest in this bemired environment through a direct investment such as private equity.

Befuddled at where to head with our thinking, I contacted a banker-colleague who happens to work in the Gulf for an Asia-based financial institution. My question was simple: “How does a Shariah-compliant investor access the China story?” I intentionally asked someone closer to the origination side of the business, figuring that the perspectives of secondary-market players on where long-term opportunities exist were shaded by capital-market turmoil.

He affirmed that the China-related work of the internationally oriented Islamic banks has not been “sufficiently comprehensive,” yet there are meaningful ideas to explore:

- *Middle-Class Growth.* Despite the cyclical setback, major opportunities remain in traditional consumer businesses such as fast-food, retail shopping, and white goods.
- *Agribusiness Development.* Investors often think of China as the world’s manufacturer, but the nation’s western regions suggest a range of agricultural plays, including livestock production, farm equipment, and food distribution.
- *Water Infrastructure.* China is relying on the private sector to develop its water supply and sewage treatment facilities. Suffice it to say that maybe three-quarters of the country’s natural water supply is polluted.

During recent prime growth years, few Islamic financial institutions used their excesses to diversify into China. Gulf banks with bulging cash balances evidently decided that at-hand opportunities in nearby markets like Turkey and Pakistan seemed more user-friendly. Somewhat mind-boggling, on the other hand, is that the Kuala Lumpur-based institutions were slow at the draw. Presumably, demand from Islamic investors for China-related transactions was diverted by the many seductive “bubble projects” afoot across the Muslim world. Under current economic circumstances, however, we suggest a major wave of Shariah-sensitive capital will make a pronounced shift toward China. Global investors may want to move ahead of the curve.

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