



future prospects for the economy and drive further outflows. Against this backdrop the Chinese authorities will do everything they can to maintain confidence in the value of the Renminbi in order to attract further inflows despite the fact that the currency appears increasingly overvalued from a corporate perspective. The necessity to attract large flows of foreign capital into China on an ongoing basis also implies that China is not such a safe haven if foreign inflows into emerging markets begin to dry up in 2014, despite the very comfortable current account and official fiscal ratios.

What should investors do in the face of such uncertainty? We would completely disregard the apparent cheapness of the market and would advise GEM investors to take a big underweight position, and non-dedicated investors to avoid Chinese equities entirely wherever possible. We do acknowledge though that this very negative stance will be considered far too extreme by most benchmarked investors in which case we would adopt a dual strategy. First, we do not see a strong case for taking big sector bets within a China portfolio, since post-Plenum, the valuation discrepancy between perceived winners and losers from anticipated shifts in the economy has become increasingly extreme. If our bearish medium term view on the economy plays out, then consumption will suffer along with investment, which will leave the very expensive Healthcare and Staples sectors very exposed. The banks are a black box, just as the developed market financials were going into the 2007-08 crisis; current valuations are obviously discounting a fairly hefty level of impairment, but it is difficult to claim that a worst case scenario is priced in. Secondly, we would advise a contrarian strategy for those investors who are understandably unwilling to take a strong structural view on China. This has been the right strategy for the past four years as the lack of visibility concerning policy and the underlying state of the economy and financial condition of the corporate sector has driven wild swings in sentiment among investors. At present, both investor surveys and fund flows suggest that weightings have increased markedly along with confidence in economic policy, so now should not be a bad time to scale back exposure.

Finally, there are many reasons why we might be too pessimistic about Chinese equities but there is one sign in particular which might cause us to concede that we are wrong. The increasingly obvious accretion of power and more assertive attitude by the Beijing based authorities has some negative connotations in terms of foreign and social policy, but could be very positive from an economic perspective if Beijing intends to impose market disciplines on local authorities. We believe that the new administration will back away from the consequences of imposing a hard budget constraint, but if this did start to happen evidenced by meaningful closures of industrial capacity and widespread curtailment of future investment plans, the long term implications would be very positive, although the economy and some key sector would take a short term hit. We will continue to monitor individual industries to try to identify any sectors where there is a clear prospect of individual winners emerging from a process of consolidation.