

# MARKET FOCUS.

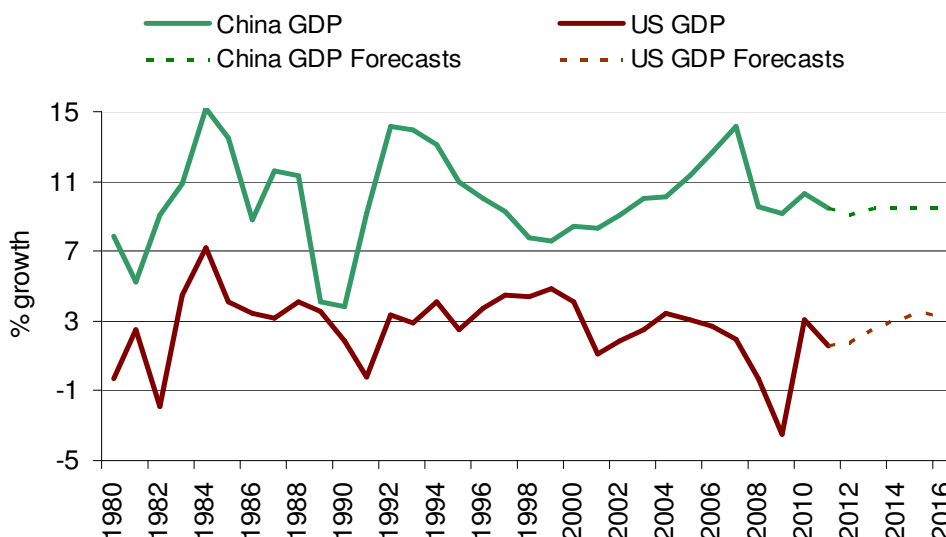
We think it's important you have access to in-depth market analysis of what lies behind market fluctuations and your fund's performance. Market Focus will dig deep into specific market themes so you can have the bigger picture of your investments with us.

## THE GREAT TRANSITION

In Chinese mythology a carp can transform itself into a mighty dragon by leaping and crossing over the rapids of "Dragon's Gate". The symbolic meaning is fairly clear. If you can overcome your hurdles, you can eventually achieve great success. This is a fitting analogy for the economy of the Peoples Republic of China. While it could be described as the growth story of our time, China's economy still has some major challenges to overcome, in order to make its transition.

Since opening up to foreign trade and investment in 1979, China has rapidly become the world's second largest economy, largest exporter and largest holder of foreign exchange reserves. Over the last 30 years its growth rate, as measured by gross domestic product (GDP), has increased at an average of more than 9% per annum. Many experts even predict that within the next two decades it will overtake the United States (US) economy in size. Chart 1 provides a thirty year comparison of China's GDP growth rate with the US.

**CHART 1 – GDP GROWTH RATE COMPARISON**



Source: International Monetary Fund (IMF).

## **THE ROAD TO SUSTAINABLE GROWTH**

There are many headwinds facing China's economy. As far as the Peoples Bank of China (China's central bank) is concerned, its high growth rate must be as much a curse as it is a blessing. This is because the economy now needs to sustain a high level of growth, in order to support a rapidly developing population, but avoid the rising inflation that growth brings with it. There are also social issues that the government will need to deal with in order to prevent political instability. These include migrant job creation, increasing pollution, high property prices and income inequality. Although it has the second largest economy in the world, the country ranks below the world average in terms of GDP per capita (annual GDP divided by citizens).

The major challenge for China's growth, however, is reforming its economy to balance export demand with domestic demand, particularly with household consumption. This is because China has become overly reliant on importers such as the US and Europe for growth. Policy makers have historically been more interested in maintaining the status quo of China's export market than developing its consumer economy. Intentionally devaluing its currency is one of the methods it has used to keep exports competitive at the expense of the Chinese consumer. One of the negative effects of this economic imbalance was highlighted in November when China's Purchasing Managers Index, which measures manufacturing, showed a sharp slowdown due to dampened export demand. Decoupling its prosperity with the West is a painful reform that China will inevitably have to undertake in order to achieve sustainable growth.

In March 2011 the government passed its '12th five year plan', which seeks to address many of the country's economic and social issues. The objectives of the plan include slowing down the growth rate to a more sustainable level of 7%, increasing domestic consumption, developing a low carbon economy and boosting non-manufacturing based industries so that 'Made in China' can become 'Designed in China'. It will be essential for the plan to work if China is to avoid a hard landing following years of very high growth.

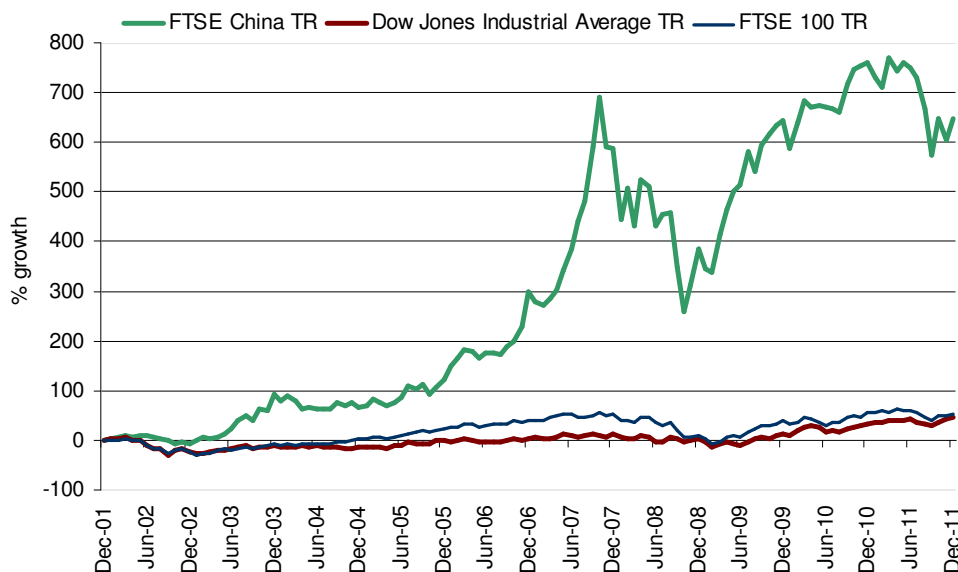
## **GETTING EXPOSURE TO CHINA'S GROWTH**

Investing in emerging economies is a high risk strategy regardless of the relatively high growth potential. China is no exception to this rule as it has not always managed to convert economic growth into stock market prosperity. This year has provided a good example of this inefficiency. Although GDP has grown by more than 9% in 2011, the country's stock markets have plummeted. There is also poor governance and regulation in China, which is unattractive to international investors, particularly when there is risk aversion in the markets. Despite the recent drawbacks, investing in China can be very rewarding. Chart 2 on the next page provides a 10 year comparison of the FTSE China Index versus benchmark UK and US equities.

Investing directly in China is complicated due to trade restrictions placed on foreign ownership of China's currency and assets. Indirect exposure through investing in funds is, therefore, the most common way for investors to invest in the country. Investors can opt for China focused funds or funds that diversify their Chinese holdings by spreading their risk across other regions. Investors opting for a diversified approach can invest in Asia Pacific funds, or funds that spread their holdings across wider emerging markets such as Brazil, Russia, India and China.

An alternative strategy is getting exposure by investing in Western companies, or assets that benefit from the growth of China's economy. Investing in commodities is an example of this approach. Due to its massive size and growth rate, China is the world's largest consumer of many commodities. Its growing demand for resources is an increasingly important factor in determining global commodity prices.

CHART 2 – COMPARISON BETWEEN INDICES OVER 10 YEARS



Source: Lipper for Investment Management as at 31 December 2011. The chart compares total return (TR) of these indices, which includes capital growth and dividends. Past performance is not a guide to future performance.

**CONCLUSION**

Although China’s economy appears to be slowing, its growth is still likely to remain higher than most other economies (according to IMF forecasts). The performance of China’s stock markets in 2011 has, however, re-emphasised the risk of investing in under developed regions.

It seems that China has yet to prove to investors that it can make the transition into the ‘mighty dragon’ that many have predicted it could become. To do so it will need to fully develop from a centrally planned economy to a market based economy. Until it can make the necessary reforms and overcome its challenges, it will remain an excellent growth prospect for investment but a very risky bet. Anecdotally, according to the Chinese Zodiac calendar, 2012 is supposed to be the year of the dragon!

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*This article was written on 3 January 2012 and provides a focus on current market themes. This content should not be considered as advice, should not be relied upon as it is the view of the authors at a single, historic point in time, and is for your information only. If you need advice, please contact your financial adviser, or call us on 0800 316 8540. We can only advise on Legal & General products and services. We may record and monitor calls. Lines are open Monday to Friday 9.00am to 5.30pm.*



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