Zacks INVESTMENT MANAGEMENT

Market Insights by Mitch Zacks

From Shanghai, with Volatility: Should Investors Be Bullish About China?

By Mitch Zacks
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Chinese stocks have been on a tear in 2015, but it's been the kind of ride that's liable to give you heart burn. Though stocks in the world's second largest economy are up over +50% on year in the local currency, it has come with a roughly 9% correction in late April, a 7% dip a few weeks ago, and days like June 3 when the Shanghai opened 5% lower only to finish the day up +0.8%. It's enough volatility to put even the most veteran investor's stomach on antacids.

You might be thinking — up +50% in just six months?! Those are the kinds of returns I'm looking for!

However, we all know better than that and the prudent investor is always reluctant to take that kind of bait. Better to let the day traders lose their hair trying to figure out which way is up, while you stand on a higher plane and focus on this opportunity from a better vantage point. As part of a global, well-diversified portfolio you should have some exposure to China, perhaps in the range of 5% – 20%. With that allocation, you can rest assured that your portfolio participates in the upward surges when times are good, while not getting battered by the declines when things go south. And, you remove the element of market timing from the equation altogether.

China is an interesting story and I think it could have more room to run even with the rapid ascent that Shanghai has seen this year. Many investors worry that a huge bubble is forming, but I think they're underestimating China's current capabilities and the forces at work – let's take a closer look.

China's Economic Story in a Nutshell

Much of the focus today is on "China's slowdown." In the first quarter, China grew at 'just' a +7% clip from the year before, which marked its slowest growth rate in six years. This

pales in comparison to the 10+% average growth China has enjoyed over the past three decades.

But what some perceive as the "end of a growth era," is actually the beginning of a new one. Over the past few years, China has realized that massive investment at the state level on infrastructure build-outs and housing was an unsustainable driver of growth, and that an economic restructuring—albeit a calculated one—was in order.

China has talked about this for years, but it's largely been rhetoric with no action until now. China loosened restrictions on foreign investment, and has notably led the charge in the formation of the Asian Infrastructure Investment Bank [AIIB], much to the chagrin of the United States (which sees its influence in the region being challenged).

At the expense of slightly slower growth, China seems more focused than ever on remaking itself into a consumption and service-based economy, while slowly weaning itself away from being an industrial economy reliant on government spending. It's a smart economic transition that has long-term viability, and the market is taking note, so should investors.

Pulling Levers

The economic transition just described, in my view, is reason enough to be a long-term bull on China. But I think the real reason behind the recent surge in equities markets has to do with…take a wild guess…*monetary easing*! China's government knows better than to let the economy slow too quickly (therefore risking a social uprising), and they have barely scratched the surface in using monetary tools they have available to give the economy a boost. The market is well aware of this.

China cut rates in 2008 and in 2012, but they were only very slight eases. In the last six months, they've cut rates twice, and the People's Bank of China has signaled that they are ready and willing to do more to keep the economy steady. In a market where risk assets love to "follow the money," or to chase easy monetary policies, China is seen as the country whose monetary levers have the most potential impact. Stock prices are surging as a result.

The Bottom Line for Investors

China is not positioning itself to become an all-out free market economy like we have in the West, but the free market strides it's taking are a positive sign of things to come. Opening up more trade, allowing the currency float and giving access to more foreign investment are all things that can help transform the economy for the better. China appears to be taking action in each of those areas.

As mentioned in the beginning of this piece, a well-diversified global portfolio should have some exposure to China. If you're worried you might be too late, you shouldn't. China's future, though not perfect, looks bright and there is likely plenty of room to run over your investment horizon. And, perhaps even room to run in this bull market—the S&P 500 is still up about 70% more than the Shanghai since the global bull started, so it wouldn't seem unreasonable to think China can make up some more ground before it's over.

-Best Regards, and Better Returns!
Mitch

About Mitch Zacks

Mitch is a Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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