OVERBERG MARKET REPORT

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Global

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Is China becoming uninvestable?

The Shanghai & Shenzhen CSI 300 index is the worst performing major equity market since the start of the year, falling by a precipitous 20.29%. This should be a concern, not just for direct investors, but for the world economy. China is the world's second largest economy, it is by far the largest consumer of industrial commodities, Europe's largest export destination, a significant cog in global supply chains, and substantial funder of US debt. Why is the market so weak and what is its outlook?

On the surface, economic growth appears robust. Official data confirmed year-on-year GDP growth of 4.8% in the first quarter, but how much can these numbers be trusted? Research firm Capital Economics has devised its own independent China Activity Proxy, which shows growth much lower. Besides, even the official numbers show retail sales falling in March by 3.5% on the year, even before Covid outbreaks in Shanghai. A rigid Covid zero policy and strict lockdown measures have shut down whole portions of the economy. Covid has spread to areas which generate 40% of GDP and ship 80% of exports. Consumers and businesses are losing the ability and the propensity to spend and invest. The residential property market, which has boomed for 25 years and been a source of tremendous growth in household wealth and economic activity remains in the doldrums following government measures to reduce excessive leverage in the sector. Government crackdowns on internet, technology, gaming and online education, have also affected consumer and business confidence.

Authorities are scaling back their "common prosperity" regulatory initiatives and delivering fiscal and monetary stimulus. However, stimulus is modest compared with previous measures as the government is wary of refuelling the property bubble and destabilising the financial system with too much debt. Moreover, under strict lockdowns there is little chance that stimulus will gain much traction and create the desired multiplier effects. Capital Economics predicts China's GDP will only grow by 2% this year, a far cry from the official target of 5.5%. Export markets, which helped so much in 2020 and 2021, when global goods demand boomed, will also ebb as the world turns its attention towards expenditure on services.

There are also longer-term impediments to growth. Population growth has slowed dramatically since 2015 and is now close to zero. The population is expected to shrink over coming years. When Trump was replaced by Biden, it was expected that trade relations between the US and China would improve but the animosity is becoming more entrenched. China is rapidly "decoupling" from the West not just in terms of trade but also in technology. Western sanctions on technology transfers will affect China's productivity. In the context of an ageing and shrinking population, productivity improvement will become increasingly vital to maintaining economic growth.

Russia's invasion of Ukraine has made the global community even more distrustful of autocratic leaders. Xi Jinping will be elected at the end of this year for an unprecedented third term. He has accumulated enormous powers and a keen appetite for using them, evidenced by his foreign policy as well as domestic measures, including attacks on large business and entrepreneurs and military aggression in the South China Sea. Ken McCallum, Director General of Britain's MI5 Security Service said in late 2020, while comparing Russia with China: "You might think in terms of the Russian intelligence services providing bursts of bad weather, while China is changing the climate." (ECR).

China's authorities are adept at moving investment goalposts, and with the nation in danger of increasing isolation from the rest of the world, some analysts have cautioned that its stock markets may become uninvestable. However, others have a more optimistic view. The managers of Scottish Mortgage Investment Trust PLC, the top performing London listed investment company, believe the regulatory crackdowns on China's internet companies will in due course be replicated in other countries as they will enhance the competitive playing field. Competition is vital to technological progress. On this basis, Beijing's policies will boost China's productivity growth rather than diminish it.

China is unlikely to ever become uninvestable. Its economy is too dependent on trade and integral to the world economy for either its own or for foreign governments to render it so. According to research firm ECR, it is the most important trading partner for over 120 countries. China's products account for 18% of US imports and 22% of EU imports. "A decoupling between China and the US and its allies may not be an impossible task if tensions continue to rise in earnest, but the consequences will be of an entirely different order than the already very considerable consequences of the struggle with Russia." There is far too much at stake on all sides, so geopolitics will somehow muddle through.

The CSI 300 index has undergone a massive derating since 2020 when it was the world's top performing major equity index. It now trades at very attractive levels that are well below long-term averages. The 12-month forward price/earnings ratio is 10.4x compared with the long-term average of 13.7x and the price/book ratio is 1.59x also well below the long-term average of 2.6x. For long-term investors, with a 10-year investment horizon, current valuations almost guarantee superior returns. However, valuations may become even cheaper. Markets can remain undervalued for considerable periods. Beijing is stepping up stimulus, but it is tame compared with previous cycles and Covid lockdowns will subtract from the intended multiplier effect. Investors will probably be rewarded for waiting for even lower entry points in the market.

LOCAL

Werner Erasmus

Behavioural lessons to improve your financial success

I was introduced by a friend of mine, to a new investment & personal finance book called *The Psychology of Money*, written by Morgan Housel. I am very grateful for this introduction because it just happens to be one of the best investment and personal finance books I have ever read. The best part about it is the fact that the book is not overly complicated and is written in layman's terms making it an easy and enjoyable read.

In the book, Morgan Housel shares various lessons about wealth, greed, and happiness. The core lesson of the book is about behaviour and how people's wealth or how well they manage their money is not necessarily determined by how much they know (IQ or education) but by how they behave. For example, highly intelligent individuals unable to control their emotions can be financial disasters while ordinary individuals with no financial education can be wealthy if they adopt certain behavioural skills. Below are some of the lessons in *The Psychology of Money* that stood out:

Never enough: Stop moving your goal post. Expectations rise with results but if expectations rise faster than results you will never be satisfied and keep on moving your financial goalpost. It is like a dog chasing its tail, it never ends. The capitalistic world we live in is great at creating wealth and envy. Wanting to surpass your peers may provide you with the motivation to work hard but life isn't satisfying without a sense of enough. Happiness as they say is results minus expectation. Morgan Housel says "an insatiable desire for more - will push you to the point of regret". Freedom, family, friends, being loved and happiness is invaluable and the best chance one has to keep these things is to know when to stop taking chances that might harm them. ***In other words, knowing when is enough financially***.

Confounding and compounding: Many books have been written about the best investor in the world, Warren Buffet. But Warren Buffet does not have the best return record of all time, that title belongs to Jim Simmons (66% compounded annual return). Nevertheless, Warren Buffet is far wealthier. Why, because he has been investing successfully for over a very long period. Long enough for the magic of compounding to take place. Housel summarises it as follows: "Good investing isn't necessarily about earning the highest returns, because the highest returns tend to be once-off hits that can't be repeated. It is about earning pretty good returns that you can stick with, and which can be repeated for the longest period of time because that is when compounding runs wild". Start investing early because time is the most important factor in investing. As Housel puts it, "Time makes little things grow big and big mistakes fade away".

Tails you win: Tails drive everything. For people not familiar with the term, it refers to events in statistics with a low probability of happening i.e., outliers. These events are plotted in the tails when looking at probability distributions which means they are far from the average or expected outcome. The idea is similar to the 80/20 rule which means 80 of your returns come from 20 % of the invested time. Your decisions as an investor most of the time will not have a significant impact on your investments, but what you do during the abnormal days - the 1% of the time or less - when the market around you is going crazy. Housel sums it up by saying the following," A good definition of an investment genius is the man or woman who can do the average thing when all those around them are going crazy". Tails drive everything which is why many things can go wrong in investing.

Freedom: Freedom in this context refers to the ability to control your own time. Housel mentions Angus Campbell a psychologist in 1910 at the University of Michigan who wrote that "Having a strong sense of controlling one's life is a more dependable predictor of positive feelings of well-being than any of the objective conditions of life we have considered". In other words, doing what you want, when you want, and with whom you want is the broadest factor that makes people happy. More than their high-paying job, luxurious house, or fancy sports car. The biggest benefit that money has is the ability it gives you to control your own time. That is real freedom. "Using money to buy time and options has a lifestyle benefit few luxury goods can compete with", notes Housel.

Save money: According to Housel "Saving is the gap between your ego and your income, and wealth is what you don't see". Investment returns can make you rich, but often are uncertain and out of your control because of market, economic and political factors. But saving is in your control and has a guaranteed chance of being as effective in the future as it is today. Wealth is the money that is left over after you have spent what you generated. You can save even though you might not have a high income, but you cannot build wealth if you do not save a lot.

Conclusion: To summarise, in the world of money, financial outcomes are often driven by luck, independent of intelligence and effort, and two, financial success is not a hard science it's a soft skill, and how you behave is more important than what you know.

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