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INVESTMENT NOTE **03 SEPTEMBER 2014**

CHINA'S FEAR FACTOR – HERMES' GREENBERG TACKLES THREE MAJOR INVESTOR CONCERNS

Nothing better illustrates investors' bipolarity – between fear and greed – than the subject of China. Before the crashes of 1997 and 2007, greed dominated, but fear is now the overriding emotion: fear of declining growth, popping property bubbles and ballooning debt. This makes China cheap, but every bargain-hunter needs to remember: things are often cheap for good reasons. In this update, Gary Greenberg, Head of Hermes Emerging Markets, analyses whether the fears are unfounded.

Declining Growth

China is experiencing its slowest growth for 15 years, and may not meet its 7.5% target for 2014. The International Monetary Fund typifies this caution, and in June lowered its 2014 growth forecast from 7.3% to 7%.

We are not extremely worried about slowing growth, providing growth is accompanied by reforms that put the Chinese market on a better long-term footing. Over the previous decade, the earnings growth of Chinese companies had been (has been) diluted, with capital having been channelled towards breakneck expansion rather than generating shareholder value.
Ultimately, slower economic growth brings benefits: lower capex spend for companies will mean a reduction in the pressure to issue new shares, allowing EPS growth to come back into line with earnings growth. Capital itself can be turned to more profitable ends or returned to shareholders.

Tide of debt

There are serious concerns the economy is being kept afloat on a wave of debt – credit creation has increased 16% year-on-year, more than double GDP growth. Since the crisis, China's economic rescue efforts have (has) produced three credit-fuelled investment booms: in infrastructure (2009), real estate (2010), and mining and manufacturing (2011). Growth was sustained through pump-priming the predominantly state-owned enterprises in these areas, creating excessive leverage.
The government now has to perform the delicate manoeuvre of streamlining the state-owned enterprises, while deflating the credit bubble in a controlled fashion. This will allow efficient companies to effectively compete, but at a pace that does not cause indebted state-owned enterprises to collapse before private industry can take up the slack. This may explain the recent mini-stimulus and seemingly slow pace of reform over 2014.

Property Bubble

China over the past quarter century has become the world's largest building site. Despite a slowing in infrastructure spend; rapid housing construction has resulted in market glut and a sharp fall in housing prices. This has sparked fears of a major property bubble.
However, there are policy options available for dealing with the property bubble, such as shanty town relocation to areas with high vacancy rates. In addition, reforms providing the huge unregistered workforce with work permits would both create housing demand and increase labour force participation in more skilled industries.

Conclusion

Over the long term, we believe China is on the right path. But currently there is short-term pain as the market digests the new realities of the economic outlook.
Our Hermes Global Emerging Markets Fund has a 30.1% allocation to China, which is almost a 10.6% overweight against the MSCI Emerging Markets Index. We are exposed to the Chinese consumer, internet user, and business services user – areas which continue to grow robustly – with minimal exposure to the high-risk areas of property and banks.

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Notes to Editors:

Hermes Investment Management
Hermes is focused on delivering superior, sustainable, risk adjusted returns for our clients – responsibly.

Hermes manages assets on behalf of more than 200 clients* across equities, fixed income, alternatives and real estate, with £27.4 billion* assets under management. In Hermes Equity Ownership Services, we have the industry's leading engagement resource, advising on more than £108.6 billion* of assets.

We believe in **Excellence**, **Responsibility** and **Innovation**

- **Excellence:** We aspire to excellence in everything we do. This manifests itself most visibly in our investment performance. We will only offer products to our clients where we believe there is a strong investment thesis and where we can deliver sustainable alpha.

- **Responsibility:** We believe it is our responsibility to lead discussion and debate about the fiduciary responsibilities of fund managers to our clients, their stakeholders and, ultimately, society at large. We have always sought positive engagement with the firms in which we invest.

- **Innovation**: We have the entrepreneurial culture to identify forward-looking products that meet those needs, along with the resources and speed-to-market mentality to develop them rapidly.

Our structure gives clients globally the benefit of access to a broad range of specialist, high conviction investment teams operating within an established and robust operating platform.

Hermes' investment solutions include:

- **Equities**: Global, Emerging Markets, Small & Mid Cap, Europe, Asia Ex Japan
- **Fixed Income**: Inflation-Linked, Government Bonds, Investment Grade, High Yield
- **Real Estate**: Segregated, Unitised, Debt, UK, US Residential, European
- **Alternatives**: Commodities, Hedge Fund Solutions, Infrastructure, Private Equity

*Please note the total AuM figure includes £3.6bn of assets managed or under an advisory agreement by Hermes GPE LLP ("HGPE"), a joint venture between Hermes Fund Managers ("HFM") and GPE Partner Limited. HGPE is an independent entity and not part of the Hermes group. £0.4bn of total group AuM figure represents HFM mandates under advice. Source: Hermes as at 30 June 2014.