SIR JOHN TEMPLETON INVESTMENT ROUNDTABLE 2015

London | 20th May

John Templeton Foundation | OXFORD METRICA

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FOREWORD

TROUBLE IS OPPORTUNITY

I am pleased to present the proceedings of the 2015 Sir John Templeton Investment Roundtable, the annual forum in which investment managers invited from around the world by the Templeton Foundations debate the threats and opportunities for financial markets. This series is the brainchild of Dr Jack Templeton, President of the John Templeton Foundation. Sadly, Jack passed away the weekend before the 2015 roundtable and we dedicate this whitepaper to his memory.

Sir John's investment approach stood out in several key ways. He was an optimistic contrarian who believed trouble is opportunity, and kept an unsleeping eye on the possibilities lying beyond the easy and unthinking mainstream; a disciplined, long-term value investor who never lost sight of the financial fundamentals; an internationalist who cast his net worldwide at a time when most investors were still domestically obsessed; a moral investor who prized substance over surface and valued social contribution above personal enrichment. All these elements continue to characterise the Roundtable. Hard-hitting and incisive as ever, it pulled no punches, lambasting the big pension funds for fleeing investment fundamentals in their terror of short-term stock market fluctuations; seeing the trend towards indexation as a failure to exercise choice; pointing the finger at mispricing and capital misallocation; and, above all, finding today's zero-interest rate, QE-fuelled markets a 'surreal and artificial' place gripped by a 'strange psychology', whose eventual unwinding might spring many a nasty surprise.

Speaking from a position of balance, the Roundtable's keynote speaker, the sinologist Andy Rothman, adeptly penetrated the enigma of China today, a fast-growing and ever-changing giant still entangled as much in Western misunderstandings as in the policy blunderings of its ruling elite. Often seen as an export-dominated economy, China has in fact enjoyed a boom, fuelled to date by state investment. Rothman expressed confidence that domestic Chinese consumption will rise to replace investment as the driver of GDP growth.

Nevertheless, looking worldwide, participants detected chinks of opportunity within the 'wall of worries', seeing the seeds of a future boom in shale oil and gas - 'the cheapest energy molecule anywhere in the world' - and setting this positive note against current anxieties such as terrorism and regional instability. However - and fittingly perhaps given Sir John Templeton's own prediction in 2005 of the Crash of 2008 and of the long shadow it would subsequently cast - the Roundtable's deliberations concluded on a sombrely prophetic note in its forecasts for the Chinese stock markets bubble just weeks before it burst.

The views expressed in the Roundtable, it should be emphasised, do not necessarily reflect the views of the Templeton Foundations, their trustees, officers or employees. I would like to thank all the participants, colleagues and, in particular, Andy Rothman for his keynote address.

Dr Rory Knight,
Moderator

Dr Rory Knight is Chairman of Oxford Metrica and he serves as a trustee of the John Templeton Foundation.
He was previously Dean of Templeton College, Oxford University's business college.

KEYNOTE ADDRESS: TEN WAYS TO GET CHINA WRONG

Andy Rothman is an investment strategist at Matthews International Capital Management.

I want to focus today on the five misconceptions that lead analysts to be overly pessimistic about China, and then turn to the five mistakes the Chinese communist party is committing.

FIVE COMMON MISCONCEPTIONS

1. UNDERESTIMATING THE PACE OF CHANGE

Within a very short period, China has become a highly entrepreneurial country. It used to be the case that everyone worked for the state and lived in state housing, and the state controlled every aspect of life, even down to one's choice of spouse. Today, more than 80% of employment in China is from small, private companies. All of the new job creation today comes from small, private companies, along with most investment and industrial sales.

It is the big companies listed in the stock market that get the attention, but they are not the biggest and definitely not the most dynamic part of the economy. One sees stories every day in the media about how miserably the big state-owned enterprises (SOEs) are doing, particularly in areas like construction, steel, cement, aluminium or glass, or in resource extraction; oil and gas, or iron ore. Profitability in some of these industries is down 50-60% year-on-year.

But a lot of companies are still doing very nicely, thank you, in sectors like electrical equipment, electronics, telecom, computers and pharmaceuticals. There, profits are still growing at a reasonable rate. You have to realise the private sector is central to how the Communist Party now views the economy. It is swayed by how problems will impact on the people creating the jobs and generating the wealth. The primary focus is no longer the SOEs - although they do not want those to suffer unduly - but on entrepreneurs.

Another big change in recent years has been that the government has abandoned its obsession with growth. The Chinese government now focuses on the same issues we do: jobs, wages and inflation, and how consumer confidence and consumer spending are faring. The government's new nonchalance vis-à-vis GDP growth (this year under 7% for the first time in decades) is rooted in the fact that China is doing rather well in these areas. The jobs market is healthy, and surveys and interviews indicate that the average factory is offering 5-8% wage increases to factory floor workers this year just to retain staff, and double digit increases to retain skilled workers. Average household income growth is 8% in real terms. Among the migrants leaving the countryside for jobs in manufacturing and construction, income is rising at 10% a year. Consumer confidence is strong and household debt is low - factors which, in turn, are generating real retail sales growth over 10%.

2. MISREADING THE STRUCTURE OF THE ECONOMY

The second misconception concerns the rebalancing of China's economy. Many of those excessively pessimistic about China – those whom I call the 'Perma-Bears' - maintain that the structure of the Chinese economy is fundamentally unsustainable. And they are right. However, they make two major mistakes: firstly, by not understanding what the structure of the economy actually is and, secondly, by underestimating the Chinese government's ability to change.

Most of us - including President Obama in a recent statement - identify China as an export economy. Nobody seems to have told the President that net exports have contributed basically zero to Chinese GDP growth in recent years. This does not mean that exports are unimportant. They still account for a disproportionate share of low-wage, low-skill jobs. That is why, in 2009, when global demand for Chinese goods collapsed, China launched the biggest Keynesian stimulus programme ever attempted. It was not sparked by fears over GDP growth, but the anxiety that millions of people might lose their jobs in a very short period, and that major social instability would follow. In response, they brought forward a lot of public infrastructure projects. Today, however, there is not much anxiety about GDP growth because the jobs market is holding up so well and, while export growth has slowed, factories are not closing down and laying off millions of workers.

The Chinese economy is driven by investment. Currently, about two-thirds of Chinese GDP comes from investment and only about a third from consumption - the reverse is true for OECD countries. That reflects the fact that China has been building the equivalent of the US intercontinental railways, the Eisenhower interstate highways and the Tennessee Valley Authority projects, for example - all squeezed into about fifteen years and all funded domestically.

The same phenomenon happened in Japan after the war when investment there was also much greater than consumption. And post-war reconstruction is basically what China has been doing - not in the traditional sense but to repair Mao's destruction of Chinese infrastructure. That rate is unsustainable, but the picture is changing very rapidly. After the nine years to 2011, when investment in China grew by 25% annually, it has slowed markedly. Last year, growth in fixed asset investment was about 16%; this year it will be 12-14%. Can consumption make up for the investment slowdown? My answer is: yes, it can, and I believe China offers the best consumption story in the world today.

3. UNDERVALUING CHINESE CONSUMPTION

In China, real retail sales growth is increasing by more than 10% across categories from instant noodles to SUVs. In the first quarter of this year, Greater China (mainland China plus Hong Kong and Taiwan) bought more iPhones than the US – and iPhones cost much more in China than in the US. This indicates the disposable incomes and positive consumer sentiment that Chinese people enjoy. They are a lot less worried than we are about China's future – and it is that future we should be investing in. You do not want to wait until consumption is bigger than investment in China because that could take twenty years. Savvy investors have already worked this out - which is why many consumer stocks in China suddenly have become relatively expensive.

4. MISUNDERSTANDING SHADOW BANKING

According to the New York Federal Reserve's definition of a shadow bank – a credit intermediary that has no recourse to a central bank, is lightly regulated, and highly leveraged - there are no shadow banks in China. Chinese non-bank financial institutions, like almost every significant financial institution in China, are still run by the Communist Party. The party may be pushing them to operate increasingly on market terms but they are still firmly under the Party's thumb. Lending is controlled by a Party quota everywhere, in the shadow as well as in the 'daylight' banks.

Entrusted loans - a big chunk of non-bank finance in China - are state-owned enterprises that take money out of accounts in state-owned banks and lend it to subsidiaries or clients. Probably the shadow institutions in this area that get most attention are the trust companies. There are some 69 of them. Almost all, and especially the large ones, are owned and operated by the Party.

This does not necessarily mean they are good institutions, or that they do a good job of analysing and pricing risk, but they could not be said to be operating in the shadows.

The trust industry emerged when the government said: we have private, high risk companies to which banks don't want to lend, and we need to provide credit to these people. Let's create trust companies (ring-fenced from the deposit-taking banks) which will create an outlet for the new wealth in China. We don't have hedge funds and other ways to invest, so let's create an opportunity that offers rich people a 5% or 6% return, combined with the ability to lend at 10% or 12% to riskier borrowers.

This sounded fine in theory but problems began to emerge in 2012. Trust lending had grown over 500% year-on-year and was fuelling anxiety that it was being inadequately managed and supervised. The bank regulator appeared untroubled at first but has since put the brakes on, bringing trust lending down 100% year-on-year. They are not going to shut it down completely but they are reining it in.

So China has its financial problems but they are not the same as ours. It would be a mistake to impose our Western framework on China because there are significant differences. For example, during the global financial crisis, Western governments bailed out their banks. China didn't have to do that because their banks were nationalised already. Western governments next said to the banks: we'd like you to lend more, to which they replied: thanks very much, but we don't think so. In China, the government simply called up the banks in November 2008 and told them to double their lending. Then in June 2009 the Chinese government called up and said: we're done with all of that, and credit growth fell at once. That is something you cannot do in an environment like this, especially with a democracy.

DEBT - A COMPLEX PICTURE

Chinese debt is the headlines a lot nowadays. A recent paper on global debt by the McKinsey Global Institute has a chapter on China which reveals very rapid and somewhat unnerving growth in Chinese debt. True, on a debt-to-GDP ratio, China scores not too badly - about twentieth among the world's economies - but Chinese debt undoubtedly is growing very fast. Two other recent papers, by the International Monetary Fund (IMF) and by the Hong Kong Monetary Authority (HMKA), reached similar conclusions. However, both found Chinese debt was highly concentrated among the SOEs and that private companies in China had in fact been deleveraging. This highlights that the solution to China's debt problems will not be the same as in the West: broad de-leveraging and a credit crunch resulting in reduced capital access. Instead, we shall see a restructuring of state-owned enterprises and shutting down the most indebted, dirtiest, least profitable companies in sectors with a lot of overcapacity like steel, cement and aluminium. This will not happen overnight but it will happen within 3-5 years.

The reports found that, even among the SOEs, debt is concentrated in a small number of firms. So what we will probably see is selective bankruptcies and closures in this sector. Since the Party dare not risk a loss of confidence in the banking system, I do not anticipate, therefore, any rise in non-performing loans in the banking system. These loans resulted from the Party telling its Party-run banks to lend to Party-run SOEs to build Party-approved public infrastructure. Nobody expected these projects to make money but that they would be paid out of general revenue as the economy expanded. So the government will underwrite any defaults.

As a result we'll probably see a significant rise in overall government debt (which, at its current rate of 55% of GDP, is not too bad), and the current deficit (now less than 3%) will increase. Looking ahead, as the Chinese government cleans the system up, they will find also their current account budgets become as constrained as budgets in other developed economies.
However, this will be a long-term process, not a crash or hard landing.

The IMF and HKMA studies found also that Chinese debt is most highly concentrated in real estate, but that only about 100 developers are responsible for the majority of the debt – out of 90,000 residential property developers. So we shall see more consolidation and M&A activity in this sector, with some people going bankrupt, but not a crisis across the board.

5. MISUNDERSTANDING THE PROPERTY MARKET

The property market is probably the most important and least understood part of the Chinese economy. It is a swing factor. If residential property is in trouble, then China is in trouble, and we shall all need to think about the impact on our investments globally. But I doubt that is the case.

China has learned from our mistakes and created a housing market that looks much more like the US housing market in the 1950s and 1960s than today's. Investment buying is running at only about 7% or 8% and has been under 10% for several years. Independent surveys indicate that 90% of new homes in China are sold to owner-occupiers, and a fifth of those buying new homes in China are paying 100% cash. It is often said that a housing bubble in China is inevitable because the average Chinese person makes only about $2,000 a year and the average house costs around $100,000. By this logic, no one in China should be able to afford a house. But 10 million new homes were sold last year among a population of 1.3 billion.

In 2006, the median cash down-payment for a new home in the US was 2%; in China, it is 30% if you intend to live in the house and it is your first house. If you are upgrading, the minimum down-payment is now 40% (down from 60-70%). No sub-prime, therefore no secondary securitisation. So from the household perspective, this looks a pretty quiet, safe property market with a lot of cash down. True, prices have gone up, increasing over the last nine years by over 8% annually but, at the same time, average incomes have risen annually by over 9% in nominal terms. That said, the boom days may be over. Last year, the housing market was very soft. It may pick up somewhat this year, because the government has reduced the artificial barriers introduced a couple of years ago to cool the market. We are beginning to see a monthly pick-up in prices but, by the end of the year, I suspect prices will be flat or only slightly up.

Indeed, new home sales by volume per square metre were down 8% last year, having been up 18% the year before. But, again, it is necessary to distinguish between successful and unsuccessful firms. If we look at the top twelve listed developers, their sales volumes last year were up 18% and their revenues 17%. This looks to me very like a situation Sir John would have found interesting, one where pessimism based on misunderstanding dominates a market and, consequently, opens up opportunities.

THE GHOST CITIES MYTH

Talking to investors in the US last year, I found questions on ghost Chinese cities repeatedly being raised. The source was a *60 Minutes* programme in March 2013 which showed lots of empty new apartments in Zhengzhou. A few months ago I went to the very same streets and shot my own video. It shows streets jam-packed with people – so much so that I spent a whole day stuck in traffic!

A lot of real estate activity in China looks strange to our eyes but the explanation is very simple. The housing market there is anticipatory, preemptive. Chinese cities are very congested and downtown land is unavailable or expensive. So the government has been selling suburban land to developers and encouraging them to build, on the basis that, in due course, it will supply the required infrastructure - light railways, subways, schools, hospitals and markets. However, developers work faster than government so, in places like Zhengzhou, the apartments were up and ready ahead of the infrastructure. Chinese typically buy a new apartment 2-5 years before moving in. Their rationale is that, if they wait until the subway opens, it is going to be a lot more expensive. When I went back to Zhengzhou, the first subway to this part of the city had just opened and the people had moved in and finally filled it up.

FIVE GOVERNMENT MISTAKES

I don't want to make the situation in China sound overly rosy, so let me end by touching on what I see as the five mistakes the Communist Party is currently making. You will notice that none of them concerns the economy or the financial system. I think that the risk of a systemic crisis in China over the next five years is quite small. The fundamentals are sound, the government is pragmatic and has a lot of resources to draw on, and if, for example, there were another global financial crisis, exports were to collapse, or millions of workers were to lose their jobs in China because you stopped buying iPhones, they'd do another big stimulus.

1. ABSENCE OF THE RULE OF LAW

This is the number one problem in China today. China is based increasingly on private property rights. Most Chinese work for private companies and about 85% of urban families own their home - probably the highest level of home ownership in the world outside Singapore. People own their businesses, cars, their intellectual property, yet there is no legal system to protect those rights. This is unsustainable, and I worry about what will happen 10-20 years down the road. As the Chinese economy becomes increasingly market-orientated, a recession will kick in as in all market economies. When it does, inevitably there will be disputes. But how will those disputes get resolved when there are no institutions in China that people trust?

I remain pessimistic that anything will be done about this problem during Xi Jinping's remaining eight-year term in office. When he talks about the rule of law, what he really means is: I make the rules and you obey. The Chinese constitution says that the communist party has to observe the law under the constitution, but we all know that does not happen in practice. When I talk to party officials they acknowledge this and say that they are working on it but, as yet, little progress has been achieved.

2. ABSENCE OF INDEPENDENT INSTITUTIONS

The second biggest mistake concerns the lack of institutions required to underpin the development of a civil society. There are no real non-governmental organisations (NGOs) in China because those that do exist are tightly controlled by the government. This is important for the development of a society that is getting richer, and whose interests and concerns change over time.

3. BLOCKING FREEDOM OF EXPRESSION

The third mistake the Chinese government makes is continuing to block freedom of expression in the political arena. Economically, you can say just what you like in China. You can say that the Chinese economy is going to collapse next month but if you add that the Communist party is also going to collapse, you will be treated just as brutally as a dissident 25 years ago. That is not acceptable or sustainable in a country where the middle class is growing rapidly, and where people have increasing access to what's going on outside China.

4. ENVIRONMENTAL PROBLEMS

China has been far too slow in coming to terms with its environmental problems. The environment there is a disaster; not just a matter of atmospheric pollution but pollution in the water, soil, food, medicine and even infant formula. According to Japanese government data, the Chinese spend more than double that which visitors from other countries spend in Japan. One of their top purchases is traditional Chinese medicine, possibly because they think that they can trust its purity more than that which they can buy at home.

5. STRATEGIC AGGRESSION

The final of my five mistakes that I think the Chinese government makes today is on the political and strategic side: being excessively aggressive in the East China Sea towards Japan and in the South China Sea towards Vietnam.
For decades, the Party line was: keep the nation's head down, concentrate on developing the economy and do not frighten the neighbours. When Xi Jinping took over, he decided that change was in order given that China is now a global power. He had read how Holland, Britain and America behaved when they first became great powers. His model seemed to be based on being arrogant, expansionist and aggressive around the world, and to throw his weight around because that's what everyone else used to do. I think he's realising now that this was a serious mistake as it's pretty clear from actions that he has no desire actually to engage in conflict. However, the risk of mistakes goes up every time they send more ships and 'planes out in those troubled waters.

In 2001 a US spy plane was shot by a Chinese fighter plane and had to make an emergency landing on Hainan Island. The local commander took hostages and it took Jiang Zemin weeks to sort it all out and return the Americans.
Imagine how more difficult that would be if it were a Chinese 'plane and a Japanese 'plane. Xi Jinping may be recognising that he grossly overstepped here because the number of incidences in those places seems to have been going down in recent months. They are still building out in the Spratly Islands, as a risk to your investment portfolio (whether to own in Japan or if there will be a war in Vietnam) I think the risk is very small. However, China needs to calm the waters internationally and, similarly, the US needs to get its act together.

The Obama administration made a huge mistake in telling Britain and other US allies not to join China's new Asian Infrastructure Investment Bank.
What the Americans should have said was: let us all join, and use our weight, collective knowledge and experience to make sure that this is the best international institution in the world. I would also add the Trans-Pacific Partnership (TPP) to the list of US foreign policy mistakes.
In an attempt to isolate China, it excluded China from the initial discussions. Significantly, the US has since backed off and entered into discussions with China. The current focus of Chinese-US trade negotiations is the Bilateral Investment Treaty (BIT). This could have a very positive impact on investment flows in both directions.

Another opportunity for the US to make a mistake will come in the fall when the IMF decides whether to include the Chinese currency, the Renminbi, in the currency basket for the IMF's Special Drawing Rights (SDR). Inclusion will probably not make all that difference economically apart from a small, positive impact on China's bond market. If Renminbi's inclusion in the SDR means that more central banks hold more Renminbi as their reserves, they'll be looking for more fixed income products to nominate the Renminbi. The issue for China is primarily about status - Xi Jinping saying that it is another way we need to be treated with respect - and the decision should be handled in this light. Over this decision, and a range of other issues, the US needs to forgo confrontation and work – economically, diplomatically and militarily – to build a sustainable, long-term relationship with its new superpower neighbour in the East.

QUESTIONS AND DISCUSSION

'Hank Paulson has argued in his recent book, *Dealing with China*, that the opening up of financial markets is less about capital flows and more about subjecting China to the competition of international financial institutions, ' Dr Knight said. 'Is this the case?'

'China joined the World Trade Organisation (WTO),' Andy Rothman replied, 'not to gain access to global markets – which they already had - but to apply the discipline of the WTO in order to shrink the state sector, allow the private sector to grow and reduce barriers between provinces. It has had a positive impact.

'The impact on banks has been huge. They have allowed foreign banks to come in. As a result, Chinese banks, which before only competed for the very wealthy clients, began courting the general public. However, there are limits, and foreign banks remain frustrated about the level of business they can do.
The government insists that Chinese banks keep a grip on the top 3% of customers who generate probably 50% or 80% of their revenue and whom Citi and HSBC would steal otherwise.

'As to the currency, I do not foresee China completely deregulating or freeing it up. Since breaking the peg between the Renminbi and the dollar in 2005, the Chinese have managed the currency in a more flexible way. In the next few years, it will move in a narrow range, up or down by about 2%. This will affect capital outflows but there will not be a lot of hot money moving in and out.'

IS CHINA MANIPULATING ITS CURRENCY?

'People in the US argue that China manipulates its currency and that this is holding up US exports but I cannot think of any country in the world that does not manipulate its currency. US senators complain the Renminbi is grossly undervalued. In fact, the Renmimbi has appreciated 35% against the US dollar. Effectively, it has gone up by about 55%. Also, the Renminbi's strength is based on the dollar. Last year, the Renminbi appreciated a lot against the euro but only 2.5% against the dollar. Since China joined the WTO, US exports to China are up over 600%, whereas its exports to the rest of the world are up just under 100%.'

DOES THE GOVERNMENT CONTROL PEER-TO-PEER LENDING LIKE THE BANKS?

The government has conflicting objectives. They want the financial system to become more market-oriented but also want to control it. So they are allowing Alibaba, for example, to create a wealth manager product - which puts competitive pressure on the banks - but they are controlling its growth. I remain sceptical of the autonomy and prospects for peer-to-peer lending because it is mostly operating through some kind of relationship or joint venture with the state bank. If it became very profitable, would they let foreigners jump in? They have not done this elsewhere in the financial sector.'

IS REFORM BOTTOM-UP AND THE GOVERNMENT SIMPLY REACTING TO IT?

'The government is on a treadmill. It reacts to pressure, for instance on the environment. But on a lot of basics it has been quite proactive. It thought about what went wrong in the Soviet Union, and in Tiananmen Square in 1989, and decided deliberately to change the structure of the economy completely. Sometimes they succeed in achieving several goals at once - for example, the anti-corruption campaign which both achieves party objectives and is highly popular at grassroots level – as well as offering a useful way to eliminate political rivals!'

A manager working in the Chinese markets stated his belief that current reforms could be laying the groundwork for a total transformation by 2035. 'The next president of China in around 2022 will be someone now in his 40s who will be very well-educated overseas and has no ideological fixation - probably a very pragmatic person who does not find it necessary to secure a broad-based mandate from the party.'

CAN CHINA CREATE REAL INNOVATION?

'There are limits. Automation, for example, still has a long way to run. We have to realise that, at this stage, automation does not really make sense; in a fast-moving economy with low entry barriers, over-capacity is needed as a buffer to protect margins. But innovation is taking place elsewhere. We are starting to see it in pharmaceuticals which was once limited to producing generic drugs and vitamin C but is now becoming far more innovative.

'Paradoxically, getting things done in China is sometimes easier than in the US, for instance in the field of environmentally-clean technologies, where there is great collaboration in China between academic, business and government sectors, and does not get a lot of attention. In the US, there can be difficulty securing EPA and OSHA permits, and in running large-scale demonstration projects. The Chinese response is: come and do the demonstration projects here, then go back to the US to obtain the permits.

'Online, there have been great developments. Online retail is growing 40% year-on-year in China and now accounts for about 10% or 12% of total retail, which is similar to the US. Alibaba is remarkable. Through its different platforms it enjoys about 80% of market share. It has just introduced a service that promises three-hour home delivery of health products.

'However, the internet is more than a technical and business issue. What you have to look for is a company that can navigate the political landscape as well. The situation is complicated. If you travel round China, you will see a billion satellite dishes on the sides of apartments - most of which are illegal. These pick up Taiwan TV, Hong Kong TV, CNN, etc, but the Chinese government does not much care. It is far more focused on controlling the 20% of the population that does not have access to outside information.'

WE HAVE BEEN TOLD INVENTORIES FOR PRIVATE, NEWLY-DEVELOPED RESIDENTIAL PROPERTIES ARE LOW. IS THIS TRUE?

'That would surprise me. In the larger cities, inventory levels went up but are now coming down as sales pick up. In smaller cities of a million people, there is still quite an overhang. That does not mean that the market is on the verge of collapse but it does explain why new housing starts are down 20% year-on-year.'

IS IT TRUE THAT TO BUY A CAR YOU NEED TO ENTER A LOTTERY FOR LICENSE PLATES?

'It varies. In Beijing they have odd and even days. If your license ends in an odd number you can't drive on an even day. Wealthy people buy two cars and hope they get both kinds of license plates! But there is no question that, as congestion and pollution worsen, more cities will adopt measures to restrict the automobile.'

ARE CONSUMER TASTES CHANGING REGARDING WESTERN BRANDS?

'Once it was all about bling. Chinese consumers wanted luxuries and logos. But preferences are changing fast and a lot of foreign companies have been behind, for instance in fields like shampoos, conditioners and ice cream. Foreign brands are still doing reasonably well in areas like diapers or skincare, where trust and quality remain issues. But many foreign companies are simply too slow. They reject government data and instead base their projections on a handful of big listed companies – say, shoe shop chains or department stores. But no one in China shops in department stores anymore, preferring instead small, individually-run stores which are cheaper and offer more variety. So we need to be careful in our assumptions.'

THE ONE-CHILD POLICY COULD RESULT IN AN UPSIDE-DOWN DEMOGRAPHIC PYRAMID. IS PREEMPTIVE ACTION A GOVERNMENT PRIORITY?

'The one-child policy is not as important as often thought. If you look at China's fertility rate, the steepest decline actually came before the policy came in, in 1980, and since has followed the same trajectory as earlier rates elsewhere in the world. Anyway, the government has now effectively ended the policy. That said, most Chinese demographers do not believe family size will grow markedly and that, as a result, the trend of an ageing population will continue.

'Fortunately, demographics are predictable. The Chinese still have opportunities now to think about what Japan did or did not do, and plan accordingly. There are positive signs. The Chinese are starting to build up their social security and pension systems. Health care spending has gone up. They are investing more money in education so that workers are better prepared for more value-added, skilled jobs. For example, the number of university graduates has gone from one million to seven million in under ten years.

'The challenge will be caring for elderly people who, until now, have lived with their families. China does not yet have the necessary infrastructure of retirement communities, assisted living, nursing homes, etc. So there will be some interesting opportunities there.'

A MORE UNPREDICTABLE WORLD?

TROUBLE IS OPPORTUNITY?

'Should we expect greater geopolitical turbulence in future?', asked Dr Knight. 'Where might the hot spots occur and, given Sir John's credo that trouble is opportunity, what opportunities might subsequently arise?'

TERRORISM

The growing threats of Middle Eastern instability and Islamic terrorism were pinpointed by one participant. 'Islam is the world's number one growth religion now – all other religions are in decline - and its extremist forms pose perhaps today's gravest dangers. The peril lies not only in any existential threat to Israel but also in its knock-on effects. The Israelis would not be prepared to suffer another Holocaust and they now have the nuclear capacity to strike back devastatingly. What would be the Western response? It could be terrible for the West. There could be a total upheaval in civilisation and not just in the markets. Under that scenario, it is hard to foresee any upsides like those in the wake of World War II (WWII).'

CONFLICT BETWEEN CHINA AND JAPAN?

This is unlikely, thought Andy Rothman. 'There is definitely more goodwill than ill will towards Japan among ordinary Chinese. The communist party likes to whip up nationalist sentiment and Japan acts as a traditional whipping boy – something Japan facilitates because they have never taken adequate responsibility for their actions in WWII. But if you look at the Chinese propensity to visit Japan and to buy Japanese goods, there is no real problem. Japanese people and culture are definitely admired in China. Everybody in China wants to visit Japan. The beginning of this year saw a 100% year-on-year rise in Chinese arrivals in Japan. There will be cycles when the government raises the rhetoric, and when sales of Japanese goods drop off but, after a few months, everything will swing back.'

KEEPING THE LID ON KOREA

'China really wants North Korea to go away – and quietly,' Andy Rothman said. 'Sharing a border, China is really worried that if North Korea blows up, the fallout will land on them in the shape of millions of fleeing Koreans.
China's policy towards North Korea has evolved. Chinese objectives are not that different from ours. The really hard question is: what will come in future? If the current ruling family is deposed, who then will replace them, and will the situation be better or worse? I think that not even South Korea believes immediate reunification is such a great idea, given the likely expense and complications. Whenever I talk to my contacts in the South Korean government, they sound generally satisfied with how China is dealing with North Korea.'

THE ENERGY OUTLOOK

'The cheapest energy molecule on earth now is US natural gas, stated one participant. 'Currently natural gas sells for $2 a gallon in the US but between $7 and $10 elsewhere, making America, by far, the beneficiary to date.
Natural gas has yet to impact coal consumption in generating electricity.
Natural gas will replace coal in our generation, and will be used in manufacturing and transport, either directly or indirectly to charge batteries in cars like the Tesla. Demand worldwide is bound to increase. That will not only benefit the US balance of trade, but play to America's strengths in the capital, energy and labour markets. The US has over 100 years' supply of shale reserves and, in future, it will shipping out more and more natural gas.'

Another participant focused on the downside. 'Lower energy costs were predicted to generate a big tailwind for the US economy but that has not really been the case. 50 cents of every dollar saved from lower energy prices go into consumers' pockets but little is recycled into the economy. Also, many companies have been hurt by the slowdown in energy production and that has affected states where previously unemployment was not a problem.'

'The current negativity about oil prices is excessive,' a third participant concluded. 'There may be further lows, but there is a lot of misinformation about Saudi ability to flood the market. On the supply side, traditional sources are relatively limited and slow while greater and quicker supplies are available thanks to the shale revolution. Shale can expand to meet new demand and shrink quicker if not required. That trend is not likely to change.
Another factor is that, whereas production has gone up some 20% over the last fifteen years, extraction costs have quadrupled. Demand will continue to grow in Asia. As Chinese get richer they will want more cars and more energy. Globally, the opportunities lie in supplying shale energy to the rest of the world, although there will be inevitable difficulties regarding legal regimes, infrastructure and the environment.'

THE DOLLAR – STILL ALMIGHTY?

'What are the prospects for the dollar as a reserve currency?' asked Dr Knight. 'In the United States, you have the benefit of a truly diversified economy and of a reserve currency that, for better or worse, has taken over from the gold standard,' a participant replied. 'It is hard to imagine a liquidity run on the dollar now. It is the worst currency except for all the others! If there were, say, four reserve currencies, those would command an unnatural premium as they do not live by the same stringent rules as the dollar. So, for better or worse, the dollar will maintain its position.'

A 'WALL OF WORRIES'?

'The Federal Reserve balance sheet has ballooned in 2009 from $1 trillion in assets to $3.5 trillion today,' Dr Knight commented.
'The Chairman of the Federal Reserve tells us that stock markets are too high. Many think that a major correction is looming. What is your view?

'One thing we are not thinking enough about right now is inflation,' a participant replied. 'There is a real possibility that inflation may take off. It may start with the long-term rates going up, and then the Fed will have to decide whether to put up short-term rates. If long-term rates go up but not short-term ones, this will result in much greater willingness to borrow and lend. With higher multipliers on monetary velocity, a dislocation could occur that could kick-start inflation. People tend to look back to the last war or to 2008 concerning liquidity. But the next war might be one of illiquidity. We could have hyper-inflation and huge volatility and, with so much base money sitting in the system, cash could have as protective a value as it did in the early 2000s.

'Just as it is impossible to draw parallels between GDP and equity prices, the same is true of the systemic movements that are afoot,' commented another participant. 'Right now, it is very hard to add a lot of value given limited volatility. I'm actually looking forward to events that might create some big unknowns. We talk about the wall of worries - all the things that might go wrong – but, in every decade, markets, businesses and the human spirit have shown themselves to be resilient. Ultimately we will come through, and personally I would welcome the efficiency of the market returning once again to the fore.'

POLICY RESPONSES – HAVE WE RUN OUT OF ANSWERS?

'HSBC has published a paper by one Stephen King,' said Dr Knight.
'Like his namesake, the author is in the horror business! He argues that there is no capacity for policy response should something bad happen.
'When I was last here was in 2012', a participant replied.
'We were then in the early stages of the recovery from the financial crisis, and I talked about austerity and de-leveraging being a very toxic combination. On the issue of the Federal Reserve's policy versus the quantitative easing in Europe, I believe the Fed has more elbow room because the momentum in the US is increasingly broad-based, even if it operates in fits and starts. The European Central Bank (ECB) runs the risk of being the greater fool. That could result in less liquidity in the bond market and consequent dislocation in equities. The real question is this: what will happen when the ECB eventually begins to unwind the process? Will it be as an orderly and gradual process? The question applies to both the US and Europe, but there are far greater complications within the Eurozone. There, many countries on the periphery have no choice. They will have to impose deep cuts that will inevitably deepen over time. Countries like Germany are doing well but have a savings glut and not recycling capital. There is a state of massive illiquidity that will prove very hard to unwind and we should brace ourselves for a disorderly spike in interest rates. The longer it goes, the more potentially dangerous the situation becomes.'

THE INVESTMENT RESPONSE: FOLLOWING IN THE FOOTSTEPS OF SIR JOHN

RUNNING FOR SAFETY

'The pension funds and endowment foundations are running away from the fundamental truths of investment,' said one manager with long experience of markets. 'Because of 2008-2009, their number one objective is to reduce volatility rather than to look where new wealth is coming from.
They're shying away from Sir John's view that volatility is an opportunity not a risk. They're not accepting that the stock market and hedging do not in themselves create new wealth. Where did the capital in the retirement plans and foundations come from in the first place? From businesses that create new goods and services that help the world, and not just the wealthy but the poor also. Today's attitude is: we can't have active management; we have to move away from equities; we have to go through all these alternatives; we have to use derivatives and zero-sum games.'

'There is a dichotomy between those companies that want to invest in the future and those just seeing themselves as a cash machine for the investment fraternity,' agreed a British manager, 'and I sometimes wonder whether the problem isn't even worse in Britain than in the US.'

Could shareholder activists spur a more positive approach? 'Just as in the emergency room you can't have enough smart doctors,' said a manager, 'so in corporate governance it is your obligation to speak up on behalf of your clients. We take a hard position on boards. We've replaced them with managers we've hired ourselves who use the cash after tax to buy shares on the open market, so that they think more like owner-operators not the recipients of an endless stream of cash.'

INDEXATION SIGNALS SURRENDER

'A recent study by SFM Private concluded that the more concentrated your portfolio, the worse that you do,' Dr Knight commented. 'What are your views?'
'The momentum behind indexation is forcing capital into the largest, most expensive securities', agreed one manager. 'It is skewing capital towards the highest valuations. The structure of the whole industry is being concentrated. You have to accept a 19% volatility above or below the index. That is how numbers work in an intensive stock portfolio. No one is willing to take risks. It poses real problems for young portfolio managers. If you're managing money, you have to pay attention to the indexes or get fired.'

'Indexing has ballooned since 2008-2009,' added another manager.
'Effectively it's saying: "We're giving up. We have all this capital, but we're not going to invest it to build economies over time. Instead we're going to invest it in everything.' However, another participant scented opportunities.
'Index discards are resulting in some very sloppy, eve-of-closure selling, presenting bargains that can snapped up by active, fundamentally-based managers.'

MIXED MOTIVES BEHIND RECENT MERGER ACTIVITY

'Contrary to the idea that corporations are sitting on their hands, I think we're seeing a major upturn in global M&As. It's a very bullish picture.
The volume of announced transactions so far in 2015 is something like $2 trillion - up 20% on the same period last year and well over double the peak of the cycle in 2009. Deals are being struck at an average 20% premium, which implies that corporations feel there is good value in the markets currently.
The logic is clear: this is a globalising world, and corporations need to take advantage of its opportunities and threats.'

Another participant, however, detected ulterior motives: 'We are in a period with limited opportunities for value growth, and one way is to make an acquisition. Acquirer stock goes up as well as the acquiree's.' 'So are we seeing these companies destroying value rather than building it? Dr Knight questioned. 'Is it a response to a position of weakness, saying: "I am going to have to buy my way out of this"?'

HOW EFFICIENT ARE THE MARKETS?

'Collectively, corporate America has a very bad record of allocating capital,' one manager stated. 'They were not buying when we were counting on them in 2008-2009. Then, as people became more "comfortable", they began to buy more shares, and prices went higher and higher. In 1999, 80% of IPOs were unprofitable companies. Today, over 80% are still unprofitable.
Unlike a disciplined value investor, people are driven by the herd instinct. Were the cost of capital not almost zero, those acquisitions would not be purchased.

'Durability is key. We monitor a small universe of 'Buffett-type' companies, maybe twenty global stocks. Twenty years ago, their average P/E was 18, today a fraction over 20 - a bit more expensive but not much. But, over that period, that collection of about 20 profit-type stocks has risen six-fold, whereas the MSCI is up less than three-fold. In other words, there is gross mispricing that still isn't being corrected.'

'Personally, I'm terrified,' commented a participant speaking from a European angle. 'The companies that, for the last two years have been saying valuations are crazy, are now saying: "Hey, look at interest rates, if we can borrow at 0.5% for ten years we should be putting money to work." That to me represents a major breakdown of capital discipline.

'The problem is compounded by a combination of illiquidity and the pace of change. We spend a lot of time looking off-radar at businesses that are interesting but often very illiquid. The market does not pay the same attention to liquidity as to other risks, and that terrifies me. If the market forecloses, there will be a great risk of exposure. It can come very quickly.
The market now is so surreal and artificial that the psychology is in a very strange place. Technical change is now so incredibly fast that businesses in many different sectors we thought durable are not. That is why I look for both durability and adaptability. Often you are confronted with two options: a cheap stock or an Amazon with a very low-cost structure and, within two to three years, a 16 multiple on earnings.'

'The real wealth creation over the last fifteen years has come from a set of companies that this conversation ignores. Apple deserves to be the world's biggest company for what it has achieved so far. Google's earnings are up 100-fold since it went public. These companies are not indulging in earnings manipulation games or buy-back steals. There is genuine growth out there. It is symbolic that most of this is being done thousands of miles from the centres of capital markets. When did London last create a company? Hundreds of years ago.
In California, there is a very different ethos of how capitalism actually works. There is a disconnect between what is happening in the real world and our acknowledgment in the investment industry.'

EMOTION IS THE MOTOR

'What can market psychology tell us?' Dr Knight asked. 'Most market psychology studies have to do with cognitive rather than emotional functions,' replied a manager with expertise in this field. 'It can be measured differently but is basically determined by a combination of business values and perception. Perception, however, is always coloured by emotion. By definition, the future is not predictable, but that does not mean that we should not worry about it. Before 2008, there were people - Sir John included - worried by the situation but who were largely ignored. In the same way, we are now ignoring zero interest rates. It is a brand new experience, and it's not clear how it will end.'

WILL THE CHINESE EQUITIES BUBBLE BURST?

A Hong Kong-based dealer gave an upbeat verdict: 'I think we are in the middle of a recovery, initially held back by widespread distrust in the markets. By the summer of last year, the Shanghai-Asia market was 66% below its all-time high in 2007 but it has since staged a major recovery. However, it is still about 29% below 2007.'

Others were more sceptical. 'What has fuelled the boom is that China is swimming in liquidity,' commented another manager. 'Household bank deposits in China are more than $8 trillion - bigger than the combined GDPs of Russia, Brazil and India, and corporate accounts are even bigger. Investors had assumed that massive easing by the government was underway but it wasn't. So now they are thinking: "Should we get nervous?"'

'Things are changing by the week,' an Asian manager concluded. 'There are now 10% more Chinese stock brokers' accounts than at the beginning of the year. Right now we are in the middle of the rally - but we should not anticipate that it's going to last forever.'

STOCK SELECTIONS

Dr Knight invited managers to identify stocks that they judged particularly promising in the coming year. As last year, this year's 12 selections are extraordinarily diverse, spanning holding companies and conglomerates, independent owner-operators and public companies; and sectors that range from financial, chemical, e-commerce, aero-space and consumer electronics to agribusiness and semi-conductors. Particularly notable, are the numbers of organisations in the vice industries such as tobacco and gambling. These are presented in Table 1 in alphabetical order .

STOCK	MARKET: SYMBOL	SECTOR
ALLIANCE ONE INTERNATIONAL	NYSE: AOI	TOBACCO
AMAZON	NASDAQ: AMZN	E-COMMERCE
ARIAD PHARMACEUTICALS	NASDAQ: ARIA	PHARMACEUTICALS
BAIDU	NASDAQ: BIDU (ADR)	E-COMMERCE
FAIRFAX FINANCIAL	OTC: FRHF	INVESTMENT
MARKEL CORPORATION	NYSE: MKL	INSURANCE
MELCO INTERNATIONAL DEVELOPMENT	HONG KONG: 200:HK (ADR)	GAMING
MICRON TECHNOLOGY	NASDAQ: MU	SEMI-CONDUCTOR
MTU AERO ENGINES	FRANKFURT: MTX (ADR)	AIRCRAFT
NINTENDO	TOKYO: TYO:7974 (ADR)	CONSUMER ELECTRONICS
WH GROUP	HONG KONG: 288:HK (ADR)	FOOD: MEAT
W.R. GRACE	NYSE: GRA	CHEMICALS

TABLE 1. Stock Selections

IN MEMORIAM

Dr John Marks Templeton Jr

19th February 1940 - 16th May 2015

OXFORD METRICA CLIENTS

BANKING

BNY Mellon
Credit Suisse
Deutsche Bank
Invesco
Schroders
Templeton & Phillips
UBS

ENERGY & MINING

BP
De Beers
Exxon Mobil
Gazprom
Gold Fields
Royal Dutch Shell

FOOD

DongA One
General Mills
Nestlé

FOUNDATIONS

John Templeton Foundation
TWCF

HEALTH CARE

Baxter
Bristol-Myers Squibb
Johnson & Johnson
Merck Serono
Natura
Novartis
Novo Nordisk
Solvay

INDUSTRIAL

ABB
Aker Solutions
BAA
BAE Systems
General Electric
INI
Jardine Matheson
Kone

INSURANCE

AIG
Aviva
FM Global
If
ING Group
Munich Re
OIL
RSA
SCOR
Swiss Life
Swiss Re
Valorlife
Zurich Insurance Group

PROFESSIONAL SERVICES

Accenture
Aon
Ashurst
Blue Rubicon
Deloitte
Edelman
EY
Freehills
Hill & Knowlton
Ince & Co
KBC Peel Hunt
Kenyon International
Marsh
Ogilvy PR
OTC Markets Group
Porter Novelli
PriceWaterhouse Coopers

PUBLISHING

Reed Elsevier

RETAIL

Huhtamaki
Tesco

TECHNOLOGY

Cisco Systems
Green ICN
Hitachi
IBM
ICN Telecom
Infosys
Intel
KNTV
Oracle
Xilinx

TRANSPORT

P&O Ferries

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