Opalesque Exclusive: 2011 could be difficult for Asian hedge funds if China stimulus is withdrawn

From Sagar Chakraverty, Opalesque Asia:

Investor sentiment is dampening on the back of rising inflation rates in China, which climbed to 2.7% in February from 1.5% in January, causing grave concerns amongst global and domestic investors that interest rates will be pushed up soon by the People's Bank of China (PBC).

The government aims to hold inflation at 3% this year but according to a WSJ report, the World Bank anticipates that Chinese inflation will reach 3.5% to 4% in 2010; while the economy will grow at 9.5% in 2010 (GDP grew 8.7% in 2009). However, the yuan has been deliberately undervalued to help the Chinese exporters maintain lower prices in international markets.

"China will have to choose either to let the yuan rise or allow inflationary pressure to build domestically," the World Bank said.

It will be interesting to see what investment opportunities that will open for the Asian-focused hedge funds industry getting affected in 2010.

The mid-long term growth story of China is intact

In an interview with Opalesque earlier this week, James Liu, Deputy Chairman and Deputy CIO of APS Asset Management, a Singapore-based fund management firm, said: "As such, the mid to long term trends in China will continue to offer plenty of investment opportunities like the accelerating urbanization, increasing domestic consumption, healthcare reform, a low carbon economy, etc."

He believes that despite short-term uncertainties, the mid-long term growth story of China is still very much intact. China has taken some pre-emptive measures to cool down the property market, cap the new lendings and tighten the credit, which would keep the economy on a healthy and sustained growth track.

Real opportunities for Asian hedge funds likely later in 2010 or early 2011

"The Chinese government's reaction to signs of inflation has been the main focus of Asian market players over the past few months...these signs, indeed, have been expected and are not at unmanageable levels yet," Kirby Daley, senior macroeconomic strategist at Newedge, a global prime broker, told Opalesque in an interview this week.

Going forward, China has to address the issue of inflation, as does every economy with such high rates of growth.

Daley believes that the real opportunities for Asian hedge funds will come, likely later in 2010 or early 2011, and the proper plays will not be beta-driven stock buying: "There will be plenty of opportunities then for volatility managers (long-volatility biased), as well as macro and FX managers to take advantage of markets as they adjust to this reality."

He sees 2011 as a relatively more difficult year compared to now, once China begins to withdraw its easy monetary policy. It will become more evident by then how dependent Asia, Japan and Australia have been on China's unsustainable stimulus.

During this period of uncertainty, volatility will remain slightly high in Asia. In another interview (Dec-09 video), Daley explained how volatility would persist and what investors should do.

He said that there are huge opportunities in Asian currency markets but there could be mayhem in the fixed income market. Inflation could spread to other parts of Asia from China and governments may impose capital controls and protectionism. All these factors will create volatility in Asian markets, and hedge fund investors need to diversify their portfolio not only within Asia but globally.

Investors should seek diversification of underlying return sources through risk identification, and spread portfolios across lowly correlated assets. They should be more discriminating - country, sector and stock picking abilities may become important (see Opalesque exclusive here).

Risk of too much dependence China cannot be hedged or easily diversified

Asian hedge funds are attractive because they allow investors to access the growth of China, which affects all of Asia. However, the risk here is in too much dependence on one nation, which cannot be hedged or easily diversified.

"I think most investors don't really mind that risk, and in some ways that's what they are seeking. They want exposure to the growth of China," said John Knox, the founder of KGR Capital, a Hong Kong-based manager of Asian FoHFs, in a recent Opalesque video interview.

Nevertheless, some experts and analysts are concerned about a potential crash in China's economy. At the recent Asset Allocation Summit Asia 2010, the former general counsel of hedge fund Long-Term Capital Management and current representative of Virginia-based consulting firm Omnis, James Rickards said, "China is a bubble waiting to burst... As I see it, it is the greatest bubble in history with the most massive misallocation of wealth." (see Opalesque exclusive here).

Inflation changes are a key trigger for markets to move

Tim Rainsford, managing director at the Hong Kong office of Man Investments, one of the largest hedge fund houses, said in an interview with Opalesque on 8-April, "Increased inflation expectations will lead to adjustments in bond yields and movements of the yield curve and also influences equity and currency markets. It is one of the reasons to believe that in the foreseeable future rates might start to move faster than in the recent past. Other factors include shifts in risk aversion which trigger money flows...and very importantly the issuance of sovereign debt which represents the key driver to the supply and demand balance. So, typically inflation changes are a key trigger for markets to move."

Emerging markets could become exporters of inflation

Ousmène Mandeng, head of public sector investment advisory at Ashmore Investment Management, views that in the short-term, inflation is not going to trouble advanced economies but emerging markets (particularly China) may be forced to withdraw stimuli due to increasing inflationary pressure.

However, in the medium-term, structural differences between emerging markets and advanced economies are likely to cause persistent expected inflation differences as emerging markets will evolve from being price takers to price setters, thereby evolving as an important source of investment returns over the medium term.

His views were published in the March edition of "the Emerging Views," from Ashmore, a London-based investment management firm.

China has long been influencing international price developments by playing a dual role. On one hand, China's voracious appetite for raw materials has caused a boom in commodity prices; on the other hand, this fastest growing nation has been instrumental in keeping international prices down by maintaining a devalued yuan.

While the former role is likely to persist amid supply constraints, sustained economic divergence between emerging markets and advanced economies is expected to induce significant relative price adjustments.

"Increasing productivity growth is expected to cause prices in emerging markets to rise relative to advanced economies' prices. Emerging markets are therefore set to move from being exporters of disinflation to becoming exporters of inflation," said Mandeng.

Therefore, somewhere in the future, China has to raise its yuan value to control the inflationary pressure from spreading to other markets as the Chinese economy grows, boosting domestic incomes. Other Asian markets markets need to adhere to anti-inflation based policies to allow bond yield to remain firmly anchored because if the bond prices goes up, yield would come down, dampening investors' sentiments. Although investors worldwide will definitely gain from the Chinese growth story, risk diversification through lowly correlated assets is a must. A Latin American call is possibly ringing loud and clear in the ears of global investors.