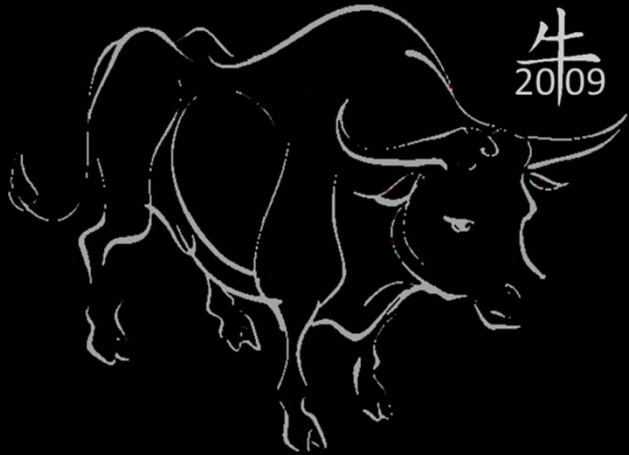


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## CHINA: RECOVERY & GROWTH

2H 2009/1H 2010



## 2009 IS THE YEAR OF THE OX

in the traditional Chinese calendar. This powerful beast of burden provides a fitting analogy for the Chinese economy during this period of worldwide recession as all eyes turn to the massive stimulus program launched by Beijing looking for signals that the rebounding demand from its voracious heavy industry, technologically savvy emerging consumers and massive government infrastructure projects will be sustainable.

Of course, Chinese internal demand cannot completely offset the impact of collapsing demand from North American and European markets –let alone single handedly lead a global recovery through sheer force of government spending. What China can accomplish in 2009 however, is the creation of catalysts to spur rapid domestic consumer demand growth in the coming years and the economic development of broad swaths of the central and western portions of the country currently largely relegated to agricultural and industrial commodity production.

All of this growth will come at great cost, with looming economic dangers, both known and unknown, on the horizon. There is the potential for deep social division as the fabric of communist society is tested by the sometimes cruel realities of free market development.

For investors, the opportunities and risks associated with this rapidly developing situation have no easy modern corollary: looking back to the developing United States during the mid 19<sup>th</sup> century may provide some clues, but the unique requirements of striking a balance between free market development on such a massive scale and centralized government planning is still a largely unknown equation.

Our core thesis is that, although China clearly represents the single most compelling global investment opportunity today, the full scope of the risks associated with investing there have not been correctly modeled by the ever expanding community of “China Bulls”. It is our contention that the investment opportunities in the Chinese public equity markets will be best captured by pragmatic investors balancing long-term strategic opportunities with disciplined tactical risk management.

In short we believe that, while the long-term opportunities represented by an ascendant Chinese economy are unprecedented, the ultimate long-term success of Beijing’s current plans for development are far from a foregone conclusion and, even if eventually achieved, will arrive only after cycles of expansion and contraction, bubble and bust.

In this brief summary we will hit on some, but certainly not all, of the primary factors that we follow as we position ourselves for the coming 12 to 18 months, and will continue to follow as we continually refine and test each element of our thesis. This document is a companion to, but not a replacement for, our daily real-time research.

#### **DATA INTEGRITY**

One of the most common questions that we field when discussing opportunities in China with investors of all types and durations is: “Aren’t you worried about the accuracy of economic data released by the Chinese government?” Our response to this question is simply “Yes, but so are China’s economic policy makers”.

There have been a number of excellent academic studies of the veracity of the facts and figures released through the National Bureau of Statistics (NBSC) and China Customs Office in recent years and we do not intend to challenge the conclusions reached in any of them. We simply operate on two principles:

**Data quality is improving** –Year-to-date three developments on the margin lead us to conclude that China’s economic leadership is taking the challenges to data quality seriously.

- The NBSC response to a May 15<sup>th</sup> article in the Wall Street Journal regarding discrepancies between electrical usage and GDP data was relatively measured and concise. Importantly, it included a degree of acknowledgement of data shortcomings. While the case made by the NBSC –that declining electricity use in the face of increasing growth was the result of a secular shift in production from heavy industries to service industries, was not entirely convincing, it was still refreshingly responsive. Open dialogue about outside criticism is in itself a positive development.
- In early June an economist at NBSC publicly published a paper in which he calculated GDP on a Q/Q basis to demonstrate the discrepancies in the current methodology.

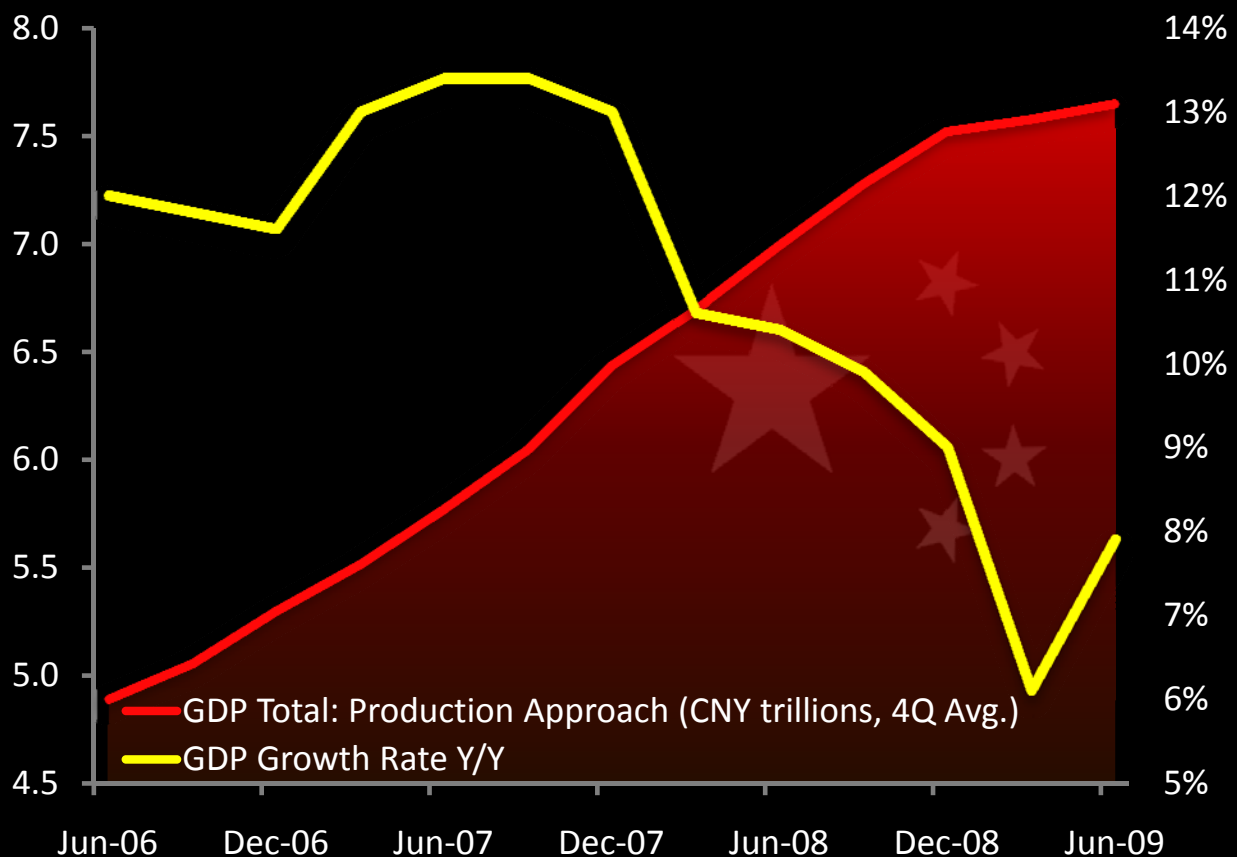
These figures suggested that the slowdown in the fourth quarter of last year was even sharper than most outside economists had believed. This report marked the second time in as many months the NBSC again publicly addressed concerns over the quality of the data it distributes. Although the opinions printed were those of a single economist, the perception is that the Bureau was engaging in indirect self criticism by even posting the document on its web site.

- On June 15th, a training course intent on improving the quality of Chinese statistical data was launched as a joint venture by OECD and NBSC with much fanfare.

**We must work with the best tools that we have available** -Regardless of marginal developments that point to improving standards for data, the reality is that the official economic measures are significantly flawed. Like a sailor venturing into unknown waters it is our contention that a bad map is preferable to no map. The overwhelming impact on Chinese growth on the global economy makes it impossible for us or any other committed investor to remain on the sidelines; therefore we use the data we have available from official sources, cross-check it with all outside information that we have access to and exercise a healthy degree of skepticism as we measure and manage risk.

## STIMULUS & RESURGENT GROWTH

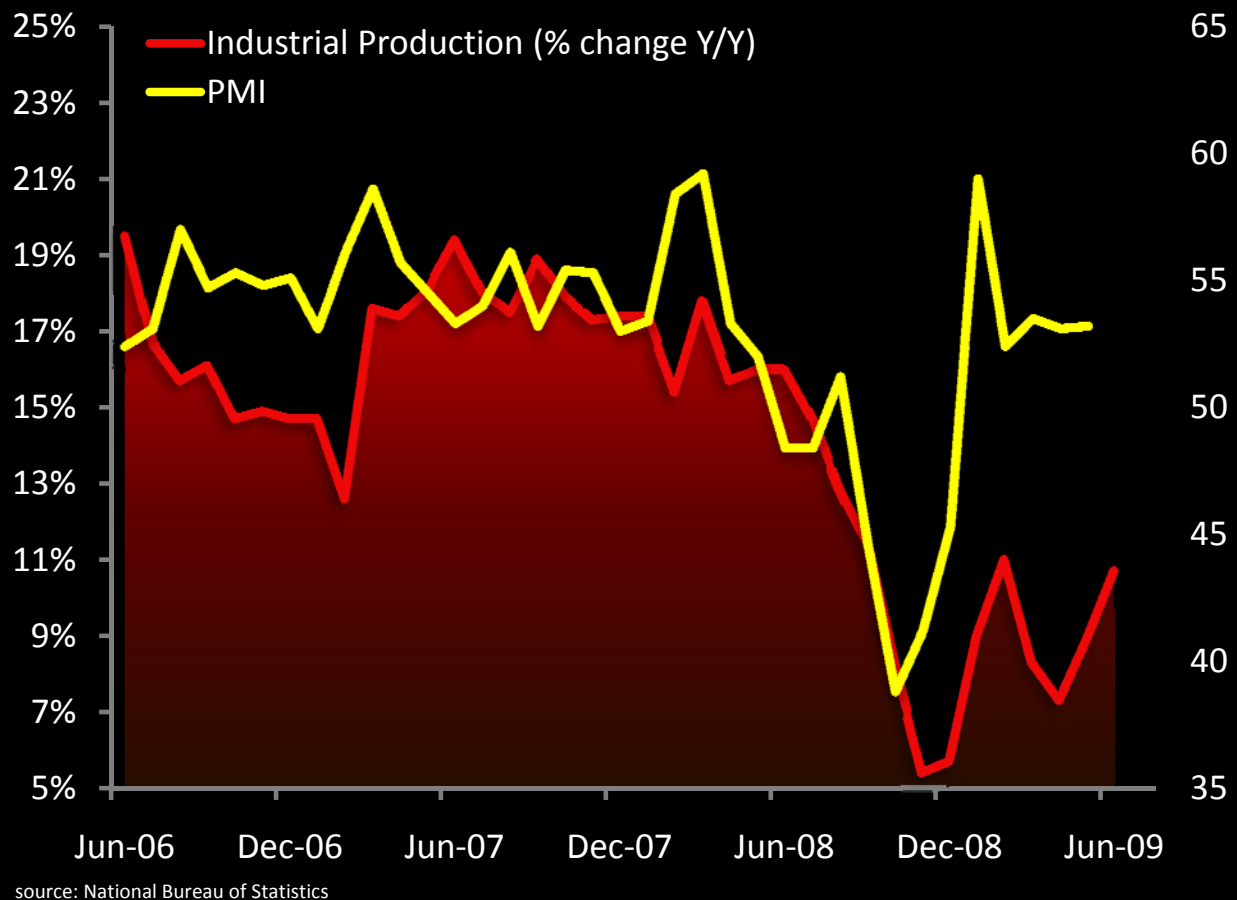
Second quarter 2009 production based GDP registered at a growth rate of 7.9% over the same period in 2008, marking the first sequential year-over-year improvement since the second quarter of 2007. At an estimated CNY 7.4 trillion on a current price basis, this data confirmed months of mounting evidence that the impact of stimulus programs implemented by Beijing starting late last year have been felt throughout the Chinese economy and are yielding the desired results.



source: National Bureau of Statistics

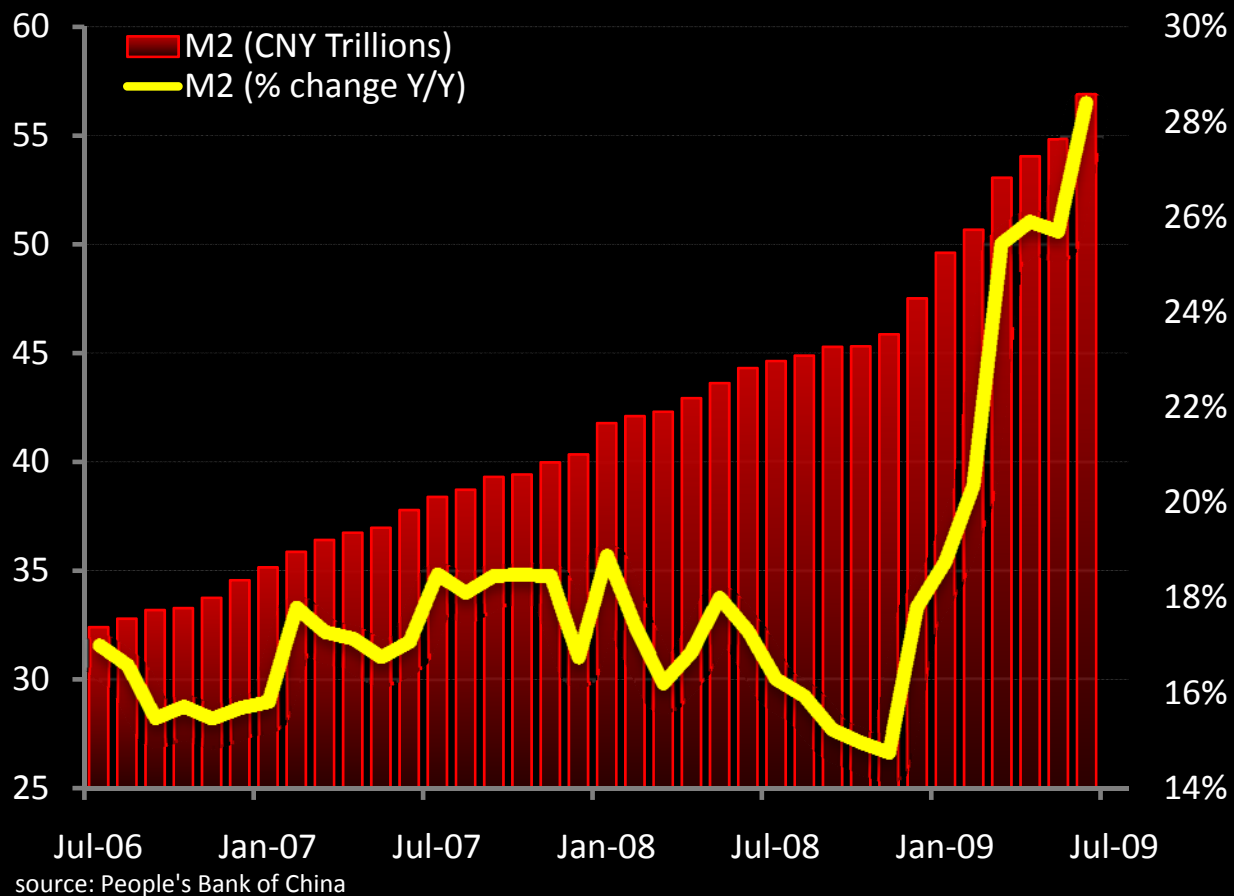
The stimulus measures adopted by Beijing in response to the current global recession have been variously reported at \$780 to \$800 billion USD by observers in the public press. While in reality that figure includes a number of programs that were already in effect or were scheduled and merely expedited (many in response to last year's earthquake); the scope of the effort has

been profound. Ranging from massive infrastructure improvement projects in the interiors to individual consumer spending incentives, the impact of the stimulus program has driven the year-over year growth of industrial production to 10.7% for the second quarter as the industrial sector struggles to regain momentum after the collapse of export demand in 2008.

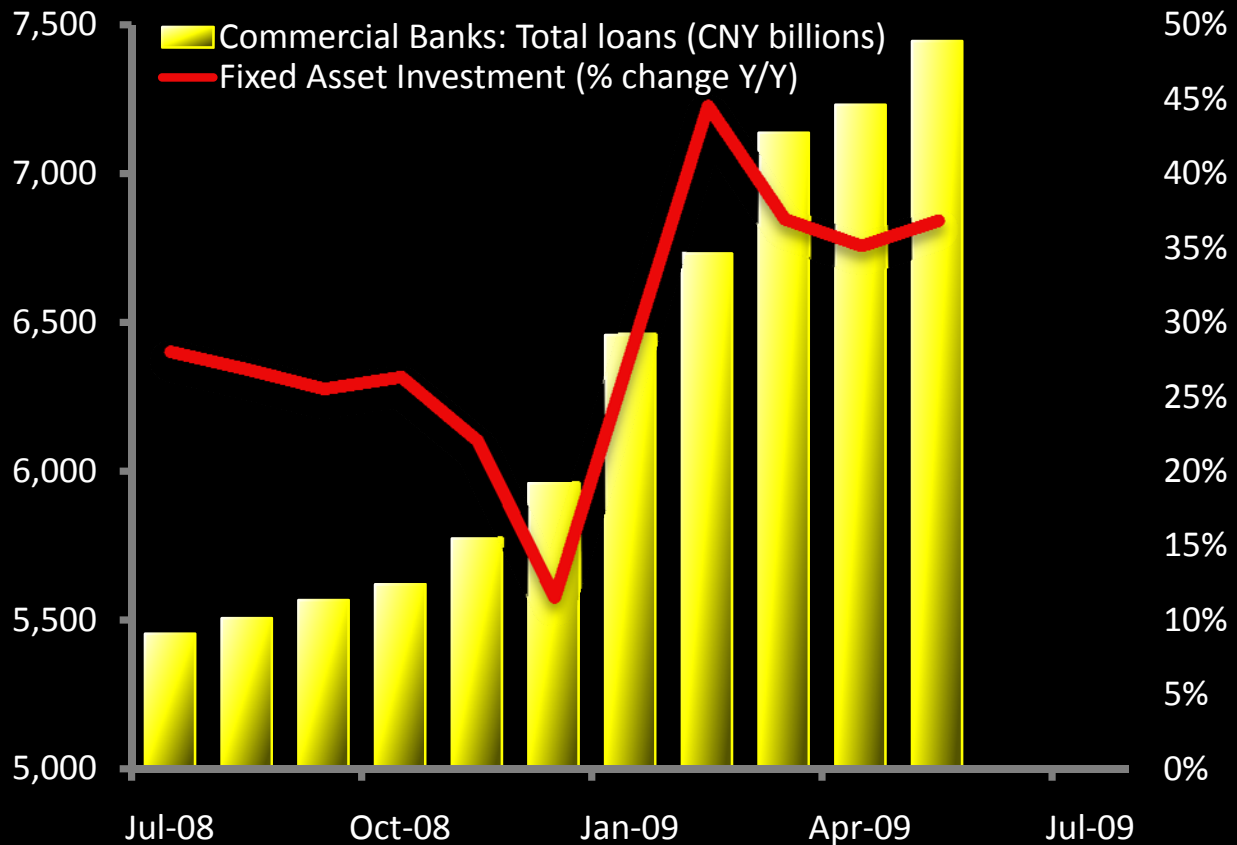


### GUSHING CREDIT

While the impact of the stimulus programs on production and demand has been pronounced, the impact on credit and liquidity has been profound –with every measure available showing a gushing stream of cheap capital flowing through the system. The staggering 28.4 % year-over-year increase in June M2 data released by the People’s Bank of China (PBOC) marked the largest one year increase in over a decade as the “moderate loosening” stance espoused by Wen Jiabao’s administration has proven to be anything but.



The loosening of credit restrictions in the commercial and private sector implemented in the fourth quarter of last year went far beyond merely rolling back the tightening measure adopted in 2007 in the face of the global credit crisis. PBOC estimates for May saw an increase in total loans outstanding by commercial banks of over CNY 200 billion to a level of CNY 7.4 trillion, an increase of 40% from the same month in the prior year. New Yuan-denominated loans by all lending institutions for the first five months totaled CNY 5.84 trillion in total. This sudden flow of capital has helped drive a boom for the time being, with the June fixed investment measure released by the NBSC registering a year-over-year increase of 36.8%.



source: People's Bank of China, National Bureau of Statistics

This infusion of liquidity has been integral to Beijing's strategy for growth recovery, but has come at a steep price:

- In the short term, a significant portion of the total credit in the system (anecdotal sources place it near 20%) has found its way into speculative investments in the equity and futures markets and has fueled a real estate boom -all of which has caused even casual observers to worry about bubble formation and has led the central bank to begin increasing money market rates and implement measures to increase lending standard oversight.
- In the longer term, the inevitable increase in non-performing loans that will result from this loosening cycle is of grave concern. Officially, non performing loans accounted for fewer than 2.5% of the total on the books of the major commercial banks in Q4 of last year, but the rising use of "special mention" classification for troubled loans and the restructuring of the Asset Management Corporations (AMCs) have created a largely opaque system. Additionally, although great regulatory strides have been made since



the recapitalization of the major commercial banks earlier in this decade, the process is far from complete.

It is our thesis that Beijing has not entered into these credit policy decisions without understanding the consequences. Rather, leadership there recognize that buying growth is always expensive, and the pain that is in the pipeline for the Chinese financial sector is a portion of price that will be paid for recovery. With June PPI and CPI registering at -7.8% and -1.7% respectively, inflationary concerns appear far away for now. As such we anticipate that any moves to rein in credit in the second half of 2009 will likely be gradual in nature.

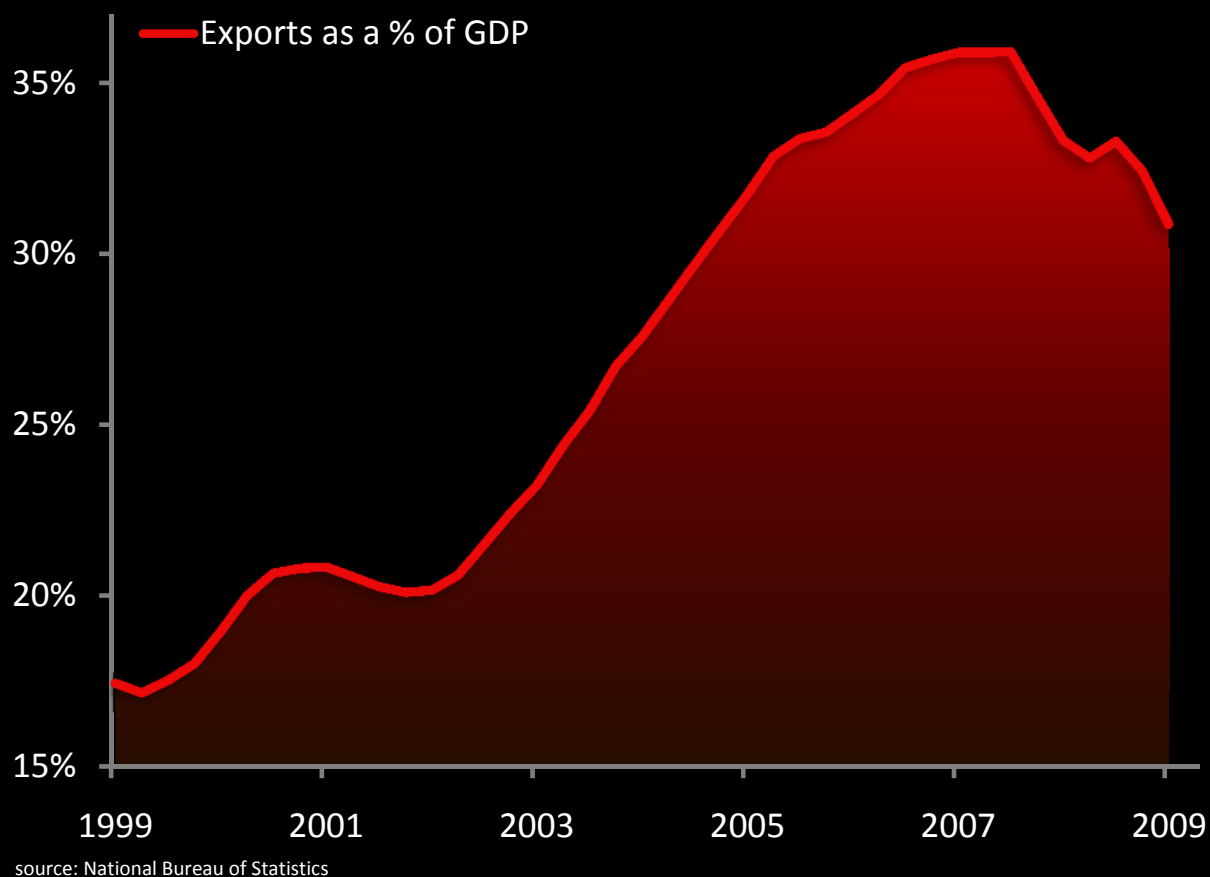
## THE CHANGING EXTERNAL DEMAND PICTURE

### DECLINING EXPORTS

In the decades since Tiananmen Square, China's relationship with the outside world has developed at an astonishing trajectory, with the country now comfortably positioned as a leading international economic and political power (if not a military one quite yet). Beijing has seized upon the crises created by the global recession as an opportunity to advance global trade relationships and continue to hone the image that it presented during the 2008 Olympic Games: that of an ascendant economic superpower still firmly rooted in a communist tradition.

By far the most visible aspect of China's economic growth over the past 20 years was the rapid export driven industrial build up. During the past decade of rapid expansion, exports rose from accounting for just over 15% of total GDP to over 35% at peak in 2007.

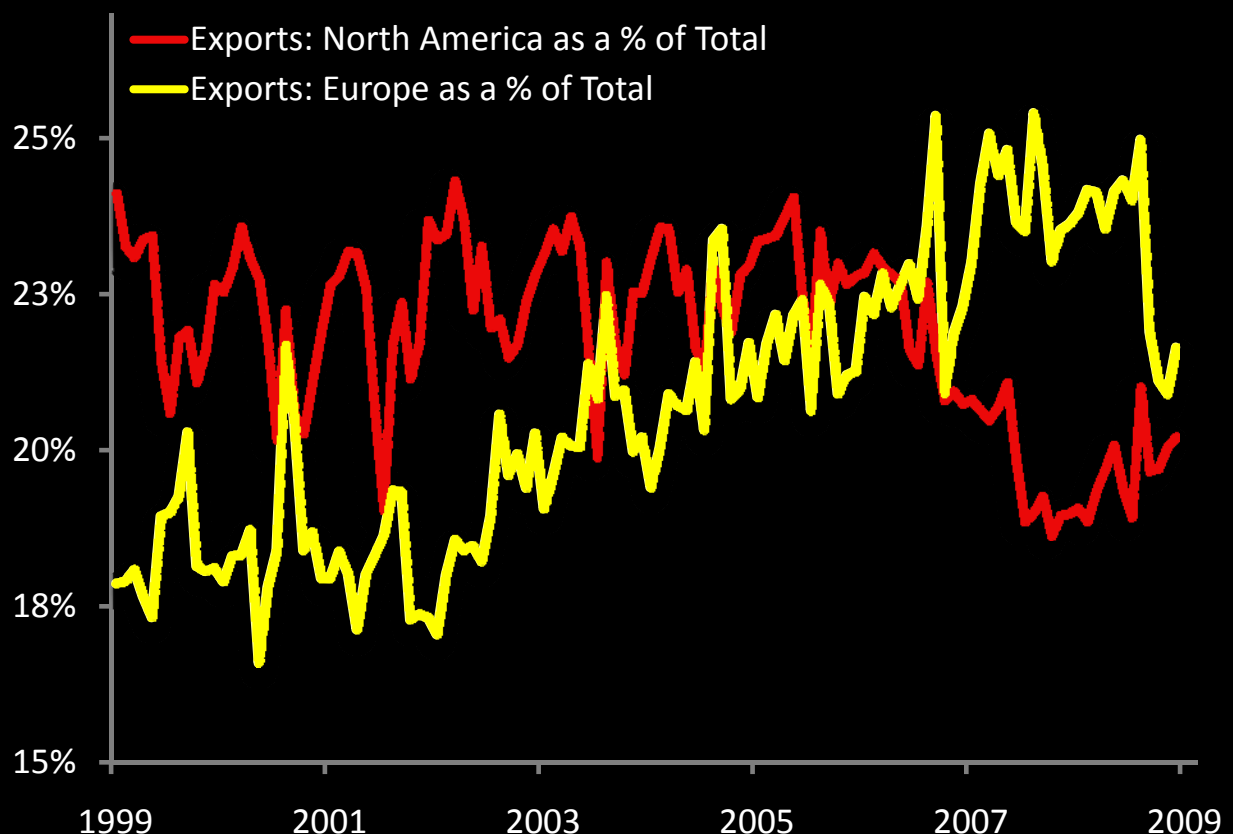




Since the beginning of the worldwide recession in 2007 heralded by the credit crisis, the steep decline in demand for Chinese exports has been part of a painful realignment process, but one that had already begun even before the global meltdown. During the first half of this decade, export industry margins declined by almost 50% as increasing capacity both domestically and regionally weighed on the market despite increasing external demand and a favorable VAT tax environment. By mid 2007 the government had moved to reduce VAT rebates and increase total effective export taxes as part an effort to refocus industry on internal demand. According to estimates from our Consumer research team, the total number of factories in the Pearl River Delta region, a critical export production region, had been reduced from 12,000 in 2007 to less than 6,000 by the start of this year.

Although the strategy of encouraging increased capacity in domestic industries (particularly in automotive and large household appliance production) remains unchanged, Beijing has pragmatically increased VAT tax rebates in response to the slump in order to reduce job losses.

Generally, we anticipate that the situation for exporters will remain depressed well into 2010, in part due to competition from regional rivals with weaker currencies or cheaper labor, but also due to our expectation that recovery in Europe will continue lag that in North America. Exports to Europe as a percentage of the total has exceeded those to North America since 2007 and, with exports to Europe in May registering growth at -32.56% year-over-year, the prospects for a near term rebound in demand there seem slim.



source: National Bureau of Statistics

### THE DOLLAR/YUAN CONUNDRUM

No aspect of Chinese policy has garnered as much scrutiny in the western media as its management of the Yuan (apart perhaps from foreign currency reserve policy in light of concerns over ballooning US government debt, a subject that we will not cover here). The escalating tone of Beijing's US Dollar replacement rhetoric of the first half of 2009 was matched by a more measured series of actions.

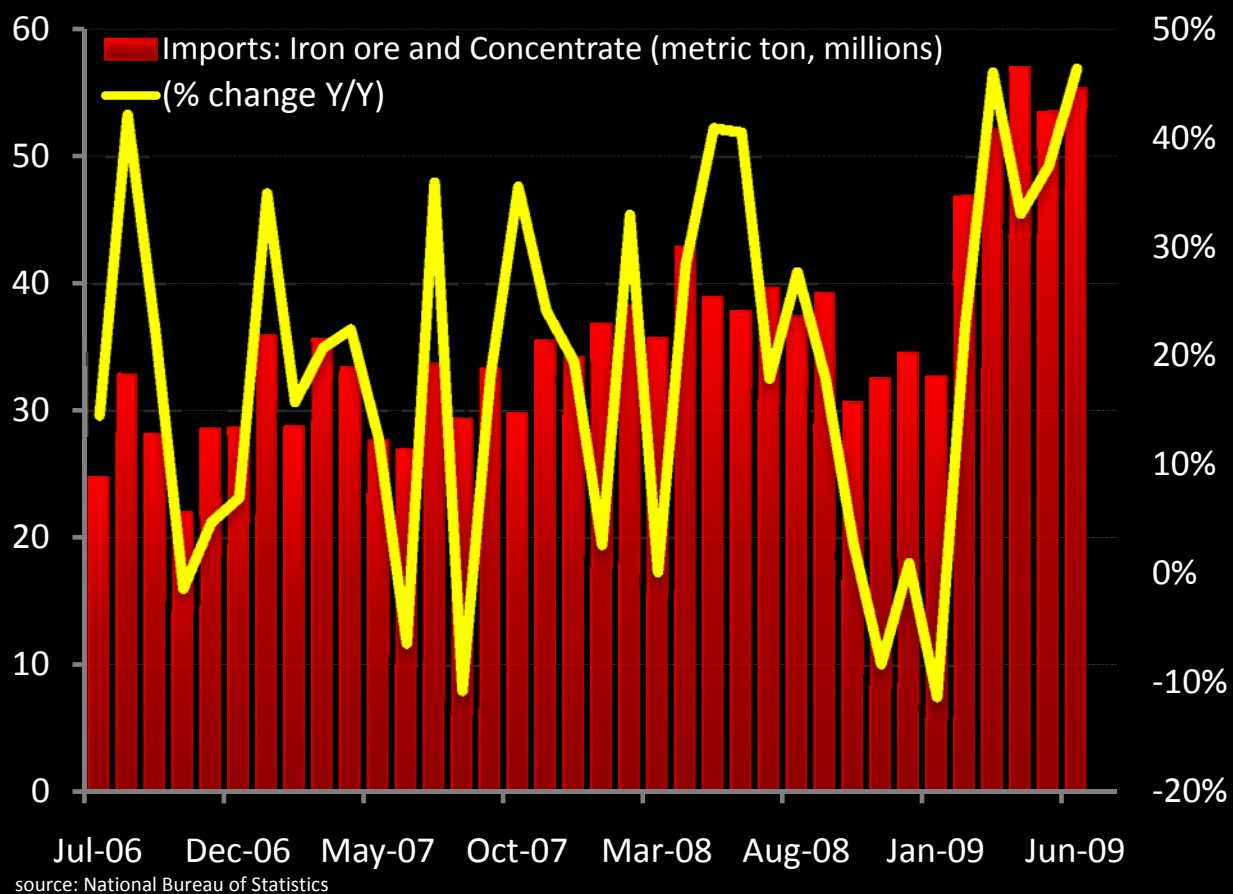
Moves by China to establish Yuan denominated swap lines with South American and ASEAN central banks, as well as the introduction of Yuan settled import and export contracts constitute a clear step towards establishing a reserve currency status in the future, and the opportunity to strengthen trade and political partnerships in the present. The modest scale of these moves in the context of China's total international trade however makes their real impact much less significant than their political significance. Furthermore, in the absence of any signal that there may be a move to adjust the dollar band policy anytime soon –the prospect of an ascendant Yuan still appears to be a real but distant point on the horizon.

## INTERNAL DEMAND DYNAMICS

### HEAVY METAL

The initial impact of the stimulus program on heavy industrial activity has been concentrated around production to fill orders for infrastructure transport and construction projects as well as dramatically rising demand for big ticket consumer durable goods.

As a direct barometer of this segment of production, Iron ore imports have reached record levels since the first quarter of this year. NBSC estimates place total iron imports for June at 55.3 million metric tons, a year-over-year increase of 46.3% and the second highest absolute level ever after March of this year.



As primary suppliers, Brazil and Australia have seen base metal demand in general, and iron demand in particular, explode in recent months (March saw total exports by Brazil to China exceed those to the US for the first time ever).

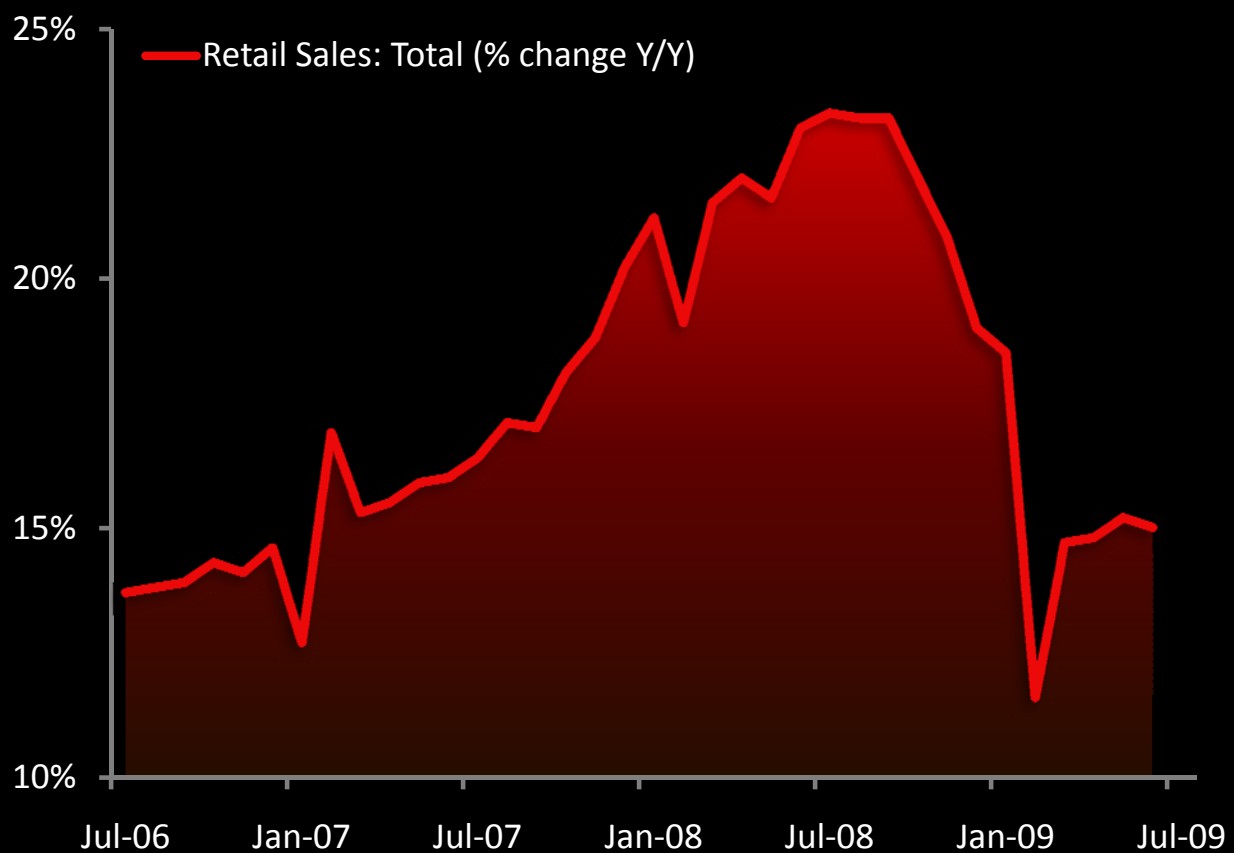


source: MDIC, Australian Bureau of Statistics

Although on the margin, anecdotal reports in May and June indicated that base metal demand in general, and Iron in particular, is increasingly impacted by speculative buying and transport bottlenecks symptomatic of a potential asset bubble forming, the continued strength in imports for those months, when coupled with production data, can only be interpreted as net positive. The recent disruptions resulting from the breakdown in pricing negotiations and the Rio Tinto related arrests will distort the data for the coming months.

## THE ASCENDING CONSUMER

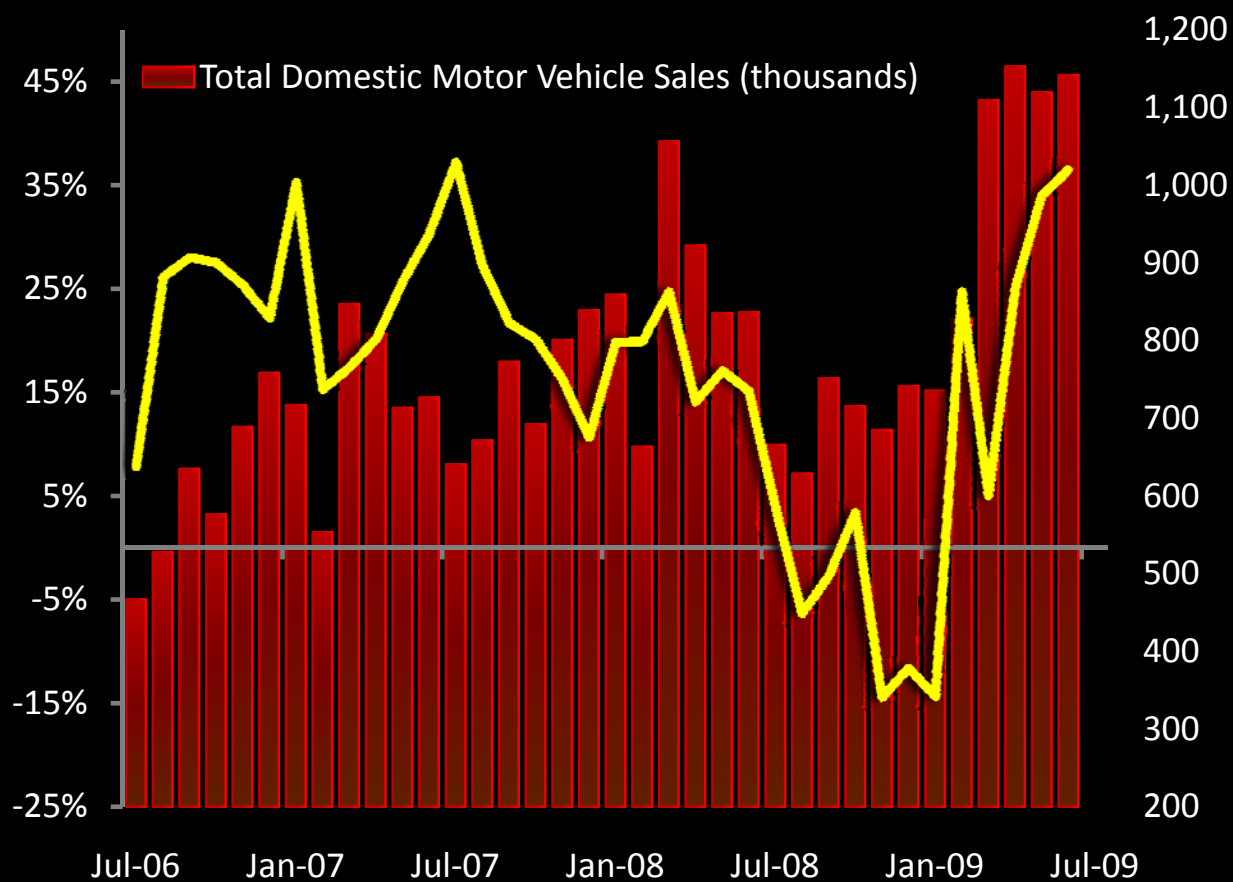
China's total retail sales withstood a tremendous drop in the rate of growth through the second half of 2008 and first quarter 2009 while still remaining in double digit territory -with June NBSC figures showing a year-over-year increase of 15%. Much of the resilience for bigger ticket items has been driven by tax cuts included in the stimulus measures adopted late last year aimed at increasing durable goods purchases by rural consumers. This program has yielded tremendous results with producers both at home and abroad in Korea, Singapore and particularly Taiwan seeing a sudden surge in demand for consumer electronics.



source: National Bureau of Statistics

The most dramatic impact of the consumer centric stimulus measures has been the profound spike in automotive sales. Total vehicle sales crossed over the one million threshold in March for the first time since the same month the prior year, and have remained above a million for the three subsequent months, with June's 1.1 million vehicles sold representing a 36.5% year-over-year increase.



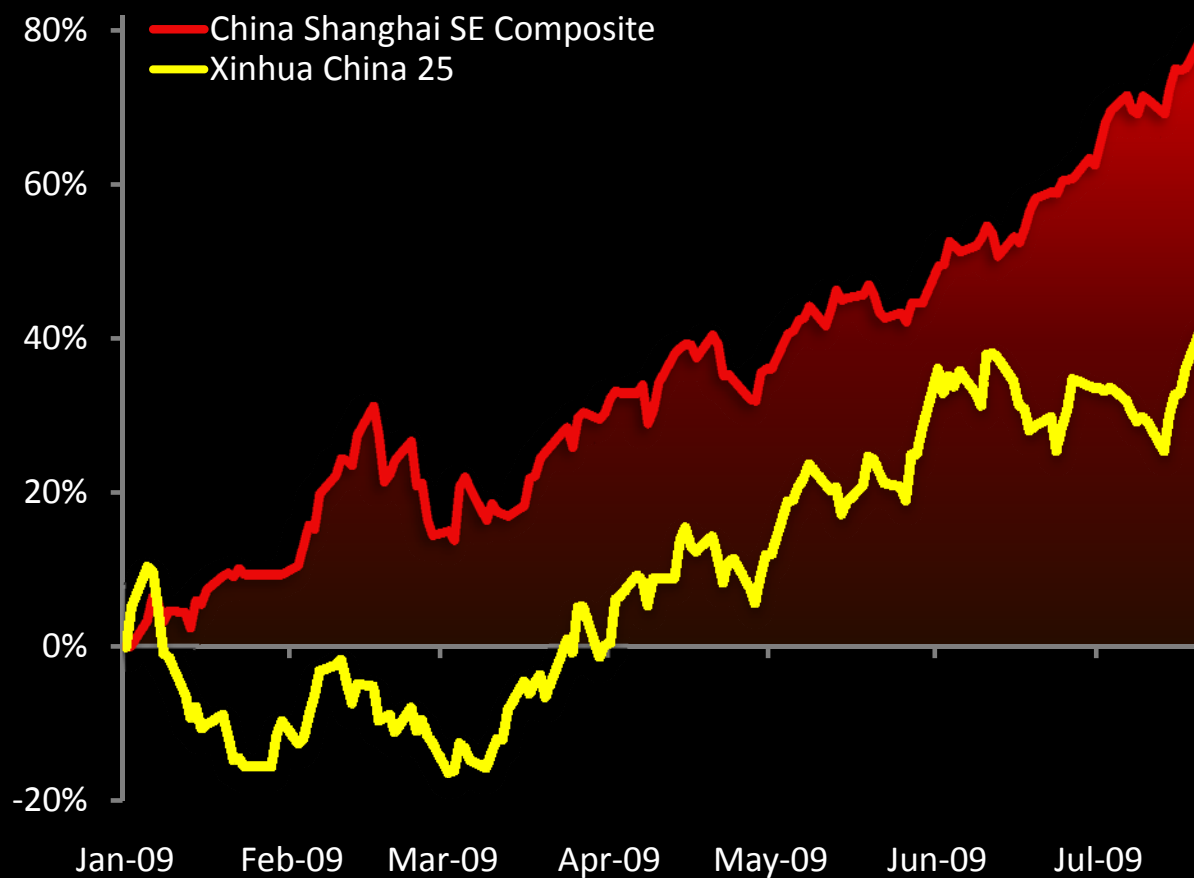


source: CAAM

## THE PATH AHEAD

### TACTICAL OVERVIEW

At the time of this publication, the Shanghai composite index highest level was 3,266 (+79.5%YTD), while the Xinhua 600 and Xinhua 25 had increased by more than 91% and 41% respectively for the year-to-date.



We believe that after this extended rally in Chinese equities, the “easy money” is now behind us and that at present **the Shanghai composite has the potential to correct to its immediate term TRADE line of support of 3020 (a 7.5% correction from its peak) without any significant fundamental change in the underlying data. Price momentum carries risk. If there is a sustained breakdown of the 3020 level, the intermediate term TREND line of support for the**

**SSEC is 2713 (a 17% correction from the peak) and that would be a critical risk management level in our model. Furthermore, the likelihood of a pullback of this magnitude occurring has increased exponentially as more “hot money” has surged into the market.** On July 20<sup>th</sup> we closed out our long Chinese equity exposure but we remain long the Chinese currency via the CYB (Chinese Yuan ETF).

The rapid expansion of credit over the past two quarters -combined with the Securities Regulatory Commission’s decision to allow margin trading accounts, has ensured that a tremendous amount of leverage has found its way into the closed domestic stock market. In addition to individual speculators, Commercial banks have also steadily increased their exposure to the equity markets.

An additional risk factor is the heavy syndicate calendar for the remainder of the quarter, with over 30 offerings on the near term horizon.

We believe that any such correction will present buying opportunities, but that sector and industry divergence will be more pronounced in the coming 12 to 18 months. As such, risk management dictates that we follow a course of sector, industry and company specific investing when feasible (given the structural blocks to foreign investors in the domestic Chinese markets). Our primary current Industry focus is centered on the automotive, technology and consumer staples sectors (with a specific focus on food production) as well as some components of the basic materials complex.

### A VERY FAT TAIL

On the more distant horizon, the investment risk facing the Chinese economy and equity market are more pronounced and the potential rewards greater. From our perspective there are three key long term risks that every long term investor must acknowledge:

- **Demographics:** with over 72% of its population above the age of 16, China is on the precipice of a profound demographic shift as a shrinking workforce and rising elderly population put pressure on the societal infrastructure.
- **Internal Politics:** China remains a bastion of communist principles. We know of no historical corollary for a large-population-economy that has successfully nurtured the development of free trade while restricting civil liberties. In fact, over the long term, every modern managed economy with an autocratic government has failed to keep pace with free market democracies. China may well be transitioning towards a more

open political system, but the gradual nature of change so far may not be enough to satisfy disenfranchised social groups (as witnessed by the recent unrest in Xinjiang) as well as dissidents among the increasingly well educated, socially mobile middle class. Any repressive moves by the government to control the population carry the risk of upsetting the economic balance in China.

- External Politics: The present Rio Tinto prosecutions underscore the reality of economic nationalism in China. Although Beijing's moves to improve the rule of economic law ranging from patent infringement to unfair competitive practices have achieved great progress, and while the trials and tribulations of foreign investors navigating the bureaucracy and local government corruption in China pale in comparison to those experienced by those in other countries (for instance those subject to the sinister machinations of the Kremlin), the fact remains that the communist Chinese state will place national interest first at all times. The risks to foreign investors whose interests are not directly aligned to the state can therefore not be overstated.

*AB*

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