



CHINA'S ECONOMY & MARKETS

China is exceptional in the literal sense of the word. It is the most populous nation on earth, one of the largest, and is both geographically and ethnically diverse. What makes China unique is the rapidity with which it is moving from an agrarian economy dominated by the state to... exactly what? Unlike other Asian nations (Japan, South Korea) that moved to fairly conventional democratic/capitalistic systems, China's idiosyncrasies do not suggest such a standard end game. Its sheer size and economic and political realities require it to create its own development path. This path presents great attraction to investors, but also contains unique pitfalls.

China is currently the world's third largest economy. Its large population, a source of both exports and imports, combined with the demand for natural resources, establish China as an economic force today, not at some point in the future. This report explores the structure of the Chinese economy and capital markets in order to create a framework for investing in its growth. Future reports will go into greater detail regarding possible scenarios for economic growth. Though the development of other Asian nations provides some guide, we also look to the United States to gain insight to China's economic future. While there are many differences between countries, China also exhibits many similarities with the US, not as it is, but as it was during a comparable period of development.

WHAT IS THE STRUCTURE OF THE CHINESE ECONOMY? The true nature of the Chinese economy remains a mystery to most. The physical distance and the opacity of official statistics complicate the analysis. One thing does appear clear. We believe most participants significantly overestimate the degree to which the Chinese economy is dependent on exports.

It is easy to do so. We are surrounded by items labeled "made in China." But on further examination, many of these items are really "assembled in China." Developed world firms typically provide the intellectual capital and higher value added components. Manufacturing of highly engineered components also occurs in the developed world, or in the case of electronics, in more developed Asian countries like Taiwan and South Korea. These goods are often imported into China, only to be exported again. Although China has some natural resources, it still imports most of its energy and raw materials; these are significant inputs to any manufacturing process.

Chinese exports have risen significantly, as seen in Table 1 below. But note as well the rise in imports into China, which have grown at a similar rate. It has only been recently that the Chinese trade balance (the difference between exports and imports) has ballooned. This trade surplus is a source for China's large (and growing) foreign currency reserve which has been invested largely in US Treasuries. But China's Gross Domestic

TABLE 1: CHINA'S TRADE WITH THE WORLD (\$ BILLION)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Exports	194.9	249.2	266.2	325.6	438.2	593.3	762.0	969.1	1,218.6	1,428.5
% change	6.1	27.8	6.8	22.4	34.6	35.4	28.4	27.2	25.7	17.2
Imports	165.7	225.1	243.6	295.2	412.8	561.2	660.0	791.6	955.8	1,133.1
% change	18.2	35.8	8.2	21.2	39.8	36.0	17.6	20.0	20.8	18.5
Balance	29.2	24.1	22.5	30.4	25.5	32.1	102.0	177.5	262.2	295.5

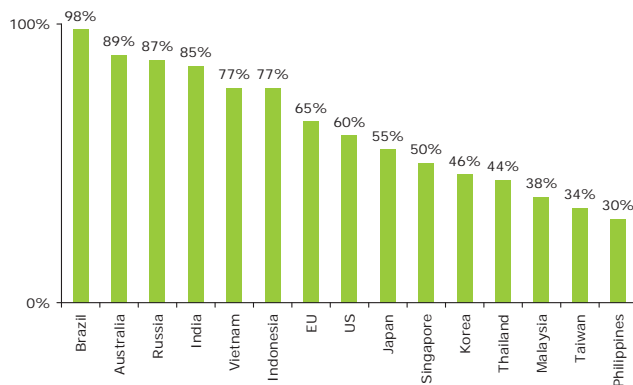
Sources: PRC National Bureau of Statistics and PRC General Administration of Customs, China's Customs Statistics

Product or GDP does not depend on exports. As China has grown, so has its thirst for imports.

The nature of the Chinese economy can be determined by examining what happens to the goods that it imports. Chart 1 displays the percentage of various countries' exports that stay in China. On one extreme is Brazil; almost all goods exported to China are consumed there. This is because Brazil's exports are mostly agriculture and energy related (which are consumed) or base metals used in infrastructure. On the opposite end of the spectrum lie Taiwan's exports, only about one third of which actually stay in China. Most of Taiwan's exports consist of components for electronic and computer equipment, assembled into finished products and re-exported. China's thirst for imported natural resources and high technology reduces the percentage of GDP attributable to net exports¹.

CHART 1: IMPORTS FOR CHINA'S DOMESTIC USE

Share of Imports for China's Domestic use, 2008



Source: CEIC, Haver, UBS estimates

China's value as a manufacturer (really assembler) for export is based on its relatively low wage rate. But low wage rates imply a low value for the exports produced by those wages, and therefore a low contribution to GDP. Exports employ a large number of people on an absolute basis, but still only a small percentage of the total workforce.

Jonathan Anderson, an economist at UBS, estimates that less than 10% of the Chinese workforce is in export oriented businesses². As an example, a 2007 study conducted at the University of California at Berkeley only attributed \$4 of a \$299 ipod to Chinese labor, despite its "Made in China" stamp³. Given the size of the country's labor force, estimated to be over 800 million, this represents some 80 million people. The reduction in export oriented manufacturing jobs was large enough to create headlines when factories closed during the height of the credit crisis, but seems hardly large enough to disturb the social order as was so often predicted⁴.

If exports are not the primary driver of the Chinese economy, what is? Fixed Asset Investment, consisting mostly of infrastructure such as roads, bridges, housing, electric grids and similar projects. This rapid industrialization is being driven by multiple factors, including:

- Urbanization of its population
- Development of basic infrastructure and
- A shift in the economy away from agriculture to manufacturing.

By virtue of the mass nationalization of business by the Communist Party after World War II, the Chinese government either engages directly in this economic shift or effectively dictates it. As a result, GDP and similar statistics show significant government involvement in the economy. The government in China appears to be the only entity that has both the capital (political and economic) to fund major projects.

Structurally, we believe the perception of the Chinese economy, internally and externally, is changing. If it ever was, it seems that China no longer seeks to follow Japan and South Korea on an export driven path to prosperity. Its workforce may be too large, and too unskilled, for that to be successful. But the creation of infrastructure, housing and consumer spending that follows can power an economy for decades. We suggest the United States as a model. The US seldom had net exports greater than 1%. The only period since

¹It also suggests alternative ways to invest in the Chinese economy, which is the subject of a future report.

²Jonathan Anderson, "The Color of China," *The National Interest*, March 3, 2009.

³Hal R. Varian, "Economic Scene," *The New York Times*, June 28, 2007.

⁴Many news stories related similar predictions of social unrest, based in part on concerns expressed by various government officials. Typical is Calum, MacLeod, "Factory Closure, Layoff Stir Unrest in China," *USA Today*, December 2, 2008.

1930 that net exports were greater than 3% were the years immediately after World War II, when US exports were needed to rebuild Europe and Japan. Even now gross exports (not including the value of imports) for the US are seldom above 10%⁵.

Underscoring the reality that despite its size China is still in many ways a developing country is the importance of agriculture. Farmers, very often subsistence farmers, account for nearly 43% of the country's workforce. Agriculture is 11.3% of GDP. In some ways, agriculture is more important to China than exports. In contrast, only 1.2% of US GDP comes from agriculture, a sector that employs 0.6% of the total workforce. Even relative to other major emerging markets such as Brazil, China (and India) rely heavily on agriculture for contribution to their GDP⁶.

We believe that the United States after the Great Depression and World War II provides a model for Chinese development. After these events, the US faced significant unemployment, especially among young men. The economy had surplus capacity due both to the Depression and also because too much of the industrial capacity required for the war had limited civilian application. Several key factors led to the reinvigoration of the economy, including pent up consumer demand after the privations of depression and war, the building of the interstate highway system, and the GI Bill, which provided young men with something to do while increasing the quality of the workforce immediately after the war. Future reports will explore these similarities in greater depth.

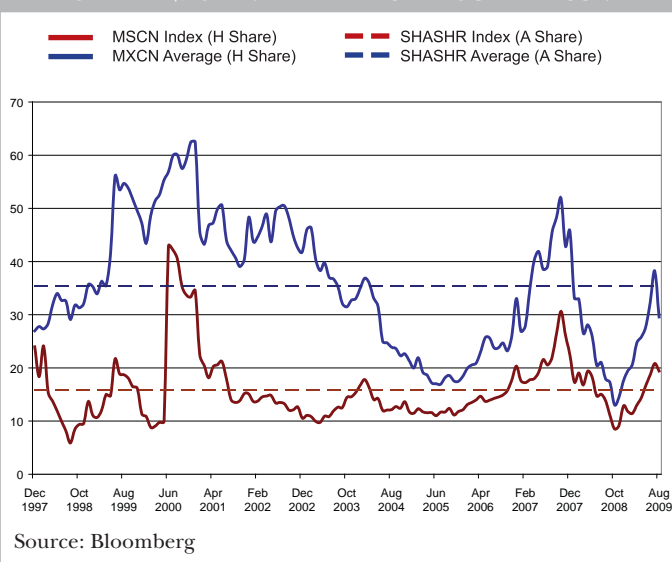
WHAT IS THE STRUCTURE OF THE CHINESE MARKET? There is no such thing as "The Chinese Stock Market." Rather there are at least three, possibly six different markets. There are two "A" share markets, one in Shanghai and one in Shenzhen⁷. Each city also has its own "B" share market. A shares are limited to local Chinese investors (no foreigners) and local investors are not allowed to invest in anything but the A share market. This bifurcation underscores the fact that the Chinese currency is not convertible. In addition, shorting of individual positions in these A markets is not allowed, though the index itself may be shorted.

These facts make the A share market structure highly volatile, even by emerging markets standards. The A shares also are highly sensitive to changes in monetary policy.

The B share market is only open to large institutional foreign investors who are granted access by the government. The Chinese government has been slow to increase these grants. According, the market capitalization of the B share market is only approximately \$25 billion, compared to the \$1.8 trillion aggregate market capitalization of the A share market. The B share market has outlived its usefulness and may be eliminated, though the process for this is opaque, as are many regulatory changes in China.

The important market for foreign investors is the H share market. These are stocks of Chinese companies that are listed and traded in Hong Kong. The MSCI China Index, the benchmark used by most global equity managers, consists solely of these shares. Increasingly, some Chinese companies are bypassing their homeland altogether and listing shares directly in the US. Some of these transactions are done using a reverse takeover, where a Chinese company merges into an existing shell company already listed in the US. However, a number of significant companies, most notably

CHART 2: CHINA MARKETS PE COMPARISON



⁵Data on the historical structure of the US economy are available from the Bureau of Economic Analysis at www.bea.gov.

⁶Information from www.cia.gov

⁷The differences between A and B markets are much more important than those of the Shanghai and the Shenzhen market. Shanghai is much more the national market and is home to the larger, national stocks such as China Life and China Mobile. The Shenzhen is focused more on technology stocks. Comparisons between the two markets and the New York Stock Exchange and the Nasdaq are fairly common and not inappropriate.

Baidu (the Chinese Google) have issued IPOs in the US directly, with many more planned once the equity markets show stabilization.

Like all emerging markets, indeed like all equity markets, Chinese stocks are subject to considerable volatility in both price and valuation metrics. Not surprising, given the captive nature of the A share market and limitations on shorting, valuations of the A market tend to go to extremes. Chart 2 shows that while these markets are correlated with each other, A share market valuations are more volatile. The differences between these markets are important because the financial press often is unclear when it writes about "the Chinese market" when discussing both returns and valuation statistics.

The future of these complicated arrangements remains clouded by two considerations.

First is the convertibility of the Chinese Yuan. Without it, the A share market will be continue to be used only by local investors who have no alternatives. The other is the ability to short individual shares, thereby providing a measure of valuation discipline into the market. Without these and other structural reforms, the A share market is likely to remain prone to exaggerated swings.

This report presents two important ideas. First, a more realistic model of the Chinese economy, one that puts Chinese exports in context, needs to be developed. Second, investors should focus on the Chinese H share, not the A share market. Our next focus will be on China's infrastructure development and how this stokes demand for natural resources, both in China and across the globe. ♦

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