



CHINA: MORE THAN JUST EXPORTS

The health of the Chinese economy has become a primary topic for investment managers and economists as the recession has swept across the globe. China is a linchpin for a number of reasons; it is also the source of significant supply and demand for different goods. Its size and stage of development puts China as the marginal buyer or seller of almost every good and service. In particular, Chinese demand, and perceptions regarding Chinese demand, are significant drivers of commodity prices. As the global recession deepens, China's relative strength makes it an ever larger driver of economic activity.

Investors have also been watching the performance of the Chinese stock market, which has significantly outperformed most equity markets in 2009. This outperformance has been partially due to China's superior economic growth and partially due to the extreme valuation of its equity market following last year's dramatic declines. While we are optimistic overall on the Chinese economy for the coming years, our positioning in that stock market varies based on valuations and the progress of economic recovery. Investors must be cognizant of China's impact on the global economy, but that does not imply that China will always be a prudent investment.

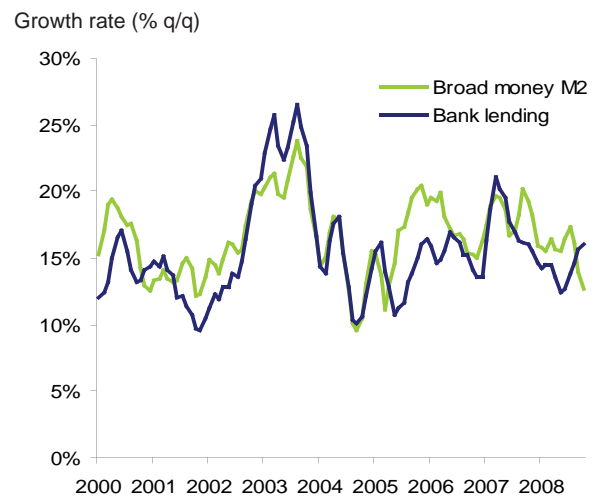
CHINESE GROWTH. Chinese GDP has slowed markedly, from the 12% annualized rate of growth to the 6.5% annualized rate in Q4 2008. Why, and when, did Chinese GDP begin to fall? Official Chinese growth targets are always approximately 8%. Growth far in excess of 8% is considered inflationary; failing to meet this target risks social unrest stemming from unemployment¹. Chinese economic growth was well above target in the middle of the decade. Moreover, inflation had spiked from below official targets of 3% to over 7% by the summer of 2007. Rising commodity prices were a significant component of higher inflation.

The Chinese government undertook a series of monetary policies to cool the economy, the stock market and inflation. Home mortgage rates, which had been rising slowly since 2002, reached 6% by the summer of 2006 and were 8% by October 2007, sharply reducing housing

demand. Banks were encouraged to tighten lending standards, especially for construction and real estate loans, resulting in fewer loans and declining property values.

Viewed narrowly, these policies were successful, possibly too successful. Loans to developers began to slow in late 2006, though actual mortgage loans to individuals did not peak until late 2007. Property prices began falling by late 2007 and broad-based CPI components fell by the spring of 2008. (See Chart 1.)

CHART 1: SEQUENTIAL GROWTH



Source: CEIC, UBS estimates

The economic slowdown in China was the announced consequence of Chinese government policy. Declines may have been accelerated by the weakening global economy, but initially the global slowdown was working in consort with Chinese government policy. It was not until last fall, when the global economy began its sudden contraction, that the slowdown became a hindrance, not an aid, to these policies.

EXPORT DRIVEN ECONOMY? Opinions on China are highly influenced by the belief in the reliance of exports for growth of the Chinese economy. Contrary to popular opinion, the primary driver of the Chinese economy is not exports. China has been hurt

¹The history of Chinese growth targets is explored in Drew Thompson's web exclusive article in Foreign Policy www.foreignpolicy.com/story/cms.php?story_id=4747.

by the very severe drop in exports as global, and especially US, consumers increase their savings. However, there are other, more significant drivers of economic growth. We believe that the non-export sector of the Chinese economy will continue to be the primary driver of growth even as the global economy recovers and exports resume.

Just how big are exports for the Chinese economy? It's a complicated question. Too many analysts start on the high side, about 40%. While even this number is lower than many people expect, in fact, even 40% is much too high. China imports most of its raw materials. When finished goods, containing imported raw materials, are exported, the value of the initial import must be subtracted.

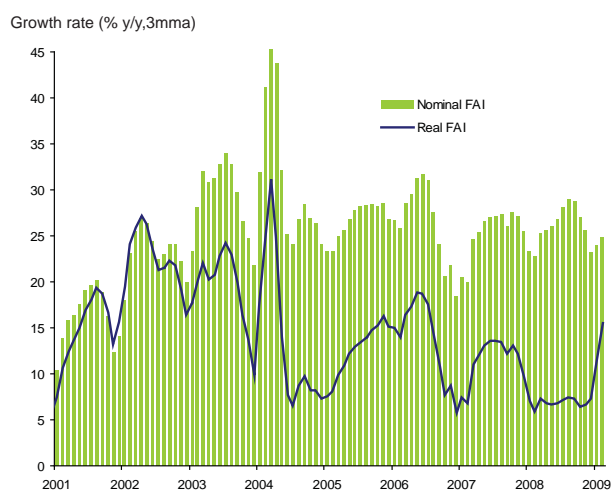
Similarly, much of the export activity in China involves assembly, where components are shipped to China, assembled and then exported. For example, consumer electronics components (like microchips) require fairly advanced levels of technology, but assembly is a relatively low value added procedure. Such small, lightweight items are also cheap to transport. Shipping them to China for final assembly and packaging allows the manufacturer to benefit from China's relatively low labor costs of unskilled workers. But the value of the net export is effectively only equivalent to the value added by the labor. Given that China's global advantage is its relatively low wage rate, this produces relatively modest gains in GDP.

In any large economy, calculating and adjusting these figures is very difficult and subject to error. But there are estimates that actual net exports from China are less than 10% of GDP². This is not to suggest that exports are unimportant to the Chinese economy. Exports employ many people, though at a relatively low wage. Exports are also an important source of cash for a country that imports most of its natural resources, and increasingly much of its food. However, the notion of China existing as a manufacturing platform is outdated, based in part on "made in China" stamped on so many goods, without looking at the source of their underlying components and on their inherent intellectual capital.

DRIVERS OF THE CHINESE ECONOMY. Far more important than exports as drivers for the Chinese economy are fixed investments, defined as assets that are not consumed directly but are used for the creation of other goods and are relatively permanent. This

includes housing, power generation and transportation infrastructure. Fixed Asset Investment (FAI) has been a key component of Chinese growth since economic recovery began in 2001. FAI had grown over 20% per annum through the first half of the decade. Growth slowed considerably, especially since the deliberate cooling of the economy in 2006. Real FAI growth (adjusted for inflation) bottomed near 5% at the beginning of 2007 and effectively stayed there for 2 years. Recently, these figures show acceleration, as have data for the bank lending necessary for firms to stock inventory and hire workers in anticipation of increased activity. (See Chart 2.)

CHART 2: FAI REBOUNDED STRONGLY



Source: NBS, CEIC, UBS estimates

The Chinese consumer is the other keystone of economic growth³. The middle class is estimated to be 100 to 300 million. The Chinese consumer has had real earnings growth and relatively low levels of debt.

One area not being stimulated by the government is the property market. On some level this is a negative; real estate prices have been falling and are expected to continue to do so for the first half of the year. But falling real estate prices have a beneficial effect on home buyers, allowing more people to participate. Lower costs also allow domestic consumption of electronics, furniture and even cars for the more affluent.

IMPACT ON THE GLOBAL ECONOMY. Given the relative paucity of natural resources in China, any uptick in economic activity in construction, transportation and

²Economic Focus: An Old Chinese Myth, The Economist, January 3, 2008.

³One of the most comprehensive studies of the Chinese middle class is "From 'made in China' to 'sold in China': The rise of the Chinese urban consumer" by McKinsey Global Institute, 2006. It is available at www.mckinsey.com.

similar projects will cause an increase in demand for basic materials, such as steel, coal, copper and other metals. This will benefit Chinese producers of these goods, as well as companies that export them. Mining and construction equipment companies should also benefit.

For all its strengths, the Chinese economy is too small to be the global engine of growth. Only the US had the apparent ability to be that sole engine, and even that has been re-evaluated given the unsustainable levels of debt incurred in the process. What China will do is accelerate the development of its local markets, reducing even more the importance of exports for the Chinese economy. That does not imply a goal of reduced exports, but a reduction of exports relative to its own GDP in order to sustain local growth.

For years, China has been viewed, and to some extent has viewed itself, as following the Japanese model of economic development. Sacrifice current consumption, maintain high savings rates, and look to exports for economic growth. But the Chinese economy is too large to be dependent on exports, especially given the new-found parsimony in the United States.

Instead, we suggest a different economic model: the US after World War II. The two situations are not identical, but there are some interesting parallels. Post-war growth in the US was not driven by exports, but by the development of the suburbs, an increase in home ownership and the resulting consumer spending. Homes were also used as a store of value. China has many, though not all, of the raw materials necessary for such an expansion. It has a large population that is under-housed and is looking to increase its material wealth. China has an

under-developed transportation infrastructure, as did the US prior to the Eisenhower interstate highway system. The US had excess capacity left over from war time expansion; China has excess capacity from production of consumer goods. Both countries struggled with urbanization, as poor farmers moved to cities searching for work.

Such a transition will not be easy for China; it will be neither fast nor cheap. However, China has a surplus of savings that can be used to ease the transition. Its command economy can more easily create the physical infrastructure necessary for the next phase of economic development. What it cannot do is create overnight a more highly skilled workforce necessary to build a more modern future. This will have to be imported, in the form of higher quality finished goods from the more developed countries in Asia, especially Taiwan and South Korea, and from the US as well. Stronger intellectual property protection would encourage more of this sort of trade.

CONCLUSION. China's economic prominence can no longer be doubted, either by economists or investors. The decision now focuses on how to invest in the opportunities offered by Chinese growth, and by the changing nature of this growth. At times, these opportunities will be in Chinese companies themselves, at other times suppliers to China will be more attractive. As always, valuation will be a key factor in the investment decision.

Two-thousand and nine is the Chinese Year of the Ox, identified by hard work, patience and steady progress. This ancient characterization aligns well with our own views for the coming year. ♦

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