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GROWTH IN CHINA, AN EMPIRICAL PERSPECTIVE

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For 30 years the economic growth model in China was built upon cheap labor and capital in order to drive its world competitiveness and foreign investment. To some extent, that paradigm has now broken down with profoundly higher inflation rates, as evidenced in wages with 22% growth in recent minimum wage levels [white collar wages even higher]. On the other side of this coin are the positive effects rising wages have on a burgeoning middle class in China – indeed, these higher incomes obligate higher consumption.

One challenge they face down this path, however, is reducing the country's rising Gini-coefficient, that is, the measure of income dispersion. This statistic currently sits near 0.50, slightly better than the U.S. but much worse than many countries in Europe, along with

coefficient of 1 demonstrates complete income inequality with 0 total income equality. Anecdotally, I overheard many of the super-rich in China [i.e. biggest domestic consumers and investors] are becoming increasingly interested in moving abroad seizing what they see as more favorable free-market opportunities elsewhere. I read this as, economies where their business is not competing with the State, nor is required to have their blessing to succeed. Too, there are greater investment opportunities for their capital in financial markets outside of China [e.g. fewer restrictions], their reasoning continued.

Nevertheless, there is ostensibly boundless opportunity in the country for domestic consumption and investment. This is surely happening in the large urban areas – unfortunately, at this point these areas represent only about 30% of the total Chinese population [when you include the many smaller cities and towns it's about 45%]. This geographic construct is what drives China's current reliance on exports to fuel growth. Yet, it's hard to escape the vast potential for economic mobility from rural to urban areas, which represents a long runway for Chinese growth. Chinese policy makers recognize this. In the last 10 years China has experienced over 15% population turnover from



rural areas to urban towns and cities.

Keeping this engine humming is critical to global markets. To illustrate this, China contributed nearly 20% of the world's economic growth in 2009; given the current run-rate that number is expected to increase to 24% in 2011. The key question on markets' minds is: will China continue to support broad global economic growth going forward? If not, if China slows or succumbs to a hard landing the negative ripple that will hit global economies would surely trouble markets. The U.S. alone sells ~\$100bn in goods and services to China, according to U.S. trade data.

While in China, many of the business people I spoke with declared that in order for China to merely sustain social stability, the economy needs to grow a minimum 7% trajectory. This is important because the Chinese people are notorious for demonstrations of social unrest. In 2010, there were approximately 200,000 incidents of social unrest in the country.

Recently, there have been a number of market participants that have called for China to slow to sub-

8% growth as early as 2012, getting dangerously close to this bogey. It is in nobody's best interest, especially the China's government, to see this bottom-up driven discontent proliferate.

To wit, there is rampant dialogue amongst the Chinese people about the government's 5-year plan where they expect to shift away from the unsustainable export dominance and building boom-driven model to a more sustainable consumption-driven model. As a part of this plan, the Chinese government recently lowered taxes on consumer goods, and are targeting 15% minimum wage growth over the course of the 5-year plan. This course would effectively double these incomes, a clear positive for onshore consumption. The hope is that the Chinese consumer will transform from the big savers who helped fuel the real estate boom to the new paradigm of the global consumer. If successful, the younger generation will be the driver of this new economic vehicle.

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In my conversations with 20 and 30-somethings, their intelligence and ambition is clear. They are hungry for growth and recognize that an immense economic opportunity lay at their feet. Their world is one of structure, their discipline astounding. The focus on math, science and hard data creates a strong foundation on which innovation is built. In addition, there are green shoots of creativity – the risk-taking entrepreneurial bravado required to take an idea to the next level – in many of China's smartest young citizens.

This new generation came of age in a China that was shifting from a command economy to a more market-oriented one. They have known nothing but non-stop growth, influence from western merchandise and lifestyles, and are less likely to save than their more frugal parents and grandparents [who put away ~35% of their incomes]. The bank savings rate for the Chinese youth is much lower, they spend much of what they earn, relatively speaking. Certainly, China personifies numerous economic cross-winds, both short-term and long-term, that can make traditional analysis difficult.

As a consequence, how do investors successfully calculate China's near-term prospects? In terms of the near-term stock market environment, answering this growth rate question is critical. Armed with my empirical analysis inside China's borders, the quantitative and qualitative data suggests that a hard landing isn't likely the case. To be sure, China will dip under 8% growth at some point; there is little debate there in my mind. But will this happen in 2012?

Unlikely.



Economic activity in China is absolutely booming; you can see it just about everywhere you go. There are infrastructure projects funded from capital rich Hong Kong banks, to Beijing to Shanghai and seemingly everywhere in between. Ports appear active; there is abundant work on railways, highways, buildings, water works and airports. It's how I imagine parts of the U.S. looked in the early and midpart of the twentieth century. The groundwork is being laid connecting population centers and commerce in China, be it by road, rail or air.

Even in large cities where you see miles upon miles of dense buildings and roads and think "how can this growth continue with this much already in place" you begin to understand when you see just how many of those buildings are falling apart and in need of repair, and many are currently receiving it. To be sure, there are many of these old buildings that appear empty and thus will not receive a makeover, but the majority does seem to be occupied.

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From conversations I had with real estate folks, I was able to deduce that about 25% of China's output is directly related to real estate, which as we know is being cooled by current Chinese policy. Still, Chinese investment in real estate has jumped almost 33% this year over 2010 while many local governments in China [municipalities] have used this real estate as collateral for new loans [loan growth in these regions is ~30% over 2010 levels]. Given this reality, it was not lost on me that if [when] real estate prices fall broadly [they have in some areas] this will undoubtedly throw cold water on Chinese credit markets.

Nonetheless, given the choice between further cooling real estate [i.e. cooling inflation], which will brake economic growth, or taking 5-6% inflation for now while boosting more robust growth, the clear answer in my mind: the Chinese government is taking door #2. This choice will likely come to fruition via more relaxed lending policies as inflation gets closer to the 5% range.

This is not to diminish the impending risk of the Chinese banking sector. In some ways it acts as a sword over the economy, ready to violently swing somewhere down the road. In the late 1990s after the Asian financial crisis the Chinese government had to write-off some \$500bn in loan values classifying them as nonperforming. In the time since, the banks have grown and so too has the value of much of the underlying real estate collateral. If real estate party were to end the aftermath would be widespread. Because the government, which owns the largest banks – and consequently the people’s savings – ultimately pays the price of any write-down, Chinese households would bear the cost of the economic cleanup. The result would be a direct dent in China’s shift toward the domestic consumption model.

Wait, what about demographics?

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In any broad analysis of the Chinese landscape, one must take into account the enormous size of the population and how it factors into the growth calculus. Many cite policy-driven population constraints as a concern for a variety of reasons. The notion that the one child policy prevents robust enough demographic growth is simply not the case, in my experience.

China has slightly over 1.34 billion inhabitants [~20% of the world population] with the median fertility rate per woman of 1.6, according to World Bank data. To put this number into context, the rate in the U.S. 2.1, Canada 1.7, Brazil 1.9, Germany 1.4, Australia 1.9, India 2.6 and regions of Africa over 6. This statistic backs up the information I gathered in many of the conversations I had. If you’re an only child and your spouse is an only child together you may have one child each [2]. Moreover, in rural areas couples are unrestricted. According to locals, only about 34% of China’s population was subject to the rule. These policies have the effect of reasonable population growth, albeit more contained than otherwise.

To demonstrate this, in 2000 Shanghai had about 16mn people. Currently, it has over 23mn, and is projected to have over 30mn by 2018, according to locally-cited statistics. In the Shanghai business district of Pudong, the building-boom long preceded the demand for the substructure. Eventually the demand caught up and the city is vibrant and densely crowded. That concept, coupled with the large opportunity for mass economic mobilization [rural to urban], organic population growth, and migrant workers and a greater sense of understanding emerge as to why empty “ghost” cities exist in China. The government sees the writing on the wall; they are getting ahead of the demand curve. Conversely, if these projections prove unnecessary, or China doesn’t eventually slow this rate of build to market equilibrium, the value of real estate in the country will surely crater – the building bubble will pop.

At the business level, the information my conversations unearthed suggested that the biggest opportunity in China right now is in the small and middle markets due to the many companies competing in a vast resource grab. The strong will survive; the weak will cease to exist. The biggest challenge these middle market companies face, the conversations continued, is access to credit as lending conditions recently tightened as a result of policy measures. This reality underscores my comments some weeks back, which stated that, to some extent, China can restart short-term economic growth if it so chooses simply by becoming more accommodative on the bank lending. Unlike the U.S., China can quickly and effectively inject credit into the market by force banks to lend merely by demanding that they do so. Easing credit conditions would re-grease the small to mid-sized business trying to feverishly compete and grow.

In terms of western business, there are a number of anchor brands on display in China. In the cities, luxury goods are hot items if one can afford such decadence – Coach, Luis Vuitton and Tiffany's dominate the consumers' mind share. On the street corners, Starbucks, KFC [Yum Brands] and McDonald's have a strong presence and are well trafficked; in the hands of these consumers are Apple, Samsung and HTC mobile devices. Caterpillar and Timberland boots welds dominance in the construction pits. And large, multinational western consumer products companies are making big, deep-pocketed bets in the country verified by Coke, Pepsi and Procter & Gamble's presence.

While the vivacious growth that embodies China is something to see, the reality is inescapable – China will indeed eventually slow.

In closing out this report, I felt it incumbent upon me to mention one under the radar narrative; a data point that I never would have gathered nor conceptualized from merely reading research from my desk: the significance of 2012 for the Chinese people. In the Chinese zodiac, 2012 is the year of the Dragon. This sign is widely seen as the most coveted year by the Chinese, the dragon conveys power and a feeling of what they called "I reign"; it circumnavigates once every 12 years. According to my many conversations, the government and the people of China simply would not allow their symbol of power on the global stage [economic growth] appear weak in year represented by the dragon. The more time I spent talking to people about this and the more I saw how much symbolism means to the China community, the more I appreciated it as a piece in the 2012 economic puzzle.

From our western viewpoint, I recognize this all may sound a bit mad. But consider this.

In Shanghai, the most coveted, most expensive real estate in a city of 23mn is a spot referred locally as the "Dragon Point." This spot is significant primarily for the Feng Shui this spot represents. Premiums paid for condos here range from ridiculous to astronomical. Also, license plates with the number 8 sell at rich valuations as the number represents luck in the Chinese culture. These symbolic elements are very real and quite powerful in the minds of Chinese culture.

Moreover, we all know that statistics [like GDP] from the Chinese government are often a virtual blackbox. Even if underlying Chinese growth truly slowed beneath 8%, I don't think it unrealistic to anticipate the government reporting 8-9% simply due to the significance of the calendar year. Markets would cheer this level of growth. In addition, I think the Chinese consumer is prime to spend more in this symbolic year. Also, many parents have carefully planned to birth new babies in 2012 as it's perceived that strength, success and vitality will befall them. This baby boom would mean more consumption

The caveat, of course, in placing any weight on this admittedly unusual symbolic data point assumes a certain level of Chinese control in the global economy's near-term destiny. In other words, if the world economy derails at the behest of a European banking shock, there is only so much sway China has. Yet, supposing sluggish growth in developed markets [currently, our highest probability scenario] in conjunction with China's most recent Q3 GDP growth rate of 9.1% [moderated, but still robust] and the activity levels I witnessed, maintaining slightly diminished but similar growth momentum in 2012 is the likely condition, in my view.

CONCLUSIONS

What I see in China at this point is major opportunity for economic growth and mobility. The domestic consumer, while still more conservative than us spend-happy, credit-driven westerners, seem to be poised for meaningful development. Luxury brands are in high demand for many citizens. On the other hand, the rural areas represent the majority of the 1.34bn population and most of these people are very poor. Getting them off of a few bucks a day and bringing them into the economic fold over the next couple decades represents a phenomenal opportunity both for China itself, and for multinational companies selling into China. This, admittedly, is easier said than done. China's income inequality is widening and the pace of this bifurcation is picking up speed. For the time being the poor's consumption is marginal.

As far as infrastructure and investment, there appears to be enough in the pipeline to sustain a major growth cycle in China for the next 12-18 months. We hear of these empty cities; I certainly understand why now after seeing the congestion all over China and the need to build, upgrade and expand.

While the bubbly growth that embodies China is something to see, the reality is inescapable – China will indeed eventually slow. A country simply cannot sustain 9-10% growth rates in perpetuity esp. when much of the recent growth has been fueled by real estate. The excitement in real estate is energetic, putting it mildly. There is certainly a feeling frothiness given the stories of price appreciation, apartment flipping and the frequency of the topic at the general conversation level. It's a dangerous path, and



those of us in the developed world painfully understand how that story ends. That said, the question: is the material slowdown now, 1 year, 3 years, 5+, is what's crucial to explore.

Presently, the data is mixed, but in my opinion it's further out that a year. Indeed, the growth rate will likely not appreciably slow as early as 2012, like some are calling for. I think a "soft landing" of 8-8.5% is absolutely achievable over the short-term. The confluence of still-robust infrastructure spend, booming business environment, increasing domestic consumption [esp. given higher wages and real estate wealth], the symbolic year of the Dragon [2012], and China's tilt toward pro-growth policies as opposed to hawkish inflation fighting when the going gets tough, lays the framework for my reasoning that 2012 will see a relative trend continuation in China. Eventually, the real estate inflation and subsequent declining property prices will chop China off at the knees. I just don't think that time is 2012.

Therefore, if China's innards are likely self-sustainable over the short-term, what is the biggest risk to Chinese growth over the coming 12-18 month period? I think the answer lies closer to home; China's trade partners, its customers, us westerns who have fed on the cheap goods for years.

If developed economies slow, or crash, the pace of manufacturing in China will grind to a much slower pace. In this vein, competition from Southeast Asia, where labor and capital costs are increasingly more favorable representing better ROI profiles becomes more eye-catching. This growing cost advantage has helped this region ramp up their global manufacturing footprint swelling FDI at China's expense. These capital flows have the effect of fueling big building and investment booms.

China has relied upon their dominance as the world's low-cost factory base for over three decades in order to propel growth. Undoubtedly, there are signs of fatigue in the system and eventually this stress will cause some major cracks sending a negative economic ripple effect, which China must buttress with targeted and sound policy. But, as asked so many times before, the question is when ... and again, in my view it does not appear to be 2012.

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