July 1, 2013

How the BRICs Stack Up: Part 3
China: How to Keep the Mojo Alive

Over the last few decades, China has experienced breakneck economic growth. In fact, just within the last 30 years, China's economy has grown from the size of the Netherlands to the 2nd largest economy in the world. China has experienced a manufacturing revolution, becoming a low-cost supplier of goods and an important trading partner to many countries. Global growth has been boosted by China's insatiable thirst for importing commodities as well as their cheap and seemingly endless supply of labor to drive exports.

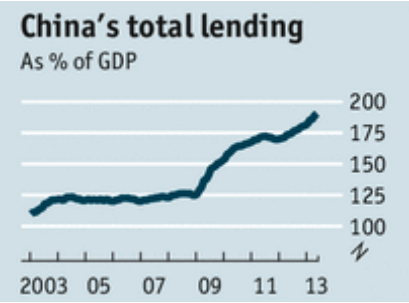

Chart 1. China's total lending.
Source: The Economist

Rural farm dwellers have migrated to the cities in search of jobs, more opportunities, and higher wages. The average individual savings rate is high, creating a source of capital that can be invested. Unfortunately trust in the banking system is low and the CD rates paid by the banks are not compelling.

Because of this, many Chinese prefer to invest in hard assets, especially real estate. Investments in real estate have been largely financed by second-tier banking institutions (Chart 1) or personal loans, sustained by strong job and wage growth. It is not unusual for wealthier citizens to own multiple properties. A real estate pricing imbalance similar to what the U.S. experienced is likely building as these leveraged "savings vehicles" may fail to hold their current market values. (Chart 2) Let us hope that this real estate euphoria will not end in a full-blown credit crisis.

In spite of its current momentum, China now faces some serious headwinds. The following is a list of current and/or future impediments to growth.

- Pressure from developed nations to let the currency strengthen, reducing the cost-advantage of exports. (Chart 3)
- Increased tariffs and punitive actions against certain sectors for "dumping" their products into overseas markets, viewed as an anti-competitive strategy.
- Lack of financial information transparency, a history of misinformation and few legitimately investable securities in the Chinese market because of complete government control.
- Uneven flow of foreign direct investment (FDI) into China, making local currency harder to manage.
- Complete government control of the banking system – both "good" and "bad" banks.

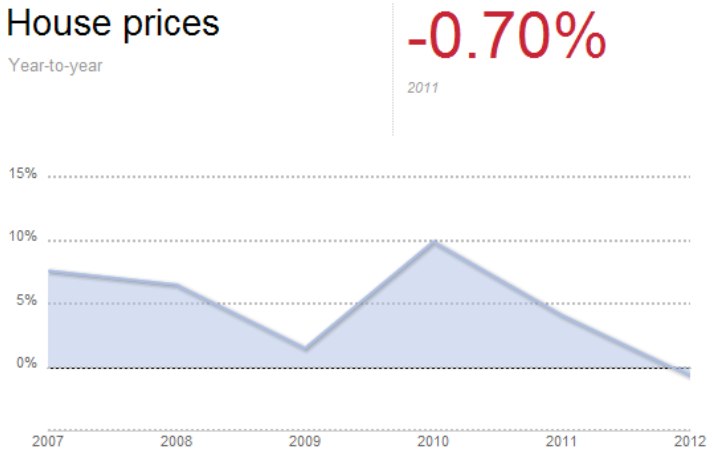

Chart 2. China's home prices.
Source: National Bureau of Statistics, WSJ

- ✘ Inflationary pressures driven by rising wages and competition for skilled labor.
- ✘ A poor educational system which does not provide adequate school opportunities for all children.
- ✘ Reliance on developed, slow-growing economies for export-led strength.
- ✘ Poor quality control on food and other products.
- ✘ Ongoing human rights abuses.
- ✘ Limited access to the global online community and available information resources.
- ✘ Rampant corruption and bribery and ineffective central policy to curb it.

If foreign investors and large companies decide to take their capital elsewhere, the equation could change dramatically.

No doubt these are but a few of the many challenges faced by the Chinese people. The future, however, is bright if a few of the following items fall into place.

- ✓ China becomes a consumer-driven economy, supported by internal demand.
- ✓ China does not start a war with its neighbors.
- ✓ Foreign investors continue to invest heavily into the Chinese market.
- ✓ China is able to avoid civil unrest.
- ✓ China puts a priority on cleaning up their environment so that they don't run out of needed resources and healthy workers.
- ✓ China embraces political and economic reforms that will allow the above to continue into the future.
- ✓ Chinese people place ethical and moral standards above their personal interests.

Should the new government under Mr. Xi decide to reform the current protectionist system to allow foreign companies to consult with businesses and sell freely to Chinese consumers, it could drive more decades of mutually-beneficial global growth. If not, growth will continue to sputter.

As U.S. citizens, we are best able to capitalize on the Chinese story by investing in multi-national companies who are able to export their management expertise as well as their goods and services to the local Chinese. It is in the globe's best interest for China to maintain their mojo.

- Rachel Wakefield, CFA

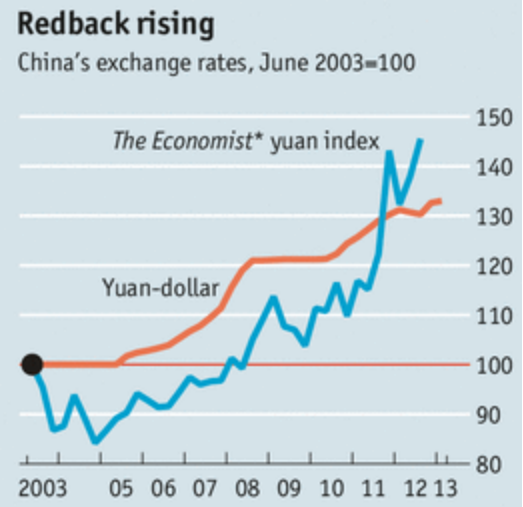

Chart 3. China's exchange rates.
Source: The Economist, Thomson Reuters.

***Trade-weighted and adjusted for unit labor cost**