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INVESTMENT PUBLICATIONS HIGHLIGHTS

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"The Chinese Consumer: Rising Star for the Next Decade"

Annie Lie, BCA Research, April 2012

China is at a critical turning point. It is transitioning from a growth model centered on investment and exports to one based on domestic demand. This change will offer investors many opportunities, but not without a wide range of risks.

China's transformation into a global powerhouse has profoundly affected the world, from both an economic and investment perspective. Chinese growth has brought about a decade-long commodity bull market, the entry of millions of Chinese workers into the global labor force, and a financing of the U.S. trade deficit via low interest rates. In China's most recent five-year plan, emphasis was placed on the need to transform from an investment- and export-centric model to a model focused on domestic consumption. As China makes this shift, it will generate tremendous opportunities for companies that are able to tap into the rising incomes of its expanding middle class.

Chinese consumption is not starting from the low base some believe. China does have one of the highest savings rates among major economies, but its households are more likely to spend than conventional wisdom suggests. In fact, private consumption has grown around 10% annually for the past two decades, and China's monthly retail sales are approaching the level of those in the United States. In any event, rising incomes, an aging population, the expansion of household credit, and an improving social safety net will all encourage lower savings and greater domestic consumption. A successful transformation will enable the emergence of a middle class that is larger than Europe's entire population.

There are three main avenues to play the consumer story in China: buying equities of Chinese companies that are available to international investors or exchange-traded funds that track the performance of domestic A-shares; owning multinational companies in developed markets that have large and increasing sales and earnings from China and other Asian countries; and proxy plays on Chinese growth through commodity and currency markets. While each strategy of playing this growth story may reap rewards, there are inherent risks.

China has already experienced the fastest growth for the past two decades among major economies, yet its stock market has consistently underperformed. Two key explanations are valuations and dilution. First, Chinese stocks were extremely overpriced in 2000, and it has taken years for valuations to fall back to reasonable levels. Second, earnings per share growth has trailed overall company profits as the increase in share count for many Chinese companies reflected structural reforms that sought to increase liquidity and dampen volatility. Also, some of the share dilution has reflected insider self-dealing, which has come at the expense of shareholder interests (mainly in the A-share market). Investors should stick to H-shares going forward, as valuations are more compelling, dilution is not as prevalent, and governance standards are stronger. Indeed, the prevalence of institutional investors in the H-share market encourages both discipline and rationality. Going forward, H-shares should continue to

perform well, as they have been among the top-performing global indices since 2000.

Buying multinational companies that have large and increasing sales and earnings from China and other Asian countries is another attractive avenue for obtaining exposure to Chinese consumers. Currently, just 6% of corporate America's revenue comes from Asia excluding Japan, but this number is growing rapidly. Already, China is Apple's second-largest and fastest-growing market. Yum! Brands—the owner of Kentucky Fried Chicken, Pizza Hut, and Taco Bell—has higher revenues and operating profits from China than from the United States. Similarly, strong German brands—Audi, BMW, and Daimler—are seeing dramatic growth in China.

As China internationalizes its currency, the renminbi should strengthen against global peers given gains in productivity. With respect to commodities, continued urbanization—not just in China, but other emerging economies—should continue to support prices for several more years.

None of this is to say that there are not substantial risks as this transition occurs. A shift toward consumption, rising wages and interest rates, and a liberalized currency will present financial and political challenges. The good news is that these risks are widely known. In its 12th five-year plan, China emphasized the expansion of social safety nets, and has recently taken steps for the internationalization of its currency. The government, banks, and households all have balance sheets that will cushion the transition. Inevitably, the road to prosperity will not be without bumps, but today is likely as good a time as ever to invest in China's consumer story.

"The Future of the Yuan"

Sebastian Mallaby and Olin Wethington, *Foreign Affairs*, January/February 2012

As the world's largest exporter, sovereign creditor, and second-largest economy, China is certainly not lacking for superlatives or influence on the global economic stage. While the yuan rising to the status of the global reserve currency is certainly a possibility, a more likely outcome is that the yuan continues its ascendance to assume a place among the secondary global reserve currencies alongside the euro, pound, Swiss franc, and yen.

The view that the yuan will eventually displace the U.S. dollar as the world's reserve currency has become fashionable in certain circles. This is viewed as the end result both of U.S. domestic events, where indebtedness threatens the value of the dollar, and those in China, where officials have since 2008 launched a concerted effort to internationalize the yuan. A more likely outcome is that the yuan continues its ascendance to assume a place among the secondary global reserve currencies alongside the euro, pound, Swiss franc, and yen.

In some respects the U.S. dollar deserves to lose its current favored position. China's exports are now greater than those of the United States, reducing the dollar's usefulness as a medium of exchange, and the U.S. dollar has lost value in recent years, weakening its usefulness as a store of value. However, currency appreciation has several downsides, which explains historically why it has been resisted by many emergent powers; rising currencies can harm competitiveness and weaken central control of financial systems. For example, despite the United States becoming a larger economy than the United Kingdom in 1872, the dollar wasn't allowed to completely usurp the pound until after World

War II. China also may require significant time before it freely lets its currency fluctuate against global peers. Therefore, recent policies should be viewed as a compromise among a Chinese leadership that understands these issues but is uncomfortable with the exposure of its economic model to the dollar.

The shortcomings of China's export-led growth model became apparent in 2009, when the fallout from the credit crisis in Europe and the United States caused global growth to plunge and saw China's growth shrink from above 10% to just over 6%. Further, China had used the dollar reserves it had accumulated to purchase assets such as securities rated AAA issued by U.S. housing agencies, which fell in value until the U.S. government eventually stepped in and guaranteed their obligations. As a result, Chinese leaders accelerated a nascent effort to internationalize the yuan. There were several aspects to this effort, including the central bank urging greater international use of special drawing rights (SDRs) as an alternative to the dollar, and including the yuan in the SDR basket. The Chinese government also began to encourage trade settlement in yuan, by opening up swap lines with other central banks and starting to allow regions and provinces to trade with Hong Kong in yuan.

However, structural and political problems hinder the reform effort. To handle large amounts of unrestricted foreign capital moving in and out of its banking system, the Chinese financial system needs to be well capitalized and provide depositors and creditors with the kind of assurances of transparency and rule of law to which they are accustomed. Bond markets must be deep and liquid. Savers and investors will gain more investment options as a byproduct of these changes. State-owned banks, which effectively pay below-market interest rates on deposits, have resisted. State-owned construction companies, which build China's infrastructure, do not want to give up their access to cheap capital. Finally, politically connected exporters, which benefit from the cheap peg, are not keen to surrender this competitive advantage. Groups that have an interest in seeing the currency liberalized, like savers, are no match for these special interests.

Further, some unintended consequences have accompanied the development of the Hong Kong market. Because the currency in Hong Kong is not subject to the same peg as the domestic yuan, it has appreciated more against the U.S. dollar. This has encouraged importers on the mainland to transfer their local currency deposits to Hong Kong, where they then buy U.S. dollars at better rates to pay for goods. As a result, the yuan is massively accumulating in Hong Kong, and the central bank of the mainland is finding it harder to dispose of its dollars. Perversely, China's attempt to internationalize the yuan has seen its central bank actually accumulate more U.S. dollars.

Eventually, China's currency will grow in international importance. But first, the domestic financial system must prove its ability to handle its status as a center for global finance. As long as China remains a state-run, centrally planned economy that is almost entirely based on growth supported by exports and government-directed lending, the currency cannot be freely convertible. The yuan may one day be worthy of a reserve currency status, but at present any talk of the yuan replacing the dollar as the world's reserve currency is largely overblown. ■