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SAFE HAVEN CHINA

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- **A Safe Harbor in a Debt-Stressed World**
- **Low Debt/GDP, Prompt Reaction to Bubbles, No denials**
- **High-Growth Economy with Geographic & Domestic Balance**
- **Smaller-City & Western Growth Already Surpasses the Coast**

We have been a regular visitor to China for six years. We recently returned from Beijing's financial sector with the same optimism and respect intact from our initial "China Factor" reports of 2004 and 2006.

Over this period, China has attracted frequent doubt about sustainable economic growth and criticism of its banking and financial market integrity. Neither concern has yet proven correct, while China's subsequent development has arguably taken it to much higher ground than for many of the world's leading developed economies.

During this period, excess financial sector leverage ultimately undermined the U.S. housing market, which subsequently precipitated the 2008-09 "Great Recession". Much of this debt has been "socialized" onto the U.S. Government's balance sheet.

Similarly, excess indebtedness is further undermining most European economies. This has also undermined the Euro, temporarily reducing U.S. "risk-free" interest rates as safe-haven liquidity pools seek comparative strength in the U.S. dollar. In a sense, the two largest currency markets are simply in a competition to be less weak.

When it becomes fully convertible, the Renminbi may well jump from understudy to viable candidate as a safe-haven currency destination. In the interim, Chinese equities are looking far more appealing than US or European alternatives.

It is in stark, ironic contrast to consider China at the opposite end of this risk spectrum. While real estate prices have recently soared in some of China's largest urban markets, such as Beijing, this has largely occurred without the distortion of leverage. Moreover, as property prices have risen, policies have rapidly been put in place to restrain speculation and further curtail the use of credit.

While we originally focused on China's financial sector for strong, yet sound growth, we are beginning to see an additionally compelling attraction – comparative safety.

Injecting a metaphor, after 23 years we note that sculptor Autoro di Modica's bronze bull in downtown New York now has a companion on Shanghai's Bund, which was just unveiled last month. This bull is red, a cultural favorite, but has another beguiling twist: The bull's head is turning to the right instead of the left. At the risk of straining this metaphor, we note that China has now matched decades of rapid economic expansion with highly conservative financial disciplines, clearly more so than in West.

China has simply built a better balance sheet than most industrialized economies. While we can cite various ratios to illustrate this point, **we have come to view their comparative absence of denial as the key reason for this success.** Rather than condone and carry increasingly suspect levels of debt to value, China has quickly and routinely reached for the monetary, fiscal and regulatory brakes.

Shortly after the U.S. financial crisis, investors began worrying that China would suffer contagious consequences. Nevertheless 2009 real GDP growth once again exceeded 8%, at the time something only the Chinese were expecting. Yet the Shanghai CSI 300 lost 73% from its peak value, while the S&P 500 lost 58% as US GDP experienced its worst collapse since the Great Depression. The CSI recovered 51% of its loss while the S&P recovered 61%. Both countries stimulated. China did so more effectively.

The US now remains somewhere between a weak recovery and another decline, while China is taking measures to rein in growth under 10-11%. The CSI is now 28% off its more recent high, while the S&P is only down 12%. Price/earnings ratios for the Shanghai market are at their lowest in a decade.

The U.S. and Europe are sneezing badly in unison, but China's underlying economy refuses to catch cold. That is not what the consensus models were predicting. Why?

Most observers would grudgingly agree that China's long-term growth potential far exceeds that of any fully-developed economy. This higher growth is repeatedly and mistakenly thought to be fragile, lacking balance and vulnerable to sharp downswings. And yet it refuses to meet these skeptical views.

Supremely ironic considering our era, not only do we believe China's exemplary growth will persist, but its balance sheet risk remains considerably lower than the likes of Europe and the U.S. We highlight two considerations that should increasingly support China's appeal to risk-averse investors:

Debt Ratios at the Opposite End of the Spectrum

The simplest illustration of China's balance sheet strength is to rank it against other economies according to public sector indebtedness. In today's market, most professionals can recite the debt/GDP ratios of Portugal, Ireland and Greece by heart, but they may have overlooked this measure for many emerging market economies. There are numerous versions of these ratios, and they are never completely comparable. Many capture the federal or national-level debt but are inconsistent when tallying regional or local-level obligations.

However crude, the most common summary indebtedness ratios portray a stunningly wide spectrum. The U.S. Central Intelligence Agency routinely updates debt/GDP ratios, and is currently showing the 10-largest developed economies averaging an 80% ratio, compared to 35% for the 10-largest (non-Japan) Asian economies and 34% for the 10-largest Latin economies.

Government Debt to Gross Domestic Product – 2009 Estimates

Japan	192	Netherlands	62	Mexico	38
Italy	115	Norway	60	South Africa	36
Greece	113	Philippines	59	Taiwan	34
Belgium	99	United States	53	Czech Republic	33
Iceland	95	Spain	50	Indonesia	30
Egypt	80	Panama	50	New Zealand	29
France	80	Argentina	49	Korea, South	28
Hungary	78	Turkey	49	Peru	26
Israel	78	Malaysia	48	Australia	19
Germany	77	Poland	48	China	18
Portugal	75	Brazil	47	Hong Kong	18
Canada	72	Colombia	46	Chile	9
United Kingdom	69	Thailand	46	Kuwait	8
Austria	67	Switzerland	44	Russia	7
Ireland	64	Sweden	43		

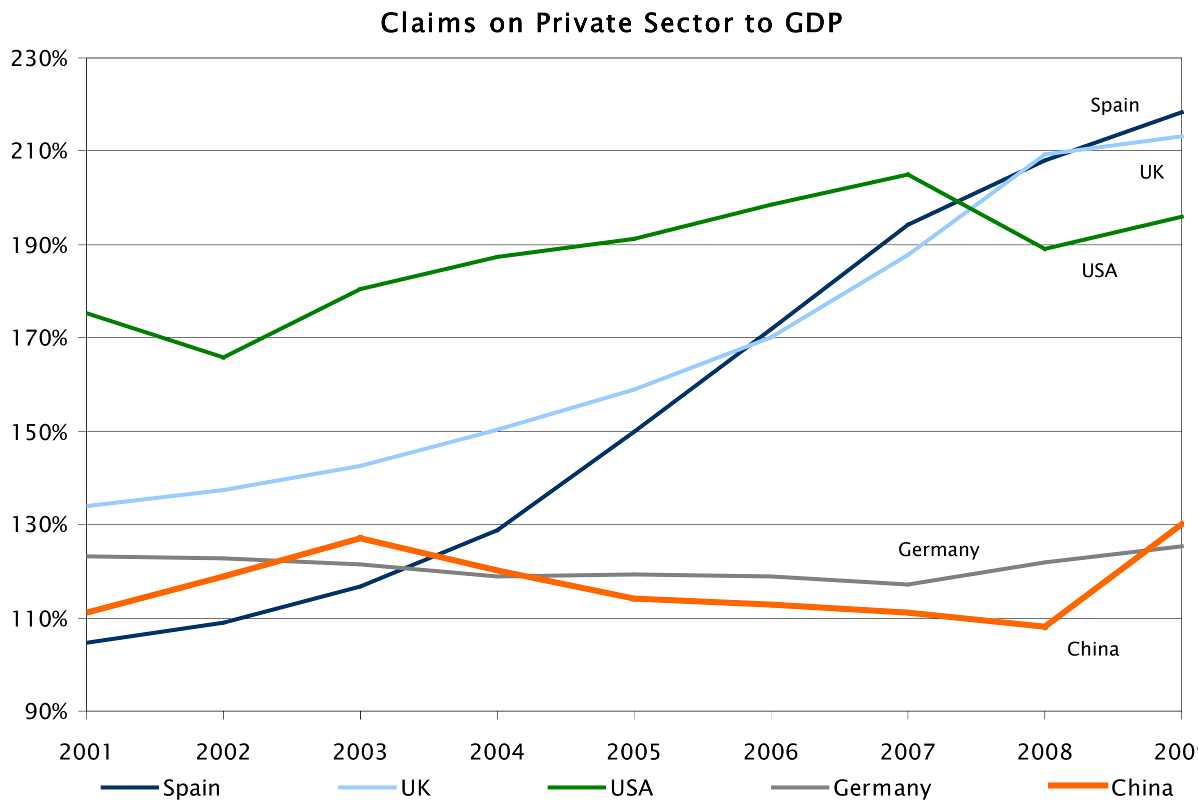
Total of all government borrowings less repayments that are denominated in a country's home currency
Source: CIA

Greece, Hungary, Italy and Portugal combine for an average 95% debt/GDP ratio. The U.S. was at 53% for 2009, on its way to 73% by 2015, with a currently estimated range of 77-90% by 2020. The U.K. is approaching 70% and Spain is moving above 50%.

Remarkably, China rests at only 18%.

Comparisons for private sector leverage are equally difficult to assemble, as financial systems and structure vary by country. Developed countries certainly have more financial intermediation mechanisms than typically found in emerging markets. The U.S. is the most "over"-developed in that sense, as lending from banks is only a fraction of total private sector credit, with a plethora of non-bank sources including money funds, specialty finance companies and asset-backed securities. Using IMF data for category consistency to assess these disparities is helpful, although imperfect, and the data often tends to lag by more than a year.

Nonetheless, the exhibit below is quite striking. The absolute levels of private sector credit to GDP are interesting, albeit susceptible to these categorization errors. The more powerful observation, however, is the marked difference in the leverage trends. On both of these measures, **China seems to be in closest company with Germany**, one of the most disciplined and responsible countries in the developed world.



Conditioned with the disturbing economic and political narrative in the U.S. and Europe over the last two years, investors are understandably worried, even cynical over any apparent price bubble in housing and commercial real estate anywhere. Unsurprisingly, there has been a very harsh, knee-jerk reaction over China's property markets.

The suspected bubble comes with ample, dramatic evidence as China's aggregate real estate market value is about to bypass both the UK and Japan. Metropolitan Beijing prices are up 35-40% over the last 12 months, where luxury apartments rival Manhattan levels. Vacancy rates are quite high.

While there is an active debate, for several reasons the financial risk simply doesn't measure up to the incendiary debt bubbles in the U.S., UK., Spanish or other "developed" countries.

1) Per capital incomes are bubbling as well: Residential property prices have been growing at an exceptional 11.4% compound annual growth rate nationally for China over the last five years. Double-digit home price growth resonates and inflames investor fears, after causing such catastrophes in the U.S. and European markets.

But there is a powerful difference. In China, urban and rural income per capita have actually been growing at 13.2% and 14.2% compound annual growth rates respectively for the same five-year period. **Incomes are rising faster than home prices.**

Additionally, urban migration has averaged nearly 16 million per annum over the last five years. Urban DPI is triple rural DPI. Population migration within China has been poorly understood. The simplified model has rural farm workers in the deep West moving to the coast and settling in three or four coastal cities. China has 122 cities with over one million in population, 41 with over two million, and 13 above four million. Beijing, Shanghai and Shenzhen understandably attract much of the attention as presumed migratory destinations, but account for under 5% of China's actual urban population.

	Total Population MM	Urban Population MM	Urban Change MM	Urban Income Per Capita RMB	Rural Income Per Capita RMB	Residential Property Price RMB / SqM	Beijing (18MM) Residential Property Price RMB / SqM	Guangdong (96MM) Residential Property Price RMB / SqM	Liaoning (43MM) Residential Property Price RMB / SqM
2002	1,285	502	21.5	8177	2713	2092	4467	3022	1991
2003	1,292	524	21.6	9061	2930	2197	4456	2994	2131
2004	1,300	543	19.1	10129	3234	2608	4972	3597	2316
2005	1,308	562	19.3	11321	3916	2937	6162	4149	2652
2006	1,315	577	14.9	12719	4302	3119	7375	4589	2884
2007	1,321	594	16.7	14909	4958	3645	10661	5682	3355
2008	1,328	607	12.9	17068	5737	3576	11648	5723	3575
2009	1,335	622	15.2	18858	6270	4474	13224	6366	3872
5-Yr CAGR	0.5%	2.8%		13.2%	14.2%	11.4%	21.6%	12.1%	10.8%
Period Chg	**4%**	**24%**		**131%**	**131%**	**114%**	**196%**	**111%**	**94%**

Sources: CEIC & NBS (China)

2) The leverage is missing: Cash is a considerably higher component in real estate transactions. The domestic investment choice in China has largely ebbed and flowed between equities or real estate. Banks currently estimate their loan/value ratios in their largest urban areas to be approximately only 40-50%.

New residential mortgages must have 30% cash down-payment, second homes require 50% and carry a 400bp penalty rate as of May 1st and third purchases are essentially prohibited.

3) Low weighting in bank portfolios: According to CBRC data, China's banking system's loans outstanding include 12% in residential mortgage and 10% in commercial real estate. By comparison, the FDIC data shows U.S. banks at nearly triple those weightings with 36% in residential (including home equity) and 25% in commercial real estate exposure.

4) Mandatory stress testing: China’s increasingly harsh but corrective actions to prevent potential bubble damage have also been taken at the risk of short-term economic slowdown. Residential construction is unquestionably a key GDP driver, but rather than risk further price inflation, this Government was willing to see urban housing construction slow sharply. Home purchases have fallen by nearly half in just a month.

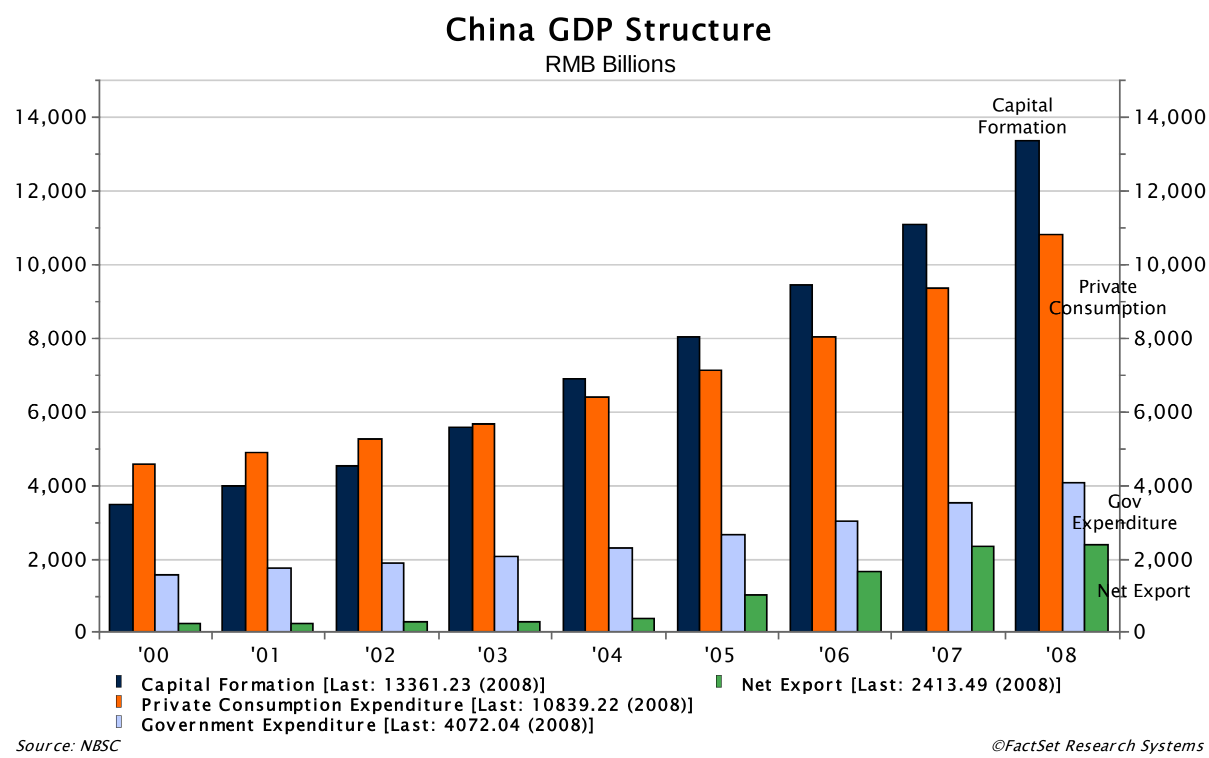
Regulators in China have consistently avoided the denial syndrome that has driven many developed economies into dire straits. All banks in China have been directed to assume a 30% drop in property prices and estimate the resulting nonperforming loan impact. In general, that impact has now been estimated at less than one percentage point.

Broadening and Balanced Economic Growth

The coastal/rural delineation has oversimplified and exaggerated real estate concerns in China. China is no more typified by Beijing than the US is typified by New York City.

A parallel oversimplification is China's reliance on exports. Exports have undeniably grown rapidly and heavily contributed to its economic achievements. But China has followed a rigorous and balanced program of economic development that additionally builds domestic demand and addresses geographical inequalities. Net exports drive GDP, not gross exports. Net exports in China have historically contributed only 3% to nominal GDP growth, as can be seen in the bar chart below.

As global demand precipitously dropped in late 2008, China's gross exports correspondingly fell in half, but were met with a comparable drop in imports. Net exports actually reduced GDP by twice as much as it ever added, as can be seen in the net-change table on the following page. Yet 2009 real GDP growth was within 15% variance of its historical growth trend line, as private sector spending and capital formation held up reasonably well. Direct government spending was not a material offset.



All RMB in Billions	Real GDP	Nominal Gross Domestic Product	Nominal Gross Domestic Product	Private Sector Spending	Govern-ment Spending	Capital Formation	Net Exports
	YoY %	Total	Net Change	Net Change	Net Change	Net Change	Net Change
1990	3.8%	1,935	204	64	29	41	70
1991	9.2%	2,258	323	128	72	112	11
1992	14.2%	2,757	499	227	84	222	(34)
1993	14.0%	3,694	937	341	128	563	(96)
1994	13.1%	5,022	1,328	543	191	462	131
1995	10.9%	6,322	1,300	653	98	513	36
1996	10.0%	7,416	1,095	559	159	332	46
1997	9.3%	8,166	749	297	126	118	209
1998	7.8%	8,653	487	231	114	135	8
1999	7.6%	9,096	443	269	136	164	(125)
2000	8.4%	9,875	779	394	195	189	1
2001	8.3%	10,903	1,028	358	184	493	(7)
2002	9.1%	12,048	1,145	362	126	580	77
2003	10.0%	13,663	1,615	459	128	1,040	(11)
2004	10.1%	16,080	2,417	757	230	1,321	109
2005	11.3%	18,713	2,633	743	407	869	614
2006	12.7%	22,224	3,511	945	413	1,510	643
2007	14.2%	26,583	4,359	1,351	537	1,799	673
2008	9.6%	31,490	4,907	1,498	585	2,739	85
2009	8.7%	34,152	2,662	1,112	266	2,397	(1,114)

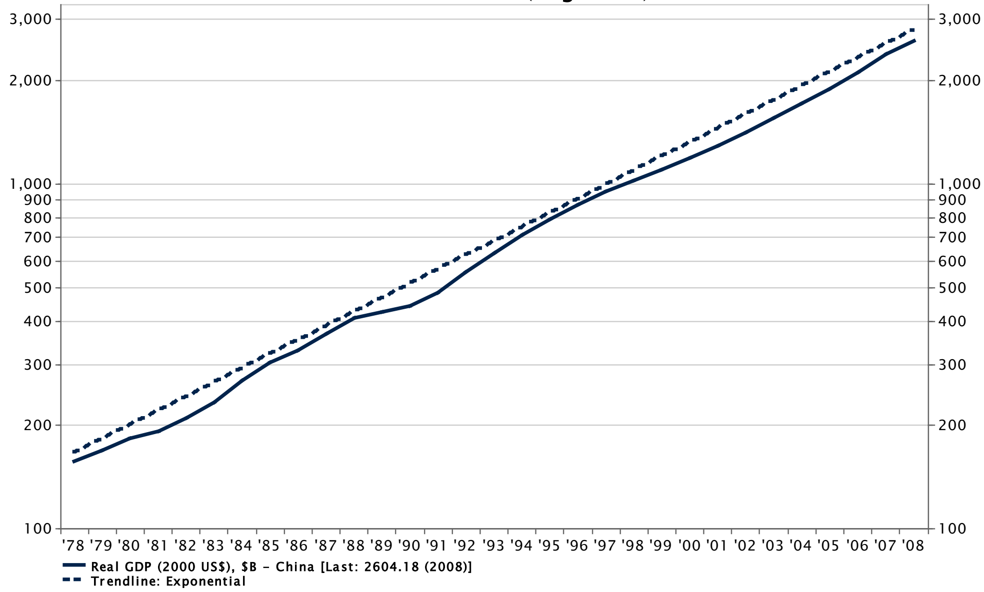
Source: CEIC

Despite significant cyclicality in global trade, China's real GDP growth has followed a metronomic, long-term growth trend line, illustrated in the log-scale exhibit on the next page. This is in no small part due to **steady expansion in domestic consumption**, in turn driven by substantial gain in per capital income. China's momentum in domestic retail sales is best shown against the world's other three largest economies. Both are graphically shown on the following page.

Some still assume that China's remarkably persistent 10% real, and 16.6% nominal GDP growth (30-year averages), presumably derives from a lop-sided boom in vibrant, exporting coastal cities, offset by moribund inland and smaller city growth. This is a prevalent but very incorrect assumption, easily made by Western visitors who tend to visit only the largest cities, which typically inspire so much awe. But China's growth is much, much broader.

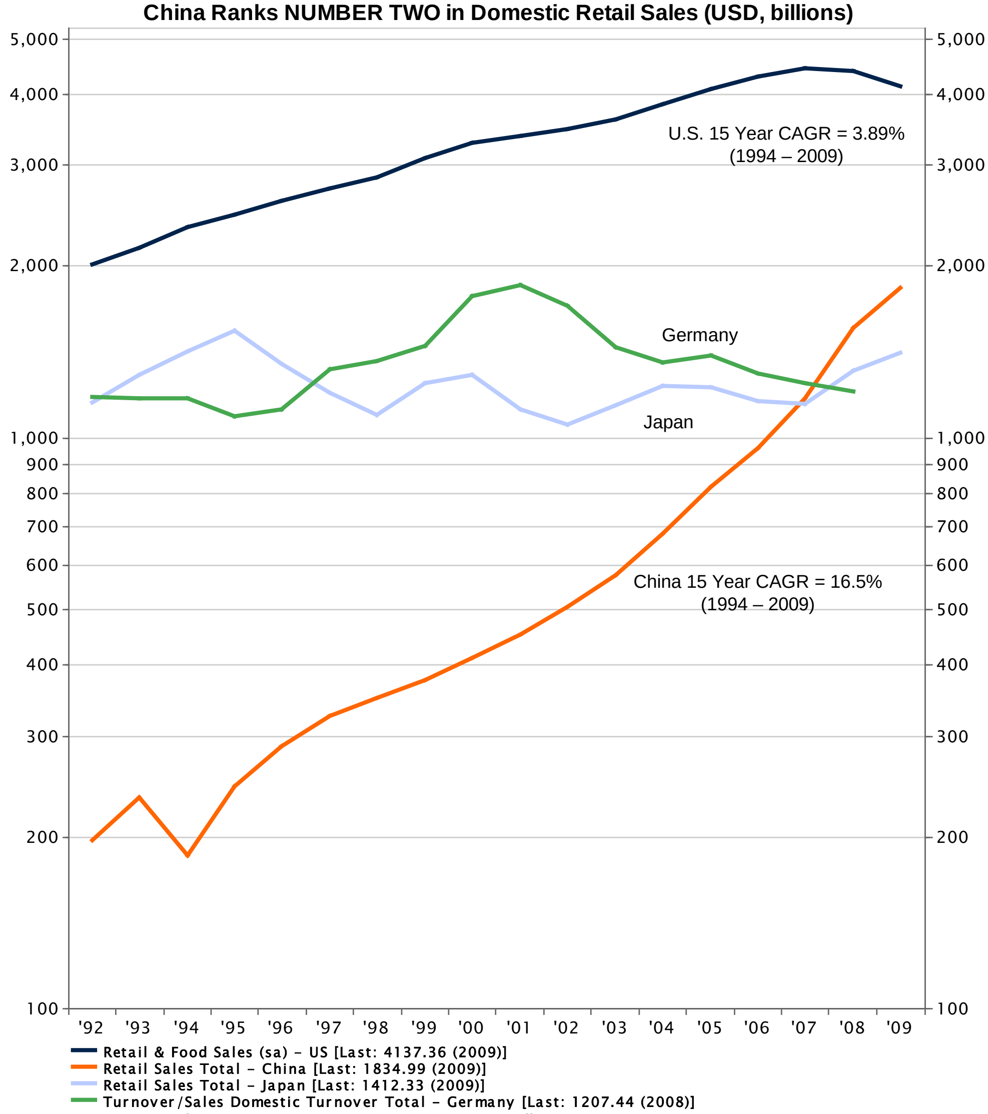
Concentrated urban growth has probably been vastly overestimated for a long time. Recently, in fact, large-city urban centers are being handily out-paced by economic expansion in county-level city areas, which make up over 46% of China's GDP. These county-level cities total over 2100 and in aggregate were experiencing 21% per annum nominal GDP growth as of 2007 and 2008 (data not yet available for 2009). This compares to only 17% for large-city urban China, which currently represents about 26% of GDP.

China Real GDP (Log Scale)



Four Largest World Economies

China Ranks NUMBER TWO in Domestic Retail Sales (USD, billions)



Source: U.S. Department of Commerce, NBS, METI, German Federal Statistical Office

Geographically, these county-level cities reside in China's 27 regional provinces and autonomous regions. They exclude China's largest cities (Beijing, Shangai, Shenzhen, Tianjim). County-level cities in Western China, long considered the least developed, least promising region, have actually been reporting 23% nominal GDP group.

Retail sales in China also displays similar breadth and vibrancy. County-level retail sales grew at 16.4% last year, nudging out the 15.5% growth in large cities, marking their third consecutive year at a superior trend. Bank deposits show similar balance.

China no longer fits the outdated, economic growth model driven by coastal exporters. China's economic advance is considerably broader. China is, indeed, a big country.

China also appears the most responsible when it comes to using leverage.

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