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We believe that Japan, South Korea and China share a common development model and a common set of problems arising from that economic system.

Japan invented this system, was the first to suffer from its shortcomings and is now finally reforming and reinvigorating its economy. South Korea appears rudderless and at risk of economic stagnation. China is papering over its problems and buying time for reform. With or without reform, China has bought enough time for Japan's improved growth to compensate for China's deceleration.

The End Of The China "Miracle" – Japan Is Where The Action Is Now

The RiverFront investment team recently concluded a two week due diligence trip to Japan, South Korea and China. The primary goals of the trip were to ascertain whether Japan is on track for a sustainable economic recovery; determine the investment merits of South Korean equities; and assess the risks that decelerating growth in China poses for the global economy.

By visiting these three economies in sequence, we gained unexpected insights into the common economic issues they all face. Each of these economies has been hailed as the latest economic "miracle" at some point over the last 30 years, and each has eventually encountered significant economic challenges. We concluded that these challenges arise from the economic model all three countries have embraced. Therefore, understanding the investment opportunities and risks in Asia requires an understanding of this "Asian Development Model" and analyzing where each of these three economies fall in the life cycle of that economic system.

Our summary investment conclusions are:

- After 20 years of stagnation, Japan is finally making significant progress toward economic reform and moving away from the Asian Development Model (ADM). For the past two years quantitative easing (QE) and a weaker yen have driven Japanese equity markets higher. We believe that continued economic reform and improving domestic demand will propel the next move higher. If the recently agreed-to Trans Pacific Partnership (TPP) free trade agreement is enacted, then Japan could accelerate its transition away from ADM and become a dynamic, growing economy again. As the world's third largest economy, a resurgent Japan could largely offset the impact of a slowing China on the global economy, in our view.
- South Korea is just now encountering the limitations of ADM as China attacks more and more of its export markets. We believe the country is at risk of repeating Japan's experience of extended economic stagnation. South Korea's small size compared to Japan and China could buy it more time to reform but no significant reform proposals are currently under discussion. Despite attractive valuations, we do not yet see promising investment opportunities in South Korea.
- China hit the limitations of ADM faster than Japan or South Korea because of its much greater population. In response to decelerating export growth, China has executed a series of policies that appear eerily similar to those of Japan in the early 1990s (real estate bubble, infrastructure binge, "extend and pretend" approach to bad debts). We believe, however, that just as extend and pretend allowed Japan to avoid a Lehman-style financial crisis, China has taken that risk off the table for the next few years. China's growth has decelerated sharply as real estate investment fell much faster than infrastructure could be increased, but growth should stabilize over the coming months as infrastructure spending comes online.

- Although we believe market fears of an imminent collapse in the Chinese financial system or economy are overblown, the long-term economic and investment prospects for China depend on its leaders adopting the painful reforms that Japan deferred. China's recently announced reform package is a good start, and it could buy time for the more pervasive reforms that will eventually be required, in our view. However, opinion is sharply divided as to whether the Xi government has the political will to follow through with the current reform proposals. Extending and pretending bad debts and pumping up growth with fiscal and monetary stimulus should allow China to avoid a hard landing for the time being, but we will need to see the proposed reforms enacted before becoming more optimistic about Chinese equity markets.

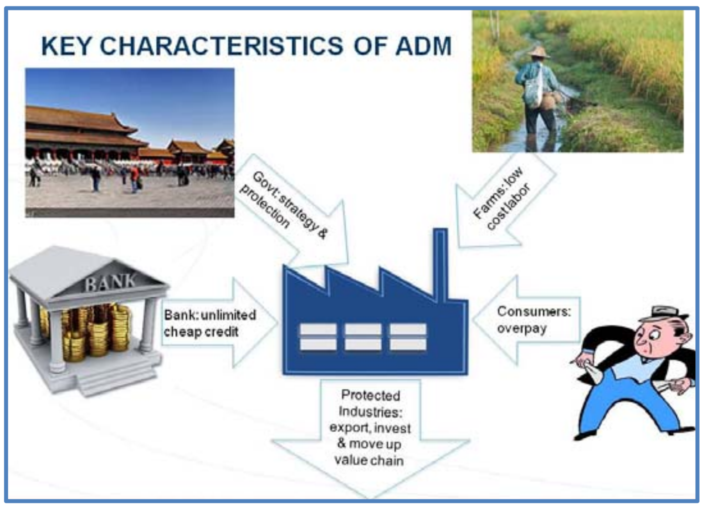
THE ASIAN DEVELOPMENT MODEL (ADM)

For the past 20 years, China has enjoyed strong economic growth and rapid industrialization. The success of their economic development model, often referred to as “Capitalism with Chinese Characteristics,” has lifted hundreds of millions of Chinese citizens out of poverty. China’s combination of top down economic direction and selective market incentives has been extolled as a potentially superior alternative to Western-style free market capitalism.

We believe that China’s development model is nothing new, and simply represents the latest implementation of the development model pioneered by Japan many decades ago. Every economy that has embraced this economic system (Japan, Taiwan, South Korea, China, etc.) initially enjoyed economic progress similar to that which has been achieved by China. However, we believe most countries that embrace this development model (often referred to as the Asian Development Model or ADM) eventually fall victim to the inherent flaws in this economic system. These fundamental flaws surface more quickly in large economies like Japan, and they can lead to excessive debt and a long period of economic stagnation. Aggressive reforms can theoretically prevent this outcome, but in practice the political alliances encouraged by ADM have created insurmountable barriers to change.

As summarized in the adjacent chart, the key aspects of ADM are:

1. The government targets key industries for development and protects these companies with trade barriers and suppression of domestic competition.
2. Targeted industries are supported with an unlimited supply of low interest loans.
3. In exchange for these benefits, targeted industries maximize exports and employment instead of profitability.
4. Workers are pulled from farms and put into factories.
5. Domestic consumption is suppressed to create a surplus for export.



A more complete description of the history and mechanisms of ADM is included in the Appendix to this report.

ADM: A Victim of Its Own Success

ADM is extraordinarily successful in lifting people from the abject poverty of subsistence farming. Export growth allows more and more workers to be drawn off the farm and into the factory, and wage gains eventually begin to make low value added exports less price competitive. Companies are directed to move up the value chain and produce higher value added exports that can support higher wages (e.g. Toyota moved from exporting economy cars in the 70s to family cars in the 80s and then Lexus luxury cars in the 90s. Hyundai is undergoing a similar transformation currently).

Although this process can catapult a country from abject poverty into a first world living standard in the space of 20 years, the system tends to fall victim to its own success. As the economy grows, the amount of exports required to continue fueling growth increases at the same rate as the economy. For countries with relatively substantial populations like Japan and China, the level of exports required to maintain historical growth rates eventually exceeds the capacity of the rest of the world to absorb all those products and services. We do not believe it is a coincidence that both Japan in the late 1980's and China, once it passed Japan in recent years, began encountering substantial economic challenges once they became the world's second largest economies.

These challenges are usually compounded by the entrance of new competitors who have also adopted ADM and therefore will follow the same script to compete with incumbent players in export industries. Japan prospered as it took market share from competitors in the US and Europe, only to stumble as South Korea adopted similar ADM techniques to take over Japan's export markets. South Korea, in turn, has had little time to celebrate the triumph of Hyundai, LG and Samsung over Japanese rivals like Honda, Panasonic and Sony. Chinese companies have already captured much of South Korea's market for steel and ships; consumer products are next on their targeted industry list. Meanwhile, China is currently being challenged by Vietnam in textiles, clothing and other labor intensive industries.

As export growth inevitably decelerates, ADM government planners try to compensate by accelerating business investment and infrastructure spending. Government policies encourage the captive banks to fund a "borrow and build" approach to fixed asset investments, and cheap, plentiful credit typically leads to a real estate bubble. When the real estate bubble bursts, government infrastructure spending accelerates to compensate. New investment spending tends to be less and less productive as capacity eventually exceeds final demand. Since the last burst of fixed asset investment is usually financed with debt, the combination of excess capacity and heavy debt loads can lead to deflation and economic stagnation (the "Japan Syndrome").

The ADM Growth Cycle

1. Export cheap stuff
2. Export value added stuff
3. Borrow and build (real estate bubble)
4. Public borrow and build (infrastructure)
5. If debt burdens pass critical thresholds then stagnation takes hold in economy.
6. Eventually reforms are enacted.

At this point, the economy desperately needs a new source of final demand and the obvious choice should be domestic consumers. Government planners recognize this obvious point and pay considerable lip service to transitioning to a "service-based" or "consumer-based" economy. Unfortunately, ADM mechanisms like trade barriers, restrictions on competition and regulated interest rates depress consumer demand but also generate considerable political support. Any attempt to allow more competition in protected industries or improve returns on savings accounts typically encounters fierce resistance. In the case of Japan, years of economic stagnation were required before a consensus was reached about the need for reform.

JAPAN, SOUTH KOREA AND CHINA: THREE DIFFERENT STAGES OF THE ADM CYCLE

Japan: First In, First Out

Japan invented the ADM and was therefore the first economy to encounter the limitations of this development system. After crippling its banks with bad real estate loans in the early 1990s, Japan spent the next two decades fruitlessly attempting to stimulate sustainable economic growth through endless infrastructure spending and other government stimulus plans. Only with the election of Shinzo Abe in late 2012 and his "three arrows" policy (monetary and fiscal stimulus combined with structural economic reform) did Japan finally accelerate the process of reform.

Our visit to Japan occurred in the third year of "Abenomics" and revealed a surprising amount of progress on badly needed structural reform. Abe's first "arrow", monetary stimulus, gets most of the attention from analysts and we agree that to date, much of Japan's progress has been based on aggressive monetary accommodation and a falling yen. Indeed, we look for the Bank of Japan to adopt negative interest rates as its next policy move, stimulating consumer spending through a "spend it or lose it" monetary policy. However, as detailed in our September 14th Weekly View, investor preoccupation with monetary policy may cause them to underestimate the power of the reform initiatives implemented by virtually all of the companies we visited.

Most companies have adopted explicit return on equity (ROE) targets. This policy represents a direct assault on one of the foundations of ADM, since under that model market share is supposed to be emphasized at the expense of profitability. Shining a spotlight on profitability helps undermine the clubby, non-competitive nature of Japan's keiretsu system. Under keiretsu, companies own major stakes in their suppliers and their customers. Keiretsu members typically only buy or sell from these affiliated companies, thus protecting one another from competition. Japan has slowly forced the dismantling of much of the keiretsu structure, but old habits die hard. The more Japanese companies must answer for profitability, the more competitive pressure will be applied to traditional suppliers and retailers. These efficiencies create the opportunity to lower costs for Japanese consumers.

Thanks to up-and-coming retailers, improved efficiency in the keiretsus is more likely to find its way into the pockets of Japanese consumers. These new entrants have exploited reforms and loosening regulations to take on established players with lower prices and better selection. The existence of these new competitors and their ability to attract financing illustrates how much is changing from the days of tightly controlled Japan, Inc.

Although much progress has been made, more can still be done. Labor markets remain fractured between highly regulated full time employees and more flexible part time and contract workers. This divide is also under assault from the simple mechanism of supply and demand. The most common concern we heard from the management teams with whom we met was finding enough young people to replace retiring workers, an unexpected benefit of Japan's demographic challenges. The worker shortage is providing a substantial impetus to Abe's drive to bring women back into the workforce, and rising female employment is helping offset a decline in the overall working age population. With unemployment at 3.2%; male, female, part-time and full-time workers are all enjoying rising wages for the first time in many years.

The recent agreement on TPP offers the opportunity for even more progress on reform. TPP forces Japan to lower tariffs and embrace reform in highly protected areas such as agriculture and automobiles. Japanese consumers pay too much for the basic necessities of life and TPP provides Abe the necessary political cover to push through badly needed reforms. As the costs of food and other consumer goods fall, Japan could enjoy a sustainable surge in consumer spending. After 20 years of relative privation, Japan's deferred consumer and capital investment needs could drive its economy for much of the next 10 years. The return of vibrancy to the world's 3rd largest economy could largely compensate for China's growth inevitably decelerating from unsustainable levels.

South Korea – Between A Rock And A Hard Place

South Korea has flawlessly executed the ADM playbook, focusing first on low value-added products like steel and then moving upmarket into automobiles and consumer electronics. Their economic challenges arise from their dependence upon China as their #1 export destination. China is following the same economic development playbook and has rapidly moved into the same value added industries. South Korea's biggest customer is becoming its biggest competitor.

Similar to the US in the mid-2000s, South Korea has maintained economic growth in recent years by encouraging home ownership. High housing costs and generous mortgage terms have resulted in South Korean consumers becoming among the most heavily indebted consumers in the world. South Korea's average household owes 160% of its annual income, compared to the US figure of about 140% at the peak of the housing bubble.

The US experience has warned South Korean government not to allow a Lehman-style bank collapse, and the Korean financial system is not sufficiently interconnected with global banking to pose a risk to the global economy. However, absent reform of the dominant family-controlled Chaebol companies (e.g. Samsung, Hyundai, LG), we see South Korea facing a difficult road ahead with few visible sources of economic growth (the country has little need for additional infrastructure spending). Prospects for imminent reform appear dim, as reflected in the South Korean saying that we heard from multiple sources: *"Presidents come and go every 5 years, but Samsung is forever."*

China – IF There Is A Will, There Is A Way

China has moved through the various phases of the ADM growth cycle faster than other ADM countries because of its vast size and the 2008 onset of a deep global recession. As export growth plunged in 2008 and 2009, China implemented an extraordinarily aggressive "borrow and build" program. Local governments engaged in a frenzy of real estate construction encouraged by central government directives and their own financing needs (local governments are largely financed by appropriating land from farmers and selling it to developers). The result of this building frenzy is a glut of half-empty and/or half-completed buildings strewn across many of China's 2nd and especially 3rd tier cities (1st tier cities are mega cities like Shanghai and Beijing, 2nd tier are provincial capitals with 3 to 10 million residents, and 3rd tier is everything else). As shown in the adjacent picture, the train from Nanjing to Beijing passes through an unvarying landscape of vacant apartment towers, commonly referred to as "ghost cities."

True to the ADM model, Beijing is now turning to infrastructure spending as an offset to falling real estate investment. We believe the current slump in economic activity is a function of real estate investment falling much faster than infrastructure spending can increase. We expect China's growth to stabilize, although not reaccelerate, as more infrastructure spending comes inline in the coming months.

The $3 trillion overhang of real estate investments and potentially bad real estate loans poses an obvious threat to China's economic stability, and the central government has taken steps to alleviate this risk. China initiated a $150 billion bond swap program in May, and quickly upsized the program to over $500 billion. Under this bond swap, banks can exchange real estate loans for a government guaranteed-bond with a 10-year maturity and relatively low interest rate. This bond swap program essentially "extends and pretends" the bad debt, pushing out the day of reckoning for many years to come. Since these bonds can be pledged as collateral at the central bank, China can print the money needed to finance the massive debt overhang. The bond swap program will likely keep being upsized until Chinese officials believe that all risk of a Lehman-style debt crisis has been pushed well into the future.

The policy combination of real estate bubble, infrastructure binge and an extend and pretend approach to bad debt bears a chilling resemblance to Japan's series of policy mistakes in the 1990s. However, China has several advantages over Japan as it enters this phase of the ADM growth cycle. First, China is still in desperate need of infrastructure investment. Water quality, public transportation and pollution controls remain woefully inadequate for the majority of China's 1st and 2nd tier cities. Second, Chinese officials believe that with proper planning the new infrastructure can actually turn the current ghost cities into productive low cost housing.

Chinese officials plan to link the ghost cities through high speed rail to the still crowded and expensive 1st tier cities. The idea is to turn the empty buildings into "vertical suburbs" for the major metropolitan areas, just as the Long Island Railroad turned rural communities into bedroom towns for New York City. The hope is that by the time the extend and pretend bonds come due, the ghost cities will be filled with workers seeking to escape the crowds, pollution and expense of big city living.

How To Pay For It All?

We believe China has a plausible plan for digging out from under their real estate mistakes of the past 7 years, but the long term success of this plan depends in large part on how it is financed. The current plan calls for China to take advantage of the fact that under China's version of ADM the government actually owns the giant, protected companies.

Rather than borrowing to finance the needed infrastructure investments, China has proposed that regional governments sell off minority stakes in their “non-strategic” state-owned enterprises (SOEs) to global investors, just as small stakes in China’s banks and petroleum companies were sold off in the 2000s. Opening these companies to foreign investment and oversight could increase operating efficiency and decrease corruption, and provide a source of funding for regional governments now that demand for real estate has disappeared.

Financing needed infrastructure with asset sales instead of debt could allow China to avoid the added debt burden that may have pushed Japan further into a deflationary spiral. Adding outside ownership to state-owned enterprises could make them more efficient and increase competition, helping move China away from the ADM model and toward a more consumer led economy.

Unfortunately, many of the people we spoke to across China were skeptical that the government will follow through with its reform proposals. The management teams that could be replaced under the reform plan are often the relatives of government officials. These same officials are often the beneficiaries of the corruption that would be eliminated. Strong political forces can be expected to oppose this plan.

CONCLUSIONS

We believe that Japan is finally reforming and leaving ADM behind. The TPP offers the potential to accelerate this process. With 20 years of deferred consumer expenditures and capital investments needing to be made, Japan could once again shock the world by becoming a major contributor to global growth. Korea, by contrast, appears locked in ADM but fortunately poses no risk to the global economy.

China stands at a major crossroads, where it will either reform or repeat Japan’s mistakes. Whether China embraces reform or not, we believe the fears of an imminent collapse in China’s economy are unfounded, despite the recent volatility in its financial markets. Extending and pretending has taken care of China’s bad debt (for now), and infrastructure spending will ensure that unemployment does not rise to destabilizing levels. Both policy responses buy time for reforms to take hold and accelerate China’s transition to a consumer led economy. If reforms are not enacted, China’s current policy response should provide sufficient time for a recovering Japan to take its place as the new engine of global growth.

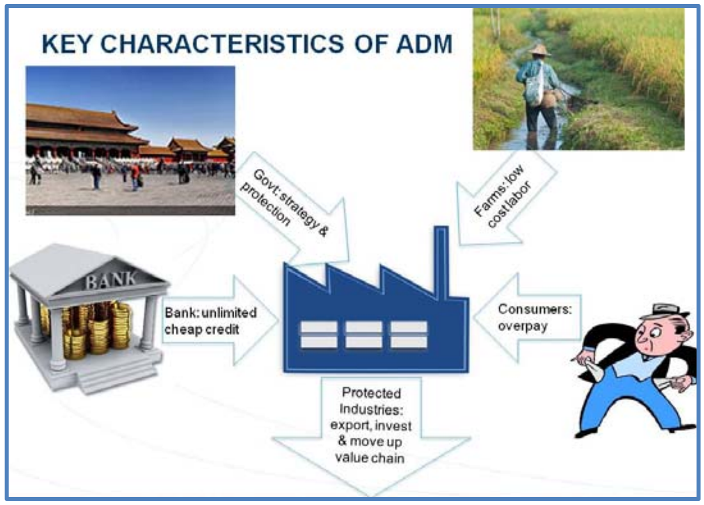
APPENDIX: THE ASIAN DEVELOPMENT MODEL

Origins of the Asian Development Model

In 1853, Japan was stunned by the appearance of US warships in Tokyo Bay. Realizing that 250 years of isolation had left them hopelessly outdated in technology and industrial capabilities, Japan subsequently shocked Western powers by transforming itself into a world-class industrial power within a few decades. The economic development system that helped propel Japan’s rapid industrialization in the late 1800’s was reintroduced (with minor modifications) to expedite the recovery of the Japanese economy after its utter devastation during World War II. Once again, Japan astonished the rest of the world by returning to the first rank of global economies within 20 years, an accomplishment that at the time was referred to as the”Japanese Miracle.” Japan’s growth model has been widely imitated across Asia, such that the system formerly known as “Japan, Inc.” is now usually referred to as the “Asian Development Model” (ADM).

As summarized in the adjacent diagram, the ADM process begins with the government identifying key industries for development. Targeted industries are usually selected by examining successful economies and mimicking their most important products and services. ADM initially targets basic industries (steel, chemicals, autos, etc.) but evolves as the economy develops and new industries emerge (e.g., smart phones, online search and social media). The government persuades companies to invest in the targeted areas by offering protection from both foreign and (in many cases) domestic competition. Government protection virtually guarantees that investments in the targeted industries will be profitable and encourages investments that might not otherwise occur.

A second key aspect of the ADM system is an assured supply of cheap credit. The specific credit mechanisms vary from country to country (affiliated banks in Japan, government credit guarantees in South Korea, state owned banks in China), but the common characteristic is that government-favored industries and companies can borrow nearly unlimited amounts at subsidized interest rates. This cheap credit allows companies to invest in the target industries with greater scale and greater speed than would be possible in a more market driven bank lending process.



The driving motivation for ADM is to pull workers off the farm and into the factory. Low productivity agricultural jobs are replaced by high-productivity factory and service industry employment, allowing for rapid gains in productivity, economic growth and worker compensation. However, worker gains through higher compensation are partially lost due to the privileges granted to protected industries. Since many companies do not face serious competition, prices for consumer goods and services are inflated.

Protected companies are expected to use the excess profits and cash flow gleaned from domestic consumers to subsidize their exports. Rapid export growth and the accompanying employment growth is expected to trump profitability, and therefore market share tends to be valued over return on equity. As export success allows more and more workers to be drawn off the farm and into the factory, wage gains begin to make low value-added exports less price competitive. Companies then move up the value chain and produce higher value-added exports that can support higher wages.

DIFFERENT NAMES, SAME CONCEPT

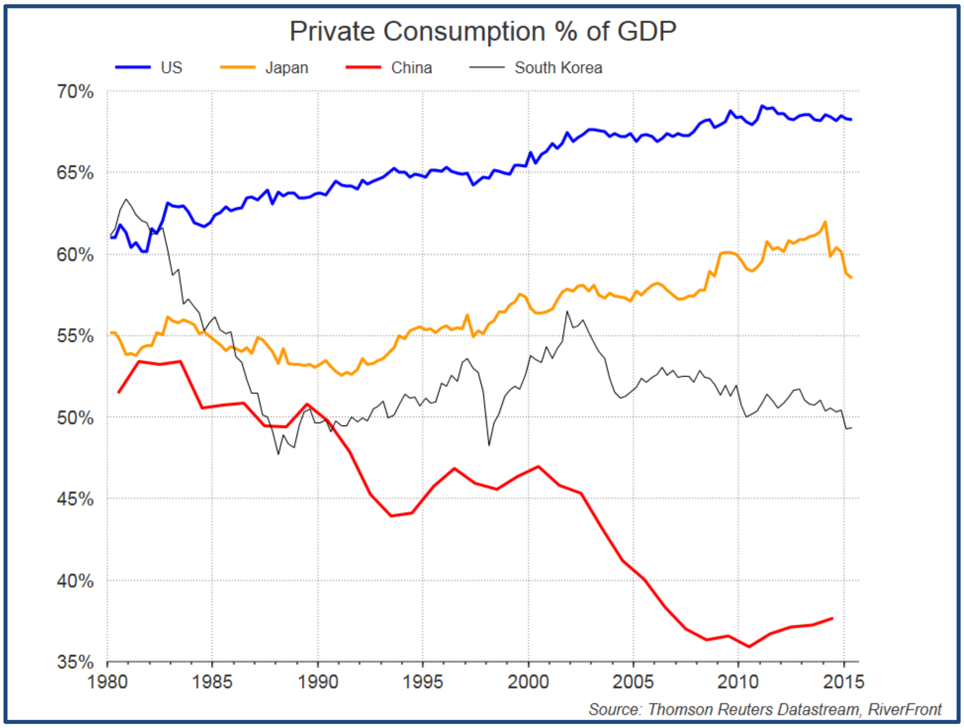
- Top down economic planning and strategic direction
  - Japan: "Industrial policy"
  - Korea: "Managed capitalism"
  - China: "Capitalism with Chinese characteristics"
- Industrial giants protected from competition
  - Japan: Kieretsu
  - Korea: Chaebol
  - China: State Owned Enterprises
- Guaranteed access to virtually unlimited credit
  - Japan: Affiliated banks and insurance companies
  - Korea: Korean Development Bank, government guarantees
  - China: State Owned Banks

ADM: Built On The Backs Of Consumers

The consumer subsidizes the ADM system through a standard of living that is far lower than their productivity could provide in a less controlled economic system, as illustrated by the simple math of economic growth. As shown in the equation below, economic activity (GDP) must come from one of four places: the products and services purchased by consumers (**C**), long term investments made by companies and consumers (**I**), total government spending (**G**) and net exports (**X**).

$$\mathbf{GDP = C + I + G + X}$$

ADM requires generating positive net exports (a trade surplus). That means that the total goods produced in the economy (**GDP**) must be greater than the goods and services used by **C**, **I** and **G**. In other words, you can't export items if they are used domestically. Therefore to have a trade surplus the economy must produce more goods and services than it consumes. Government planners do not want to depress **I** or **G** because business investment and government infrastructure spending are required to support exports and are key elements of the Asian Development Model. Therefore consumer spending must be depressed to create a surplus for export.



The chart above demonstrates this depression of consumer spending. Japan, South Korea and China have much lower levels of consumption as a percentage of GDP when compared to the US. ADM's impact on consumer spending is shown by the plunge in South Korean consumption in the 1980s and Chinese consumption in the 1990s and 2000s. These declines occurred as these economies aggressively embraced ADM. Japan's loss of export markets to these economies is similarly reflected over this time period by a slight upward trend in Japanese consumption.

Depressed consumption occurs almost automatically under ADM. First, consumers must overpay for most goods and services. In addition, banks making subsidized loans to favored companies cannot pay a market rate of interest, and so interest rates on savings are often below the rate of inflation. Savers cannot escape low returns by buying equities since companies emphasize market share over profitability, and low profitability ensures that long term equity market returns are low. Thus under ADM consumers have a disincentive to spend (prices are too high) and a compelling reason to save (low investment returns force higher savings to achieve financial goals). High savings rates in Asian economies are often explained as the result of a supposed cultural proclivity to save. In reality, high savings rates are compelled by the economic systems deployed in many Asian economies.