The Issues

January 5, 2011

2011 OUTLOOK: POLITICS MATTER

From a stock investor's perspective, 2009's sharp, across-the-board rebound in global markets was a snapback from the extreme oversold situations of the 2008 global financial meltdown. In 2010, economic recovery drove market action, which explains the wide disparities in stock market performance: the better performers were those with stronger or more visible foundations for an economic recovery, e.g., the German bourse, +16% for the year, vs. Spain, -17%, and in Asia, Thailand and Indonesia were up 45%+ vs. single-digit gains in Taiwan.

How politics evolve in global markets will matter in 2011. In the eurozone, will Spain see political cohesion or upheaval as the state is forced to bail out overly indebted banks and property investors in the private sector? The answer obviously matters. Turn PIG (Portugal, Ireland and Greece) into PIGS (+ Spain) and the euro will test new lows, and dollar strength will drive a correction in the S&P (as it did in May 2010). In this issue, however, we will confine our discussions only to China, a key economy in Asia.

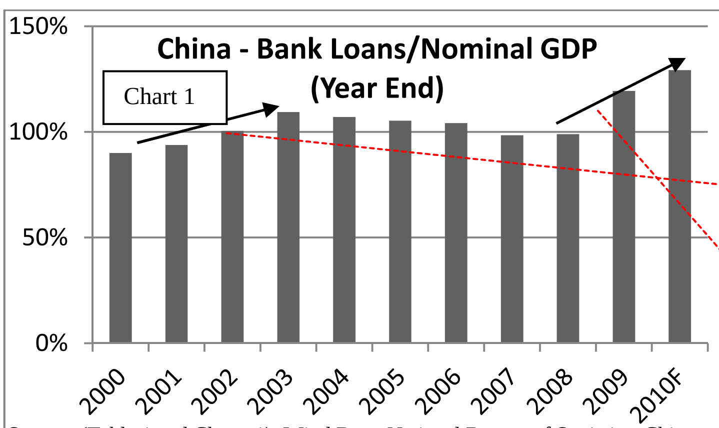
China—Very Much a Political Economy

Analysts used to regard China's economy as largely export driven until the 2008 global financial crisis demonstrated that this view was too one-sided. While the global recession did slow exports, China's huge base of domestic consumption and investments drove GDP growth to accelerate beyond 10%+ YOY, fueled by the government's easy credit policy.

China's Credit Cycle--the Source of Asset Inflation

The main driver of China's economic cycle is heavily influenced by how the Chinese Communist Party manages itself. Important posts in central, provincial and local district governments, the big-5 banks, and major state-owned firms are rotated every five years (marked in blue in Table 1). The lack of long-term career opportunities creates a built-in tendency for officials to maximize self-interests for making money (by creating credit) while in office. The asset price bubbles in 2002-03 and 2009-10 can be attributed to easy credit cycles.

What constitutes a bubble? Asset inflation and a housing boom are symptoms. Two overall gauges are: 1) a yearly rise in bank loans vs. gains in GDP (Table 1); and 2) the trend in outstanding bank loans as a percentage of nominal GDP (Chart 1 shows the cycles of the last 10 years). The former derives from ICOR (Incremental Capital to Output Ratio = Annual Investment/Annual Increase in GDP), bank loans being a primary source of investment funds in China. The higher the ratio, the lower the productivity of used capital: it offers a barometer on the degree of non-productive, speculative use of funds for activities such as hoarding of commodities, land, etc. The second ratio is the accumulation of yearly numbers.



Sources (Table 1 and Charts 1): Wind Data, National Bureau of Statistics, China.

Table 1	Loan Increase as % GDP	Loan Gr/ GDP Gr	Food CPI Peak (YOY)
2000	6%	0.33	+0.6% Feb
2001	12%	1.2	+1.7% May
2002	15%	1.7	+1% Feb
2003	21%	1.8	+9% Dec
2004	14%	0.9	+15% July
2005	13%	0.9	+9% Feb
2006	15%	1.0	+4% Jan
2007	14%	0.7	+18% Oct
2008	16%	1.0	+22% Apr
2009	29%	3.6	+5% Dec
2010F	23%	2.3	+12% Nov

The Credit Up-Cycle in 2002-03

Zhu Rongji, the central bank governor from 1993 onward and, subsequently, the fifth Premier of China from March 1998 through March 2003, wielded a strong hand against government waste and corruption, and pursued tough but pragmatic macroeconomic policies that brought runaway credit growth under control and tamed 20% plus inflation in the late 1980s down to near zero by 2000. In the midst of the 2001-02 global recession, China's GDP grew at 7% to 8% p.a. However, as a strong, strict administrator, intolerant of flunkies, nepotism and a dilatory style of work, Zhu's tight rein created resistance. His power faded well ahead of his mandatory retirement in March 2003.

By 2002 a new team was already assigned as Zhu's replacements. Those officials and their network of business associates, unable to get their hands on enough bank credit under Zhu to fund pet projects/spending/investments, now had their chance. A renewed credit up-cycle began in 2002: bank loans as a percentage of GDP jumped from 90% at the end of 2001 to 110% by the end of 2003 (Chart 1). Fixed asset investment, in the high teens YOY in 2001, surged to over 45%+ YOY by 2003-04, and the ratio of loan-growth-to-GDP-gains jumped to 1.7x to 1.8x vs. under 1.0x during Zhu's reign. This period of easy credit drove the first major asset price inflation of the recent decade. The rich started to get richer.

The Period of 2005-07
Credit growth nationwide was steady, averaging ~+15% p.a. (Table 1) over this period. The ratio of bank-credit-growth-to-GDP-gains was also steady at ~1x: each yuan of credit growth generated one yuan of gain in GDP. There was no surge in fixed asset investments, which grew at a steady pace of 25%+ p.a. Property prices in most cities in China were steady to slightly retreating from the prior 2003-04 asset boom. The record of 2005-06 strongly suggests that normalized credit growth of ~+15% p.a. for China is consistent with low asset price inflation and is sufficient to keep GDP rising at ~+8% p.a. in real terms, or ~+10% p.a. in nominal terms. The stock market boom during this period was driven more by A-share reform and government policies promoting private sector investment in mutual funds (which gave the retail public the wrong idea of a government "put," i.e., government policies that would not allow the stock market to fall).

Backdrop to the Latest Credit Binge in 2009-10
By 1H07, excess liquidity from the export-driven current account surplus, which jumped from 6% of GDP in 2005 to a peak of over 10% in 2007, plus hot money inflows into the capital account (on rising Rmb revaluation speculation) was ploughed into Rmb-denominated assets. Property prices and other financial assets contributed another strong leg up.

Rising inflation by 2H07 pushed authorities into administering stringent credit control policies that continued into 1H08. However, the global financial crisis sent the central economic planners into a complete policy reversal. When the credit flood gates opened at the start of 2009, there was no shortage of government officials and their vested interest network of local business tycoons and willing local bankers, who took out as much credit funding as they could (note: 2008 was the start of the current five-year term for these officials). As discussed in the conclusion, this credit binge was massive.

Development Economics: Government Policy on Wages—The Key Secular Driver of CPI in China
Analysts generally cite weather as the driver of food CPI and, hence, headline CPI in China. But wage policies are important factors influencing China's cycle in food CPI/headline CPI.

The Surge in CPI Inflation in 2004-05
From the 1990s to 2003, rural income gains substantially lagged those in urban areas (Chart 2). Rural income had been stagnant at ~2000 yuan p.a. per capita average (~US$300) during much of the 1990s. Since 2003-04, the central government cut agriculture taxes, raised subsidies and invested in urban infrastructure to lift rural wages. From 2004, rural income grew at double-digit rates in real terms, surpassing urban workers.

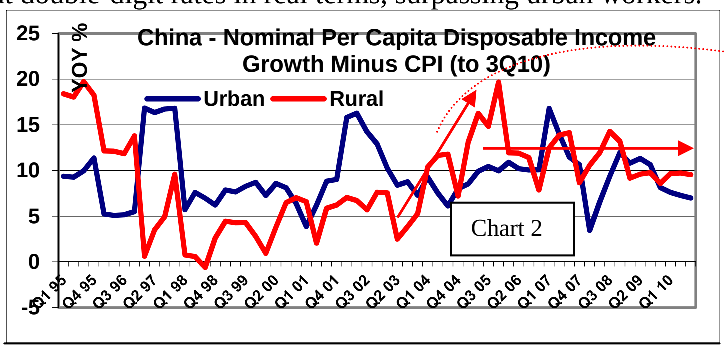


Chart 2

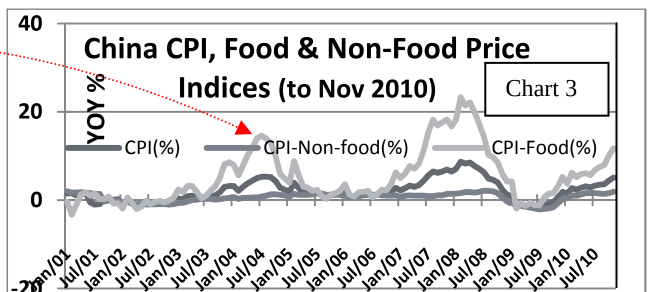


Chart 3

Sources (Charts 2-3): Wind Data, National Bureau of Statistics, China.

The small size of family farms in China limits productivity gains over the shorter term. Rising unit production costs (cost push) thus drove prices up. Higher rural income raises food consumption, e.g., protein intake. So, demand-pull causes prices to rise further, as people consume more. These factors drove up food-CPI and, thus, headline CPI, in 2004-05 (Chart 3).

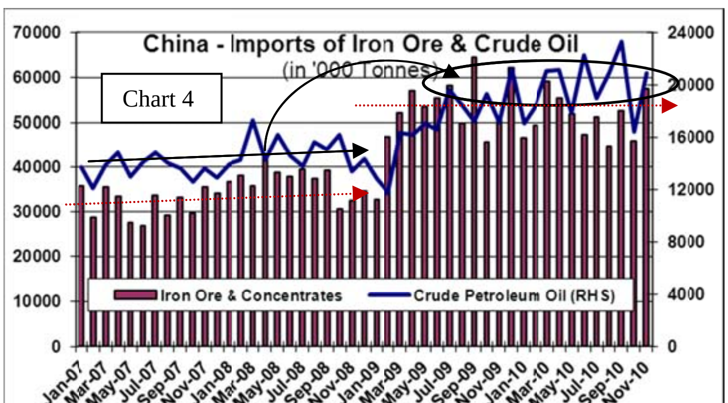
Food CPI Rose Sharply Again from 2H07 to 1H08
Global factors such as the rise in the prices of oil and grains cannot explain why, in China, pork and poultry prices surged by +45% to 50% YOY from 4Q07 to 1Q08. Cost push and demand pull factors were again key drivers of the surge in food CPI (and headline CPI) during this period as rural income continued to increase to double digits in real terms.

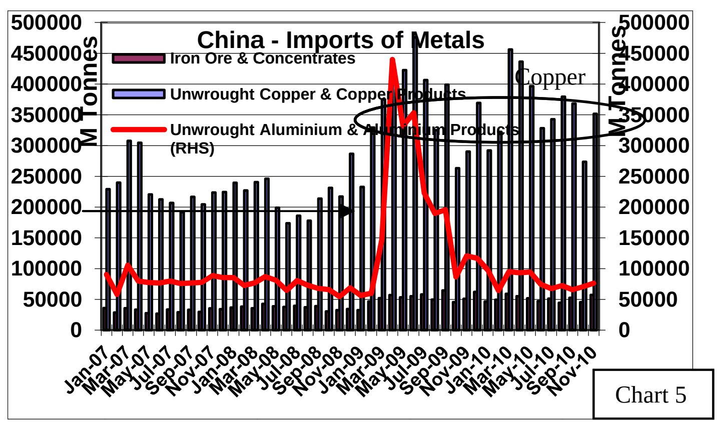
Rising Inflation in 2010-2011
The rich got even richer with the super-easy credit cycle of 2009-10 and subsequent asset price inflation. Government policies to raise rural income, for political reasons, continue —witness the implicit government support for the 30% plus increase in wages of factory workers in the coastal areas in 2010, achieved through collective bargaining. The Beijing municipal government just raised salaries by over 20% for 2011. We can expect other cities to follow suit.

<u>Similar factors of cost push (rising production costs as wages rise) and demand pull factors (higher demand as income rises) are thus driving the latest increase in food CPI (+12% YOY in November 2010) and headline CPI (+5.2% YOY). We are still in the early phase of this inflation uptrend. Market consensus of CPI peaking at 6% by 2Q11 is optimistic</u>.

<u>Conclusions</u>
The latest credit binge in 2009-10 was massive. During this period, official bank loans totaled an amount equivalent to 50% of China's GDP at end 2008. Include off-balance sheet loans (estimate by Fitch), and the figure might be 20% higher. The net loans-to-GDP-gains ratio shot up from 1x to between 2x to 3x, indicating that many of these loans went to unproductive activities such as hoarding commodities (thus adding to inflation pressures).

Charts 4 and 5 show China's imports of commodities such as crude oil, iron ore and copper between 2009-10 vs. 2007-08 are up +50% in crude oil, +70% in copper, and +60% in iron ore. Why would China's real demand be at such higher levels now vs. 2007, a year when all three cylinders were firing: exports, consumption and fixed asset investment. The answer has to be speculative hoarding of inventories, financed by easy credit.





Sources (Charts 4-5): Wind Data, National Bureau of Statistics, China.

The current group of government officials' term of office ends Mar 2013. Numerous vested interest groups want the boom to continue. This is why China is currently in a dangerous game of politics: central planners vs. vested local interest groups. The central planners have been way behind the curve in credit tightening, underestimating the degree of inflation in asset prices, food CPI and headline CPI. Either the top decision makers muster the political backing to administer much more stringent credit control, or China will risk runaway inflation. Either scenario is not looking good for 2011. Our bet is that top leaders will institute meaningful tightening, assigning loan quotas to individual banks, as they did in late 2007. Tight credit will lead to price falls in properties and a number of commodities as financial speculators exit these markets.

The Net Asset Values   GSI Asian Capital Growth –US$29.66 & Long Short Fund – US$27.21 (Dec 30, 2010)