



Creative Global Investments

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Objectivity

Integrity

Creativity

Betting The Over/Under On China— We'll Take The Over

Given the depth of the challenges facing China today, many question whether its leadership has the will to follow through on its planned reforms, which is understandable given repeated (often seemingly half-hearted) reform attempts in prior years. Premier Li Keqiang's Report on the Work of the Government, delivered last month at the Twelfth National People's Congress was not only a political tour de force for the reform movement but, in our view, an unwavering message that the shroud of secrecy may no longer be counted on as sacrosanct within government to slow progress. With transparency comes greater accountability. **We assign a much higher probability of success this time around given the degree to which the veil appears to be lifting over the process.**

The Premier's report provides the blueprint for reform missing from the initial outline offered last November during the third plenum that will enable China to reshape its economy to assure that domestic demand becomes the main engine driving growth. In our judgment, fears that the rebalancing program will trigger a sharp economic contraction are overblown given the monetary and fiscal tools available to the government. Whatever China's GDP ends up being for 2014, we're confident that there'll be a seven placed before the decimal point.

These are some of the investment themes that we're working with based upon our constructive view that China can navigate the waters to successfully rebalance the economy.

- **Growing affluence spawns increased consumer demand**
- **The rise of the mobile-based consumer society**
- **Liberalization of financial services**
- **Green initiatives get a new lease on life**
- **Second derivative consequences of reform increase growth opportunities**

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China Gets Serious on Reform

The naysayers and Cassandras are again out in force. It's an easy story to tell—even I can do it: The government's attempts to rebalance China's economy will cause an already slowing economy to accelerate to the downside. As the domestic property market weakens, the economy will suffer yet another blow and begin to wobble. Like a punch-drunk fighter, the economy starts to stagger as reforms rein in the rabid growth in local debt that has fueled much of the investment-led growth. The knockout punch arrives with the advent of China's first domestic bond defaults that cause lenders to price in escalating credit risk, further aggravating already nervous credit markets and adding to capital flight. The problem with the story is that the Cassandras have already counted the fighter (China's economy) out to ten before the bout has gotten underway. **Betting against China has been a losing proposition for many years.**

Given the depth of the challenges facing China today, many question whether its leadership has the will to follow through on its planned reforms, which is understandable given repeated (often seemingly half-hearted) reform attempts in prior years. Premier Li Keqiang's Report on the Work of the Government, delivered last month at the Twelfth National People's Congress was not only a political tour de force for the reform movement but, in our view, an unwavering message that the shroud of secrecy may no longer be counted on as sacrosanct within government to slow progress. With transparency comes greater accountability. **We assign a much higher probability of success this time around given the degree to which the veil appears to be lifting over the process.**

In his address, the premier stated that "... we adhered to a proactive fiscal policy and a prudent monetary policy. We did not adopt short-term stimulus measures, increase the deficit or issue excessive currency." We suspect that many investors would be soothed to hear similar words from the Federal Reserve. And in the duality that is China, the premier gave a nod to both Adam Smith and Karl Marx, when he also stated "...we endeavored to resolve deep-seated problems and difficulties, took reform and opening up as the fundamental way to advance development, and gave full rein to both the invisible hand of the market and the visible hand of the government to promote steady economic growth." Not to be cynical but that last reference should not be forgotten least one get too caught up in all the talk of free independent markets.

China's Party politics have always been opaque, adding to uncertainty. Even those "China hands" have a hard time unraveling all the intricacies. In the United States, corporate lobbying is much more transparent as special interest groups attempt to maneuver the political process. In China, the special interest groups are essentially the state-owned-enterprises (SOEs). The linkage (both indirect and direct) between them and members of the Party, especially the ruling elite, is seldom, if ever, transparent.

China still essentially remains a centrally controlled economy. The leadership formally announced at last October's third plenum that it intends to enact reforms and rebalance the economy by shifting from an investment driven economy (almost 50% of GDP) to a consumption driven one (currently about 35% of GDP). This also constitutes major change, if not upheaval, for the government bureaucracy charged with implementing the plan—and the biggest threat to a bureaucrat is change! Not coincidentally, given the high proportion of the workforce still employed at state-owned enterprises, that same bureaucracy may be the biggest threat and impediment to reform.

Excesses are being reined in—publicly for sure and most almost certainly privately, as well. For anecdotal evidence, consider that a couple of years ago it was commonplace to see headlines and news stories chronicling the activities of young Mandarins, high profile scions of wealthy families and high-ranking Party members speeding around in flashy Maserati's and Ferrari's while they partied like rock stars and acted with impunity. When was the last time that you can remember reading a similar story? It's difficult to recall, isn't it? That's because the message has been sent by

Beijing and received loud and clear that change is coming.

To do otherwise risks social alienation that will fester if disparity in income or wealth is allowed to grow or if Chinese society's perception degenerates into one of class warfare in a battle between the haves and have not's—an anathema to the leadership and their vision for China's own brand of socialism. But regardless of one's own political views, one has to admire the directness and diligence by which China's leadership is approaching the problem—taking a proactive approach rather than reactive where they'd otherwise be reduced to fighting fires. Frankly, it's also easier to enact change under more authoritarian rule. **The government is trying to lead by example as last year Beijing cut spending by 35% while provincial spending was reduced by 26%. Special attention was directed toward reducing extravagant spending by officials**

As The Credit Bubble Deflates, Is China Facing a Financial Meltdown?

In our judgment, China's biggest near-term challenge will be managing the supply of credit. Regardless of all the talk about becoming more free-market oriented with market-determined pricing, China's decisions ultimately have a political basis. Perpetuation of the leadership cadre and preservation of social order are the paramount goals. We believe that even as China moves to enact sweeping reforms that require selective austerity and sacrifice, Beijing will still be forced to compromise by making more credit available...the leadership can ill afford the risk to stability by draining too much capital from the system. This means that, for example, in spite of the leadership's stated intent, the People's Bank of China (PBoC) will find that it must still be more accommodative in facilitating credit to the large export driven sectors if it hopes to achieve its growth targets and maintain social order by not risking too rapid a disruption to employment. (Although as China's population ages, its pool of excess labor will shrink, reducing the pressure for higher economic growth and providing the government with additional room to maneuver.) The pace of change is unlikely to be uniform but vary by the situation and conform to what the leadership believes is appropriate. Once growth in consumption and services rise sufficiently, Beijing can proceed with greater alacrity to remove inefficient capacity as it reshapes the investment-driven side of its economy.

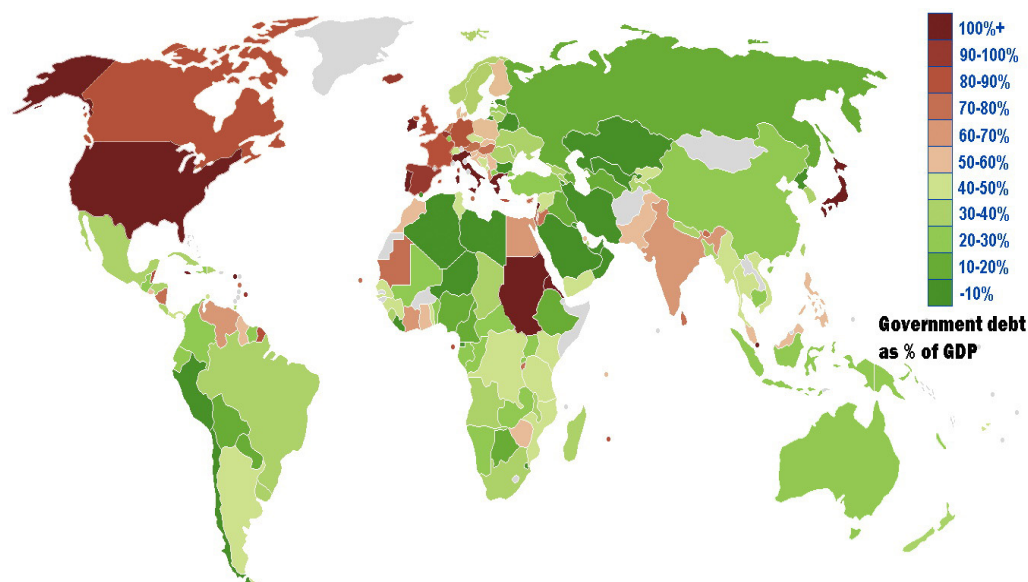
Often overlooked is the advantage that China's closed capital account contributes to managing the burgeoning supply of credit, which is why much of the fear over China instigating another Asian debt crisis (a la 1997) is misplaced. However, it is also why we believe that one shouldn't expect China to liberalize capital controls any time soon in spite of any contrary comments or indications by government officials. While China has \$3.85 trillion in foreign liabilities (equal to approximately 40% of GDP), the majority of it is illiquid direct foreign investment with limited ability for repatriation due to China's tight capital controls. Short term foreign liabilities are approximately \$1.15 trillion, which equals only about 12% of GDP. This external debt appears even more manageable when one considers that China has \$3.8 trillion in foreign currency reserves available to cover those foreign liabilities.

China's total debt to GDP is often cited as a reason for concern. According to the Chinese Academy of Social Sciences, China's total debt was \$18.3 trillion at the end of 2012, which equaled 215.7% of GDP. In our judgment, this still compares favorably to many countries and has yet to reach the point where it risks being viewed as irreversibly problematic given the ongoing economic expansion. For example, total debt to GDP is still half that of the PIIGS. Yet the consensus view remains that a credit bubble has formed; due largely to the speed of expanding credit but also shaped, in our view, by a lack of trust due to poor transparency for central bank operations.

On the other hand, China's low public debt-to-GDP is often cited as one reason why a financial crisis isn't imminent and the following graph would certainly appear supportive of such claims. The country's exceptional rate of economic growth coupled with reasonable fiscal discipline by the central government is primarily responsible. However, it is local government debt that has been skyrocketing and in China the central government is ultimately responsible for all public sector debt. **To obtain a true picture of the government's debt, one must therefore adjust upward the numbers below to account for the local government liabilities, which we believe takes public debt-to-GDP to approximately 55%.**

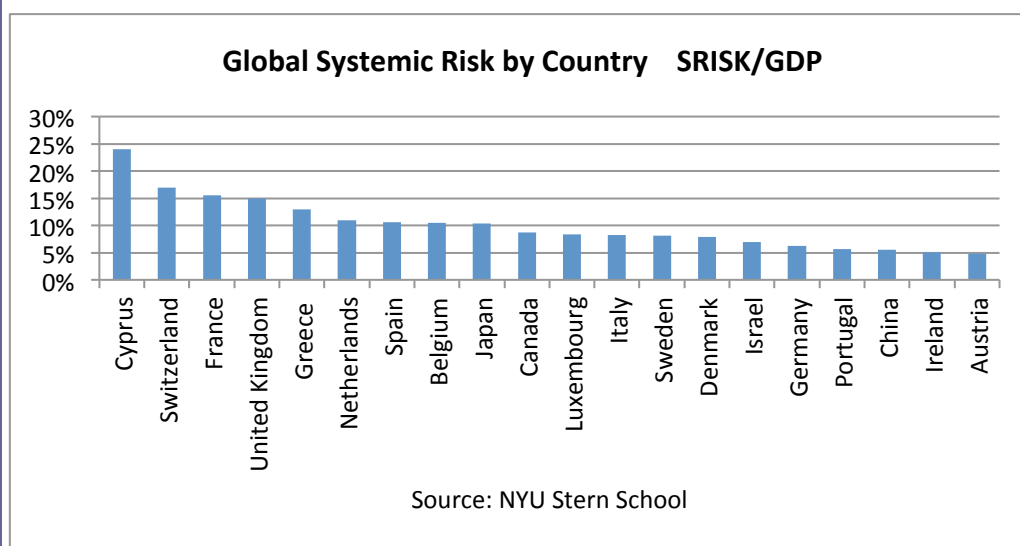


As the adjacent chart shows, China's public debt is well contained compared to most other countries even after adjusting for local government debt.



China stacks up even better compared to most of the world when using the NYU Stern School's systemic risk (SRISK) tool adjusted for GDP. The analysis, however, has come under criticism because a significant amount of China's debt falls outside its banking system so the magnitude of the potential financial challenge is somewhat understated. Since the debt is overwhelmingly denominated in yuan, we believe that China has ample tools at its disposal to contain the threat. The other main issue for many is that much of China's capital account surplus is in foreign assets that would be difficult to sell in a distressed environment. That is probably the case but no more so than faced by many other countries since the pain in such a scenario would doubtless be spread around the globe—and having that capital account surplus is still a

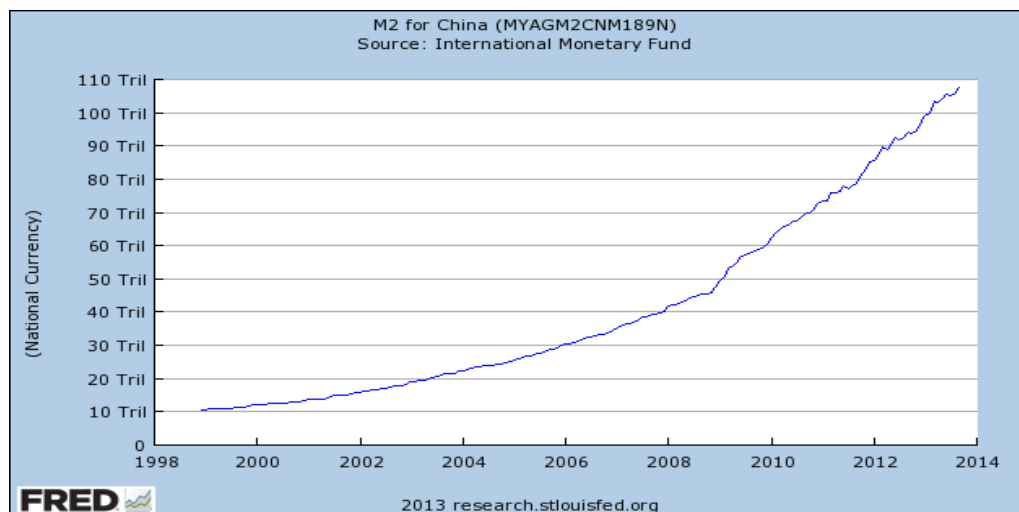
big net positive on both an absolute and relative basis.



The government has challenged itself to perform a balancing act as it has set one of its main tasks to be the development of an inclusive (i.e. private capital) financial system with lower interest rates for small business as well as accelerating financial innovation (The development of internet-based finance is singled out as a priority). Different regulatory standards will be applied between state-owned banks and private ones as they develop. Failure to do so by the government could inadvertently create a void in lending due to the higher reserve requirements in place for the big state-owned banks, which the shadow banking system could rush to fill.

Reining in local government debt also puts Beijing between a rock and a hard place. In order to prevent defaults and complete unfinished projects, the central government is now allowing local governments to roll over debt by issuing bonds. China's provincial and local governments have been prohibited from borrowing directly or running a budget deficit since 1994 as a result of China's last major financial crisis. This subsequently caused local governments to often set up companies to borrow funds through traditional channels such as bank loans and capital markets but also via non-traditional avenues such as shadow banking products such as high cost trust loans in order to finance their spending agenda. It also helps to explain a large measure of current skepticism over the almost non-existent non-performing loan ratio (~1%) of the banking system. Leading up to the last financial crisis in the early 1990's, undercapitalized state-owned institutions kept rolling over debt from state-owned enterprises, hiding bad loans until the government finally forced an accounting where non-performing loan ratios exceeded 30% as a real estate collapse followed. There's little doubt that many projects already funded are unlikely to ever earn adequate returns. However, vetting is receiving heightened scrutiny from the new central regime, reducing the likelihood that the situation escalates to uncontrollable levels.

Local government borrowing has been viewed as out of control. Government audit figures from last summer show that local government debt grew by 70% from the end of 2010 to 17.9 trillion yuan (\$2.95 trillion). But it's not just the debt itself at issue. Much of the money was spent on projects either poorly executed, having sub-par economic returns or both. Unfortunately, this has led to shrinking returns for China's investment-driven growth as cronyism or official corruption too often has led to poor investment decisions. As the premier himself directly acknowledged "some government employees are prone to corruption and some still do not perform their duties with integrity and diligence". A second derivative of this poor credit efficiency is often serial overcapacity in those manufacturing sectors targeted for job creation. While the huge jump in local debt has a sensational eye-catching aspect to it, one should still keep it in perspective. Local debt equaled about 25% of GDP in 2010 but increased to just 30% of GDP last year due to the high rate of China's economic growth.



It appears that worries over a potentially steep economic slowdown due to a contraction of credit are premature. M2 rose 13.2% in January y-o-y. Growth in local currency loans continued the steady slowdown of the past three quarters (see below) but still increased by 14.3%. While loan growth may have slowed, aggregate financing still hit a record 2.58 trillion yuan (\$425 billion) in January. Perhaps to no one's surprise after media warnings and high profile government officials jawboning, new trust loans fell by almost half to 106.8 billion yuan. At year end, the weighted average lending rate in China was 7.2% versus 6.2% a year earlier. Almost two-thirds of loans carry interest rates above the benchmark.



The government budget deficit for 2014 is projected to be 1.35 trillion yuan, an increase of 150 billion yuan over last year. The projected government budget deficit consists of 950 billion yuan of central government deficit and 400 billion yuan of provincial-level government debt in the form of treasury bonds issued by the central government on provincial-level governments' behalf. The government deficit and national debt are increasing along with the growth in the whole economy. However, the deficit rate should be contained at 2.1%.

Finally, many observers believed that the bond default by Shanghai Chaori Solar Energy Science & Technology Company would unleash a tidal wave of defaults for the \$2 trillion in wealth management products (WMPs) that have been sold mainly by banks but carried off balance sheet. However, the actual event proved less catastrophic than the nightmare envisioned by many pundits. An orderly handling of the process might calm those worst fears over moral hazard and growing systemic risk and actually improve sentiment.

Real Estate—Is It The Achilles Heel That Many Believe?

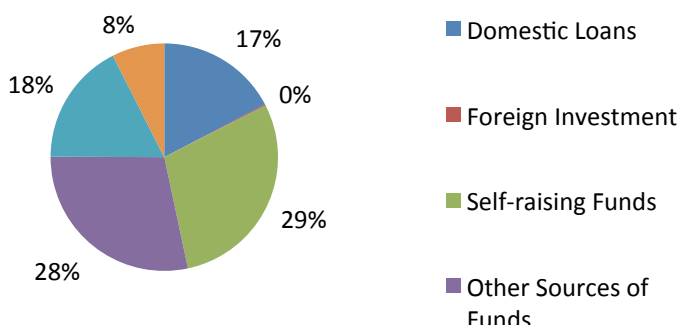
A few high-profile observers see similarities between the housing bubble that set off the United States' financial panic in 2008 and China's rapidly escalating housing prices. In their view, China's ultimate financial collapse will be rooted in an unsustainable housing bubble. However, there are several important distinctions overlooked in that argument.

The implosion in the US housing market was driven by excessive household leverage, exacerbated by government policy that encouraged home ownership. Home prices were pushed higher as the enlarged pool of mortgage applicants outstripped supply. Many of these new home buyers utilized no income verification ("liar") loans with minimal or no initial equity and terms that typically reset after three to five years. Investment banks eagerly abetted and compounded the problem by repackaging and syndicating loan portfolios that were indiscriminate in credit ratings (all were AAA rated predicated upon the past long-term pattern of behavior by mortgagees) despite the historic downshift in the mortgage qualification process that weakened the pool. In our judgment, the government had enacted its own brand of financial repression in the housing market with disastrous consequences. Defaults spiraled upward while overbuilding in many localities had a negative spillover effect on the construction market as credit terms tightened and qualified buyers evaporated. It's taken half a dozen years to clear surplus inventory and although stabilized, the sector has still yet to return to normalized levels.

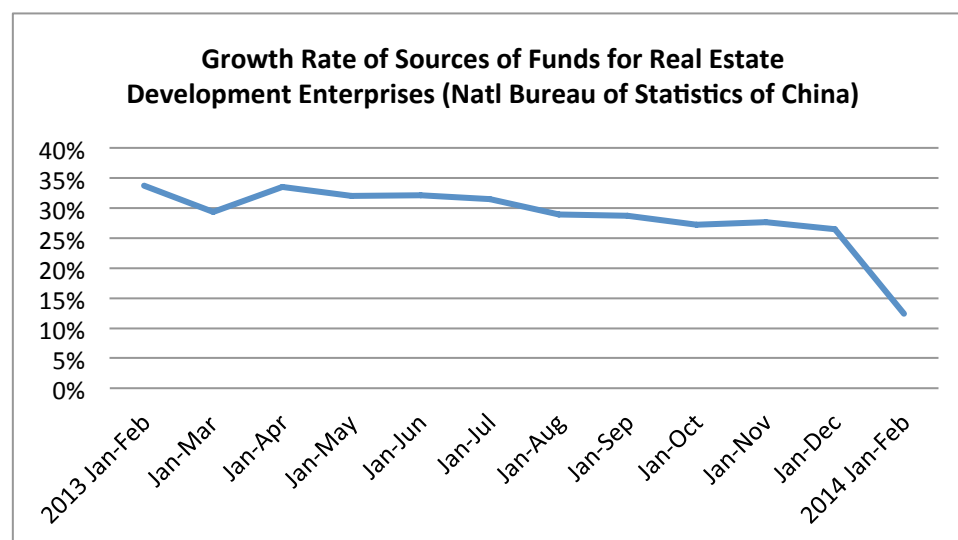
In China, on the other hand, the home buyer's investment is simply too big to walk away from. Since 2010, home buyers must make a minimum down payment of 30% with 40%-plus typical for their principal residence (down payment for a second home has been raised to a minimum 70% in some larger cities since last year). This helped restrain the rise in home prices and slow the pace of home buying until this past year. There is no mortgage loan syndication or liar loans. However, more recently, it's been observed that banks have unofficially relaxed their credit policies to allow some prospective borrowers having difficulty coming up with the higher down payments to let the borrower's parents take out a loan against their house to help.

Although a credit problem is unfolding, it is at the developer level, where speculation is widespread. But if a developer defaults, stronger developers or a designated government-financed player can step to buy assets at a discounted price and complete the project at a lower cost, which translates into less expensive homes. Foreign funding accounts for less than one percent of the housing market, which fortifies the government's ability to restructure/recapitalize enterprises as required since financial exposure is contained domestically. Affordability is enhanced as empty units are filled at lower transaction prices.

Sources of Funds for China Real Estate Development Enterprises (National Bureau of Statistics of China, Feb. 2014)



Financing for real estate development has become more difficult to obtain and hence more expensive. The following graph plots the steady downward trend during the past year. More of the finance sourcing has been pushed into the unregulated shadow lending market as households, corporations and even local governments chase yield. We attribute the steep drop in the new year partially to the early lunar New Year holiday but more likely due to rising market tension over pending defaults as the very real possibility of such events began to enter the collective consciousness of lenders finally realizing that government bailouts for trust products aren't likely to materialize, especially the more inferior wealth management products typically offered by non-banks. Eventually one of these non-bank products is allowed to fail otherwise Beijing's stated intent to address moral hazard is just talk. The asset class gets repriced lower to reflect higher risk and Beijing, along with China's financial system gets tested. A common misconception among many foreign investors is that shadow banking is bad and must be eliminated. Not true, since it is an important source of funds needed to facilitate growth. But in order to succeed and enable the "market" to determine where and how capital flows, regulatory oversight must be broadened just as the entire investment process must become transparent with individual investors adequately informed to evaluate risk rather than simply investing blindly for yield. In recognition, China's State Council has issued new guidelines for supervising the sector.



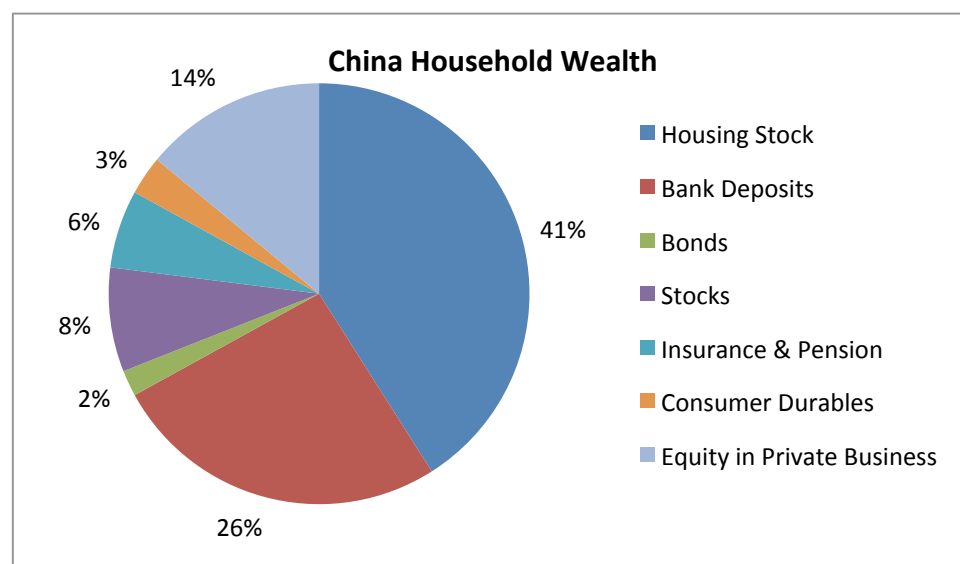
Urbanization and the lack of investment alternatives for private capital are contributing to the steady rise in real estate valuations throughout China. The great migration of rural workers to the cities over the past three decades continues unabated as another 200 million people are expected to resettle in urban areas over the next seven to eight years. Demand for housing continues to climb, particularly in Tier 1 and Tier 2 city centers, driving up prices to levels hardly affordable for the average Chinese (much as we've seen in New York, for instance). As populations continue to climb, overcrowding in city centers has reached near breaking points causing city footprints to expand. This results in less expensive housing being built further out from city centers and acts to some degree as a safety valve to prevent affordability from shifting completely out of reach. Additionally, the government maintains an affordable housing program for new construction. Last year, approximately 5.4 million government-subsidized homes were built with plans to start another 7 million this year.

Despite government efforts to cool the property market, the value of new homes sold re-accelerated last year rising by 27% (versus an 11% rise in 2012) to a record 6.8 trillion yuan (\$1.1 trillion). The rise was driven primarily by surging demand in tier one cities like Shanghai that overshadowed the government's more successful efforts to slow the ascension of prices in tertiary cities. Existing-home sales added another 2.25 trillion yuan (\$365 billion) or so to total home sales, which might seem counter intuitive at first glance since existing home sales normally dwarf new home sales as a proportion of the housing market until one takes into consideration that private home ownership has only existed in China since 1998.

So is China destined for a financial meltdown generated by a housing bust similar to what the United States experienced in 2008? One day perhaps, but not now. Put in perspective, Chinese banks have approximately \$1.5 trillion in mortgages carried on their books, far less than the approximately \$10.5 trillion mortgage debt issued by US banks when the bubble burst in mid-2008. Unlike the US, China doesn't yet trade mortgage-backed securities so the derivative risk is nonexistent. The threshold of pain is therefore much higher for Chinese banks given the disproportionately large down payments required by the government. A recent study conducted last summer by Southwestern University of Finance and Economics in Chengdu determined that if home prices were cut in half only 5% of homeowners would be underwater on their mortgages. China's large banks are well capitalized--operating with a 20% reserve requirement and a 65% loan-to-deposit ratio. Admittedly, banks are becoming more creative to enable resource-constrained potential buyers to circumvent credit restrictions in order to gather together the down payment, but the magnitude of aggregate exposure for the banking system still appears manageable at this juncture.

That same survey cited above also found that Chinese households continue to put an inordinate share of their total assets in their homes. The problem is particularly acute in the middle class that has fewer options for asset diversification than the wealthy. The survey infers that the figures in the chart below may be outdated or understated as the survey found that nationally households had 66% of their assets in their home (with Beijing an astounding 84%). **It is imperative that the government create investment opportunities for individuals beyond real estate. The government must provide access to the formal financial sector for private capital and allow deposit rates to rise, which has the added benefit of reducing the allure of shadow banking.**

This means an end to the financial repression that China has practiced for decades, which has enabled it to inexpensively fuel its investment-led growth. As interest rates rise to more efficiently allocate capital and boost household income through higher returns, it is incumbent upon Beijing to ascertain that only economically viable projects are approved with government funding as the nascent private capital market begins to assert itself.



Rebalancing The Economy Takes Shape

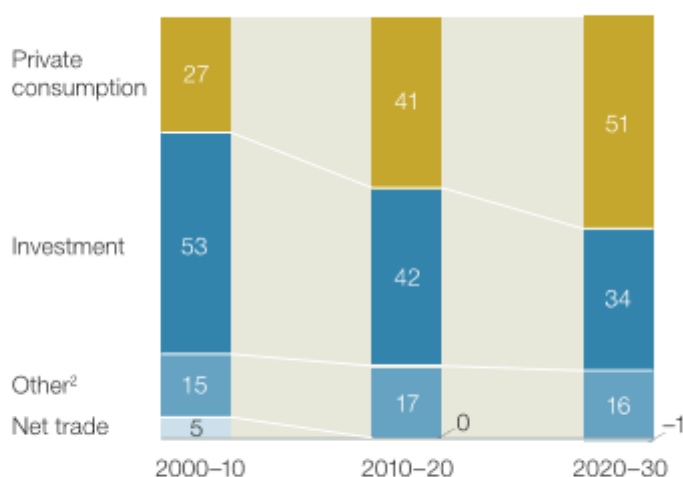
Premier Li Keqiang's Report on the Work of the Government as last month's National People's Congress provides the blueprint for reform that will enable China to reshape its economy. "Reform is the top priority for the government's work this year. We will focus on economic structural reform, advance it on different fronts in a targeted way in light of different conditions, take key measures that will have an overall impact, strive to make substantive progress and reap more benefits reform." It sounds encouraging but what does it really mean for the economy?

According to the premier it means "making domestic demand the main engine driving growth". As the report goes on to amplify, "In working to increase domestic demand, we will focus on boosting consumption... **We will enhance people's ability to consume by increasing their incomes, improve consumption policies, foster new areas of consumption and increase consumption of services**"

China's highest priority is rebalancing the economy away from reliance on its investment-driven model to one built upon growing household consumption. It really had no choice as eventually the economy would fall under its own weight from stresses built up in the financial system given declining returns on investment. There was much doubt when the idea was first floated (and still is) due to many of the impediments to success discussed earlier such as bureaucratic interests and rising debt levels. These doubts were hardly erased as broad outlines for reform were disclosed last November at the third plenum. After all, this wasn't the first time that reforms had been proffered only to be squashed by entrenched special interests. Yet Premier Li Keqiang provided detail and real teeth for implementation of large-scale reform in his Report on the Work of the Government delivered and adopted at the National People's Congress last month.

Consumption will be the driving force of economic growth in China, accounting for 43% of GDP growth by 2020, according to a recent McKinsey study. By 2020, it's estimated that almost 200 million more people will reside in urban areas (850 million total urban population), seeding the advent of the largest bloc of middle class consumers in the world.

Real GDP growth decomposition,¹ %



¹2010-30 data are estimated.

²Includes government consumption and inventory.

Source: Global Insights; McKinsey analysis

The Chinese people among the highest savers in the world, principally to prepare for retirement and their care in old age. Once reform of the social security system outlined at the recent National People's Congress (and repeated below) is implemented and gains the confidence of the people, it materially reduces the need to save and potentially diverts a substantial portion of household income to be available for discretionary spending.

"Social security is the foundation of people's wellbeing. We will focus on advancing reform of the social assistance system, continue to raise subsistence allowances to rural and urban residents, implement the system of providing temporary assistance nationwide, provide safeguards to enable extremely vulnerable groups to meet their basic living needs, and improve social services so that people can focus on work."

"We will establish a unified basic old-age insurance system for both rural and non-working urban residents and improve the way it is linked with the old-age insurance system for working people. We will reform the old-age insurance system for government bodies and public institutions, and encourage the development of enterprise annuities, occupational annuities and commercial insurance. We will improve the system of unemployment insurance and insurance against workplace injury. We will implement a mechanism for increasing social assistance and social security benefits when the cost of living rises."

Even as China moves forward with its plan to stimulate consumption, it will still maintain the world's largest aggregate level of investment spending. The central government plans to accelerate reform of the investment and financing while maintaining "proper" growth in fixed-asset investment.

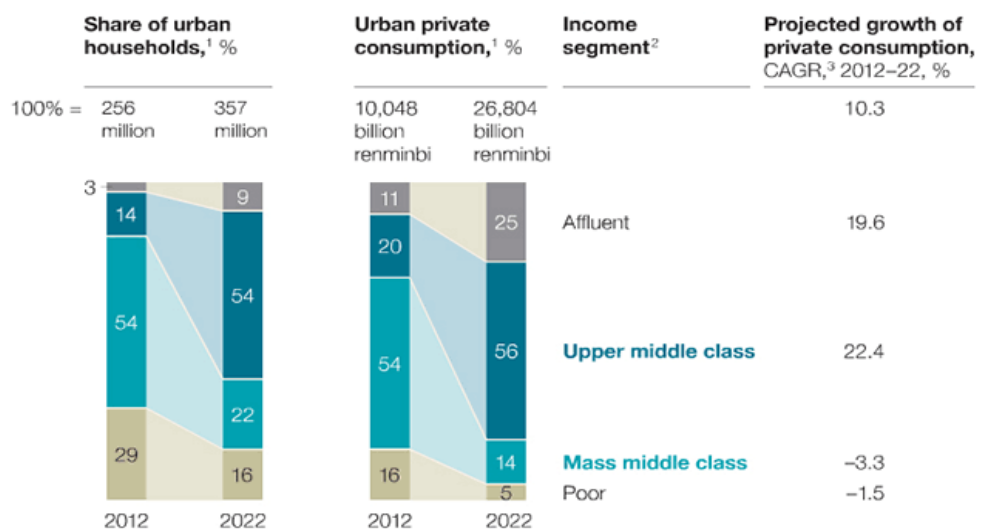
"Urbanization is the sure route to modernization and an important basis for integrating the urban and rural structures. We must improve the system and mechanisms for integrating rural and urban development and embark on a new path of urbanization. This new type of urbanization should have the following features: putting people first; integrating the development of industrialization, IT application, urbanization and agricultural modernization; improving the spatial layout; protecting the ecological environment" as detailed in the Works Report.

If China's rebalancing efforts prove unsuccessful, a likely tail risk is that China's foreign policy becomes more aggressive, if not belligerent, to distract from domestic policy problems. Regardless, China foreign policy is already headed in that direction as cultural pride demands that the country asserts itself to become an international power with stature. This is reinforced by old cultural attitudes and history with very long-term vision. For example, take its view of Taiwan as a runaway province (or their Taiwan compatriots as referred to by the premier at the National People's Congress)—it may take 50 or 100 years to get it back what they view as theirs but they're patient with an extended strategic timeline. A glimpse into how China is establishing precedent for expanded foreign policy can be taken from another excerpt from Premier Li Keqiang's speech at last month's National People's Congress, "the seas are our valuable national territory. We will steadfastly promote land and marine development in a coordinated way, fully implement China's marine strategy, develop the marine economy, protect the marine environment, resolutely uphold China's maritime rights and interests, and build China into a maritime power".

The Key To Rebalancing: The Growing Middle Class

The middle class continues to broaden at a rapid pace. Chinese households have among the highest savings rate (31%) in the world. A central goal of the 12th Five Year Plan (2011-2015) is to reduce the savings rate by expanding social security and increasing wages in order to increase discretionary income. This is intended to increase consumption, along with the rising use and availability of consumer credit.

The magnitude of China's middle-class growth is transforming the nation.



¹Figures may not sum to 100%, because of rounding; data for 2022 are projected.

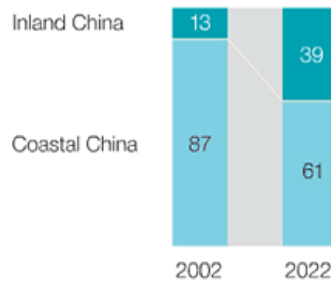
²Defined by annual disposable income per urban household, in 2010 real terms; affluent, >229,000 renminbi (equivalent to >\$34,000); upper middle class, 106,000 to 229,000 renminbi (equivalent to \$16,000 to \$34,000); mass middle class, 60,000 to 106,000 renminbi (equivalent to \$9,000 to \$16,000); poor, <60,000 renminbi (equivalent to <\$9,000).

³Compound annual growth rate.

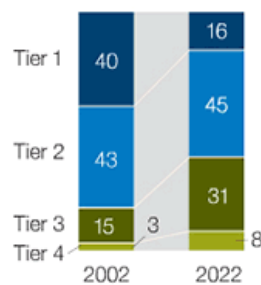


The geographic center of middle-class growth is shifting.

Share of middle class,¹ by geography, %



Share of middle class,¹ by type of city,² %



¹Based on information for 266 cities; data for 2022 are projected. Cities in China are grouped into 4 tiers based on their economic development and political importance. For Tier-1 cities, 2010 nominal urban GDP is >932 billion renminbi; for Tier-2 cities, 120 billion–932 billion renminbi; for Tier-3 cities, 22 billion–120 billion renminbi; for Tier-4 cities, <22 billion renminbi.

²Figures may not sum to 100%, because of rounding.

Long-Term Investment Implications of Policy Initiatives

If China successfully implements its current slate of reforms it will constitute nothing less than a radical transformation of the country's social, economic and political landscape. At this early stage of transition, we are not offering specific stock recommendations but instead are highlighting thematic opportunities for long-term investment where we believe investors should focus attention to screen for investment ideas along with some observations on the tertiary impact on other markets that may lead to other investment opportunities. These are some of the investment themes that we're working with based upon our constructive view that China can navigate the waters to successfully rebalance the economy.

- Growing affluence spawns increased consumer demand
- The rise of the mobile-based consumer society
- Liberalization of financial services
- Green initiatives get a new lease on life
- Second derivative consequences of reform

Infrastructure

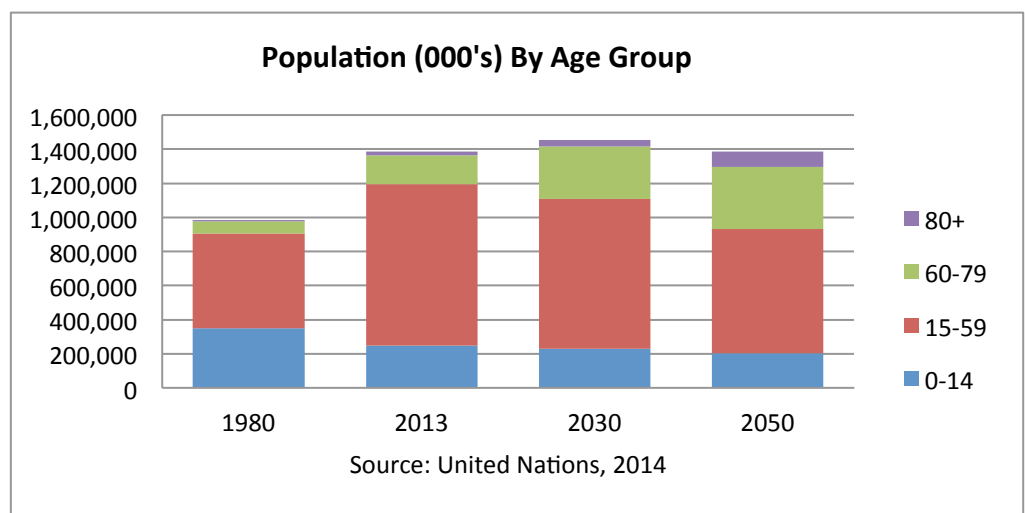
Prioritizing consumption over investment-driven growth does not mean an end to infrastructure investment. To the contrary, the new push for accountability, efficient use of resources and return on investment in evaluating and approving new projects will create opportunities for private sector investment. Excerpts from The Report on the Work of the Government outline future direction:

- We will increase support for a new type of urbanization in the central and western regions.
- We will help their industries develop and attract people and encourage rural migrant workers in the two regions to find employment in local cities and towns. We will speed up development of infrastructure including transportation, water conservancy, energy and municipal services in the two regions and make development of city clusters and towns there more sustainable. We will also improve the structure of cities and towns in the eastern region and raise the quality and standard of urbanization there.
- We will strengthen management innovation and institutional development pertaining to urbanization.
- We will expand the rebuilding of rundown urban areas so that cities will take on a new look instead of having stretches of rundown areas existing side by side with high-rise buildings. We will make plans for urbanization in a coordinated way in accordance with the national guidelines for developing a new type of urbanization. We will use urban construction land more efficiently, give high priority to developing public transport, protect sites of historical and cultural interest and natural landscapes, and avoid making cities and towns all look the same.

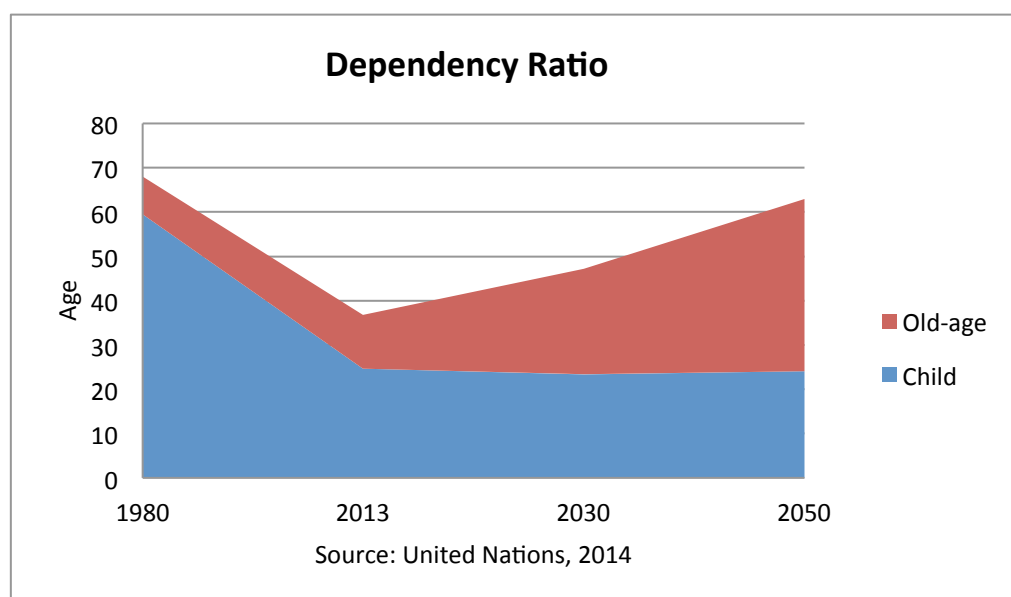
The development of the central and western regions augurs for massive future spending with long-term implications as the inland urban population rises. China should benefit in the same manner as the United States when the interstate highway system was created in the 1950's. Almost 70% of China's goods transport is by truck yet the proportion of paved roads is low and concentrated in the eastern coastal zone. High speed rail service should experience a massive build out as well. Companies will ultimately follow their customers west to provide better cost efficient service. Logistics companies should sprout as distribution hubs are built to place suppliers closer to their customers. **National productivity will receive a substantial boost as will the demand for increasingly sophisticated travel-related services of all types.**

Health Care

Rising incomes will produce an improved standard of living, contributing to higher demand for better healthcare treatment and services. Demographics will increasingly drive healthcare demand as the population ages over the next three decades and we anticipate that China's public health policy will begin to reshape itself in response. Urban increasingly affluent middle-aged consumers will also drive demand for selective services and procedures. Even rural residents will mimic their urban cousins in the pursuit of ever-lasting youth as their income rises more than generally believed.



Virtually all Chinese are now covered by health insurance as the government has spent almost \$400 billion on improving health care over the past five years. Accessibility and affordability remain unresolved issues for most of the populace and need to be addressed especially given population shifts that are bound to increase demand for services, particularly among the aged. Too little of past investment found its way into upgrading the state-owned hospital complex or training of medical professionals. This is being addressed and government subsidies are being increased for the poor. **It is still unclear to what extent the sector will be opened to private investment, but the opportunity bears watching.**



Financial Services

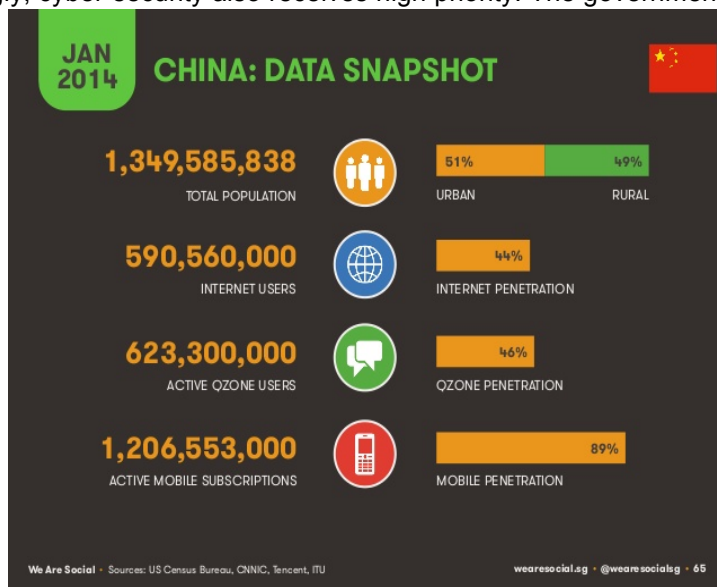
In our view, the greatest opportunity in the sector for growth will be for non-bank financial services as barriers to entry for the private sector are reduced or eliminated just as the underserved rising affluent population's growing household wealth simultaneously creates a boom for financial services. The biggest potential losers (at least initially until they learn to adapt to changing market conditions) as financial liberalization takes hold will be the large state-owned banks that for the first time will face a meaningful competitive challenge for deposits. One cautionary note is that the huge regulatory challenge could slow the rate of evolutionary change. We'd expect that the strongest lobby for increased oversight would be the big banks since they already have the internal controls and compliance structure in place.

Private banking, insurance, asset management and private equity should all experience large-scale opportunities from sector reform. We've highlighted the following five key relevant points for reform quoted from The Premier's address at the National Party Congress. We've done this for emphasis because, in our view, without these reforms it is highly unlikely that China's financial system would survive without a massive shock to clear the excesses that would doubtless continue to intensify.

- "We will continue to liberalize interest rates by granting financial institutions more power to set their interest rates. We will keep the renminbi exchange rate basically stable at an appropriate, balanced level, expand its floating range, and move toward renminbi convertibility under capital accounts."
- "We will steadily promote the establishment of small and medium-sized banks and other financial institutions by private capital, and guide private capital to invest in or hold shares in financial institutions and intermediary financing services."
- "We will establish a deposit insurance system and improve the risk disposal mechanism of financial institutions. Reform in policy-based financial institutions will be carried out. We will speed up development of a multilevel capital market, advance the reform to introduce a system for stock issuance registration, and develop a well-regulated bond market. We will actively develop agricultural insurance and explore how to establish a catastrophe insurance system. We will develop inclusive finance."
- "We will formulate measures for non-state capital to participate in investment projects of central government enterprises, and allow non-state capital to participate in a number of projects in areas such as banking, oil, electricity, railway, telecommunications, resources development and public utilities. We will formulate specific measures to permit non-public enterprise participation in franchising."
- "We will reform the railway investment and financing system, and open competitive operations in more areas so as to create a platform for the full participation of private capital. We will improve the property rights system to ensure that property rights are inviolable in both the public and non-public sectors."

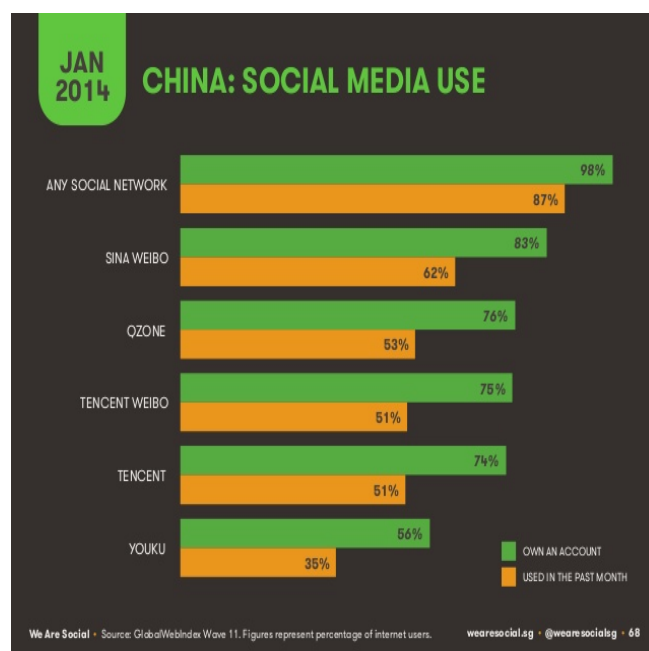
Internet Services and e-Commerce

China has ambitious goals to aggressively implement China's broadband strategy that include speeding up the development of 4G mobile communications, building 100M fiber optic networks in cities and extending broadband connectivity to rural villages while greatly increasing the speed of the Internet to deliver telecommunications, radio, television, and Internet services over a single broadband connection across the country while encouraging the creative development of e-commerce. Not surprisingly, cyber-security also receives high priority. The government also wants to revamp distribution channels and remove all barriers to a nationwide unified market with the goal of cutting distribution costs as it encourages development of logistics and delivery, express delivery services, and online shopping. **As the adjacent chart shows, internet penetration is only 44% for China, leaving plenty of room for high growth over the next decade.**



We view Alibaba and to a lesser extent JD.com as the leaders most capable of driving active customer and order growth through social and mobile platforms and networks. Just as Facebook and Twitter are ingrained within social activities through the Web, mobile and TV on a daily basis, we are seeing Weixin, Mobile QQ and Weibo replicating these same social activities within China. As the two largest competitors in the country's e-commerce space, their scale and network presence have generated substantial revenue growth (and profit in the case of Alibaba). **Both merit investor attention as they transition to public companies and Tencent's recent strategic investment in JD.com potentially strengthens its relative competitive position.**

JD.com could be Beijing's new poster boy as an example of a company already positioned and aligned to exploit the government's policy goals to promote internet consumption and reform distribution channels. While the company is growing rapidly and aspires to be the leading e-commerce company in China, it will still have to demonstrate that it can execute an expansion of product offerings beyond just selling consumer electronics. Additionally, as the company likes to trumpet, it has the most expansive warehouse, fulfillment centers, delivery and pick-up stations and more employees than any other e-commerce company in China.



Environmental Services

Enforcement of tightened environmental regulations will be a real litmus test for credibility of the reform movement. This will be especially challenging at the local government level where land sales typically provide 40% of their funding and environmental issues are hardly conducive to enticing new investors to buy and develop property.

Irrespective of the contemplated environmental reforms, we still believe that China will encourage investment and growth of green industries and technology to help offset losses in traditional basic/heavy industries where excess/obsolete capacity is being eliminated. Accordingly, the decision is as much part of the social order agenda (full employment) as environmental, although environmental degradation has become so severe that we'd argue it must increasingly be addressed to maintain social harmony.

Beijing's green initiatives outlined at the National People's Congress (and highlighted below in bullet points) present a host of long-term investment opportunities. As one reads through the text below, it's easy to spot the rhetoric sprinkled in among the very ambitious goals. The degree to which the government intends to dedicate attention to improving the environment speaks to the magnitude of the problem. Not every effort will move forward with equal speed. For instance, China already has 28 nuclear power plants under construction at the expense of coal-fired power generation. However, pollution control standards are likely to be applied selectively across the country so that the decline in coal usage might not be as rapid as policy targets infer.

As the old saying goes "the squeaky wheel gets the grease"; expect to see highly visible initial efforts to reduce environmental contamination concentrated in the large eastern cities where pollution has become an open social issue and an embarrassment to the Party. An example is the ordered closure of 1,725 small low-quality coal mines in the eastern provinces with total capacity of 114 million tons (3% of industry capacity). However, total industry production will still rise as output rises at larger more remote mines.

- We will fully implement the plan for preventing and controlling air pollution, with the focus on mega cities and regions with frequent occurrence of smog. We will start by reducing PM10 and PM2.5 emissions, and focus on the following key areas: improving the industrial structure, raising energy efficiency, reducing vehicle exhaust emissions, and preventing and monitoring wind-borne dust.
- We will implement the clean water action plan, strengthen the protection of sources of drinking water, prevent and control water pollution in key river basins, and carry out land restoration. We will control non-point agricultural source pollution and build beautiful rural areas. We will declare war against pollution and fight it with the same determination we battled poverty.
- We will continue to raise the proportion of electricity generated by non-fossil fuel, develop smart grids and promote balanced distribution of energy resources, encourage the development of wind and solar power and biomass energy, and start construction of a number of hydropower and nuclear power projects. We will strengthen exploration, exploitation and utilization of natural gas, coal seam gas and shale gas.
- We will reform pricing of resource products and establish a sound system of tiered pricing for household water and gas consumption. We will launch projects to enhance energy efficiency of buildings and subsidize the production of energy-efficient products; develop clean production, green and low-carbon technologies and the circular economy; and become better able to respond to climate change. We will intensify water and materials conservation and comprehensive utilization of resources. We will speed up the development and use of energy-efficient and environmentally friendly technologies and products and turn the energy conservation and environmental protection industries into dynamic sunrise industries.

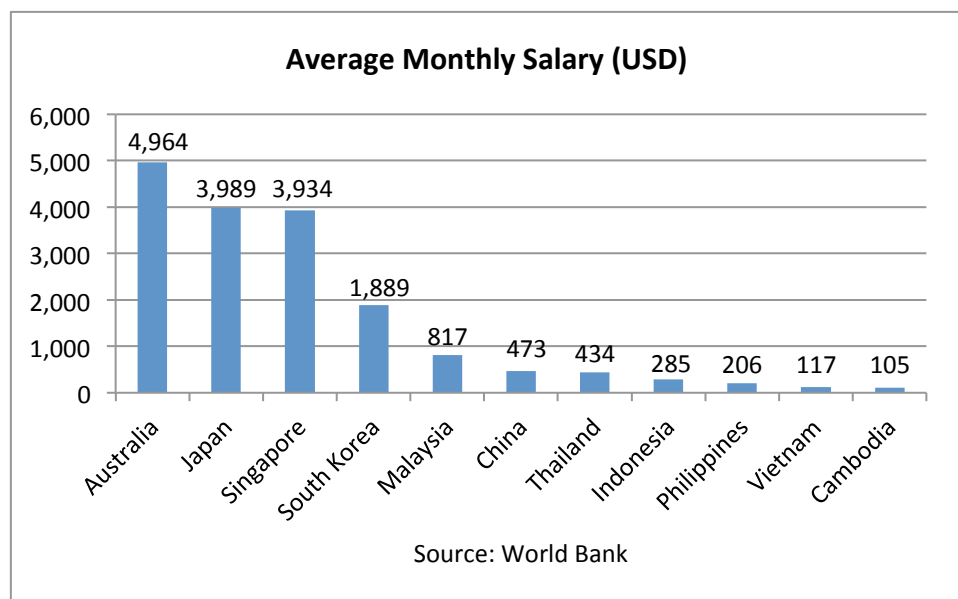
Second Derivative Consequences

Off Shoring

The escalating cost of labor (as seen in the chart immediately following) over the past two decades is finally beginning to catch up with the Chinese. Production that is not prioritized under the Five Year Plan is increasingly finding its way offshore to countries possessing pools of young, educated skilled and semi-skilled labor. Countries that are prime beneficiaries of this trend with close proximity to the Chinese mainland are Vietnam and the Philippines. (Not coincidentally, these are among our most-favored emerging markets). Chinese direct investment and procurement in these countries is quickly being challenged by Korea and Japan that are drawn there for similar reasons.



Long viewed as a seemingly endless source of cheap labor, the chart below paints a different picture given the compelling wage differential that's developed between China and its southeast Asian neighbors. That wage differential will widen given the encouragement of China's central planners for wages to rise more freely and augmented by declining labor surpluses and the ongoing effect of urbanization that will pressure wages higher.



Commodities

Fears that weakening industrial commodities demand in China could cause a collapse in pricing may be premature even as many traders and some industrial commodity producers are envisioning an economic slowdown in China negatively affecting demand, aggravated by the planned elimination of excess production capacity across several sectors. This year, China plans to reduce outdated production capacity of 27 million metric tons of steel, 42 million metric tons of cement and 35 million standard containers of plate glass or approximately 10% of excess production capacity in those targeted industries. More noncompetitive facilities will be shuttered over the next few years as part of the government's structural reforms. The most likely candidates will be inefficient standalone facilities unable to fund (i.e., unprofitable) upgrades to production or environmental technology without government assistance. These are typically smaller scale production facilities serving localized markets. These smaller companies do not have the purchasing power that larger competitors with national footprints possess. Often unable to negotiate long-term supply contracts on favorable terms, they are forced to buy at the usually higher spot-market price.

As the various targeted industries are downsized, the bigger players will benefit from gains in market share as the weaker players are weeded out. This will accelerate as access to government funding eventually dries up to all but the favored players destined for survival. Volatility in spot-market prices will likely pick up initially then falter as spot demand weakens. **The volume-weighted average transaction prices probably declines much less than one might suppose as the larger, more dominant producers are more exposed to the international market and must maintain stable supply relationships, leading to better-than-expected realized prices for suppliers.**

The chemical industry is likely to be negatively impacted by reform policy. As energy prices are liberalized, input costs will climb from higher energy/feedstock prices. Higher wages will also eat into margins and contribute to eroding competitive positions, particularly those exposed to international markets.

As people elevate out of poverty and gain disposable income, one of the most pronounced trends is for their protein intake to rise. Rising consumer affluence, population growth and the rapidly growing middle-class will continue to pressure agricultural commodities such as beef, pork and chicken higher along with more complex grains as well as coffee, tea and sugar as consumption increases along with more sophisticated tastes. **As urbanization speeds forward, higher incomes and lifestyle decisions will feed through to added upward price pressure for foodstuffs as packaged food concepts not only find greater acceptance but are increasing sought out by an increasingly active urban population.**

The centuries have taught the Chinese to always have a little gold or precious stones on hand for emergencies and that is unlikely to change despite rising affluence and increased confidence in their outlook. However, liberalization of the financial system and the end of financial repression will make new alternative investment options available that will compete with gold for their attention.

In this regard, the bigger potential impact could be on the speculative residential housing market as Chinese households are no longer coerced into the property market for investment. Demand for building materials such as lumber, steel and cement would suffer. Although this last point shouldn't be taken at face value. There is still another 200 million people relocating from rural to urban areas with the requisite demand for adequate housing. We believe that many observers have overlooked another latent demand driver for housing. As land and housing became privatized, much of the existing housing stock was substandard just as initial construction was often of poor quality and design, as well. Rising household income will create significant incremental sustained demand to "trade up" in order to satisfy the aspirational needs and growing sophistication of a rapidly growing segment of the population.

The Technical Market Outlook

The Shanghai exchange is in the process of carving out a technical bottom after three years of underperformance. Although short term momentum indicators are trending up, we note that the index is close to exiting its period of seasonal strength. Money flow has improved over the past month as global investors continue to be underweight Chinese equities.



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