

China Research Trip, November 2008

In November, the principals of Cornerstone took a long-anticipated trip to China in an effort to further understand an important trading partner and a country that is a primary driver of global economic growth. Our timing – three months after the Olympic Games – was such that our observations would not be hindered by any last-minute construction or tourism. For our trip, Mark visited the larger cities on the coast, primarily Shanghai and Beijing while Scott went to the interior with visits to Chongqing and Wuhan in addition to Hong Kong. We determined it was an appropriate time to visit the country and were actually fortunate it occurred in the middle of a once-in-a-generation financial crisis as it offered additional insight into our interactions, interviews and observations.

China has been an important source of both marginal demand for commodities and marginal supply of consumer goods deflation in the world economy since joining the World Trade Organization in November 2001. And, the country's growth rate has been unparalleled for the past twenty years for a country its size, primarily due to joining the Industrial Age 140 years after Western economies.

You may now be asking yourself, *how do two investment analysts from Alabama with no knowledge of Mandarin land in China and begin to conduct any meaningful research on a country offering more diversity, both economically and ethnically, than almost any other place in the world?* The answer is that we have a lot of help; there are a number of individuals willing to take time to host our inquiries, but they are unfortunately too numerous to thank individually in this report. Among those we were able to have conversations with were CFA's from Shanghai, Beijing and Wuhan, PRC-national factory owners, and multi-national businessmen from Hong Kong (both individually and at a Hong Kong Rotary club).

The Chinese Industrial Revolution began in Shenzhen, formerly a fishing village, in 1978 as an experimental economic project. Today Shenzhen is a city of an estimated 12 million people with a stock market, skyscrapers, etc. – this offers an idea of the **size, scale** and **speed** of change in China. The Chinese see their growth as a result of a carefully planned and balanced approach to their economy by party officials. The primary sources for this growth have been:

- **Infrastructure**
- **Exports**
- **Internal demand**

Chinese **infrastructure** is awe-inspiring. Where the nation has made development a priority, it has done so in spectacular fashion. Architecturally-challenging buildings, new highways and airports, long-span bridges and more are visible up and down the eastern coast of the country. When we spent time in these areas, it did not look much different than the rest of the developed world. At the same time, the government really does not face any challenges from private land-owners (or historical commissions, or...) when a project is being considered and implemented. This infrastructure demand is a function of the increased urbanization which is requiring the development. That urbanization, in turn, is a function of the Chinese export market.

In our opinion, **exports** have driven China's growth. Though the export business has been price-driven for a number of years, Chinese factory owners are aware of the need to diversify end markets and move further up the value chain rather than competing strictly on price. As an example, the exporters we spoke with have decreased dependence upon the American consumer from 75% of exports to roughly 40 – 50% of exports over the past five years. Unfortunately, at the same time individual manufacturers are making better decisions, increased optimism has resulted in over-capacity across broad sections of the Chinese economy.

Also, for the most part the manufacturing taking place in China is for products with highly cyclical demand. These are the most discretionary of items that can be mass-produced to certain specifications – pens, toys, basic household items, etc. As the US consumer has less to spend on discretionary items in the short-term and as we re-consider our spending habits on a more permanent basis, final demand for these types of goods will likely be lower. The idea that US economic growth can slow dramatically and Chinese economic growth will not slow is sheer folly...

... which brings us to **internal demand**. The thought is China will begin to reach its 1.3 billion citizens as potential consumers in a more effective way. Over time, we believe this *will* be a profound shift in strategy for the Chinese and will effect the global allocation of scarce resources, but for the near-term we feel it may be overstated.

Chinese savings rates are excessive, but it's not simply because "Asians like to save". There is truth to that generalization, but it also oversimplifies something more complex. One important reason Chinese savings rates are so high is that there is no societal safety net – the "[Iron Rice bowl](#)" was eliminated in the early 1980's, and families have to save for retirement, education and unanticipated medical expenses among others. Since so many in the country who survive on such meager salaries are required to save as preparation against potential emergencies, internal demand is far beneath what it needs to be in order for it to be a legitimate driver of the Chinese economic engine. Party officials are aware of this, but it will take more than a few policy changes to increase the consumption of the millions of people who live on very little income especially relative to the affluence on the eastern seaboard.

The story associated with the growth of the Chinese economy is that each of these engines of economic growth - infrastructure, exports and internal demand - does its part to support a balanced stool. Our supposition is that export growth due to lower Chinese prices and higher US consumption on disposable items has played a disproportionate role in this growth.

This is why we assert that a slowdown in US economic consumption will be damaging to the Chinese economy, at least in the short run.

Longer-term, though, there remain opportunities. One of the questions we had been asking ourselves prior to our research trip was – “who will be the next China?” In other words, where does manufacturing move after China?

We now have an answer to that question... the next China *is* China. There are over 1.3 billion people within the country, and prosperity has only arrived on the Eastern coast. Over 800 million (!) Chinese citizens do not live in these areas and have not been impacted by the rising standard of living in the East. As those on the East coast are required to add more value to the production chain to more effectively compete relative to higher input costs, low value-added production will move west into the interior of China.

As the Chinese reduce their dependence upon the US consumer and work through the excess capacity, the balance will likely return to the three drivers of growth. When this happens, there will again be tremendous opportunity in China as the rest of the country gradually joins the Industrial Age. This offers a number of investment ideas as new Chinese factories are developed, old ones are upgraded, necessary infrastructure projects are completed and internal demand rises. The primary question for us as investment managers is “when?”

Obviously, there are a lot of ideas we could not even begin to discuss in our mini-report. Some issues we will address in our expanded China report are the following:

- Really, you’re a Communist?
- Demographic challenges ahead (including the One Child policy)
- Potential societal unrest (related, but unrelated - the rise of Christianity)
- Challenges within the Chinese banking system

Our expanded report will likely be available towards the end of January as we prepare it in a presentation format. As always, we welcome your feedback on our commentary and ideas.