U.S. Global Investors

Searching for Opportunities, Managing Risk *August 2009*

Why China Shines Through the Global Gloom

Years from now, the 2008–09 global recession may be considered the point at which China's critical role in the world economy was crystallized. While other nations watched their output fall into negative territory, they looked to the Far East and saw that even amidst such difficult times, China was growing at an 8 percent clip—down from recent years to be sure, but nonetheless impressive for a nation of more than a billion people.

Conventional wisdom attributed the growth to China's image as the supplier of cheap goods to the world, but in this case the conventionally wise are wrong. Exports are expected to contribute nothing to GDP growth in 2009.

So if it's not exports, as in years past, what is driving China's growth this year?

U.S. Global Investors hosted a webcast titled "China's Impact" to address this question and more. The full webcast, including audio and presentation slides, is available at **www.usfunds.com**.

Andy Rothman, the Shanghai-based chief macro strategist at CLSA, was the featured speaker for this webcast. Mr. Rothman shares his comments below.

Growth in China

Andy Rothman
Chief Macro Strategist, CLSA

China's GDP growth began to slow well before the U.S. went into recession and well before Chinese exports collapsed. And the reason for this is simply that, in late 2007, the Chinese government was worried about the economy overheating, about commodity inflation and wage inflation, so they deliberately tightened bank lending to much of the economy, especially real estate developers, construction and infrastructure.

After the recession started, it was easier for officials in Beijing to set the economy back on track because they had slowed it down and because they have considerable control over the banks. Once the government decided to act in December 2008, China had 1,000 percent year-on-year loan growth. The pace has slowed down a little bit but credit flows are still very, very strong in China and they're not going to be pared back. This is a government that is clearly going to continue to err on the side of a loose monetary policy.

The government has committed to a $586 billion stimulus program over two years—relative to the size of the Chinese economy, that's a bigger stimulus than the one in the U.S. A lot of that bank lending has gone into infrastructure projects: roads, rail, bridges, power, water. These projects were, in large part, shovel-ready very quickly because this is a country that has been building a lot of infrastructure in the last decade. Half of growth this year is going to come from investment, a lot of it from that infrastructure.

There's absolutely no question in my mind that the Chinese government is able to fund this program. In fact, I've been arguing since late last year that the Chinese Communist Party is the most liquid financial institution in the world.

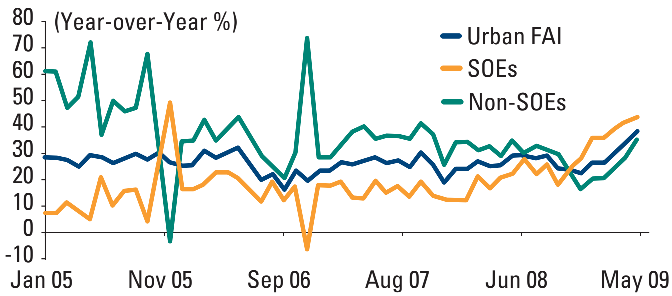
Unlike most other countries, China is in a good fiscal position to fund this massive infrastructure build-out. The deficit last year was less than 1 percent of GDP, and I think this year we're not going to see a fiscal deficit larger than 5 percent, even with that massive stimulus. Compare that to the U.S., where we could go to 14 or 16 percent of GDP.

In 1998 and 1999, in response to the Asian financial crisis, the central government raised its spending on infrastructure very sharply. In 2000 when private investment started to recover, the central government pulled back very, very quickly. And this, I think, is going to happen again next year after the recovery is stabilized. The one-party system in China will make it much easier to cut all of this extra spending, and this will bring the budget deficit under control much more quickly than in the U.S.

Private Investment and the Chinese Consumer

Private investment picking up

Non-state investment rose 35% Year-over-Year in May, up from 16% in December



Source: CEIC

FAI=Fixed Asset Investment, SOEs=State-Owned Enterprises

Government spending is not the only reason that the Chinese economy is moving back into a strong position, as you can see on the chart above. The orange line is the fixed-asset investment by state-owned enterprise, and that's obviously leading the process right now. But what I think is more important is that private sector investment shown by the green line was up 35 percent year-on-year in May, and it's moving on a similar trajectory to state money. This trend tells me that the government will be able to pull back its spending and allow the private sector to drive investment growth again.

Other indicators support this growth story. Several purchasing managers indexes have turned positive in recent months, with new orders rising steadily from the bottom last year. Domestic new orders are already positive, while new export orders are close to being there, too. I think this is because Chinese companies, which are very competitive at low price points, are going to start to grab market share of a much smaller pie with spending less in the United States and Europe.

Manufacturing employment in China is improving as well. Our employment survey of manufacturing companies found that after skyrocketing last year, the number of companies laying off workers has returned to almost normal levels because the domestic economy has stabilized and exports have stabilized as well. China is probably the only country in the world where the manufacturing sector is actually adding head count.

All of this data has had a positive impact on investment plans from companies, which is very important for commodities consumption. It has also had a big impact on consumer sentiment, which is equally important for commodities because you need people to keep buying the goods being produced by those companies. Our research tells us that retail sales are growing at a 7 percent to 9 percent rate, which is extraordinary given the flat or negative retail sales growth seen around the world.

There are several reasons why Chinese consumers can be doing so well. We've had strong wage growth in China for the last several years before flattening this year. And we also have very low inflation right now, especially food prices which are down dramatically from last year. This puts a lot more spending power in the hands of Chinese households. And unlike in the United States or Europe, there's almost no consumer debt in China. When peoples' confidence comes back, they're able to start spending again right away. They don't have to first pay off their debt.

A remarkable 39 percent of Chinese households who had told us that they were looking to buy a flat are now saying this is a good time to buy a house. Interest rates are well down from last summer and many banks are offering a range of subsidies and discounts. As a result, property sales have gone through the roof in a release of pent-up demand, and prices have stabilized.

Property developers already have a lot of land banked, and the government is encouraging banks to lend to major developers. I think we're going to see a significant increase in new housing starts in the second half of the year in China, which is very bullish for commodities demand.

Another potential tailwind for commodities — for the first five months of 2009, 40 percent of Chinese consumers have told us that this is a good time to buy a car. Obviously, if this was the situation in the U.S., the U.S. government wouldn't be a major car producer right now.

Domestic Growth Leading China

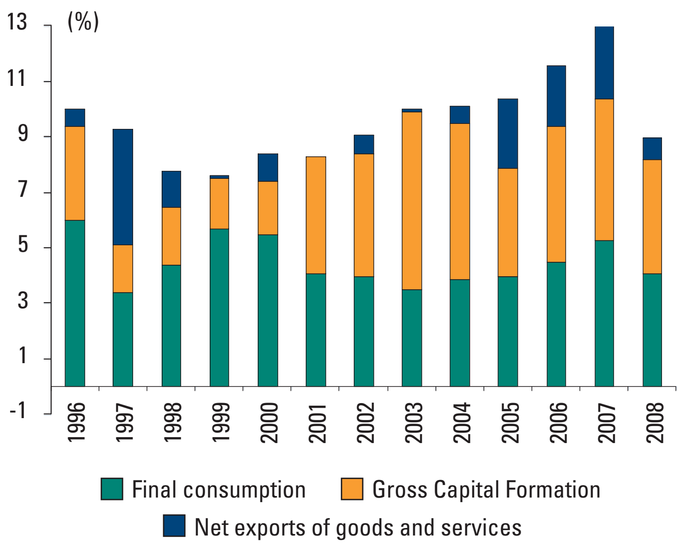
One of the biggest misperceptions about China is that it's an export-led economy. The truth is that China is a domestic consumption-domestic investment story.

About half of Chinese "exports" are simply processed in China or assembled in China, so the contribution to the Chinese economy is not that big. Another part of the misconception is the oft-mentioned statistic that the gross value of Chinese exports is equal to about 40 percent of GDP, so it seems export-led. But the statistic to pay attention to in China or any other country is not "gross exports," but rather "net exports:" exports minus imports.

A good example to illustrate the notion of net exports is the iPod. All iPods are assembled in China by a Taiwanese company. Researchers at the University of California in Irvine calculated that the factory cost of a 30-gigabyte video iPod when it leaves China is $150, but that only $7.50 of that value was actually generated in China in the form of parts, labor, packaging, testing and transportation. That's just 5 percent of the factory cost. The high-value components, like the hard drive and the video display, are manufactured in Japan, Taiwan and Singapore and then imported into China for the final assembly.

Primary drivers: Investment, consumption

GDP growth rate by expenditure approach



Source: CLSA

The chart above shows the key drivers of GDP growth in China going back to the mid-1990s. In nearly every year, most of the growth came from domestic consumption and capital investment, with a far lesser impact coming from net exports.

In 2005 through 2007, about 20 percent of GDP growth came from net exports and this drove GDP growth up into double digits. If you take that away, you're left with investment and consumption, and in most years we have had between 8 percent and 9 percent growth. In 2001, when the tech bubble burst, exports fell off everywhere and we still had over 8 percent growth in China, half from investments, half from consumption.

I really want to drive home this point — the primary thing you need to be watching in terms of understanding where the Chinese economy is going is not exports, but rather what's happening domestically. This is the case even in terms of commodities. Only about 20 percent of the metals imported into China are bashed into goods and appliances for export. The rest is for the home market.

What might derail this recovery is corporate profits. Profit growth has been down significantly as it has been around the rest of the world. My concern is that if we don't see a turnaround in profit growth by the fourth quarter of 2009, we have to worry about the sustainability of both the recovery and the stock market rally in China. That said, I'm also reasonably optimistic — the price of industrial inputs in China has fallen dramatically, domestic sales volumes have been rising strongly and export growth should start to pick up.

This recession has been a defining moment for China at home. The Communist Party has been able to demonstrate to its citizens that it is able to manage a severe global economic crisis in a very constructive and successful way. In terms of China's presence overseas, it's obviously enhanced by the fact that it's done well with its economic policy. And we may have seen a bit of an acceleration of the Chinese government's efforts to have its government control resources companies overseas.

China is big and important, but can't be the world's economic savior. In terms of global consumption, it's still too small to play that role. I think the best we can look for from China is to put a floor underneath the decline by having its economy remain strong to offset in part the slowdown in the U.S., Europe and Japan. The only place where you can look to China to drive things back up on its own is the commodities sphere because it is such a significant part of global commodities demand and the single greatest source of incremental demand.

In my view, China cannot resume the double-digit GDP growth rates that we've seen in recent years while the U.S., Europe and Japan are in recession. But it can easily grow at 7 percent or 8 percent when the world is in recession if the domestic sector is strong.

CLSA Asia-Pacific Markets is Asia's leading, independent brokerage and investment group. The company provides equity broking, capital markets, merger and acquisition, and asset management services to global corporate and institutional clients. Recently CLSA was ranked the best brokerage in Asia-Pacific (ex-Australia, New Zealand, Japan) over the past twenty years in the ***Asiamoney*** *magazine 20-year Poll-of-Polls. The poll ranks the top 20 brokerages in Asia based on Overall Combined Research and Sales Results from 1990 – 2009.*

U.S. Global Investors is a Texas-based investment adviser that specializes in natural resources, emerging markets and global infrastructure. The company's mutual funds include the China Region Fund (USCOX).

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