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Special Report

July 2007

The View From Shanghai

Why Being Wrong Will Not Matter

By Hugh Peyman

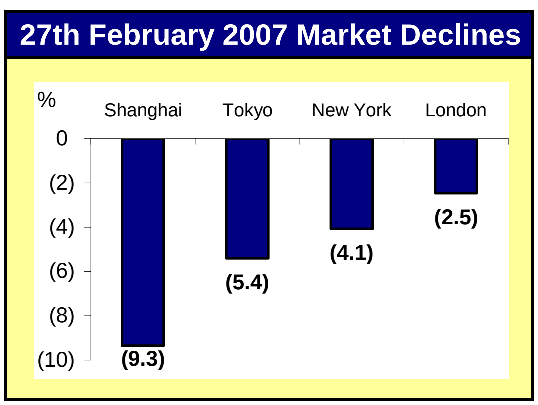
This is the third in a weekly series of *Special Reports* about China, its markets and economy.

Mr. Peyman is the founder of Research-Works the leading independent research firm in China. Based in Shanghai for over five years Hugh brings his 30 years of experience in Asia to the phenomenon that is grabbing the headlines, moving global markets and puzzling investors worldwide.

For more information on Mr. Peyman or Research-Works, please email Fritz Handler or call 847.756.3600.

Last week we ended our outlook for the A Share market with the prediction that although the market will correct from time to time, it is a classic Asian liquidity-fuelled market and therefore could double from here. Even should we be wrong, we asserted, a Chinese market collapse would do no harm to investors overseas.

Coming only a few months after a 9% dive in Shanghai sent shudders around global equity markets, New York, London and Tokyo included, this may seem to be a rash prediction. Let us explain.



Source: Bloomberg

The domestic Chinese and global markets are not connected. Capital controls, with the exception of about $10 billion of approved foreign investment through the Qualified Foreign Investment Institution scheme, keep Chinese capital within China. There is some leakage in both directions, but nothing significant.

Not only can we say the domestic and global markets are unconnected, but we can say the same of the domestic A Share markets and the Chinese economy. Presumably that was the global fear. If the A Shares tumbled nearly 10% in one day, they must be saying something about prospects for the Chinese economy, an important source of global growth.

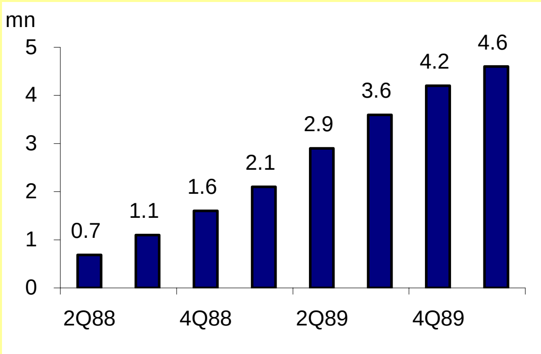
In fact they were not. They were responding merely to government measures that triggered selling in an attempt to bring the bubble under control. This proved to be short-lived, so presumably global markets will react less swiftly next time.

What could harm foreign investors would be if any market collapse hit the Chinese economy and therefore the world economy. This seems unlikely for two main reasons. First, consumer spending is unlikely to be affected much. The percentage of people invested in the stock market is limited: the amount of credit given to them is even more limited. Secondly, the main drivers of China's economy are still well in place.

Individual Investors: Limited Negative Wealth Effect

Press reports about tens or even hundreds of thousands of individuals opening accounts in a single day make for great headlines and serve the government's purpose. However, they lack credibility. They are not part of a regular data source and mysteriously never appear in national statistics. It will take a couple more years for the number of individual accounts to peak, judging by Taiwan's experience in the 1980s.

Taiwan Active Brokerage Accounts 1988-90



Source: The Great Taiwan Bubble, Steven Champion

Market experts maintain that so far in the rally about half the funds have been coming from local government and corporate accounts. Even the department responsible for maintaining Shanghai's sewers has over $100 million invested in the market – good news for the citizens of Shanghai given the market's strong performance over the last couple of years, as long as the bureaucrats-turned-investors know when to take profit. In fact the government has probably forced them to sell, booking a tidy profit.

Whatever the true number of individual accounts, it is well below that in mature markets. By the time this cycle is over the number of individual investors may rise further but still be well below numbers in the US as a percentage of the population. Therefore the negative wealth effect will be a lot less than many overseas imagine.

Economic Resilience

China's economy is being driven by a whole series of what could be called mega trends. These are not just cyclical factors but structural changes that have generated all the growth momentum of this decade. These trends are not about to subside, let alone die because of a market meltdown.

What are we talking about? In no particular order, as they all reinforce each other, they include:

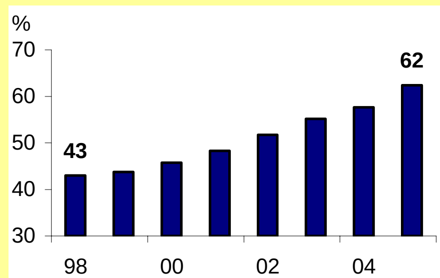
Consumerism: As a younger generation that has only known rising prosperity since the 1990s come to be the key economic actors, as they move into the nesting era that sees housing and consumer goods as priorities, so growth strengthens. It is not just numbers but a mind set. Younger people are much less debt-averse than their parents who have been through the Great Leap Forward and the Cultural Revolution.

Household Incomes: Urban wages have risen 8-10% a year for the last three years. For those in short supply like managers and skilled workers the increases have been 25-50% as salaries catch up with value.

Mortgage Market: The single most important development this decade has been the introduction of the mortgage market. This was greatly helped by the change in the constitution in 2004 to allow the concept of private property. This cycle is starting to slow but should still be strong for another couple of years.

Private Sector: This constitutional change also spurred growth of the private sector in business. There are still obstacles but steadily they are declining, unleashing the potential of private enterprise.

Industrial Output: Private Sector



Source: CEIC

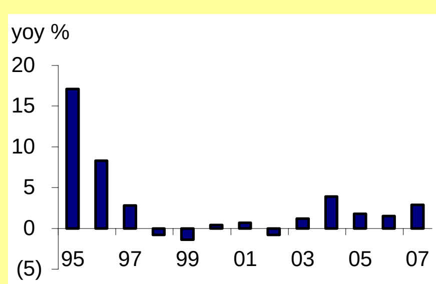
SOE Reform: State Owned Enterprise reform has been equally important, arguably more so. This has slimmed the industrial workforce by some 30 million workers even while output has doubled every five years or so.

WTO: Accession to the World Trade Organisation in 2001 has levelled the playing field, not just for foreign companies but domestic as well. Local protectionism historically has been a powerful force, now it is on the wane.

Productivity: Improvements in the state and private sectors as well as competition have set off what Alan Greenspan would doubtless call a "productivity miracle".

End of Deflation: Has stimulated growth in white goods now that consumers expect prices to rise rather than fall.

CPI 1995-07

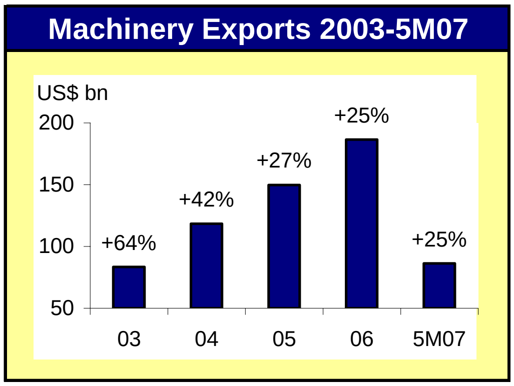


Source: CEIC

In short, China is making up for 50 years of lost time. These factors and many others ensure that the economy would be resilient even if the stock market collapsed.

These are mega trends that will not be stopped in their tracks. They have been gaining momentum since the first economic reforms of 1978 and still have plenty of force.

China is often called the Workshop of the World. In fact this is only true for white goods. The story of the next decade is likely to be China's growing share of heavy manufactured goods from shipping to machine tools, machinery to autos and auto parts.



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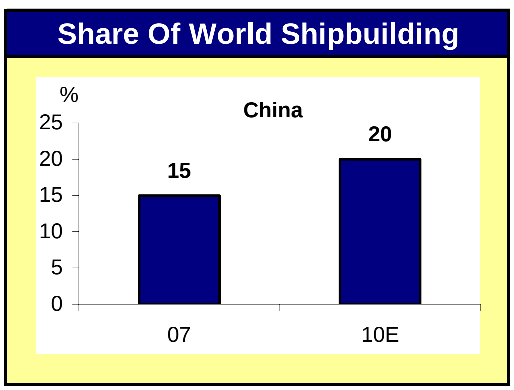

Source: Research-Works estimates

For the last six years China has been gaining one percentage point of share in global traded manufactured goods. With these trends underway this can last another six years and possibly even more.

Infrastructure is still in short supply in China. Therefore its construction will remain strong regardless of what happens in the markets. The road and rail networks are set for major expansion – think the US in the 1950s when suburbia and the development of the federal highway system changed the face of America. The same thing is happening in China.

So far only about five cities have underground rail systems. By 2015 another 50 systems are planned. Without them Chinese traffic will be gridlocked.

Conclusion: Don't Lose Any Sleep Over the Market. It's The Economy

US and other foreign investors are insulated from any meltdown in Chinese markets. There will be minimal lasting impact on global markets. The economy is what matters and that has so many strong trends that even after a market meltdown we would expect it to remain resilient. This is what matters for foreign investors: whether China can continue to supply growth to world demand. It can.

All of the economic factors we have highlighted deserve greater explanation. They will be examined, together with other topical trends, in a proposed series *The View From Shanghai* starting in the Fall. Next week we shall introduce the *China Monitor*, Research-Works' monthly commentary and charts on China's markets and economy that we say gives investors China in 20 minutes a month.

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