The Middle Kingdom – Zhōngguó – China.

A few months ago, I was fortunate to spend some time in Southern China during the lead up to Chinese New Year. As the second largest economy in the world, it's extremely important for me to keep above-average awareness in the region for the benefit of my clients. In this month's letter, I will share some observations gleaned from the streets of Guangzhou, Shenzhen and Jiangmen – three important and populous cities producing outsized portions of the things Americans consume.

Any thoughtful discussion on the outlook in China requires some context, so I want to start with a lively refresher on the history of Asian economic reform:

In 1960, Malaysia had per capita income on par with Haiti. Many other nations around the region also had languid economies and widespread poverty. As the 60's progressed, however, major reform swept across South Korea, Hong Kong, Taiwan, Singapore, and Malaysia, changing the trajectory of global development.

Leaders in these “Asian Tiger” nations, while maintaining relatively tight political control, began to follow a strategy of industrial policy that emphasized the reduction of state control of large firms, and shifted focus to regulatory activity aimed at fostering competitive export sectors. Simultaneously, they protected select domestic markets from outside competition. This uniquely opportunistic blend of government intervention with market forces proved over time to be a stunningly successful approach to development economics. As measured by rising income levels, life expectancy, and other broad measures in standard of living, it was nothing short of miraculous for the people of those nations. Within 30 short years, the Asian Tigers had skipped over many of the difficult chapters industrializing Western economies had experienced, and arrived as leaders in some of the highest value-added businesses in the world. As a friend of mine described succinctly—what you had was “a classic leap-frog situation.”

For a variety of reasons, China was slower to adopt these shortcuts. As a vastly larger nation with an entrenched centrally planned economy, China lagged behind the achievements of the more quickly liberalizing nations during the 1960’s and early 70’s. This all began to change in September 1976, with the death of Mao Zedong and the emergence of Deng Xiaoping, who emphasized pragmatism for the future of the Chinese Communist Party (CCP.) Chairman Deng differentiated himself from the prior leadership through his lack of interest in political dogma. He most famously declared two things: First, *“Poverty is not socialism.”* And second, *“It doesn't matter if a cat is black or white, so long as it catches mice.”* Under the influence of these views, and with newfound willingness to draw policy lessons from its Tiger neighbors, China began to accelerate into the economic position we see today.

Deng Xiaoping Saddles Up.

I want to gloss over the next 35 years by simply saying it was a period of phenomenal economic and cultural growth. China not only uplifted people’s standards of living, it also emerged as a nation of relative peace after many decades of strife and widespread political violence. While clearly many social and economic issues remain, *progress* during this period was significant.

Jumping forward to 2012, I want to use this background to highlight my experiences in China and discuss how far this liberalization has gone. To assist, it makes sense to delineate cultural observations from economic observations, despite the fact they are clearly intertwined at an accelerating pace as China seeks to spur innovation – the next frontier of its development.

Let me start by dispelling some commonly held myths. You can't be blamed for having them if you haven't yet seen Guangzhou, city of 14 million people.

Myth: China is slowly embracing capitalism.

In the urban areas of Southern China, it is safe to say that if you're not witnessing capitalism in its most full-tilt application, it is pretty darn close. Never have I witnessed a place where people are more focused on doing business, accumulating wealth, and basking in its benefits. Banks bustle with activity, often with long queues. Cash is flying through people's hands, smart phones are ringing and chiming everywhere, and giant digital screens advertise automobiles from the sides of skyscrapers.

Entrepreneurial activity is evident all around. Competition is fierce. Construction workers sleep on the lower floors of buildings still under construction above them. Ask for the price of a tablet computer in one shop, and the proprietor next door sees no issue in leaning around the corner to pitch a better deal on the first shopkeeper's front porch.

If capitalist theorists think of socialism as a wide safety net under society that undermines the Darwinian nature of competition, they should really visit Socialist China. In this land with essentially no safety net, you must compete or get trampled by the other 1.3 billion people who will. Competition is a way of life, rather than some theoretical ideal.

Deng Xiaoping, the pragmatist, to Margret Thatcher:
"By following the concept of 'one country, two systems,' you don't swallow me up, nor I you."
– Deng Xiaoping on Hong Kong's Return to China.

From a policy standpoint, the pace of liberalization is startling. Shortly after I returned to the U.S., the *China Securities Regulatory Commission* announced it was vetting the first exchange traded fund (ETF) that would allow mainland investors access to Hong Kong traded equities. Simultaneously, the *National Development and Reform Commission* suggested a deal was close at hand to allow certain pension funds broader access to homeland securities markets. Similar reforms appear to be in the offing for the Yuan currency market. You can't read any financial paper without seeing news about markets opening in China.

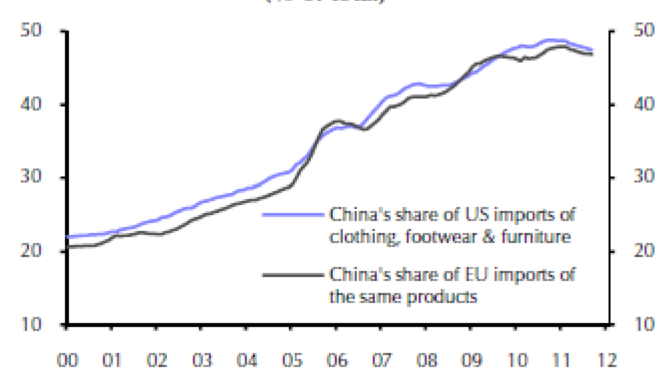
Myth: The Chinese don't understand quality.

While it is true much in China is produced without an eye towards durability, many Americans assume it must be primarily due to some naturally lower Chinese standard. What is often forgotten is that our own willingness to consume low quality products is a huge driver of this dynamic.

The average Chinese factory is approached by foreign customers looking for cutthroat pricing, playing one factory off the next over the slimmest of margins. As a result they receive exactly what they pay for; discount-level quality. Adding to the problem is the fact that some unscrupulous factories are willing to quote unachievable prices, and then try to reduce material or construction standards once the deal is completed, hoping customers won't notice. While this is a serious ethical issue, and chronic enough to require a general discounting of producer's promises, it points back to the fact that things are being produced to lower quality standards on purpose, not due to lack of capability.

Is this state of affairs static, and unlikely to change? No. China is actively transitioning to more profitable up-market opportunities. This shift is perhaps best seen in the fact that the coveted iPhone is produced to very high standards right in Shenzhen. Other examples abound. *Capital Economics*, a Canadian economic journal with good Asian research, recently offered an interesting plot of these trends:

Chart 1: Share of Low-end Exports
(% of total)



Sources – CEIC, Capital Economics

You can see China's share of low-end exports to the U.S. and EU have recently started to level off. Rising wage levels and land scarcity is causing some of this production, especially textiles and apparel, to be sent elsewhere in Asia – particularly Vietnam. All the while, more high-end exports are starting to come online.

One exchange I had in Guangzhou somehow encapsulated the issue. While talking with a Chinese consultant, I asked her middle-school aged son what he wanted to be when he grew up. He said "an engineer of underground parking garages." Needless to say, I was stunned. Once I got over the shock, I realized he was onto something – parking is getting very scarce in downtown Guangzhou. But more importantly, the current educational and cultural framework is clearly setting up the next generation to do bigger and more fantastic things. The pace of progress is palpable. We must be careful not to underestimate what Chinese engineers are capable of, and also recognize that in our global economy the quality of supply flows quite directly from the quality of demand.

Myth: Increased Chinese consumption will fix the U.S. trade deficit.

In my view, this idea requires the most serious reconsideration. If the United States is having trouble selling enough goods and services to the world, then we say it must be the result of poor consumption elsewhere, currency manipulation, or unfair trade practices. In each case America is seeking to place blame for our competitive troubles on others. Little examination is made into whether we ourselves might be the cause of these imbalances. *(Further reading on this important subject can be found in the March 2012 issue of the Harvard Business Review.)*

To say consumption is too low in China does a considerable disservice to how much enthusiastic spending is going on there. German automobiles, Italian shoes, and French wine are leaving shelves at a rapid pace. The U.S. has also found it can sell the right products in China when we have them – but presently, net on net, we simply don't have enough to sell them that they can't already produce themselves. Few Americans learn Mandarin or take other symbolic steps required to make the sales that would help fix the trade shortfall. Nor do we see the issue from the other side of the coin, and think much about how our *consuming less* might also help resolve the trade deficit.

While it is politically easy to scapegoat China, America does so at its own risk. After witnessing the shopping patterns of the new middle-class in China, I can assure you we are shouting into the wind. China is consuming more everyday – just not enough of *our* stuff. America needs to refocus on its own competitiveness to solve these problems – not seek an ethereal macroeconomic bailout from Chinese consumers. As investors, we need to be particularly mindful of this bellwether issue as it is a good indicator that America is proactively addressing its long-term economic sustainability.

Related to this, the first thing I did when I got back to my desk from China was check the financials of a few firms in Germany's DAX. They appear to be living up to their claims that they are successfully garnering the attention of Chinese consumers.

Beyond the economic realities, you have cultural growth.

China appears to be leap-frogging in the cultural realm much faster than the world realizes as well. While riding the clean and well-used new subway lines, I was exposed to a lot of marketing collateral. The images and messaging suggest that consumers are being attracted to what Americans might call "culturally sophisticated aspirations." Awareness is being directed at three realms in particular:

innovation, the environment, and family values. The repeated presentation of these themes as desirable is surely a sign of bigger things building in the society beneath.

Some may suggest the lip service is disingenuous. I disagree. While it's nice to imagine change can occur in a big leap from high-minded musing to spotless practice, we all know it takes hard work, time, and a range of actors. Until new ideas are accepted by either the commercial or cultural marketplace, the possibility for widespread adoption is limited. The fact commercial markets are welcoming these ideas means that pressure will also be increasing for further policy action.

*An image from China Environmental Protection Foundation's '*Green Pedestrian Crossing**'**
Winner of a 2011 ADFEST award.

As far as I can see, any new idea formed at the highest levels of thought in the U.S. can be expected to be taking its first consideration in China nearly as quickly as light bends through optical cable. While America pioneered the Internet and reaped huge benefits, even more accelerated benefit seems to be accruing to Chinese productivity. China Mobile, for example, has about **double the number of cell phone subscribers that the U.S. has citizens (655m Jan 2012.)** Chinese internet adoption has also eclipsed our own. As we are being leap-frogged, we decry Chinese freedom of information without realizing that Chinese people can access most anything online, either on-demand or with minimal hacking capability.

Regarding family values, it's clear that China is grappling with some of the unintended consequences of the "one-child policy." But given this unique backdrop of privileged only-children, it appears more generally that Chinese society is in the process of collecting itself, rather than nearing any massive upheaval as gloomy Western commentators love to predict. Chinese people seem quite focused on their families, dressing for success, and preparing their children for even more success.

It is certainly possible my view is biased by the urban areas I visited, but I did not come away with a sense of a nation seeking immediate change. Certain groups are clearly feeling disadvantaged or cheated in the struggle for wealth and status, but some resolution seems to be coming in the paced and controlled political change that is occurring. Broad wages continue to rise around the country, and as a result I must err on the side of optimism. I see many parallels to the 1950's in America, and thus, relative stability.

The idea of innovation dovetails well with those observations. As people have their basic needs more easily met, we can also expect them to begin seeking fulfillment outside their material requirements. This may well create the space required for the inquisitive and counter-culture mindset of the innovator and entrepreneur. While I'm not ready to declare the dawn of a Chinese 1960's, and thus what may turn out to be the *largest, most influential and innovative generation in world history*, the possibility is real enough to require keen attention. In the very least, I'm positive the underground parking situation is going to improve dramatically!

All this leads me to the crux question for my clients.

In this type of environment what actionable items exist and what are the timeframes?

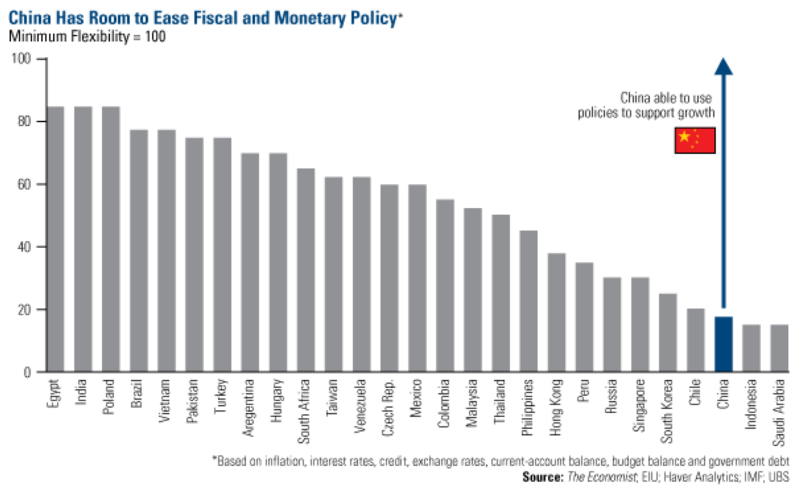
The majority of my observations suggest China still looks extremely strong over the long-term. A big part of my enthusiasm comes from the types and variety of problems they currently have. Many of these problems have already been solved fairly well in other nations, suggesting the game of leap-frog will continue. Additionally, while counter-intuitive, these problems will actually become the source fuel for future economic growth. Economic *animal spirits* feed on problems and inefficiencies, so a broad but tractable set of them should keep these spirits prowling happily around the economy for years to come.

Will there be setbacks? For certain. Will any come soon? Yes – we are in the midst of one right now. But these setbacks must be regarded as openings to add, not reduce exposure. Our current large-cap allocations in China are hovering around a humble 2-3%. If a significant setback comes along, I visualize doubling them to 4%-6%. In the meantime, strong dividends on par with the S&P 500, combined with even better earnings yields than the S&P 500, will support us as we wait for the next significant bull run.

In the medium-term, I saw that Mainland stock market sentiment was clearly negative enough to suggest the market is fragmented. In the midst of all the volatility, last year's weak performance was almost entirely recouped by mid-March, contradicting some of the concern about an economic "hard landing." Good fundamental value is stretching all the way into some of the most desirable domestic brand names. We can buy these blue-chip firms confidently. From these firms, which have both pricing power in the world's largest market, as well as implicit government cooperation, we can reasonably expect good outcomes from current price levels – even in sub-optimal growth environments. Additionally, I expect this segment to be the leading beneficiary of the liberalization activities in the policy pipeline mentioned earlier.

On a more immediate basis, I also drew some conclusions about what we shouldn't be investing in. So much gold was being sold from bank windows to highly enthusiastic Chinese retail investment buyers that I feel quite confident we need not waste our precious time accumulating the "precious" metal. It appears to me that the gold market is in a distribution phase versus a consolidation phase. Institutions are clearly liquidating into the retail market. Additionally, I confirmed that despite the conceptual attractiveness, investing in smaller firms successfully in China is outside our capability. Opacity and red tape reins, and likely will for some time. The problem is such that even investing in small-cap indices makes little sense. I expect to take more interest in this segment in 7 years time, as governance improves.

Last but certainly not least, China remains very well positioned with available resources to stimulate the domestic economy, as I have detailed more fully in past letters:



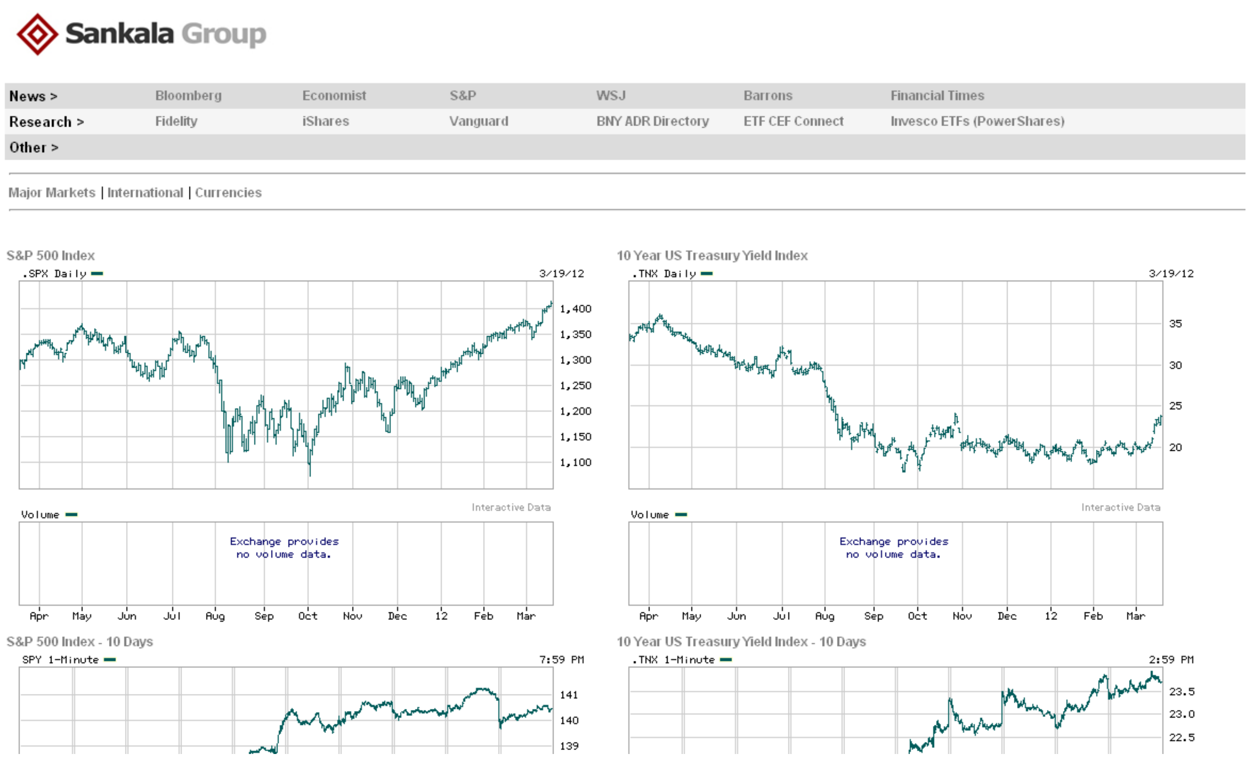
On the risks, leading is the real estate market. Through my discussions and travels I witnessed firsthand the storied "real estate bubble." And yes, I confirmed prices are a bit out of line in Shenzhen. And yes, the broader property market looks visually stretched with cranes still everywhere. But from a capital flows perspective, when you have huge numbers of people migrating into cities, combined with rising wage levels, plus *less* attractive real estate, the new wealth being created needs to go somewhere. The attractive options are very limited. That's another supporting argument for the presently unpopular case for Chinese large-cap equities. A younger population seeking investment, but priced out of real-estate, will be attracted to shares.

While many Westerners remain uncomfortable investing in China, figuring out a way to get reasonably priced exposure to this economic juggernaut is crucial to our long-term success. Making isolated bets on American growth and ascendance is too big a risk for us to take wholesale in 2012. With disciplined methodology and unbiased cultural thinking, I feel confident we can invest across this divide successfully.

Other Developments:

- I had a short piece published this month on the unique investment considerations of entrepenuers: **Under30CEO.com**

- Sankala Group's back-end website is finally complete. It will help clients vizualize a range of key global indicators, and assist our communication about trends. A screen capture can be seen below:



Best,

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