Bradley, Foster & Sargent, Inc.
Quarterly Market Commentary

October 2012

Crossing the River While Feeling the Stones: China at an Inflection Point

> Reform is China's second revolution.
>
> Deng Xiaoping, Chairman, Central Military Commission, 1985

> No one, no matter what the rank, will be immune from Communist Party discipline. The entire Party must fully realize the perennial, complex, arduous nature of the anti-corruption fight…
>
> Xinhua, Chinese News Agency, September, 2012

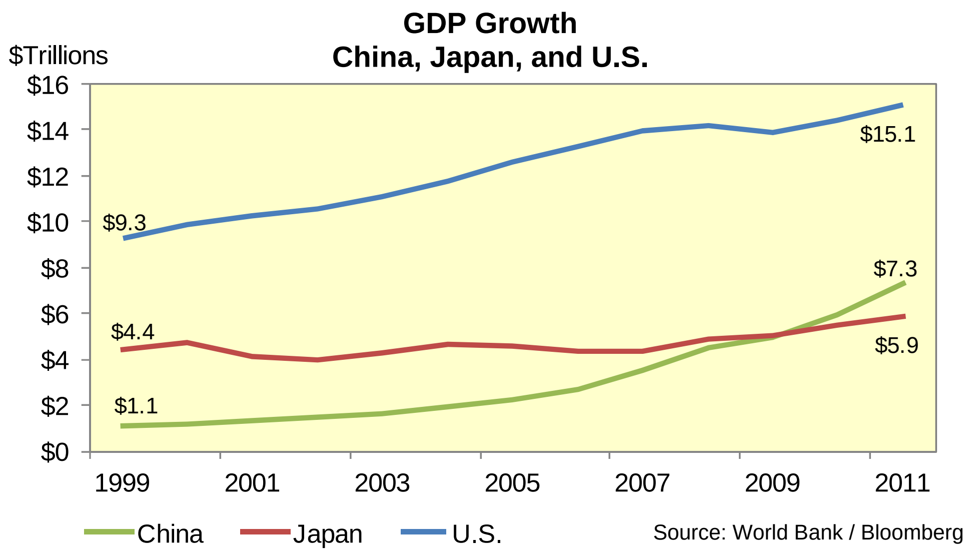
There are momentous changes underway in the People's Republic of China. Politically, a new Politburo Standing Committee of the Communist Party of China (CPC) will be chosen in November by the 18th National Congress of the CPC. It is very likely that the CPC will confirm Xi Jinping as General Secretary of the Communist Party and President of China and Li Keqiang as Premier in the so-called fifth generation of leadership in China. On the economic front, China has recently experienced a rapid deceleration in the rate of economic growth. Analysts report that there are more than 120,000 small scale protests and riots annually arising from social and economic conditions prevalent outside the major cities. There is also a growing recognition that a moral vacuum has caused rampant nepotism and corruption in Chinese society. Finally, China is flexing its muscles militarily, sending armed naval vessels to contest the Senkaku Islands – a group of small uninhabited islands controlled by Japan. How will China navigate through these potentially stormy waters over the coming years?

In order to better understand these political, economic, and cultural changes and their effect on the global economy as well as on companies in China and abroad, three Bradley, Foster & Sargent Principals traveled to China in June and spent ten days in Hong Kong and Beijing. This was our fourth trip to China over the past decade. In our most recent trip, we sought to analyze whether there are ways to profitably invest in companies in the rapidly growing Chinese economy at acceptable levels of risk. However, before we chronicle the potential risks and rewards of putting money to work in China, let us first look at the bigger picture.

A Great and Ancient Civilization

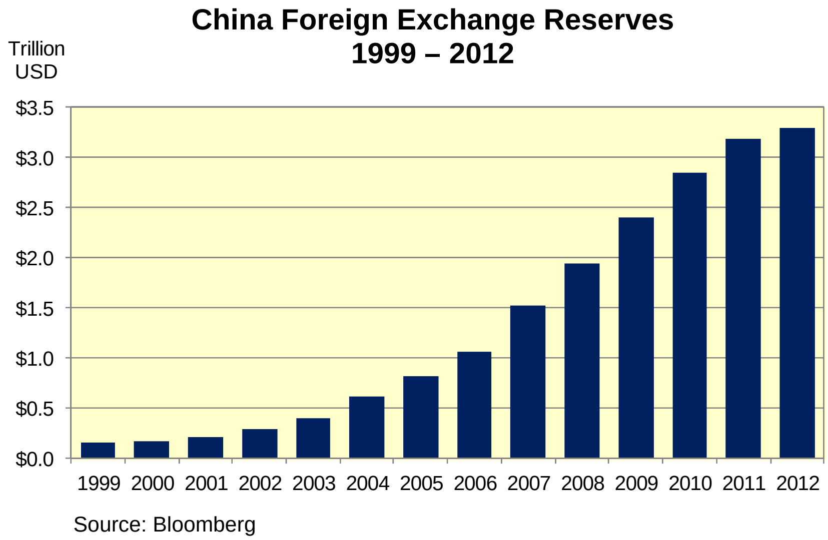
China has nearly 4,000 years of recorded history, dating back to the Shang Dynasty in 1675 B.C. Confucius lived in the 5th century B.C. – the same period as the Golden Age of Athens, Greece. Several hundred years later, China was unified by Ying Zheng, who established the Qin Dynasty and was the first emperor to build the Great Wall to keep the "barbarians" out. According to most general histories of China, the Middle Kingdom was ruled by eight or nine Dynasties, the final one collapsing in the revolution of 1911. Whether a Dynasty lasted one century or six, there was a common pattern in the ascent and fall of each. In its early years, each Dynasty was powerful, virtuous, and vigorous. Sooner or later, decay and corruption set in, leading to its fall and its replacement by a strong and able emperor who would establish another just and efficient government, returning harmony to the land again. In 1949, a new Chinese emperor, Mao, took control of China and led it until his death in 1976. The Dynasty which he founded, and which was rejuvenated by Deng Xiaoping and his reforms, is still led by the leaders of the 80 million strong Communist Party of China (the new Mandarin elite).

Since the beginning of recorded history in Asia, China was its sole superpower. China, with a land mass the same size as the U.S., rarely made its power known by invasion and conquest but rather through its cultural, spiritual, and educational influence. The Chinese invented paper, the compass, gun powder, and printing, among countless other inventions. In 1820, China's GDP represented 30% of the world's GDP, exceeding the combined GDP of all of Europe and the U.S., but from the middle of the 19th century until 1979, when Deng Xiaoping assumed power, China's economy declined disastrously. The war against Japan, its civil wars, and Mao's rule decimated the Chinese economy. Mao's Great Leap Forward during 1958-1961 resulted in the death by starvation of an estimated 35-50 million Chinese. Following the further devastation of the Cultural Revolution, Deng's reforms unleashed the latent productivity of the Chinese people. As a result, the economic growth since 1979 has been astonishing. The chart below shows China's remarkable economic growth in the 21st century, as it surpassed Japan as the second largest economy in the world:

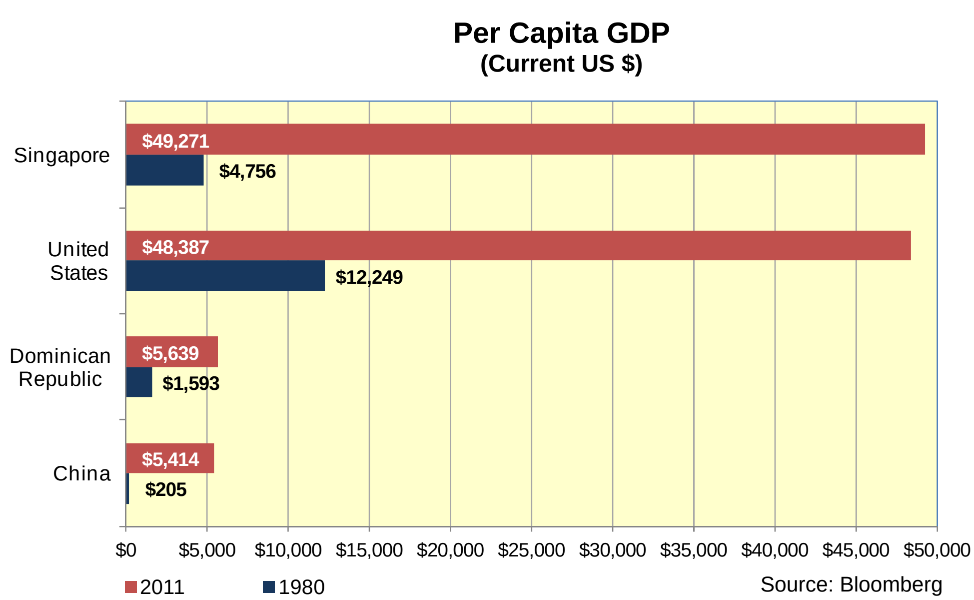


Size and Scale of China

Even our brief visit to China brought home the vast size and scale of China. With a population of 1.3 billion people, it has 150 cities of more than one million people and ten cities which are more populous than New York City. Beijing is vast, stretching 55 miles – the distance from Boston to Providence. 18 million people live there. The length of the Great Wall is 5,500 miles; it rivals the Pyramids as the greatest man-made structure of the pre-modern world. In the 33 years since Deng Xiaoping assumed power, China has been transformed from a country of bicycles with all men and women wearing the same uniform and with only one book allowed in libraries and bookstores to a country of significant economic power and wealth. Today, China sells more automobiles than any nation in the world. Of the 1.4 billion tons of steel that are produced globally each year, China produces 50%, while the U.S. produces 5%. China consumes between 40% and 50% of the world's aluminum, zinc, lead, steel, coal, iron ore, and cement. It also consumes 38% of the world's eggs and 45% of the pork. Its real GDP growth from 2002 through 2011 never dropped below 9.1% in any year, and in 2007, the real GDP grew at an astounding 14.2%. With its undervalued currency and manufacturing efficiencies, China has become the manufacturing base for the world and has accumulated enormous foreign exchange reserves, as the chart below shows:



Despite its amazing economic growth, China is still a relatively poor country. China has its billionaires and millionaires, but wealth is spread unevenly. Approximately 700 million Chinese live rurally, where the average disposable income is less than $1,500 annually. There are major inequities in income between the relatively prosperous coastal areas and the poorer inland provinces. Due to China's housing laws and the prosperity of the coastal cities, there are approximately 150 million migrant workers from rural areas who travel to the cities looking for work. They compete with each other for short-term, low-end jobs and are a source of instability in China. The CPC understands that inequities in wealth distribution, the large number of migrant workers, and widespread corruption are the main sources of social unrest. The 120,000 incidents of public protest, involving 3 million people annually, are a real threat to the very existence of the CPC. The CPC aims to mitigate this unrest through the planned migration of 250 million rural inhabitants to newly developed cities in the next 20 years. This will result in a 70-30 city/rural population ratio, which is more typical of advanced developing countries. The chart below compares the per capita GDP of China, now vs. 30 years ago, with that of several other countries:



China over the Next Decade

When the 18th National Congress of the CPC meets in Beijing in November, a new generation of leadership will be inaugurated. Both Xi Jinping, the likely President, and Li Keqiang, the likely Premier, have been groomed for their jobs for many years. The real question is the composition of the remaining members of the Standing Committee of the Politburo, which represents the 240 members of the Central Committee of the CPC – China's all-powerful decision-making body. The expulsion of Bo Xilai from the CPC, his removal from public office, and his arrest are a clear signal that politicians on either wing of the party – Maoist or radical democracy reformers – have no future. Decisions will continue to be made largely by consensus; party leaders like Bo, who try to create a cult, will be discarded. And it is probable that the Standing Committee will consolidate its power, shrinking to seven members from the current nine. Most importantly, the CPC's leadership seems dedicated to attacking corruption and nepotism within the Party. An example of how far the CPC has strayed from its roots, as reported by James McGregor in his book *No Ancient Wisdom, No Followers*, is that "the wealthiest 70 National People's Congress members are more than 10 times richer than the top 660 officials in the U.S. government." There have been previous CPC campaigns to root out corruption, and only time will tell whether this attempt will be successful. As long as *guanxi* – a dynamic in Chinese relationships, emphasizing personalized networks of influence and reciprocal favors and services – remains an important part of the Chinese culture, it seems unlikely that this campaign will be more successful than past efforts. James McGregor writes that the CPC has two ultimate goals, which have not changed over the previous three decades: "Make China rich and powerful, and guarantee the Party's political monopoly."

Future Economic Policy

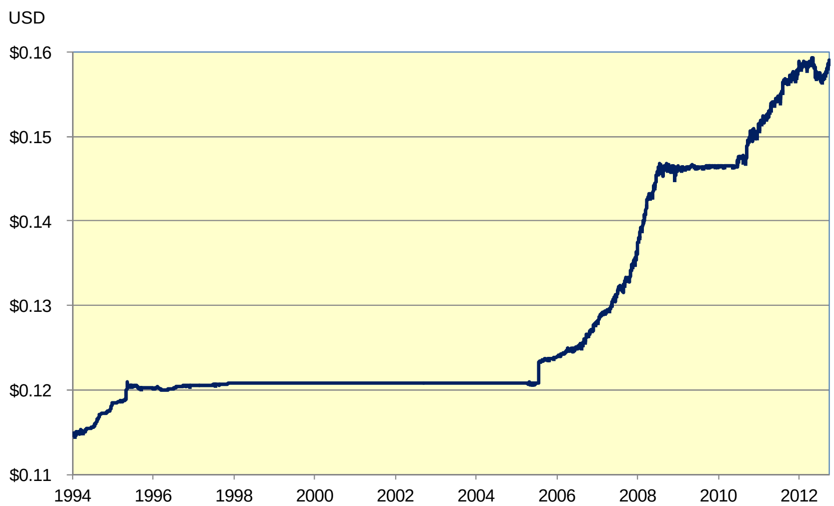
China's real annual GDP growth has not dipped below 9.1% since 2002. China is now, however, in a period of decelerating economic growth. Many economists and businessmen are forecasting real GDP growth of 7% this year – a "soft landing." A "hard landing" for the Chinese economy, according to many pundits, would mean real GDP growth of 5% or less. A decline of 4% or more in GDP could have serious economic repercussions in China and globally. During our trip to China, we heard members of the CPC leadership underline their commitment to growth of 7% or more. Recently, the government has undertaken numerous fiscal and monetary initiatives to help guide the economy to a soft landing. Real GDP growth in China for the 3rd quarter of 2012, which was just announced, was 7.4% – evidence that the projected soft landing may well happen.

Looking ahead to the new political leadership's objectives, it seems clear that the CPC wants to transition the Chinese economy from an investment-and-export-led economy to a more domestic consumption-driven one. Currently consumption as a percentage of GDP in China is less than 40% – compared with over 70% in the U.S. Economic policy in China has served the country well in developing its heavy industry, infrastructure, manufacturing base for exports, and military. But it has held back domestic income, consumption, and the development of the service economy. The CPC's plan to build new cities to accommodate the planned migration of 20% of the Chinese population from farms to cities may indeed reduce the risk of challenges to its political leadership, by moderating income inequality and reducing social tensions. There is also the possibility that China may change its one-child policy. Aside from the tragic human rights considerations, the leadership understands that under the current policy, China will be old before it is rich. The demographics of having one child supporting two parents and four grandparents will soon begin to bite, as China's working age population will peak in 2015.

Another key step expected to be taken by the CPC will be the reform of State-Owned Enterprises (SOEs). There are tens of thousands of SOEs, and they dominate the Chinese economy. In each key SOE, there is a CPC leader whose input is often more important than that of the Board of Directors or the CEO. The government heavily subsidizes many of these SOEs and protects them from foreign competition. This system of "authoritarian capitalism" has aided China's remarkable growth but has become increasingly unproductive. As James McGregor writes, "Corruption is endemic, and the SOEs are consuming the fruits of reform; the economic engine is running out of gas." The financial system, which is effectively an arm of the government, continues lending to money-losing SOEs, thereby undercutting competitors. The reform of the SOE system will be necessary if the service economy is to prosper and consumption to increase.

After years of pressure from the U.S. and other developed nations, China in 2005 commenced a policy of allowing the slow appreciation of its currency – the yuan – against the U.S. dollar. As the chart below shows, the yuan has appreciated 30% against the U.S. Dollar since 2005. In spite of the yuan's gradual appreciation, China's foreign exchange reserves have tripled from $1 trillion to $3 trillion since 2005 (as the chart on page 3 indicates).

Chinese Yuan's Appreciation vs. the U.S. Dollar



Source: Bloomberg

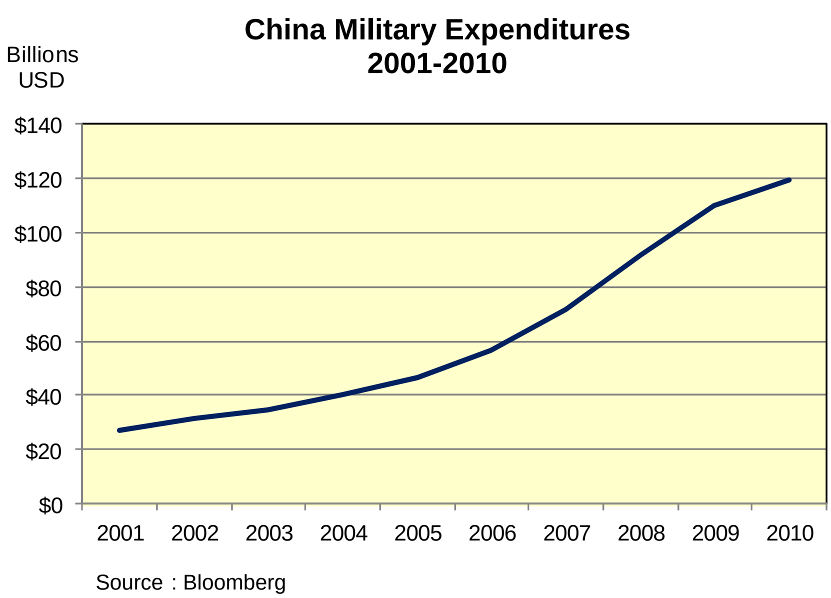
Chinese Culture

For the last three decades, the Chinese moral belief system has been in a kind of limbo. Mao and his comrades had waged a 30-year war on Confucius, traditional Chinese values, and all other religions. Marxist-Leninist principles, according to Maoist interpretation, were rigorously enforced at all levels of society. Commencing with Deng in 1979, this value system – in regard to the creation of wealth, owning private property, the arts, fashion, and even religion – was trashed. The only remaining guiding principle was the stricture not to challenge the CPC politically. However, Communist values were not replaced, thereby creating a moral vacuum. Recently, however, the CPC has resurrected Confucian values. A statue of Confucius has even been erected in Tiananmen Square. Confucian values emphasize the strength and influence of the family to maintain a culture of hard work, thrift, filial piety, and respect for elders and education. These, the CPC believes, will make for a more stable and productive nation and help the economy.

One of the remarkable traits of the Chinese people is the extent to which they are forward-looking, not dwelling on past troubles and the oppression which they have suffered. As Henry Kissinger writes in his book, *On China*, "Among the many extraordinary aspects of the Chinese people is the manner in which many of them have retained a commitment to their society regardless of how much agony and injustice it may have inflicted on them…. The Cultural Revolution is treated, sometimes wryly, as a kind of natural catastrophe that had to be endured but is not dwelt on as defining the person's life afterward." Our trip to China reinforced our belief in the strength of the Chinese work ethic. We also saw that the Chinese people remain confident that China will always be the "Middle Kingdom."

China's Foreign Policy

China is on its way to becoming one of the most powerful nations in the world. There is considerable risk to the international community when another major world power emerges. One need only look at France under Napoleon, or Germany and Japan in the 20th century, to see how badly things can turn out. As one of the world's largest importers of fuel, commodities, and raw materials, China has also entered into many trade agreements with countries in Asia, Africa, and Latin America, and it is investing growing amounts in strategic industries overseas. The People's Liberation Army is 2.3 million strong – 50% larger than the U.S. military. China's navy already has five nuclear submarines and has recently put into service its first aircraft carrier. China's annual military spending rose more than fourfold between 2001 and 2010 to $120 billion as the chart below shows:



China's recent troubles with Japan over the Senkaku Islands have been a warning signal to Asian nations that China may intend to use its military strength to gain an advantage. China's unwillingness to play a constructive role in defusing the situation on the Korean peninsula and its refusal to assist Western nations in their bid to stop Iran's drive for nuclear weapons is also disappointing. Nevertheless, there is little question that the U.S. and China now maintain a system of co-operative co-existence (as Henry Kissinger calls it). There is an enormous amount of mutually beneficial trade and economic activity between the two countries. Each country depends on the other for a portion of its economic success. And for most of its neighbors, China is an indispensable trading partner. These realities, we believe, will temper the hawks in China so that flash points such as the standoff over

Taiwan will be handled peacefully. While there may be bumps along the road, common sense will likely prevail as China emerges as a world power.

Investing in Chinese Stocks

Some institutional investors are allowed to own shares on the Shanghai and Shenzhen stock markets, but most foreign investors are prohibited from buying stocks on these exchanges. Accordingly, our comments here are restricted to the Hong Kong stock market, where foreign investors may own shares. Companies listed on the Hong Kong stock market include Hong Kong companies, mainland Chinese companies, and international companies such as HSBC Holding (formerly called The Hongkong and Shanghai Banking Corporation). The Hong Kong dollar has been tied to the U.S. dollar at a fixed exchange rate for many years so currency fluctuations do not affect returns for U.S. investors. The chart below shows the performance of the Hang Seng Index since the turn of the century:

The Hong Kong Stock market has made very little headway during this 12+ year period. This is surprising, considering that China's GDP increased almost *sevenfold* during this period. The main reason, we believe, for this lackluster performance is that the Hang Seng's P/E ratio at the end of 1999 was 27.8. It reflected the same overvaluation that the S&P 500 had in 1999 with a nearly identical P/E ratio. Currently the P/E ratio is 9.9 – not much greater than the Hang Seng's P/E ratio of 7.6 at the trough of the panic in March 2009. Why is the market P/E of the Hang Seng 25% lower than the S&P 500 at this time? The main reason, according to many analysts, is the fear of a "hard landing" for the Chinese economy, as China grapples with a slowdown in exports due to the troubles in Europe and the anemic economic growth in the U.S. There is also uncertainty about the political and economic inflection points in China at this time, which this commentary discusses. Additionally, there have been numerous issues of corporate governance and accounting which have made foreign investors cautious about investing in the Hong Kong market and in the ADRs of Chinese companies listed in the U.S.

Conclusion

During the midst of China's great reforms undertaken by Deng Xiaoping, he used the phrase "*crossing the river while feeling the stones*" to describe the pragmatic and experimental approach that China was to take as it sought to build a modern industrial nation and create wealth. Chinese leaders are confronted with different challenges now politically, economically, culturally and in foreign policy. Their approach seems to be the same as Deng's was: change and reform with an incremental and pragmatic approach. We believe that there is a high probability that the CPC will succeed. We see a reasonable chance that the Chinese economy will make a soft landing with GDP growth settling into a 6-8% range over the foreseeable future. We also believe that the new generation of CPC leadership will make a serious attack on corruption within the party and undertake a restructuring of the SOEs. Our view is that the CPC has no other choice if they wish to remain in power. In a similar vein, they will need to allow the Chinese working class to enjoy more of the fruits of China's economic success, raising the national income level and allowing for more consumption. The old model will no longer serve them well in their desire to create a rich and powerful China. The strategic plan to build cities to accommodate the planned migration of 250 million Chinese from rural areas will be a powerful economic stimulus. On the cultural front, it is likely that the resurrection of Confucian values within the broader culture combined with the strong Chinese work ethic will assist in continuing their rapid economic growth and maintaining social stability. Finally, the mutual economic and trading benefits which accrue to China, its Asian neighbors, Europe, and the U.S. should help make for a peaceful Chinese entrance to the family of world powers.

In regard to Bradley, Foster & Sargent's approach to investing in China, for most portfolios we will continue to identify and invest in leading U.S. and foreign multinationals that are well positioned to take advantage of the economic growth in China. This has been our primary approach to investing in China for the past decade, and we will continue this strategy at this time. For these portfolios, we prefer to see the fruits of the political, economic, and social change in China before committing funds directly to these markets. Also, there have been a sizable number of accounting issues and corporate governance problems with apparently fast growing Chinese companies that mandate caution and extra diligence when investing in these markets. For portfolios which invest solely in international equities and for clients who wish to put a toe in the water in the emerging markets, our favorite emerging markets at this time are Hong Kong and Singapore. To invest in the Hong Kong market, we are using an ETF that closely tracks the Hang Seng Index (EWH), and for the Singapore market, which we wrote about last quarter in our investment commentary, we are utilizing an ETF that closely tracks the Straits Times Index (EWS). In due course, we will begin to utilize individual equities on these exchanges and through ADRs. As China continues its march to modernity, we will follow developments ever more closely, as China will have an increasingly important impact on global markets, on the U.S. economy, and on U.S. Treasury debt in the future.