

China Watch . . .

More Random Gleanings . . .

THE WORLD DOESN'T NEED another "China is big, China is growing, China is a great opportunity, great threat" kind of article so I won't bore you. But I was in China recently for the second time in a year and visited twenty publicly traded former state owned companies. The managements I visited are the big guys in power, telecommunications, banking, commodities (aluminum and metals), oil and shipping. I missed the newer fast growing private Chinese companies and the foreign multinationals but I will catch some of these the next time. Here are my thoughts on the trip and hopefully some of them will be new to you.

1. China is losing jobs.

In manufacturing, China has actually lost jobs the last ten years. That's right, lost jobs. State owned companies have shed jobs faster than private companies and foreigners have created them. Sinopec Shanghai Petro Chemical for instance, an enormous chemical and gas operation has gone from 68,000 employees in 1983 to 15,000 today. China is facing the same problem as the U.S., that is we both produce a lot more with fewer employees.

2. China's biggest problem is....?

Everyone is talking about income disparity. The East Coast of China and the big urban areas of Beijing, Shanghai and Guangzhou are

booming. The middle class there earns between \$5,000 and \$12,000 U.S. a year which gives them a living standard equivalent to Americans earning \$40,000. But many of the 800 million living down on the farm are still getting by on \$2 a day. It's estimated China can produce all the food it needs with just 100 million farmers. How do you find good paying jobs for the other 700 million and how do you prevent income disparity from widening further? Good question and a big problem.

3. Bone up on Chinese history.

It's surprising how often in ordinary business conversation the Opium War, the Boxer Rebellion and the Western Treaties of the 1800s come up. Isn't this ancient history? For many Americans China is an impressively growing but still basically Third World country. The Chinese see themselves much differently. Their culture goes back 6,000 years and they have always been the "Middle Kingdom" or the center of the world. China is very sensitive about the one sided treaties that they were forced to sign in the 1800's and foreigners will be surprised how the Chinese expect them to "pay" for these inequities through favorable (for the Chinese) business dealings today. Interesting.

4. The big thing in China is...?

The growing consumer market. The

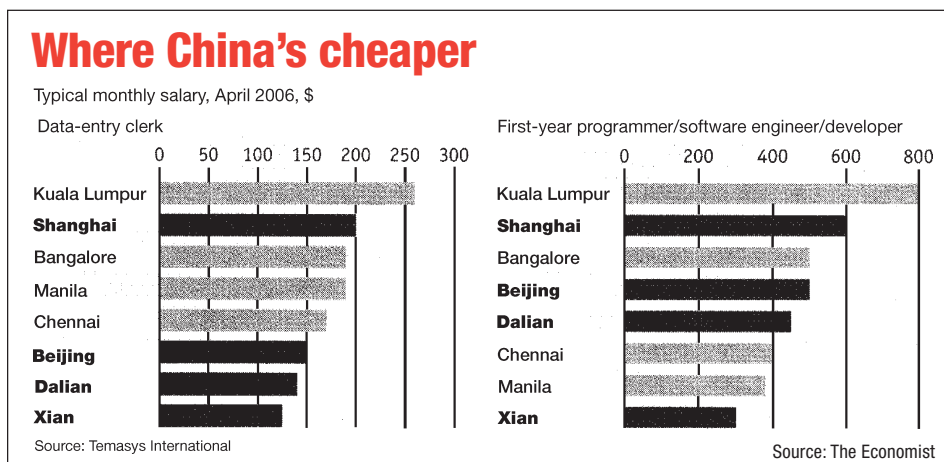
middle and lower middle class will be 500 million people by 2025, almost double our population. As recently as 1995 only 4.5 million Chinese traveled abroad. In 2005 this was 31 million and it is estimated to be 50 million by 2010. To put this in perspective about 60 million Americans travel abroad annually. The big investment play will be selling to the newly affluent wage earners: insurance, consumer goods, travel opportunities, health care, you name it. General Motors may be a disaster here but they have read the tea leaves in China just right. The Buick Regal (of all things!) has caught on with the Chinese and it is making GM a bundle there.



5. Go West young man.

Everyone is talking today about the government's push to develop the West. When Intel sited its newest chip plant it did so in Chengdu capital of Sichuan and 1000 miles from the coast. Wages are cheaper in the West and there is still an abundance of talent (*see chart*). Get used to finding Chongqing, Chengdu, Xian and Wuhan on a map. This is not the end of the East Coast but it does mean China is becoming a bigger country.

—Eric Hanson



Globalization at Work . . .

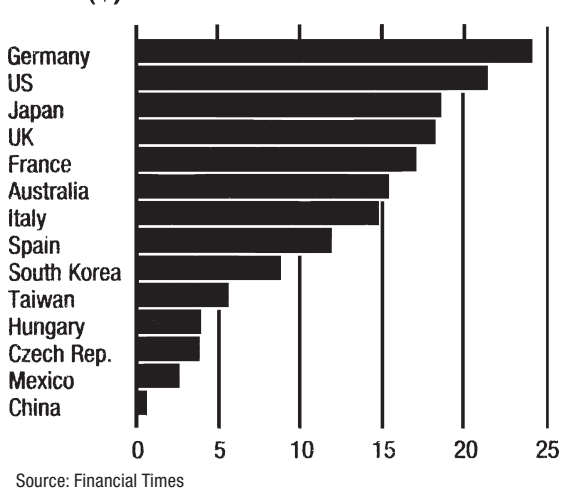
Exportweltmeister

ON THIS ONE, YOU NEED your German: “export world champion.” Germany today is the world’s leading exporter of goods, exporting more than we do on a GDP about 20% our size.

What is more remarkable is that Germany has the *highest* hourly manufacturing labor costs in the world (see chart right). Usually, when we think of export champions, we think low cost, and almost reflexively, we think China. Yet Germany had a trade surplus six times larger than China’s in 2004.

How does a nation with enduring structural unemployment and high wages do it? One thought is that Germany’s engineering-dominated industry excels at the high end of the market, and its reliable, quality equip-

Hourly labour costs in manufacturing 2002 (\$)



future, baby boomers liquidate assets to fund retirement but find there are not enough buyers among the younger generation. Prices of stocks, bonds, real estate, and other assets fall 40 to 50%. Lower living standards, later retirement, and higher taxes ensue. This scenario appears in Wharton professor Jeremy Siegel’s 2005 book, *The Future for Investors*, and it is the subject of his upcoming book, *The Global Solution*.

Though it is not a sure thing, Siegel sees a possible way out of this that he calls the “global solution.” It entails China, India, and other

developing economies with much larger and younger populations buying a substantial portion of U.S. assets and supporting our retiring boomers. Siegel figures that every 1% of growth there leads to 2 extra years of retirement here. If emerging economies increase productivity at 6% per annum – a rate China has long exceeded and India recently achieved – things will be fine. If the developing world stops growing, however, the solution will not work, and future generations here will need to push retirement to 77 instead of 62.

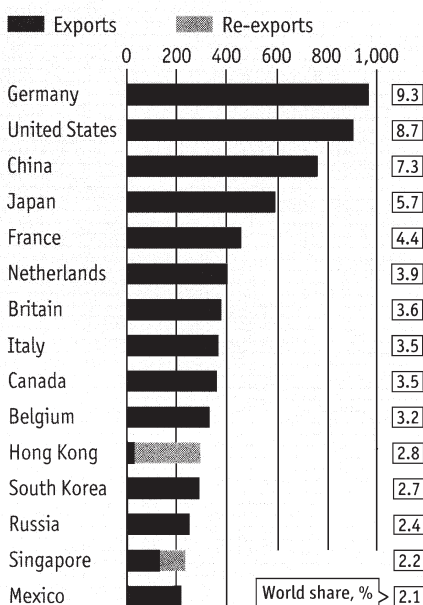
Sustained rapid growth in developing economies is not the only requirement. The other is a major attitude shift in the United States. We are talking about foreigners buying large portions of our corporate sector, and recently, this has touched a nerve.

Siegel recently debated the generational issue with Michael Milken, who is more optimistic. Milken posits the following: Technological innovation will create more wealth in the future, this wealth will need to find a home, and there will be plenty of liquidity to sop up boomer assets. Remember too that boomers will not need to liquidate everything at once. Ninety percent of all financial assets are owned by the wealthiest 10% of the population. This is a demographic that does not need to sell assets quickly.

–Julie Won

Top Exporters

Merchandise exports, 2005, \$bn



Source: The Economist

ment and parts have benefited from global capital investment. China, after all, needs quality fixed assets, and they buy from Germany.

Another explanation for Germany’s strength is the *mittelstand*, those less-known but specialized companies that have been called “hidden champions.” Since these companies focus on narrow

niches, they must go global to achieve market size and economies of scale. As an example, the *Financial Times* cites Herrenknecht, a company with sales of EUR 384 million, 92% of which are exports. The company is making in Germany and assembling in Shanghai the world’s largest excavator for road tunnel construction under the Yangtze River.

The crux of the story seems to be that German companies get globalization. To survive high labor costs and unspectacular demand at home, German firms focus on the high end of capital goods markets. They offshore labor-intensive processes, retain capital-intensive ones, and search the globe for customers with wealth. Of course, not everything Germany touches turns to gold. In autos, a market the Germans once dominated, quality has slipped and the industry is drifting.

The German experience is good news for the United States. It shows that cheap labor is not the be-all and end-all for global competitiveness. The export figures also remind us that the United States, in the number two position, remains a serious manufacturing power.

Retiring Boomers and the Global Solution?

Imagine this: In the not too distant

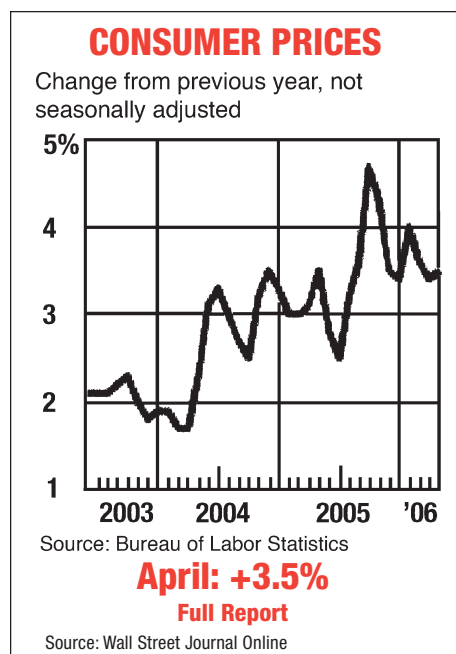
Market Trends . . .

Is This a Slump or a Stampede? . . .

WHAT A DIFFERENCE A month makes. On May 10th, the Dow Jones Industrial Average hit a six year high of 11,643. Today, a mere 30 days later, the Dow sits 712 points or 6.1% below this recent peak.

After more than three years of solid stock market gains, investors were particularly unprepared for the latest "correction." Over that time, a combination of low inflation and interest rates, strong economic growth and stable monetary policy helped the Dow gain almost 60% and outperform most asset classes including real estate.

So what sent stocks south last month? Market pundits are blaming the sell-off on everything from the weak dollar to the upcoming election. But I think the reason can be summed up in one word - *stagflation*. This term, which brings back memories of the 1970s, refers to that



awful combination of rising inflation and stagnating economic growth.

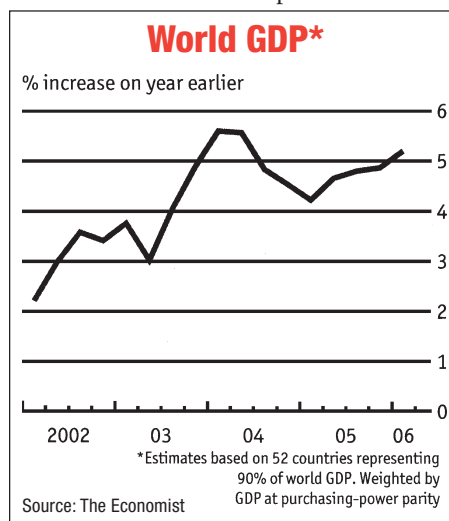
Until now, a steady flow of cheap imports helped offset the inflationary impact of soaring energy prices. *But as the chart above shows*, inflation measures are picking up steam. Strong economic growth has pushed capacity utilization ratios to 81.3%, the highest level since 2000. And wage rates are rising too with

average hourly earnings up 3.8% in the year to April vs. 2.7% for the same period a year ago.

These developments increase the likelihood that the Fed will continue raising interest rates. But this strategy comes with its own risks. True, higher interest rates slow economic growth but their impact is not immediate. This delayed impact has caused the Fed to raise interest rates too much in the past and push the economy into recession. Investors suspected just such an outcome when April's job creation numbers came in lower than expected.

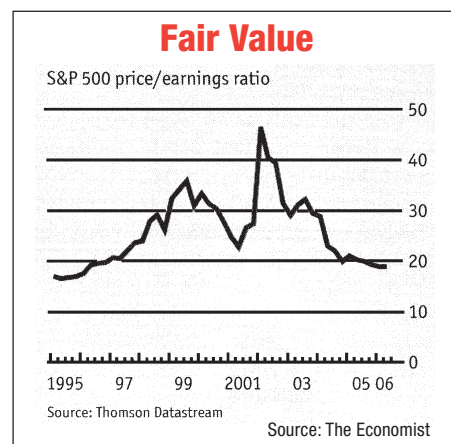
So which is it? Rising inflation, economic slump or both? Regardless of the economic outcome, I think there are reasons to suggest the sell-off, while painful, may not be too drastic. *Take a look at the chart below.* World economic growth remains in good shape. And importantly, the growth is more balanced now coming not just from the U.S. but from Asia and Europe as well. For the last several years, economists have warned that growing trade and budget deficits in the U.S. would ultimately cause a crash in the dollar and rising interest rates. A shift away from U.S. led growth would help avoid such an outcome.

Importantly, productivity measures remain high and borrowing costs relatively low. Strong productivity gains allow U.S. businesses to produce more



without raising prices. And borrowing costs, while certainly higher than they were 2 years ago, remain modest. This means that companies, both here and abroad, will have an easier time investing in productivity enhancing equipment.

Finally, stock valuation levels are in a reasonable range. Before the 1987 and 2001 market "blow-offs" stocks were selling at extremely high valuation levels. Today, the P/E ratio on the S&P 500 stands at about 18 or almost exactly in line with its long-term historic average.



Stock prices can certainly swing to extreme levels of over and under valuation. But this outcome is less likely at current prices.

Where the market is headed over the short term is anybody's guess. But two factors remain clear. First, stocks never advance in a straight line and periodic sell-offs are the norm. Second, attempting to time the market by selling at its peak and reinvesting at its trough has been a fool's errand. If you doubt this, consider the following research by University of Michigan professor H. Negat Seybun. In evaluating investment returns from 1963-1993, Seybun found that if you had been out of stocks during the market's best 90 days, your average annual return dropped from 11.3% to 3.3% - less than half of what Treasury bills earned at the time. So will the stock market be down this year? Possibly. Should that impact your long term investment strategy? Definitely not.

-Anne Williams Doremus, CFA