

# ISI INTERNATIONAL STRATEGY & INVESTMENT

## China Research

Mon  
Jan 11  
2010

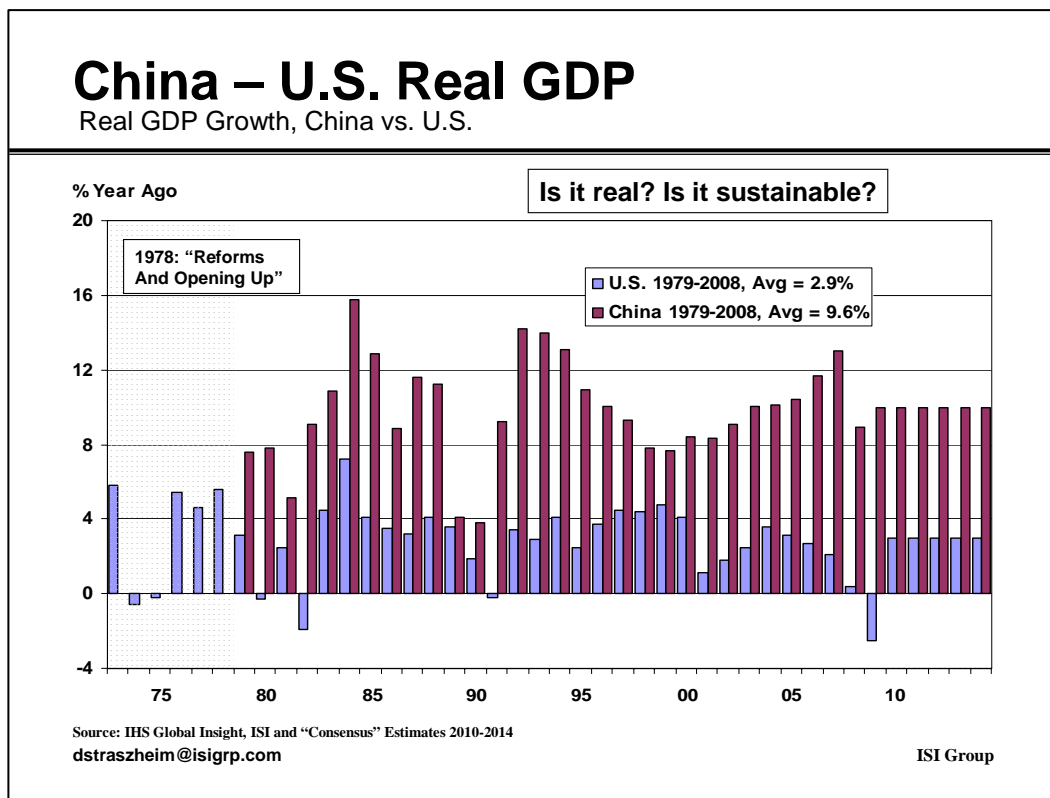
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- **GDP accelerating** to 11% 2009Q4 and 12% 2010Q1. No near-term collapse.
- **CPI headed up**, to 3-4% by mid-2010 peak. Settle down thereafter.
- **Monetary tightening** during 2010H1 against excessive loan growth. Policy shifting. Beijing will save the banks.
- **Export manufacturing** still the economic development core.
- **Currency slow revaluation** to resume mid-2010. Currency 'made in Beijing', not 'made in the markets.' Too bad.
- **The state** still dominates every important economic sector.
- **Investors are underexposed** to China. Don't be afraid of state-owned enterprises (SOEs).

PLEASE do not forward

## China Best in World Growth



1978 “reforms and opening up” launched fastest income gains for more people than anytime in recorded history.

*Q. Is it real? A. Yes. About 9% productivity; 1% labor force growth. Anything better than the collective disaster before.*

Migration, agriculture to manufacturing. Infrastructure building yielded massive productivity gains in both sectors.

*Q. Is it sustainable? A. Yes. Another 350 million migration, rural to urban, over the next generation.*

Similar income, productivity gains (slowing somewhat). Great growth amid inefficient resource allocation.

Imagine what growth might have been with more market-driven decisions?

## ISI China Forecast

ISI China Macro Forecast (Jan-2010)								
	09Q3	09Q4	10Q1	10Q2	2008	2009	2010	2011
Real GDP (%Y)	8.9	11.0	12.0	9.5	9.0	8.6	9.5	8.5
Urban FAI YTD (%Y)	33.3	27.0	25.0	25.0	26.2	27.0	25.0	20.0
IVA (%Y)	12.4	15.0	13.0	13.0	12.5	11.2	12.5	11.0
IP (%Y)	12.4	18.6	16.3	13.8	12.5	11.9	13.7	12.7
Retail Sales (%Y)	15.4	8.0	11.0	15.0	21.6	13.1	11.6	10.5
Total Vehicle Sales (Million)	3.6	3.6	3.6	3.7	9.4	13.2	15.1	16.6
CPI (%Y)	-1.2	0.3	2.0	3.5	5.9	-0.8	2.6	3.2
PPI (%Y)	-7.9	-3.6	1.5	5.7	6.9	-5.8	7.2	3.5
M2 (%Y)	26.9	24.4	19.3	14.2	16.8	26.2	14.8	12.9
12 M Lending Rate (Period End)	5.31	5.31	5.58	5.85	5.31	5.31	5.92	5.92
12 M Deposit Rate (Period End)	2.25	2.25	2.52	2.52	2.25	2.25	2.52	2.52
Required Reserve Ratio (Period End)	15.0	15.0	15.5	15.5	15.0	15.0	15.5	15.5
Exports (%Y)	-20	-3	47	34	17	-17	25	15
Imports (%Y)	-12	19	74	40	18	-12	34	17
Trade Balance (\$ Billion)	39	60	40	30	297	197	150	140
RMB/\$ (Period End)	6.83	6.83	6.83	6.83	6.95	6.83	6.63	6.30
Forex Reserve (\$Trillion)	2.2	2.3	2.4	2.4	1.8	2.1	2.5	2.7

January 8, 2010

While damaged, China's economy has recovered nicely from the 2008-09 global meltdown. Real GDP growth in 2009Q4 and 2010Q1 is accelerating to around 11-12% year ago. The % year ago low was a still respectable 6.1% in 2009Q1. Fears that an economic blow-up in China is near at hand look way off the mark to us. The risk for 2010 is precisely the reverse.

China in 2010 will be leaning against the wind of a too-hot economy and rising inflation with tighter money courtesy of the PBoC. The 2009 loan push, thru the state-owned banks, was panic-level excessive. Beijing shifted economic policy gears (too hot TO too cold) in 2008Q3. They are shifting gears again in 2010Q1 (too cold TO too hot). Fiscal stimulus is being removed. Global growth is up. This shift seems right to us. Don't worry about the banks – which Beijing owns and will take care of. The same is true for the many other SOEs

As we see it, inflation should rise, then temper. By 2010H2 and into 2011, the data mill in China should be reporting moderating inflation but healthy economic activity statistics. After midyear 2010, on Beijing's timetable, we look for a gradual currency-appreciation to be resumed. Don't forget; the currency value is made in Beijing, not in the markets.

So what's not to like? China proudly flexing its growing muscles; a 'listen politely and go your own way' policy mentality; the heavy hand of government getting even heavier at home; friction mounting on trade everywhere; and anger with the west over the meltdown. THE RISK IS of unpredictable and punishing policy swerves -- born of inexperience with markets and global systems, and the complicated new post 2008-09 world economic order.

DHS

## China — Short-term Outlook

*Economy held up world's best in 2008-09 meltdown. We see GDP accelerating 2009Q4 and 2010Q1. Short-term prospects still #1 in world. Massive (too much) stimulus. Money tighter in 2010H1. CPI up sharply thru June 2010. No currency revaluation pre 6/30/10. China trade-friction rising; is deadly serious. Still, China blow-up economic fears are wrong. Don't be afraid to buy Chinese SOE equities.*

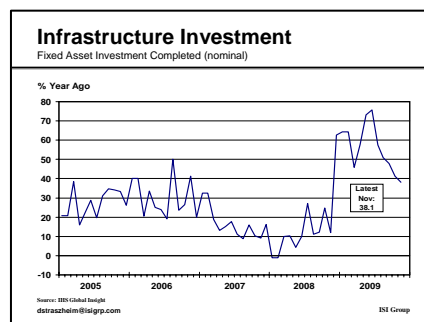
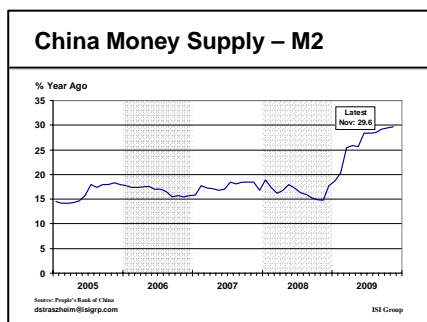
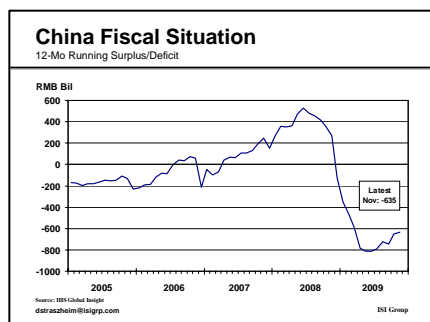
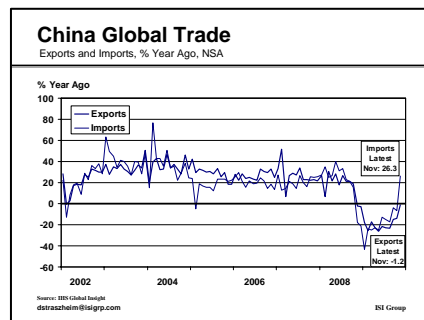
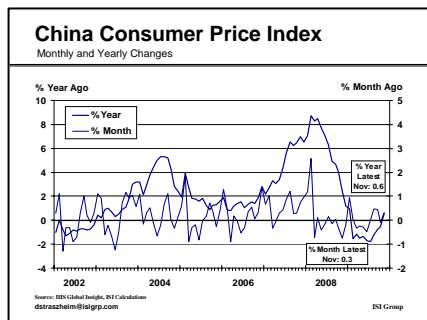
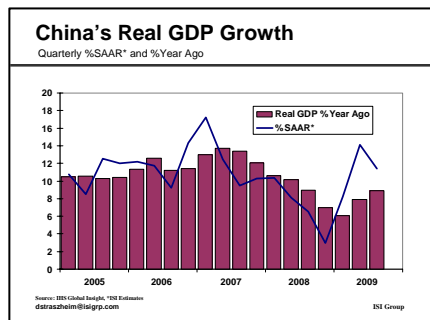
- **G2 member.** Beijing's G2 goal achieved. But now China is subject to external events, while Beijing wants CONTROL. This policy dilemma (control or big-boy?) is driving their old-line leadership crazy. Such inexperience can yield swerves.
- **New policy transition underway.** In mid-2008, China shifted from fighting inflation to fighting recession. Now, talk is already signaling reversal (start Feb 2010, done by July 2010) focused on inflation/asset prices rising, potential overheating, slow the lending explosion, try to settle things down, unwind stimulus. This will have all global investors' attention in 2010H1 – details? Consequences?
- **Real GDP and growth.** Meltdown whacked China. They remain angry; blame US (rightly so I think). Real GDP 2009Q2 at 7.9% year, 2009Q3 at 8.9% year. Our view 2009Q4 at 11.0% year, above consensus, and 2010Q1 at 12.0% year, also above. 2010 annual is 9.5%, confirming strength. Goodbye recession talk.
- **Inflation and CPI.** China CPI is on the rise; was -1.9% year in mid 2009 to -0.3% year in October, +0.6% November, and about +1.5% December. We see 3.5% by mid-2010. This is nearing where jawboning (for public consumption) might occur.
- **2008-09 stimulus.** Focus was infrastructure (fine), some government buildings and real estate (not so fine) occurred. Also some consumer purchase incentives.
- **Retail, consumers.** Retail sales still 15-17% year ago range Oct-Dec 2010. No news here. Sadly, there is no decent measure of the China consumer. Deal with it.
- **M2, banks.** SOE banks remain gvmt lending arms, shoveling out 2009 loans in stimulus push. Always most loans in Q1, least in Q4. M2% year to slow in 2010H1 against massive bulge in 2009H1. Rates rising in 2010, ending steady 2009. China's banks are OK -- property blowups, bad loans, etc. Beijing is the backstop.
- **Currency.** Still de-facto pegged at CNY6.83/US\$; since 7/1/08. No quick change despite global screams. Currency made in Beijing, not in markets. Crazy. Slow revaluation to start again mid-2010. China 2009 trade surplus lower (but still big).
- **And more.** Much outbound M&A in search of industrial fuel. Beijing listens politely, goes own way on policy. China market reforms setback from global meltdown. State economic controls secure. China more assertive on foreign economic links.

## China — Long-term Fundamentals

*China's best-in-the-world economic growth record to continue, albeit slowing, in coming years. Here are some of the major trends and themes to watch.*

- **SOEs are the 'mainstay.'** Beijing wants state-owned enterprises to be their economic "mainstay." Many big sectors remain largely closed to major foreign competition. Few if any re-invented SOEs will compete successfully abroad.
- **Promoting its home-grown enterprises.** We see much stronger efforts within China to help domestic firms along relative to the globally known competitors.
- **Manufacturing for export is everything.** China's advance to date has been built on manufacturing for export. They are not about to give up this winning strategy.
- **Urbanization, migration.** Look for another 300 million people migrating rural to urban over the next 20 years, following 350 million in the last 20. Jobs and incomes grow. China's megacities work -- unlike in much of the rest of the world.
- **Infrastructure.** Infrastructure building is key to China's growth rate. Makes cities work, creates good jobs. Yields higher agricultural productivity.
- **Global M & A.** China will aggressively seek secure sources of fuel for its economy – industrial fuel (commodities, metals) and real (energy) fuel. Global footprint.
- **Future source of capital.** China is evolving from being a destination for capital into a source of capital as her trade and manufacturing supremacy mounts.
- **Keep growth going.** Rising income remains all-important to China's leaders as it is all-important to the people. Beijing will be held to account for any slippage.
- **Growing consumer sector a struggle.** High savings rate because safety net is not trusted. Will take a generation, for consumer sector to drive China's economy.
- **Move up the value chain.** Produce flat screen TVs, not shower slippers, towels.
- **Currency?** Made in Beijing, still. 95% managed; 5% floating. To continue. China's "weak currency strategy" is at heart of their growth, development plans.
- **Japan-China-Taiwan.** Ever closer economic ties (trade, capital, labor); relations are improving. Economy #1 priority to all three. This is unambiguously positive.
- **Global outreach.** Seeking new foreign relations everywhere -- Africa, South America, middle East, ASEAN. We see all new global links as positive.
- **Demographics.** Aging fastest in the world, births below replacement rate. Need to save, changing demand patterns, labor pool, strain on gvmt. Unprecedented (in world history) gender imbalance developing, with totally unknown consequences?

## China at 2010 Beginning



China real GDP growth bottomed at 3% annual rate, 2008Q4 versus 2008Q3 – like US, Europe, Japan everyone else reports.

ISI calculations. I think it was even worse, but no 'proof.'

CPI worry? What was done with all those loans?

The state will take care of the big SOE banks. They were created as lending arms of the government. Do not worry.

Infrastructure bump – talk about 'shovel ready.'

The fiscal plus. Tax take rising as more of commercial life comes into the measured (and taxed) market economy.

China wants global trade dominance.

This goal supports jobs, migration, urbanization, modernization, income engine. NO GIVING UP THIS GOAL IN NEXT QUARTER CENTURY.

## 2008 – 09 Economic Meltdown

### 2008-09 Economic Meltdown

Real GDP % SAAR, Various Countries

	China*	U.S.	JP	EZ	IN	BZ
<b>2007 Q1</b>	17.2	1.2	6.8	3.2	10.2	7.9
<b>Q2</b>	12.5	3.2	-1.6	1.5	8.5	4.3
<b>Q3</b>	9.5	3.6	0.1	2.4	8.2	4.3
<b>Q4</b>	10.3	2.1	1.5	1.3	10.6	10.5
<b>2008 Q1</b>	10.3	-0.7	5.6	3.3	6.8	7.5
<b>Q2</b>	8.1	1.5	-8.1	-1.4	6.3	3.9
<b>Q3</b>	6.5	-2.7	-4.0	-1.7	6.7	4.5
<b>Q4</b>	<b>3.0</b>	<b>-5.4</b>	<b>-10.2</b>	<b>-7.4</b>	<b>3.8</b>	<b>-11.2</b>
<b>2009 Q1</b>	<b>8.3</b>	<b>-6.4</b>	<b>-11.9</b>	<b>-9.3</b>	<b>6.1</b>	<b>-3.5</b>
<b>Q2</b>	14.1	-0.7	2.7	-0.6	8.3	4.4
<b>Q3</b>	11.4	2.2	1.3	1.5	13.1	5.1
<b>Q4</b>						

Source: IHS Global Insight, ISI Estimates\*  
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%Q SAAR FIGURES for China are ISI estimates.

Depth of 2008-09 downturn in developed nations. Versus China, India mild damage.

Recovery beginning early 2009 equally stunning.

Not just China, but recovery worldwide evident in PMIs, leading indicators, IPs.

Monetary, fiscal lift is facilitating these broad macro gains.

### 2008-09 Economic Meltdown

Real GDP % Year, Various Countries

	China	U.S.	JP	EZ	IN	BZ
<b>2007 Q1</b>	13.0	1.4	3.5	3.4	9.6	5.3
<b>Q2</b>	13.8	1.9	2.3	2.6	9.3	6.6
<b>Q3</b>	13.4	2.7	1.8	2.6	8.9	5.6
<b>Q4</b>	12.1	2.5	1.7	2.1	9.4	6.7
<b>2008 Q1</b>	10.6	2.0	1.4	2.1	8.5	6.7
<b>Q2</b>	10.1	1.6	-0.3	1.4	8.0	6.5
<b>Q3</b>	9.0	0.0	-1.4	0.4	7.6	6.6
<b>Q4</b>	<b>6.8</b>	<b>-1.9</b>	<b>-4.4</b>	<b>-1.9</b>	<b>5.9</b>	<b>0.9</b>
<b>2009 Q1</b>	<b>6.1</b>	<b>-3.3</b>	<b>-8.6</b>	<b>-5.0</b>	<b>5.7</b>	<b>-1.8</b>
<b>Q2</b>	7.9	-3.8	-6.0	-4.8	6.2	-1.7
<b>Q3</b>	8.9	-2.6	-4.7	-4.1	7.8	-1.5
<b>Q4</b>						

Source: NBS China, IHS Global Insight  
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After the economic disaster of World War II, the Communist takeover of 1949 and thru the so-called 'Cultural Revolution' of 1966-76, China's economy was a total mess. Ready to try anything, they launched the "Reforms and Opening Up" (their phrase) in 1978 as an experiment (in Guangdong Province, down south) with limited market rules. They were desperate. If it worked, fine. If not, kill it. It worked, the program was taken national and the rest is history. The people are smart and industrious.

But the 2008-09 meltdown was the first time that China has experienced an external economic event that has had any material effect on the domestic Chinese economy. Most of China's leadership remains uncomfortable and unfamiliar with market forces, preferring decision making by a group sitting around a conference table.

# China in the Global Economy

## Real GDP Growth – Developing

% Year	98-02	03-07	2008	2009*	2010*
China	8.2	11.0	9.0	8.5	9.0
India	5.4	8.6	7.3	5.4	6.4
ASEAN	1.7	5.9	4.8	0.7	4.0
Central/Eastern Europe	2.7	6.0	3.0	-5.0	1.8
Russia	4.2	7.3	5.6	-7.5	1.5
Middle East	3.4	6.1	5.4	2.0	4.2
Africa	4.1	6.0	5.2	1.7	4.0
World	3.2	4.7	3.0	-1.1	3.1

Source: IMF, IMF Estimates  
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## Real GDP Growth – Developed

% Year	98-02	03-07	2008	2009*	2010*
China	8.2	11.0	9.0	8.5	9.0
G7	2.5	2.4	0.3	-3.6	1.3
U.S.	3.2	2.8	0.4	-2.7	1.5
Euro Zone	2.5	2.1	0.7	-4.2	0.3
Japan	0.2	2.1	-0.7	-5.4	1.7
UK	3.1	2.7	0.7	-4.4	0.9
Canada	3.9	2.7	0.4	-2.5	2.1
Australia	3.8	3.3	2.4	0.7	2.0
World	3.2	4.7	3.0	-1.1	3.1

Source: IMF, IMF Estimates  
dstraszheim@isigrp.com

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China’s global ascent last decade confirmed here.

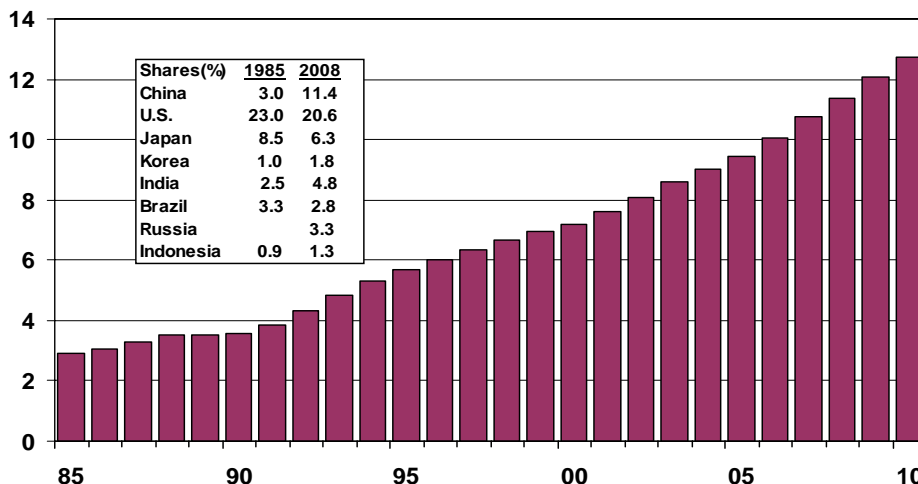
They want to be a ‘big-boy,’ a real global player. But this means losing control to outside events (like 2008-09). Traumatic.

When does China catch the US in absolute size? (Not whether)

## China’s Global Economic Share

Using “PPP” Basis (and Global Comparisons)

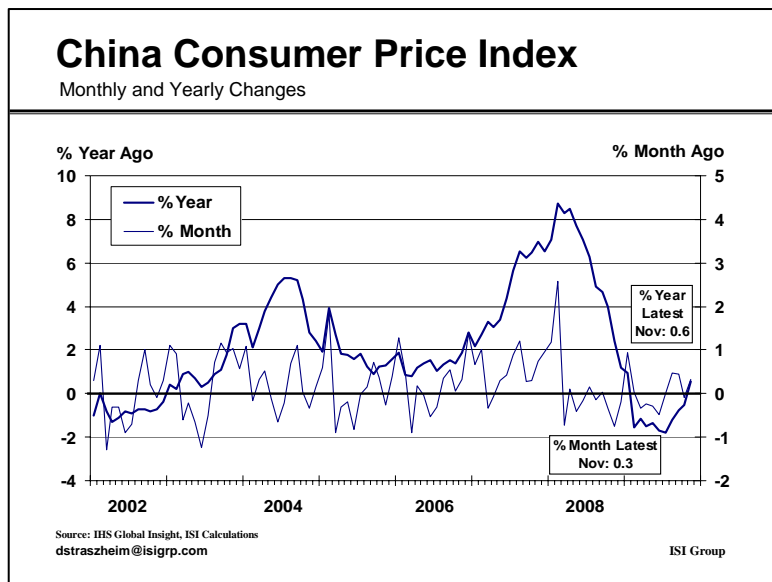
% of World Total



Source: IMF, IMF Estimates 2009-2010  
dstraszheim@isigrp.com

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# Consumer Prices

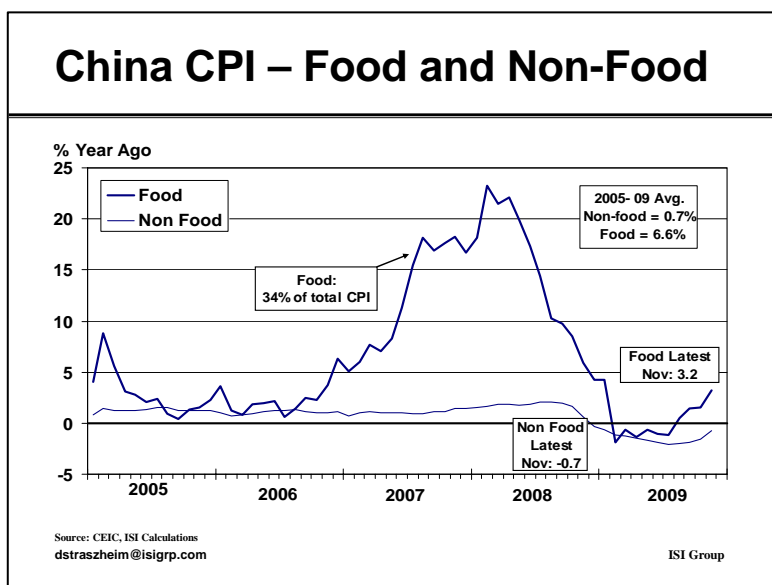


Total CPI up, to plus 3-4% year by mid-2010. Not to the 8% of 2007. Core to 2%.

Equity headwind.

Rise will get market's, Beijing's attention.

China will respond, tighten monetary, fiscal policy.



2007-08 rise largely food.

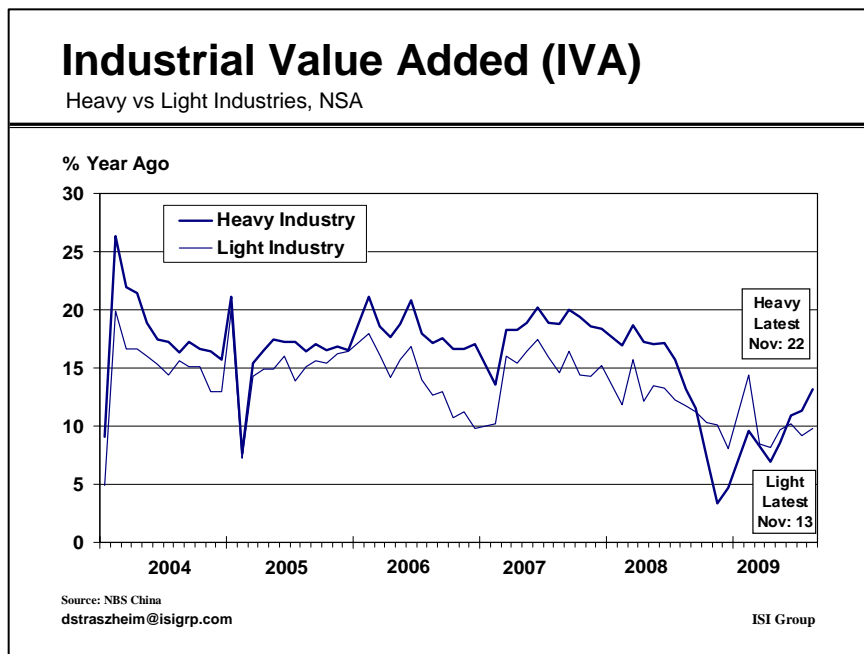
Note Food 34% of China CPI, versus 15% in US.

See CPI component weights (estimated) below.

## China - Consumer Price Index (CPI) and Weights

% Year Ago	2005	2006	2007	2008	Nov-08	Jul-09	Aug-09	Sep-09	Oct-09	Nov-09
<b>General index (100%)</b>	1.8	1.5	4.8	5.9	2.4	-1.8	-1.2	-0.8	-0.5	0.6
<b>Food (34%)</b>	2.9	2.3	12.3	14.3	5.9	-1.2	0.5	1.5	1.6	3.2
<b>Tobacco, Liquor &amp; Articles (2%)</b>	0.4	0.6	1.7	2.9	3.2	1.2	1.3	1.3	1.3	1.3
<b>Clothing (9%)</b>	-1.7	-0.6	-0.6	-1.5	-1.7	-2.4	-2.2	-1.8	-1.6	-1.2
<b>Household Facilities, Articles &amp; Services (6%)</b>	-0.1	1.2	1.9	2.8	3.1	-0.4	-0.7	-0.9	-1.2	-1.1
<b>Health Care &amp; Personal Articles (10%)</b>	-0.1	1.1	2.1	2.9	2.0	0.7	0.9	1.1	1.2	1.6
<b>Personal Articles &amp; Services (2%)</b>	0.8	3.2	2.1	4.4						
<b>Transportation Communication (10%)</b>	-1.0	-0.1	-0.9	-0.9	-0.7	-2.7	-2.9	-2.6	-2.7	-2.2
<b>Recreation, Education &amp; Culture Articles (14%)</b>	2.2	-0.5	-1.0	-0.7	-0.3	-0.7	-0.9	-0.9	-0.7	-0.6
<b>Residence (13%)</b>	5.4	4.6	4.5	5.5	1.1	-5.8	-5.4	-5.0	-3.8	-1.2

# Industrial Value Added



Industrial Value Added (IVA) a better measure of China manufacturing than is Industrial Production Index.

Global slide hurt China.

Upturn to last thru 2010. And 2011 also in our forecast.

## China -- Industrial Value Added (IVA)

% Year Ago	2006	2007	2008	Nov-08	Jul-09	Aug-09	Sep-09	Oct-09	Nov-09
Coal	24.2	30.9	4.5	6.1	8.3	10.6	9.1	13.8	24.4
Ferrous Metal	37.9	57.9	15.6	8.3	34.4	32.4	39.3	40.3	30.8
Non Ferrous	58.5	43.6	12.2	10.4	12.1	17.1	17.1	34.8	36.7
NonMetallic Min	34.8	36.8	22.9	12.6	20.2	19.5	21.6	27.4	27.5
Food Process	27.2	32.9	13.5	9.7	10.6	12.6	15.5	22.5	20.5
Textile Mfg	22.3	24.0	5.5	6.2	8.6	9.8	9.1	11.1	11.2
Footwear Mfg	29.1	23.5	7.4	11.9	11.3	9.6	9.3	10.7	9.0
Timber	34.2	50.3	11.1	15.3	17.4	17.6	20.9	20.6	21.9
Paper Process	20.9	25.7	4.5	2.1	9.4	9.2	11.3	16.3	20.3
Coking, Nuclear	16.8	33.8	-15.1	-8.3	4.7	4.8	11.4	15.0	20.3
Raw Chemicals	22.9	36.0	5.6	-3.3	11.7	18.2	21.4	25.4	30.7
Pharma	18.2	26.5	13.1	16.2	12.2	14.9	17.6	15.6	19.9
Chemicals Fiber	24.5	34.0	0.7	-5.3	18.4	20.3	15.0	21.8	25.4
Transport Eq	28.8	41.4	2.8	3.6	20.4	26.7	25.9	28.9	31.3
Elect Eq	29.2	31.1	12.8	12.5	11.0	13.0	11.7	12.7	16.8
Comm Eq	23.8	11.9	-2.4	-0.2	5.3	4.8	6.3	7.2	14.4
Waste, Enviro	58.1	71.1	9.1	33.4	25.1	32.1	65.2	49.0	28.2
ElecPwr, Heat	20.9	27.7	0.8	-1.1	5.3	6.8	6.9	9.7	15.6
Natural Gas	42.5	60.0	9.9	5.6	15.1	13.4	12.8	6.5	20.2
Water Prod	20.4	16.1	9.1	5.1	6.9	6.7	5.1	5.7	4.6

2008 # are as of Dec 2008

Scan the November 2008 components (low) versus last few months. Extraordinary turnaround.

Textile, footwear represent the old low-tech China (weak recovery). Losing those markets to Vietnam, other frontier markets.

*Beijing's explicit strategy – up the value curve. Reminiscent of Japan, Korea 20-40 years ago.*

## QDII and QFII

### QDII (Qualified Domestic Institutional Investors)

Source:SAFE, as of 09/30/2009, in US\$ 100 Million

List of Names	Approval Date	Quota
<b>QDII Bank</b>		
1 Industrial and Comm. Bank of China	2006.07.11	15
2 Bank of China	2006.07.10	10
3 China Construction Bank	2006.07.27	7
4 HSBC Holdings (China)	2006.08.07	7
5 Standard Chartered Bank	2006.10.24	7
6 Agriculture Bank of China	2007.02.09	6
7 Bank of Communication	2006.07.27	5
8 China Merchant Bank	2006.09.05	5
9 Citigroup,China	2006.09.27	5
10 Industrial Bank	2006.10.18	5
<b>Bank Total</b>		<b>79.6</b>
<b>QDII Fund Management</b>		
1 China Southern Fund Management	2007.09.04	50
2 China Asset Management	2007.09.10	50
3 Harvest Fund Management	2007.09.26	50
4 China International Fund Management	2007.10.12	50
5 China International Capital Corporation	2007.11.16	50
6 Yinhua Fund Management	2008.04.03	20
7 Bank of Comm Schroder Fund MGMT	2008.05.22	20
8 ICBC Credit Suisse Asset Management	2007.12.05	14.3
9 Fortune SGAM Fund Management	2007.12.28	10.7
10 China Marchants Securities	2008.05.04	10
<b>Fund Management Total</b>		<b>336</b>
<b>QDII Insurance</b>		
1 PING AN INSURANCE (GROUP), CO.	2004.12.14	88.9
2 China Life Insurance Co., Ltd.	2007.04.10	17.5
3 CHINA INSURANCE (GROUP) CO.	2006.12.14	15
4 CPIC Life Insurance Co.	2007.09.17	4.0
5 Taikanglife Life Insurance Co., Ltd.	2007.06.22	3.9
6 China Reinsurance (Group) Corp.	2007.10.18	3.5
7 PICC Property and Casualty Co.	2006.12.14	2.4
8 Taiping Life Insurance	2007.10.31	2.1
9 Huatai Property Insurance	2007.11.15	1.3
10 Huatai Asset Management	2007.04.23	1.3
<b>Insurance Total</b>		<b>144.3</b>
<b>Total</b>		<b>559.5</b>

### QFII ( Qualified Foreign Institutional Investor)

QFII List	Country of Incorporation	Quota
1 UBS AG	Switzerland	8
2 Citigroup Global Markets Ltd	United Kingdom	5.5
3 Credit Suisse (HK) Ltd	Hong Kong	5
4 Fortis Bank SA/NV	Belgium	5
5 Goldman Sachs Asset Management Int'l	United Kingdom	5
6 Norges Bank	Norway	5
7 Nikko Asset Management Co.,Ltd	Japan	4.5
8 Morgan Stanley & Co. International Ltd	United Kingdom	4
9 The Hongkong and Shanghai Banking Co., Ltd	Hong Kong	4
10 Deutsche Bank Aktiengesellschaft	Germany	4
<b>Total</b>		<b>157.2</b>

*Qualified Domestic Institutional Investors (QDIIs)* are domestic money managers allowed to invest a certain amount of funds in overseas capital markets despite China's ongoing capital controls.

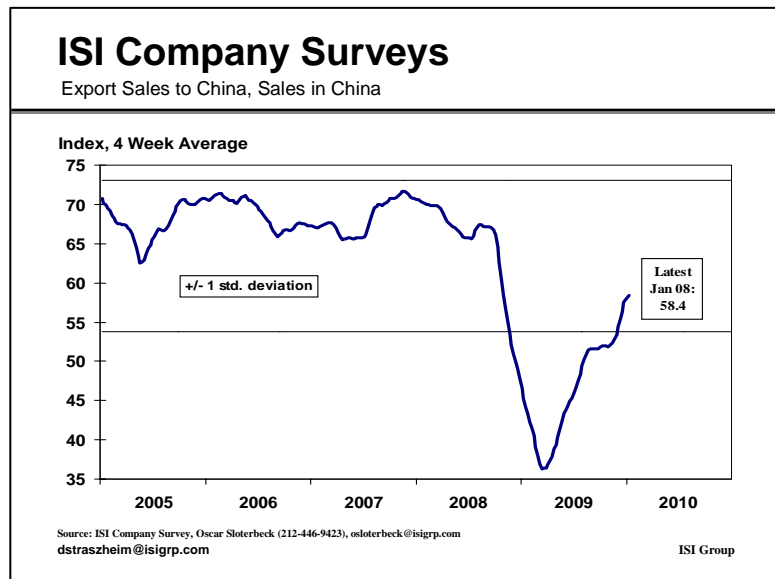
Inexplicably, Beijing does not want funds leaving the country to be invested elsewhere.

Prestigious program. Great way for China to learn global markets and investing.

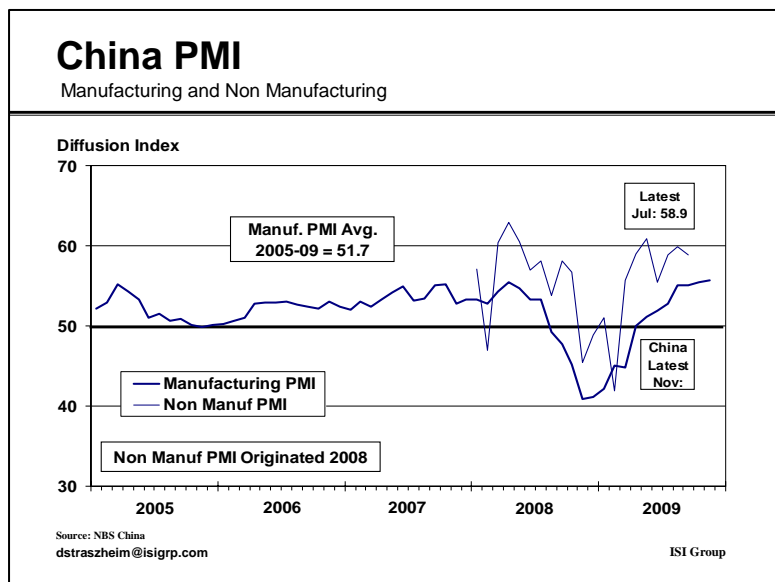
*Qualified Foreign Institutional Investors (QFIIs)* are foreign investors allowed to invest in the Shanghai and Shenzhen markets (that are otherwise closed to foreign investors).

Beijing does not want to expose its inexperienced market participants to the rigors and volatility of foreign investment decisions.

# ISI China Survey and PMI



ISI China Survey a good, current indicator of sales of US firms operating in China, and US exports to China. **Sharp bottom in March 2009.** Straight up since. **Contact Oscar:**  
[osloterbeck@isigrp.com](mailto:osloterbeck@isigrp.com)



PMIs (Manufacturing and Services) sharp down – and up. Should remain strong remainder of 2010.

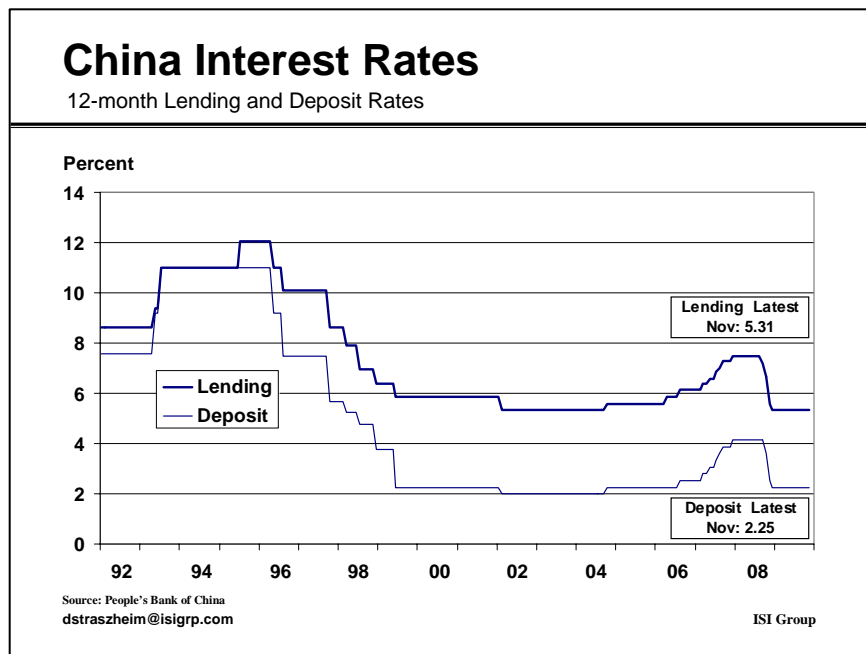
Service sector survey new. Service sector developing in China. Opportunity.

Essentially no ‘services’ in China consumer data.

## REFERENCE COUNTRIES - Purchasing Managers Index - November-2009

% Year	2005	2006	2007	2008	Nov08	Jul09	Aug09	Sep09	Oct09	Nov09
China		0.7	2.7	-6.4	-22.5	-0.9	12.0	15.3	22.5	36.2
U.S.	-7.9	-2.4	-3.8	-10.9	-27.4	-1.2	7.3	21.2	43.9	46.4
Australia	-7.0	1.2	5.7	-15.5	-42.2	-4.7	10.4	11.9	25.2	63.8
Brazil				-8.8	-26.3	-10.3	-0.9	3.8	17.5	33.5
Canada	-0.6	-0.2	-1.1	-3.8	-31.5	-20.9	8.2	1.1	17.2	39.1
Eurozone	-3.7	10.1	-3.6	-14.4	-32.6	-2.4	1.4	9.6	23.4	43.9
Germany	-0.9	9.7	-2.5	-11.8	-23.8	-6.0	6.1	6.8	13.4	30.7
India			-1.2	-1.5	-24.8	-4.1	-8.1	-4.0	4.4	15.8
Japan	-0.5	2.4	-7.1	-11.5	-27.8	7.1	14.3	23.1	28.7	42.6
Russia	1.2	1.7	-2.1	-8.5	-36.3	-15.3	-4.6	-1.1	12.9	44.6
S. Korea		-3.3	2.0	-11.0	-24.3	15.8	15.7	24.4	21.9	22.3
UK	-6.8	4.9	2.5	-17.4	-36.6	16.3	13.6	22.2	31.8	47.9

## Interest Rates and Bank Reserves



Lending rates cut in late-2008 on economic fears.

Now the reverse.

Lending rates, we see 3 hikes in 2010, 27 basis points each (don't ask).

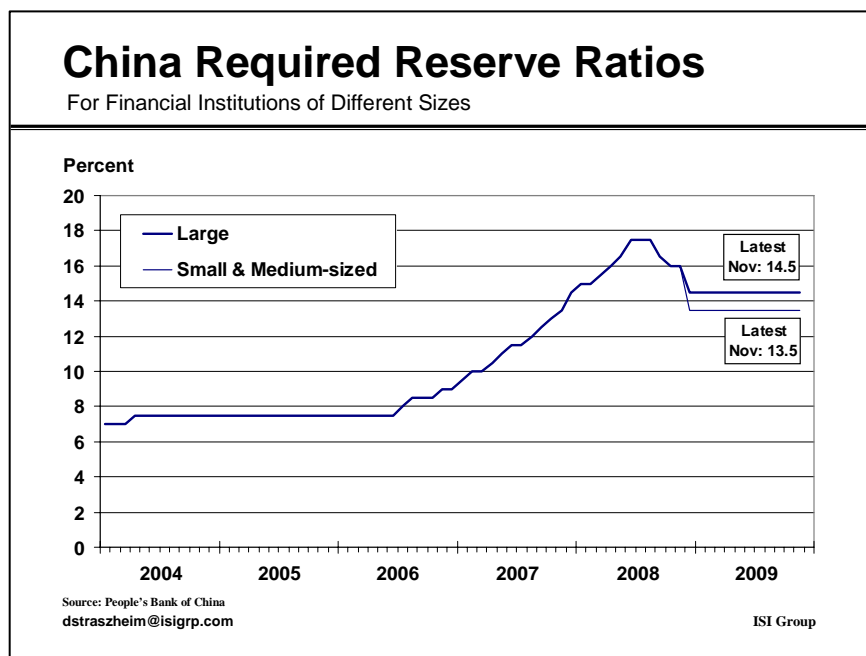
An anti inflation signal.

Still lots of loans.

Deposit rates cut late-2008.

We see one hike (27bp) in 2010.

Combination above helps profitability (spread) at banks. Consumers can fend for themselves.



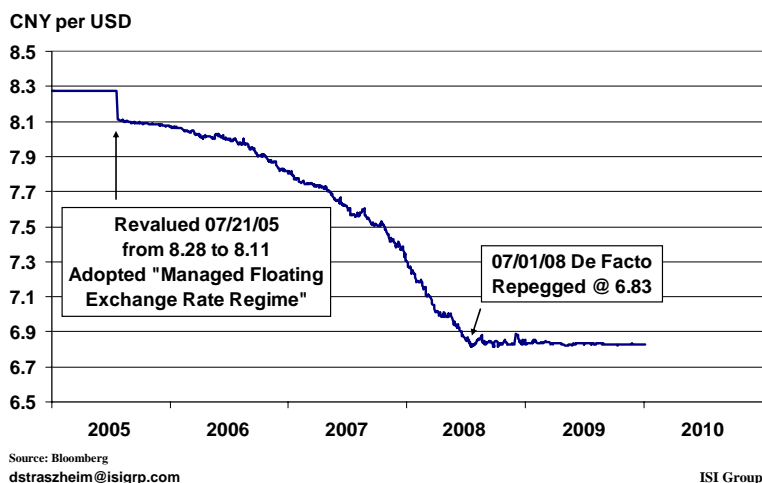
Required reserves made 2-tier in late 2008, first time. Likely this distinction permanent.

Expect one 50 bp hike in 2010, consistent with tighter policy, but little aggravation to the Beijing push for 2010 bank capital raising.

## Currency and Forex Reserves

### Chinese Yuan vs. U.S. Dollar

Currency Value – Dollar Decline

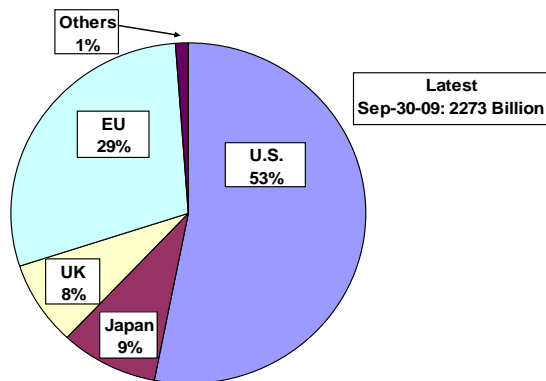


Currency still de-facto pegged at CNY6.83/\$ since mid-2008 when China started worrying about growth, not about inflation.

Currency value ‘made in Beijing’, not ‘made in the markets.’ Crazy for a country of China’s significance.

### China’s Forex Reserves

Composition by Currency



Despite Wash DC, Europe protests, Beijing decides. Deal with it. No interest in US currency advice.

Slow currency appreciation again?  
6.83 to 6.73 in 2010Q3;  
6.73 to 6.63 in 2010Q4.

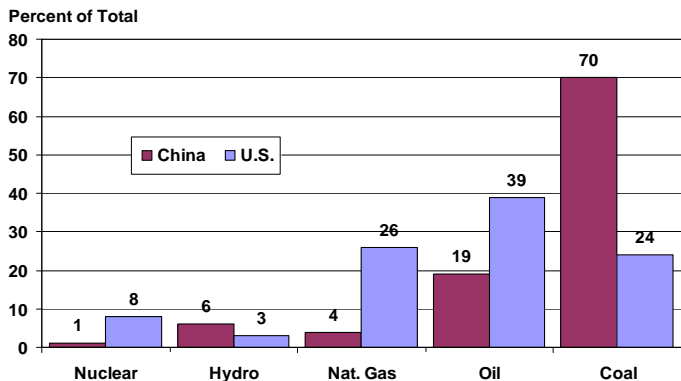
China forex reserves determined by trade surplus/deficit, net FDI flows, and ‘hot money.’ No worry that China will dump dollars, no longer buy US Treasuries.

China a SLOW push away from dollar as reserve currency.

# China Energy

## Energy: China and U.S.

Share of Total Primary Energy Supply, 2008



Source: BP  
dstraszheim@isigrp.com

ISI Group

Why is China's air so polluted? Easy.

*Use dirty fuel, 70% coal.*

*Use clean fuel, 4% nat gas.*

Big push on nuclear, our favorite sector.

Hydro nearly maxed out as energy source.

## Total Primary Energy Consumption

As % of Total World Consumption

	1980	1990	2000	2007	2008
<b>China</b>	6.3	8.5	10.4	16.8	17.7
<b>U.S.</b>	27.4	24.3	24.9	21.2	20.4
<b>Japan</b>	5.4	5.3	5.5	4.6	4.5
<b>EU</b>	23.6	20.3	18.4	15.6	15.3
<b>India</b>	1.5	2.2	3.2	3.7	3.8
<b>Brazil</b>	1.4	1.5	2.0	2.0	2.0
<b>Indonesia</b>	0.4	0.6	1.0	1.1	1.1

Source: BP  
dstraszheim@isigrp.com

ISI Group

Oil to keep rising as more transportation with higher incomes.

China working on raising energy efficiency (more \$GDP per energy use).

Making good progress, as all developing nations do. More to come.

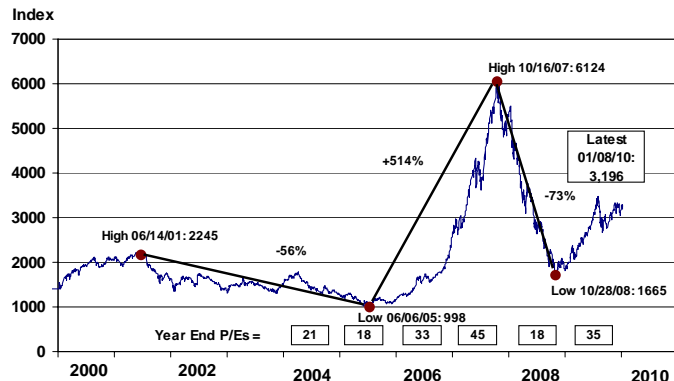
All other alternatives (solar, wind, geothermal, biomass, etc.) under 2% still.

But China more committed than anywhere else in world on alternatives.

# China Equities - 1

## Shanghai Composite

Overall Equity Index



Source: Bloomberg  
dstraszheim@isigrp.com

ISI Group

Shanghai the most extreme in the world -- 2005-07 up, 2007-08 fall, 2008-10 up.

No bubble evident. No mania. P/Es at decade average. 2009 rise mild given the extreme policy push.

Strong economy now.

## China's Stock Exchanges

Shanghai Stock Exchange	2000	2006	2008	2009
No. of Listed Companies	572	842	864	
No. of Listed Stocks	657	886	908	
Market Capitalization (\$ Billion)	356	919	1400	2626
Average P/E Ratio	59	33	15	24
Total Turnover Value (\$ Billion)	660	1180	3914	
Equity Funds Raised (\$ Billion)	12	22	32.2	

Note: 2009 numbers are as of 12/30/2009

Shenzhen Stock Exchange	2000	2006	2008	2009
No. of Listed Companies	514	579	740	
No. of Listed Stocks	557	621	782	
Market Capitalization (\$ Billion)	256	223	347	837
Average P/E Ratio	56	33	17	60

Note: 2009 numbers are as of 12/30/2009

Source: Shanghai Stock Exchange, Shenzhen Stock Exchange  
dstraszheim@isigrp.com

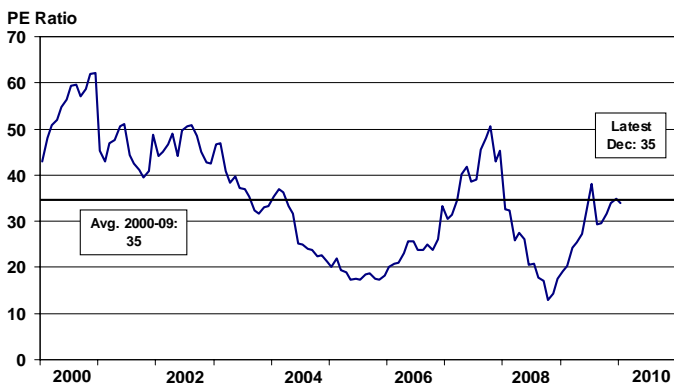
ISI Group

China survived the first big overseas 'event.'

Good earnings prospects rebounding from the recent slide. Many other markets more expensive.

## Shanghai Composite Price/Earnings

PE Ratio



Source: Bloomberg  
dstraszheim@isigrp.com

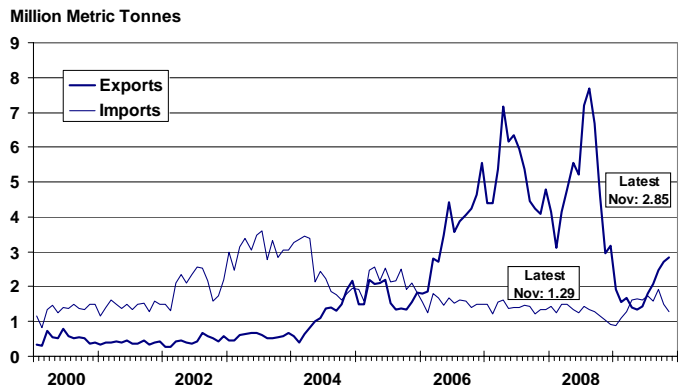
ISI Group

INVESTORS: DO NOT BE AFRAID OF OWNING CHINESE STATE-OWNED ENTERPRISES TRADED AROUND THE WORLD. THE FAVORS THE GVMT CAN DO **FOR YOU** OUTWEIGH THE BAD THE GVMT CAN DO **TO YOU.**

# Steel Industry

## China Int'l Trade of Steel Product

Exports & Imports



Source: NBS China  
dstraszheim@isigrp.com

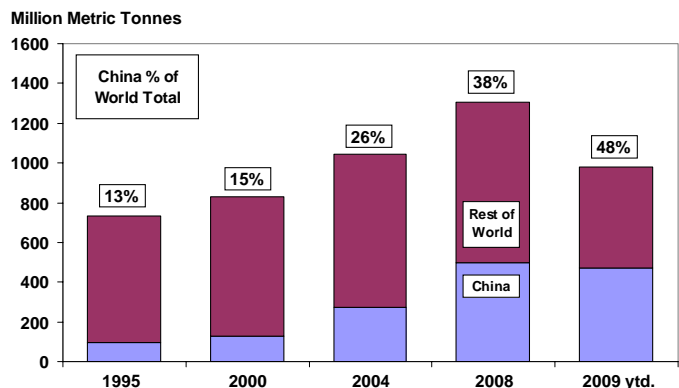
ISI Group

China 52% of global steel production and demand. More to come. Production 600 mil metric tonnes 2009; 700 mil 2010.

Massive demand – infrastructure, urbanization, modernization. And demand for exports of various products.

## Crude Steel Production

China and World Total



Source: International Iron and Steel Institute, IHS Global Insight  
dstraszheim@isigrp.com

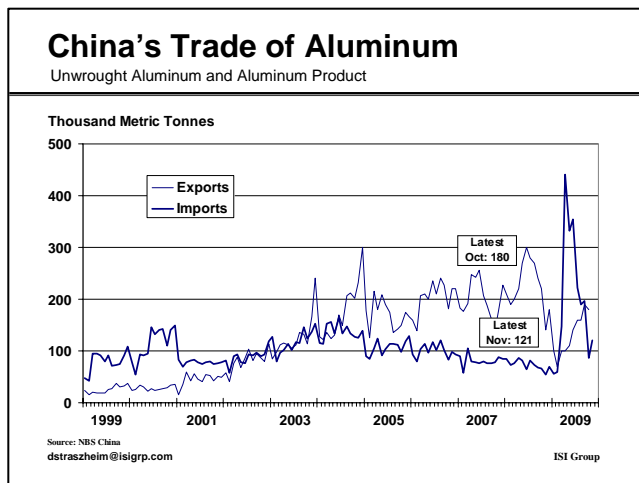
ISI Group

Industry is 'strategically vital' – Beijing term. SOEs dominate industry, will in future. No room for much outside competition.

Ongoing conflicts with ore suppliers – Australia, BZ.

Upward pressure on ore prices; downward on excess steel production. Not equilibrium. Complicated.

# Aluminum, Bauxite



**China, Aluminum Industry**  
Production of Mineral Commodities

	Thousand Metric Tonnes			
	1996	2000	2004	2008
<b>Bauxite</b>	6,200	9,000	17,000	35,000
<b>Alumina</b>	2,550	4,330	6,990	22,800
<b>Refined Metal</b>	1,900	2,830	8,560	15,900

Source: USGS  
dstraszheim@isigrp.com

Still strong aluminum demand in China's modernizing economy (up the value chain) – consumption and product exports.

China now no more than a fringe player in aluminum, bauxite.

Import spike in 2009 was one-time event, fears of shortage.

WATCH. Can China find a country that will sell it bauxite reserves?

China would pay up big time – economic security. China Sovereign Wealth Fund (CIC?)

**Bauxite, World Reserves**

	Thousand Metric Tonnes		
	1999	2003	2008
<b>China</b>	720,000	700,000	700,000
<b>U.S.</b>	20,000	20,000	20,000
<b>World</b>	25,000,000	23,000,000	27,000,000

Source: USGS, ISI Calculations  
dstraszheim@isigrp.com

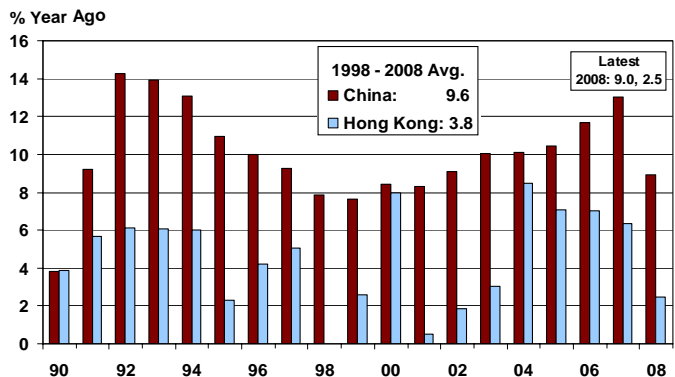
**Bauxite, World Mine Production**

	Thousand Metric Tonnes		
	1999	2003	2008
<b>China</b>	8,500	12,000	32,000
<b>U.S.</b>	N/A	N/A	N/A
<b>World</b>	123,000	144,000	205,000

Source: USGS, ISI Calculations  
dstraszheim@isigrp.com

# Hong Kong

## Hong Kong and China Real GDP



Source: IHS Global Insight  
dstraszheim@isigrp.com

ISI Group

Hong Kong #1 direct beneficiary of China development.

Mainland trans-shipment point.

Hong Kong still overseas to Chinese. Passport required.

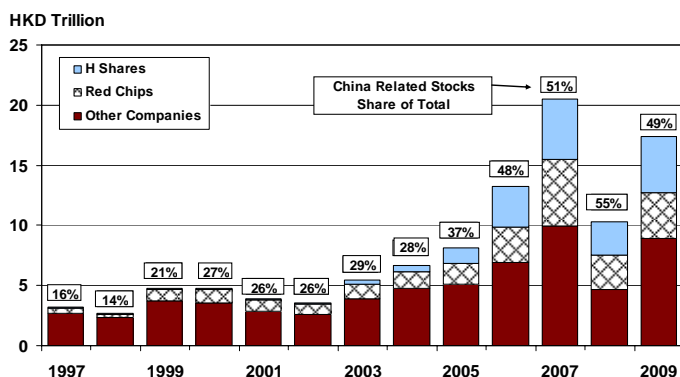
Hong Kong kept, likely to continue, currency peg to US dollar.

Since recovery set in, lots of capital flowing into Hong Kong.

Big high-end property price bubble now.

## Hong Kong Stock Exchange

Main Board, Market Capitalization and Company Capitalization



Source: Bloomberg, ISI Calculations, As at the end of November 2009  
dstraszheim@isigrp.com

ISI Group

Hong Kong Stock Exchange (HKSE) a real market – transparency, accounting, protections, outside directors, long history, etc. Good avenue for western investors to get China exposure.

China headquartered companies and China affiliated (most of business in China) listed in HK.

HKSE market cap dominated by Chinese companies.