The People's Republic of China (PRC), the latest incarnation of an ancient land and culture, is turning 60 on October 1st. During the decades of economic upheaval following the establishment of the PRC by Mao Zedong in 1949, few could have imagined that China would become the engine of global economic growth that it is today. The first three decades of the PRC were dictated by Mao's vision of transforming China from a peasant, agrarian economy to a communist agricultural and industrial powerhouse through programs like the "Great Leap Forward" and the "Cultural Revolution". His economic policies and forced redistribution of land and wealth resulted in widespread famine and death, and major setbacks to China's economic growth. Modern economic reform began in the late 1970s following Mao's death and the ascent of Deng Xiaoping to paramount leader. Under his influence, the ruling Communist Party gradually embraced a series of market-based economic reforms, including the reversal of collectivized agriculture, the development of a modern banking system and stock market, and the opening of foreign trade and investment. In these last three decades, the PRC has transformed into something far from Mao's original vision.

The China of today is still somewhat a paradoxical mix of government control and capitalism. It is the third largest manufacturing country in the world, the largest foreign holder of U.S. Treasurys, the source of 2009's two largest IPOs, and the recipient of nearly $84 billion in foreign direct investment[1]. At the same time, the government continues to exert periodic control over the markets and closely regulates the flow of economic information to the public. For example, in preparation for the nation's anniversary, localities were ordered to "create a harmonious and stable price environment" for items such as food, gas, and transportation. The government has played down recent price increases in certain food staples as normal seasonal fluctuations, and according to the Shanghai Daily, implemented only half the increase in gas prices that would have been mandated by the government's price-setting mechanism. Despite the unpredictability that this type of "market socialism" introduces into the equation, China is an undeniable global force that is flush with capital and rich in natural resources. Below we discuss China's evolving role on the world economic stage, and some of the benefits and challenges of investing in, and alongside, the emerging country.

[1] Inflows in 2007.

Statistical Factsheet	US *(Country Rank)*	China *(Country Rank)*
Population July 2009 est	307,212,123 *(3rd)*	1,338,612,968 *(1st)*
Median Age	36.7	34.1
Population growth rate	0.98%	0.66%
Population in Urban Areas	82%	43%
Life expectancy	78.11 *(50th)*	73.47 *(105th)*
Population Below Povery Line	12% 2004 est	8% 2006 est
Labor force	154,300,000 *(3rd)*	807,300,000 *(1st)*
Total Area (square km)	9,826,675 *(3rd)*	9,596,961 *(4th)*
GDP (Purchasing Power Parity)	$14.26 Tn *(1st)*	$7.973 Tn *(2nd)*
GDP Real Growth Rate		
2008	1.1% *(172nd)*	9% *(16th)*
2007	2.0%	13.0%
Composition of GDP		
Agriculture	1.2%	11.3%
Industry	19.2%	48.6%
Services	79.6%	40.1%
Fixed Gross Investment*, % of GDP	14.3% *(137th)*	40.5% *(4th)*
Public Debt, % of GDP	60.8% *(24th) 2007 est*	16.2% *(101st)*
Current Account Balance	-$673.3 Bn *(189th)*	$426.1 Bn *(1st)*
Exports	$1.291 Tn *(3rd)*	$1.435 Tn *(2nd)*
Imports	$2.112 Tn *(1st)*	$1.074 Tn *(3rd)*
Electricity Consumption 2007 est	3.9 Tn kWh *(1st)*	3.3 Tn kWh *(2nd)*
Oil Consumption, bls/day 2007 est	20.7 Mn *(1st)*	7.9 Mn *(2nd)*
Oil Imports, bls/day	13.7 Mn *(1st)* 2005 est	4.2 Mn *(3rd)* 2007 est
Mobile telephones 2007 est	255 Mn *(3rd)*	547 Mn *(1st)*

Source: CIA - The World Factbook, updated Sept. 24, 2009

Data points are for 2008, unless otherwise noted

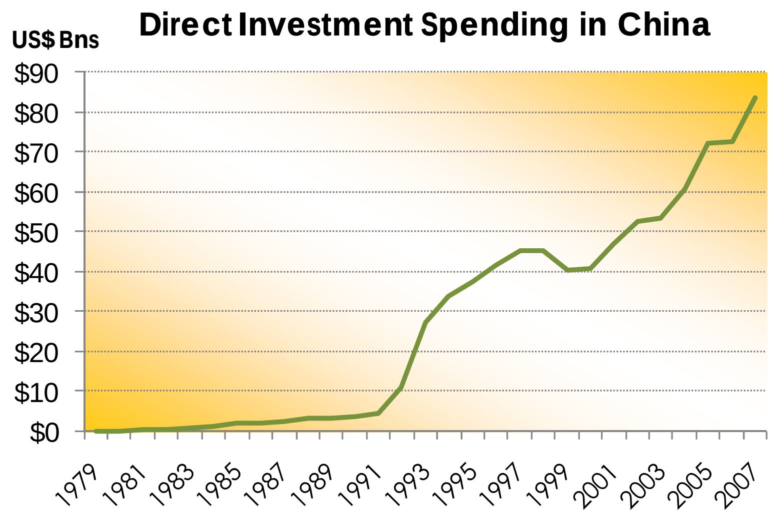
Statistics for China do not include Taiwan, Macau or Hong Kong

** Fixed gross investment is total business spending on fixed assets, such as factories, machinery, equipment, dwellings, and inventories of raw materials, gross of the depreciation of the assets.*

Throwing its Weight Around

Though China is only slightly smaller than the U.S. in land mass, it boasts nearly four and a half times the population. The demographics alone make it a powerful story. While a majority of the population still lives in rural areas, the growth and relative prosperity experienced in China's urban centers are gradually drawing both migrant and permanent workers into its cities. Last month, the Ministry of Housing and Urban-Rural Development released an estimate that an additional 300 million rural Chinese will move into urban areas by 2025. This population shift will surely put an incredible strain on China's already dense cities. While the world average for city population per square kilometer is 10,000, that number in central parts of Beijing and Shanghai already exceeds 50,000. The deputy policy director of the Housing Ministry is calling for a doubling of the currently planned 120 square meters per person requirement, which includes all living space, parks, roads, schools and public utilities. Maintaining the quality of life for urban Chinese is critical in avoiding the development of slums and the erosion of the benefits of urbanization, as has happened in other overpopulated, developing cities.

The demand for roads, schools, hospitals and public utilities that will result from this trend is massive. China is investing heavily in infrastructure, allocating more than 40% of GDP to direct fixed investment spending. While the once-dominant manufacturing and export sectors have been beaten down in the global recession, the government's 4 trillion yuan (US$586 billion) stimulus projects have picked up some of the slack. The stimulus has called for nearly half of the spending to be dedicated to new highways, railways, airports, power grids and other public works, at once providing needed infrastructure and an economic boost. The State Council, the nation's cabinet, has approved a plan to build 79 new rapid transit systems in 22 Chinese cities over the next 6 years, laying the groundwork for better mobility of workers and further development of a middle-class society.



Does not include Taiwan, Macau, or Hong Kong
Source: U.N. Conference on Trade and Development

The recent downturn has hit migrants who travel into the cities for industrial work particularly hard. This dislocation has further widened the income gap already in place between urban and rural residents. According to the Ministry of Agriculture, the ratio of urban-to-rural per capita income has deteriorated to 3.3 to 1 in 2007 from 2.6 to 1 in 1978. To help mitigate this imbalance, the government has increased spending on agriculture, has begun providing small loans and tax cuts to encourage migrants to start their own businesses, and launched a plan to provide equitable and universal access to health care within 10 years. Improving the buying power of non-urban residents is a key to reducing China's reliance on exports, building a sustainable domestic-consumer society, and continuing the development of a middle class. This will create a new group of consumers for cars, houses, and even iPhones, which go on sale in China on October 1st at a cost of 5,000 yuan (roughly US$732).

Retail Sales of Consumer Goods January through August 2009				
	All Areas	Cities	Counties	Sub-County Level
Total Sales (100 Mn Yuan)	**78,763**	53,562	8,809	16,392
Year-on-Year % Change	**15.1%**	14.6%	16.6%	15.9%

Source: National Bureau of Statistics of China

We believe that the "emerging middle class" story in China (and India) is compelling from an investment point of view. Just as the U.S. closed the income gap and evolved into a nation of home and vehicle owners in the post-World War II years, we expect a portion of the Chinese population will gradually adopt higher living standards. Retail sales across all types of geographic areas are already strong. Investments that provide the infrastructure necessary to support this growth are attractive, as are Chinese consumer plays in the medium to longer term. A recently filed prospectus with the SEC seeks to launch six new ETFs that will track different sectors of the Chinese economy, one of which is the Global X Consumer ETF. We will monitor the development of these ETFs as possible avenues for domestic-oriented investments.

Fast and Nimble Despite Its Size

The GDP of China has increased more than tenfold since economic restructuring began in 1978. This rapid growth has propelled it to the second largest economy in the world, just behind the United States. Much of China's growth has been driven by its export sector. Understanding the importance of exports to China's growth, the government has been quick to support its businesses during this recession. To help companies weather the storm, the State Council has promised additional loans and tax cuts for small businesses. A recently released purchasing managers' index indicates that stimulus measures have helped bridge the gap. Despite falling exports, September marked the sixth month of expansion for China's manufacturing sector. An indicator for manufacturing employment also rose to its highest level in more than two years.

With only 40% of GDP originating in the service sector (versus almost 80% in the US), there is room for economic diversification. The Asian Development Bank reported that the Chinese economy grew at a 7.1% annualized rate in the first half of 2009 despite a -2.9% contribution from net exports. Record bank lending and domestic consumption buoyed the growth. The Bank has raised its full-year 2009 forecast for growth to 8.2%, up from its March estimate of 7.0%. The Bank's Chief Economist Jong-Wha Lee also upped growth prospects for 2010 to 8.9% from 8.0%. The Bank based these estimates on expectations that the major drivers of growth will be infrastructure investment, construction and the expansion of consumption, with only a minor contribution from net exports. They also expect higher growth to contribute to a 3% inflation rate by 2010.

Even if China does not soon return to the double-digit GDP growth of the early 2000's, expansion of 8%-9% is faster than expected anywhere in the western world. We continue to favor the Brazil, India, and China portion of the BRIC country block to benefit from the emerging market growth stories.

Creative Thinker

In a far cry from the centrally-planned economy of three decades ago, small-and-medium-sized businesses now account for 60% of China's GDP and half of its tax revenues. They have grown exponentially in number, from only about one million in 1990 to more than 60 million today. These businesses are the country's source of innovation, produce more than 80% of China's new products, and initiate more than two-thirds of China's patents. This is significant in a country where trademark applications are up 153% in the year through August, ranking first in the world in volume. Perhaps surprisingly, almost all of these businesses are privately owned, which allows them to operate largely outside of the bureaucratic web that ensnares the larger state-owned enterprises. This allows them more creativity and flexibility, but also makes them more vulnerable to economic conditions.

As mentioned above, the State Council recently reiterated and strengthened its support for the country's small- and medium-sized business. In addition to tax breaks and loans, the government promised to lower barriers to entry in currently-monopolistic industries to create a more competitive environment for the smaller players. It seems that so far in the current crisis, however, state owned firms have fared better. Of the 7 trillion yuan loaned out in the first half of 2009, only 10% has flowed to smaller firms. Bank lending in China remains politically influenced and favors state owned enterprises, while in the commercial lending market small companies face difficulties since they are seen as bigger credit risks. Follow through on access to capital for these companies will be another key component of China's continued growth.

Monitoring the flow of capital within the country will be an indicator of how this large chunk of the economy fares once the stimulus measures have ended.

Friend or Enemy?

Tensions between the governments of China and the U.S. are nothing new. The latest spat, however, comes at a time when leaders of the G20 are pledging to avoid nationalistic policies and refrain from raising new barriers to trade to help foster a global economic recovery. In mid-September, the administration in Washington responded to an earlier complaint from the United Steelworkers union by imposing a 25%-35% tariff on tires imported from China. As a campaigner, President Obama promised to enforce trade laws more forcefully than his predecessor, a commitment which likely underlies his decision. At the same time, the President has tried to position himself away from criticisms that he has protectionist tendencies. The move has prompted a World Trade Organization challenge from China, and the country has threatened retaliation against American chicken and auto imports. The positive economic impact of the tariff for the U.S. is likely small, but the message that it sends could be damaging to trade relations. Meanwhile, China itself is under fire from the WTO and appealing a ruling that it unfairly restricts the sale of American films, music and books. The government still keeps tight control over the media under the guise that restrictions are needed to safeguard Chinese culture and protect public morals.

China's status as America's primary lender also complicates the countries' relationship. China is the largest foreign holder of U.S. Treasuries, with total holdings of Treasury bonds reaching $800.5 billion in July. In efforts to keep the yuan relatively weak and exports competitively priced, China's interventions in the currency markets have also made it the world's largest holder of foreign exchange reserves. This puts the U.S. and its debt in a very vulnerable position should China wish to reduce its dollar reserves and/or Treasury investments. Earlier this year China used its power to hint at the possibility of the U.S. dollar being replaced as the world's major reserve currency. This caused widespread speculation as to its successor, and the future denomination of commodities. The contenders include the euro, the yuan, and the International Monetary Fund's Special Drawing Rights (SDRs), a notional currency that exists primarily between central banks. The euro seems the most probable candidate due to its liquidity, but given the relative youth of the currency and the challenges involved in managing the monetary policy of the Euro-zone, it is unlikely that the dollar will be displaced as primary world currency in the near future.

Strange Bedfellows

China's intimate relationship with Iran also creates problems for the U.S. and other G20 allies, particularly in light of recent nuclear advancements. Washington needs China's diplomatic weight to help deter Iran from further developing its nuclear program, but economic and political interests seem to be taking precedence. China has recently signed a series of deals with Iran to develop the Middle Eastern country's natural gas fields, oil refineries and pipelines. These economic ties provide Iran with some insurance that the Chinese will remain its ally on the United Nations Security Council, where it holds veto power over potential economic sanctions. In total, it is estimated that China has committed $120 billion to Iranian gas and oil projects, while China already has been the biggest oil importer from Iran over the past five years. Iran in turn solidifies itself as one of China's largest trading partners through imports of Chinese factory equipment, machinery, and other heavy goods. In the past, China has backed some restrictions on nuclear materials and the freezing of assets of some Iranian companies, but has stopped short of supporting tougher sanctions. China has generally acquiesced only after diluting American proposals and following the lead of Iran's other major backer, Russia.

Fueling the Beast

In 2006, China became the world's biggest emitter of greenhouse gases from fossil fuels. They are followed by the U.S., Russia, India and Japan, according to U.S. Department of Energy data. At a recent United Nations Climate Summit, Chinese President Hu Jintao promised a "notable" cutback in the country's level of carbon dioxide emissions. He gave no specific goals, but indicated that his government's next five year plan would include steps to reduce emissions per unit of GDP in the world's second largest energy consuming country. This is likely a preemptive strike against critics of China's environmental record before the Copenhagen conference on climate change in December. Many world leaders are looking to the U.S. as the necessary leader in initiating a climate change bill. American businesses, however, fear that without similarly strong commitments from China they could be undercut in price by their rival's lax environmental standards. Just today, Democratic Senate leaders John Kerry and Barbara Boxer proposed a bill to cut greenhouse gas emissions by 20% before 2020.

Despite its hesitance to commit to specific emission-reduction goals, China is becoming a leader in alternative energy investment. According to China's top economic planner, the National Development and Reform Commission, investment in alternative energy sources may exceed 2 trillion yuan by 2020. Wind power, one of the cheapest forms of renewable energy, is in focus for the Chinese. They will invest about 100 billion yuan ($14.6 billion) to more than double wind power capacity in the next year. The government stimulus package allocated 210 billion yuan for carbon-reducing projects, including the upgrading of power grids. Some analysts predict that China could become the world's biggest renewable energy consumer by 2010.

Though Alternative Energy has been a volatile asset class in general, increasing political pressure on emissions reduction may provide this area with more consistent investment dollars. We continue to favor countries rich in natural resources that are necessary for the advancement of green technology. For example, China's abundance and control of the "rare earth" elements market – inputs for the likes of hybrid cars and iPhones – gives it a leg up on keeping costs of development low.

Taming the Beast

For centuries, China has been a political force to be reckoned with, but today it is also the 800 pound economic gorilla that cannot be ignored. The sheer volume of people becoming educated and entering the labor force, and thus the global economy, dwarfs both the U.S. and the European Union. It is our largest creditor, and still flush with capital and resources. The country's economic clout has made it a peer in the G20 and it can now apply influence as well as receive it.

Certainly, there are challenges to investing in China from the outside. Even in researching this paper, it was abundantly clear that finding reliable and consistent data on the closely-guarded country is a difficult process. Despite its progress, China is still a developing economy, and must be analyzed with the same diligence as any other emerging market. At Miracle Mile Advisors, we continue to invest in China through both a broad Emerging Markets ETF and a China-focused ETF.

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