

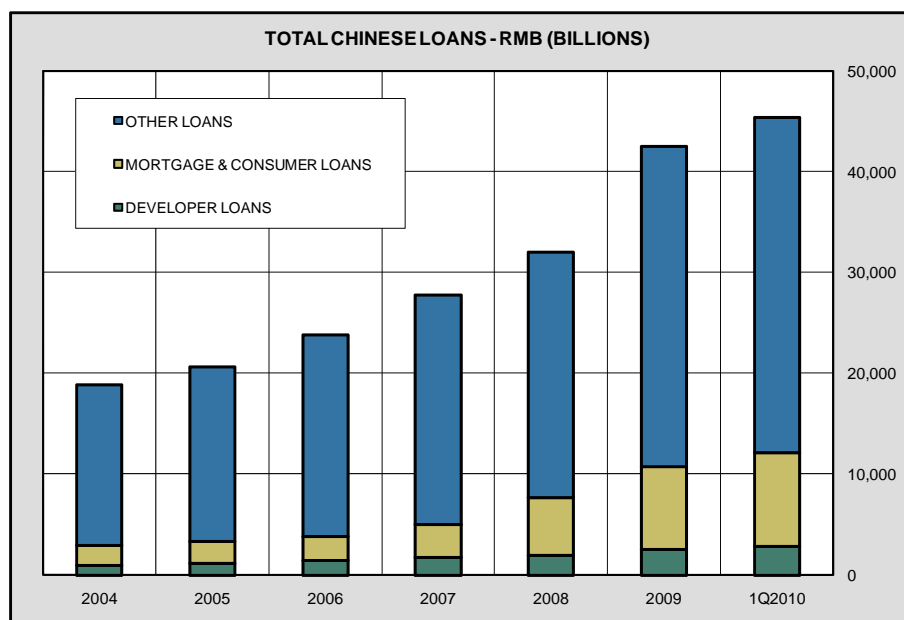


## Insights from Northern Trust

### Commentary from Jim McDonald, Chief Investment Strategist

June 28, 2010

The second quarter of 2010 is shaping up to be the first “down” quarter in the U.S. stock market since the first quarter of 2009. Investor concern about the state of European sovereign creditworthiness has been front-and-center, along with concerns about the proper path forward. Should the advanced (i.e., overly indebted) countries continue to stimulate their economies to grow their way out of their problems (as proposed by the United States), or get their financial houses in order by reducing budget deficits (as most prominently espoused by the Germans)? This past weekend’s G-20 meeting managed to split the baby in half – committing to reduce budget deficits by one-half by 2013 but also agreeing that economic growth was the primary goal. At the G-20’s Pittsburgh meeting in September 2009, global leaders signed on to a rebalancing effort to have countries with trade surpluses (e.g., China and Germany) boost domestic consumption while the trade deficit countries (e.g., the United States) boosted savings. Over time, this will lead to a more stable global economy that should be less prone to imbalances, but the transition will be neither quick nor simple. A major component of this transformation will be the ability of emerging markets to transform their economies from reliance on exports to boosting personal income and consumption. And China will be the poster child for this process.



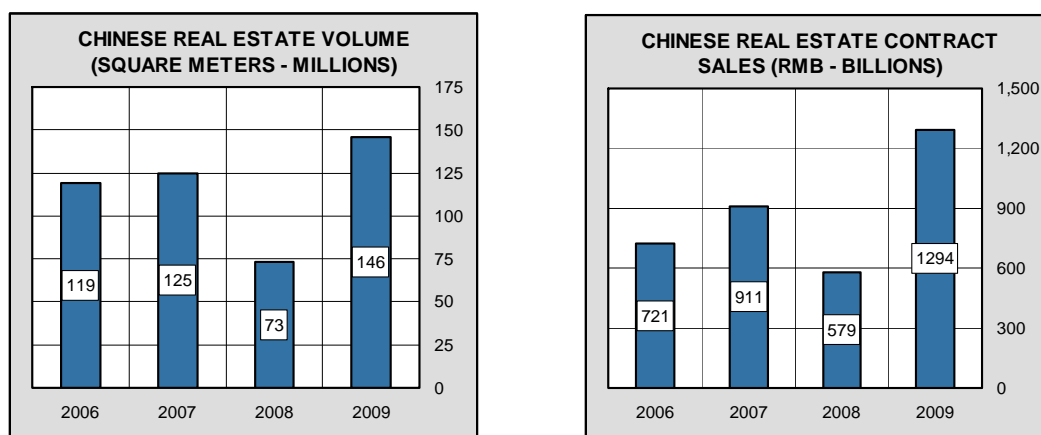
Source: PBoC, CEIC, Goldman Sachs, Northern Trust Global Investments.



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Earlier this month, I had the opportunity to spend eight days in China – split between Shanghai and Beijing – meeting with companies, bankers and policy-makers. My goal was to better understand the current state of the banking system, real estate market and the Chinese government’s longer-term objectives. These are especially important topics today as China attacked the global financial crisis with overwhelming force – including 7 trillion Renminbi, or approximately US\$1 trillion, in loans to local municipalities. Where did these funds go, and did they generate productive investment or stimulus pork? Transparency on this issue is not great, but one educated analyst we spent time with estimated that around 2 trillion Renminbi of the projects supported by these loans may not be generating cash flow. As the banks issuing these stimulus loans were apparently told that they would not be punished if the credit quality of these loans didn’t match their normal standards, these loans are in effect state-backed obligations. The municipalities currently cannot issue their own debt, but liberalization of this over time may allow them to refinance some of these obligations. Local stock market participants indicate that they believe domestic investors are underweight the Chinese banks due to concerns over the potential of these non-performing loans. This gives some credence to looking to the performance of the Shanghai exchange as a leading indicator of not only the Chinese, but also the world, growth outlook.

Residential real estate, especially in Tier 1 cities, has been on a tear over the last two years, with prices in the top three cities up 60% year-over-year in April 2010. While it seems ripe for a price correction, the nature of the market means that the fallout is unlikely to come close to the problems experienced in the United States. In a meeting with Century 21 China Real Estate, the largest network of real estate brokers with 1,200 sales offices, it was clear that the government’s actions to cool the market were starting to take hold. After a gangbuster 2009 in real estate sales, the combination of tightening mortgage standards and jawboning have led to a sharp drop in sales and prices. Century 21 was surprisingly bearish on both transaction volumes and pricing for the remainder of the year.



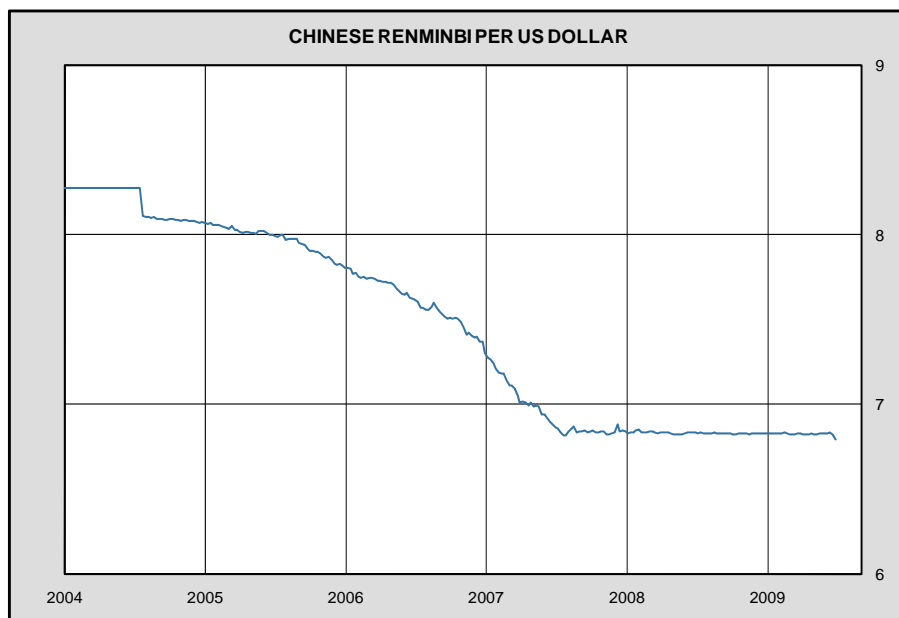
Source: NBS, CIA, Gao Hua Securities, Northern Trust Global Investments.

Numerous sources we met with corroborated the cash-heavy nature of Chinese residential real estate transactions, with down payments averaging around 40% of the sales price. Due to the controlled nature of the Chinese economy, there are few outlets for the country’s very high savings rate – primarily the domestic stock market, the property market and savings accounts with a negative real

return. There are numerous “vacancies” in higher-end residential developments, but these tend to be flats owned by residents of Hong Kong, Taiwan, or outer provinces where the owner only uses the space occasionally. We also witnessed some of the legendary “see-through” office buildings, which are extra capacity that will only be filled through continued economic growth (which seems a good bet). So the residential real estate market, while likely to undergo a noticeable correction (at the hands of government policy), seems unlikely to significantly damage the national economy due to the high level of equity held in most properties.

As I was preparing to leave the United States for this trip, the Chinese labor situation was just starting to heat up. At that point the now-famous Foxconn workers had secured a raise on the order of 10% in the wake of a rise in worker suicides. Early in the trip, the raise had increased to around 33% and was finalized at roughly 100% by the end of the trip. This phenomenon spread to other foreign manufacturers, like Honda Motor suppliers, and has served to highlight the growing income disparity and concern over social stability in the country. While the magnitude of these raises is mitigated somewhat by negligible raises during the financial crisis and high productivity, this will have to impact profitability at domestic manufacturers, leading to some exporting of manufacturing to lower-cost countries and some increase in export prices. The Chinese government seems to have decided that the higher worker rates (at least at foreign companies!) will help social harmony and, on a longer-term basis, help the transition to a more consumption-based economy.

With the much ballyhooed “revaluation” of the Renminbi last week (the Renminbi is the official name of the currency, while a yuan is a unit of measure; you revalue the Renminbi but pay 30 yuan for a Coca-Cola), China primarily succeeded in taking this off the table for the G-20 meeting last weekend. Purchasing common products and services in Shanghai and Beijing (certainly two of the most expensive cities in the country) demonstrates undervaluation – whether it was the US\$0.45 equivalent price of a can of Coca-Cola or a bottle of water or the US\$3.00 equivalent price for a cab ride most anywhere in either city (and this is with gasoline that costs around US\$4.00 per gallon).



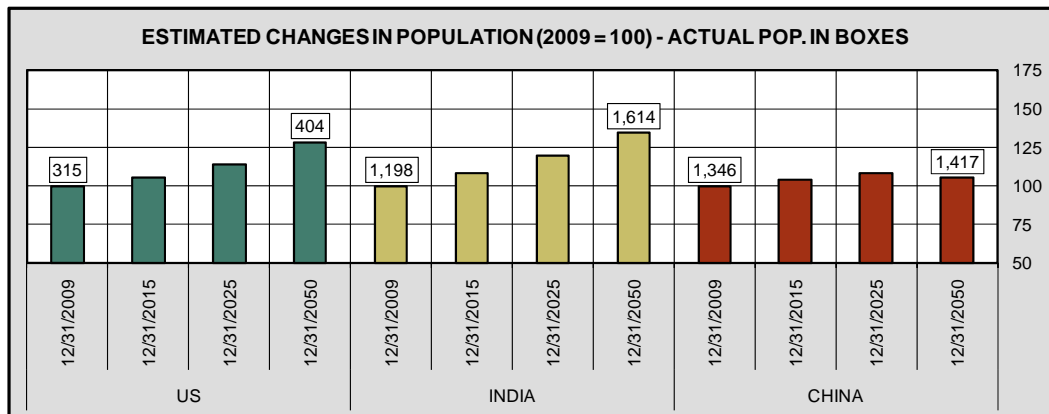
Source: Northern Trust, Bloomberg



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According to the Peterson Institute for International Economics, the Renminbi is now 14% below its equilibrium rate, compared with 21% at the end of last year, as China's current account surplus has dropped. China's mercantilist approach has clearly benefitted them greatly, and so far, hasn't created problematic price inflation outside of recent jumps in real estate prices. So getting the Chinese to move off a policy that has worked to their significant advantage will be a long, slow process that will go at the pace that benefits China. To the extent that domestic consumption continues to become a more important policy goal, an appreciated currency will help improve consumer buying power and may gain favor.

China's current growth is being driven heavily by urbanization and modernization, and on a longer-term basis, has less attractive demographic support than many understand. How many people would guess that the United States is expected to have a larger increase in its population over the next 40 years than China? The United States is expected to add 89 million people, or growth of 28%, through 2050, while China is estimated to grow by 72 million people, or a 5% increase. Better understood in some camps is the blistering growth expected in India – a country with better demographics but with a less organized economic plan.



Source: United Nations. World Population Prospects, 2008 Revision.

An example of the aging of China was apparent during our visit as high school students were sitting for the college entrance examination. A total of 9.57 million students sat for the exam this June, compared with the peak of 10.53 million in 2008. This reflects the drop in primary school enrollments (as a result of the one-child policy), which in 2008 had declined by one-third from the peak in 1995. Similar to the United States, China has benefitted from the inclusion of women in the workplace to expand the scope and quality of the workforce. In my unscientific observation, we met with a higher percentage of women in management and policy roles in China than we would have seen in the United States.

So what are our takeaways on China – both near- and longer-term? I was impressed with the very commercial/capitalistic approach of the companies, banks and policy-makers. While clearly accommodating governmental interests and mandates, if left to their own devices, the commercial instincts will reign supreme. This behavior is also working its way into policy, as the historic free-trade agreement signed last week between Taiwan and China demonstrates. Believe it or not, it is

only within the last year that you could fly directly from China to Taiwan – greatly facilitating trade and business dealings. Previously, you had to fly through Hong Kong and switch planes! It seems clear that the Chinese government is attempting to manage through the hangover from the huge stimulus enacted to counter the global financial crisis. Property prices, a very visible sign of wealth, are falling and seem likely to correct more. There will be losses from uneconomic stimulus loans made, but the overall level of debt and non-performing loans within the economy seems manageable.

The transition to the new leadership within the State Council (the group of nine politicians that governs the country by consensus) is set for 2012, and the power balance between the current leaders and incoming leaders seems set to mute both the dovish inclinations of the incumbents and the hawkish leanings of the newcomers. The new leaders might favor taking any pain on non-performing loans now, ahead of their tenure, but may not succeed in that endeavor. The leaders do seem to truly understand that they need increased social safety nets to be able to increase consumer confidence and thereby consumption – but these programs take time to develop. As the standard of living rises with income levels over the coming decade, increased spending on consumer goods, health care, education and travel seem like good bets. Finally, the Chinese modernization process seems likely to continue to bolster their growth for years to come. But at some point over the next couple of decades, their weaker demographic picture could lead to a new global growth darling taking center stage.

#### **Important Information**

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