

Business Across Borders

*The Dawn of Full-Scale – Did Someone Say
“Permanent” Globalization – Capital Formation,
and Investment Strategies*

(With Increased Localization)



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Introduction

I have conducted seminars all over the world, during good times and bad, with regard to the current financial meltdown and global economic crisis – although many believe, or perhaps “feel in their collective gut,” that quite possibly the worst is over. Reflection is a powerful tool, whether it originates from a highly personal and deeply philosophical perspective, or as a function of so-called modern management doctrine.

The enclosed text content for this paper is originally derived from a compilation of after-dinner programs that I performed for a number of Wall Street types, membership within the professional investment community, composed of financial analysts in such far-flung places as New York City, London, Hong Kong, Shanghai, Chicago, and even Milwaukee, Wisconsin. It is mildly entertaining to look back on its contents and compare and contrast this effort with the most recent headlines, dating from the summer of 2007, through the autumn of 2008, and into the present day, summer 2009.

Often times, while teaching at a university or providing what I had hoped would become thoughtful insight for the listening audience, I would find myself asking the assembly of bright business people to – in one word, not even a phrase – describe the new center of the commercial universe, namely China. Their multiple or singular syllabic summary consists of words such as:

threat miracle challenge frustration opportunity reality
perception corrupt unknown explosive new growth large
finally ally menace courageous

But the number one word, by numerical tally, was “unpredictable” by a large margin.

During the brief e-journey of this written discourse, I shall try to provide the curious reader with not so much the same old tired rhetoric about what China is or perhaps is not (yet), in the unfolding of the new century, mimicking what any number of books have tried to convey in thousands of pages already. Some bookshelf titles are from journalists who describe their work as being “on the front lines” in China. Hardly an appropriate description for someone who in fact watches from the sidelines, letting real work and real negotiation be done by guys like yours truly, and have actually been responsible for the development of a large company’s organizational mission in China, met with customers, and built an infrastructure including personnel and facilities. Been there, done that.

The goal at this moment instead is sharing with you what goes on inside the minds of folks such as Certified Financial Analysts, given their pre-seminar question & answer inquiries, from which I created this document. The queries as well as my preparation have origins in attempting to think about the borderless global economy, the so-called “flattening” (credit Mr. Thomas Friedman) of the planet’s *creative energy spectrum* (my words), and how in this tumultuous time the world financial markets are increasingly

inter-related and dependent upon one another. What do financial planners think about? How do they recite investment strategies? What keeps their clients awake at night?

First, Let's Examine Global Reach

I really do like that phrase, “global reach,” as it is catchy and rolls off of the tongue with considerable ease. Indeed, it is overused quite possibly, but then again so is the notion of synergy, or paradigm shifting, and core competencies – I rant about these in other writings and further elaborate upon their misuse. For now, global reach can be examined in the Then Versus Now model, or the time period of 1965-1985, as compared to the time frame enveloping 1985 to present day.

During the mid-sixties, the world began in earnest to re-deploy assets and re-develop national infrastructures in what has been often called the U.S. aided Post-World War II industrialization efforts of Europe and Japan. That dual initiative coordinated America's emerging prosperity of the 1950s and 1960s, along with the concept of the corporation on an international scale. Now we tend to refer to that business organization as the MNC, or multi-national corporation in today's vernacular.

U.S. companies began to extend their “global reach” by planting the company flag in Western Europe, say about 1965, in a big way. Mergers and acquisitions followed in hot pursuit in the mid-60s and 1970s. Then Japan became a target, a competitor. Asia was always a tough proposition – “*breaking the code*” became cumbersome for Western firms. So the West settled into first creating an overseas organizational structure in what is now commonly called the European Union, save for a handful of newer partner nations which now embrace the common currency and trade reciprocity.

Meanwhile, Asian industrial organizations came into initial maturity, including Japan, Korea, Singapore, and Taiwan. China remained in the stranglehold of the Cultural Revolution, virtually isolated from the rest of the world (1966-1976). Hong Kong, still a British Colony at that time, had its own form of growth-oriented capitalism and equally prospered, maybe to a smaller extent than the other major Asian agricultural-turned-industrial nations already mentioned. Most of us know the China Miracle by now, which got its start around 1978 and catapulted into the news during the decade of the 1990s.

So please fast forward to present day dynamics. We are witnessing fundamental shifts in virtually every industry, every business model, each competitive advantage possessed by industrial countries. Autos, steel, oil & gas, chemicals, auto parts, retail, financial, legal, insurance, home construction, franchising, food & beverage, household goods, white goods appliances, publishing, media, airlines, energy, information technology – the list is seemingly endless. As a direct result, the planet has overcapacity in every industry just described, resulting in a continuing push for consolidation and overlap-synergies, M&A activity, private equity buyouts, and bankruptcies (something not covered when I first initiated this CFA program three years ago, fall of 2006). Chapter 11 filings are at an all time high. And the news details efforts in distressed-debt deals, “vulture” deals.

There are new, increasingly global brand names. Labor competition beyond simple localization parameters, and continued piracy (both the ship-boarding and intellectual property types) have made the forecasting and modeling murky at best – both in terms of corporate financial performance and sustainable overseas operations. One of my favorite subjects for research has grown to become the notion of the movement of professional classes to where the jobs are. Examples include, but are not limited to: airline pilots, doctors, finance, engineering, consulting, real estate. 21st century white collar migrants.

Continuing on with the topic of fundamental shifts, we can worry relentlessly about global warming, a worsening energy crisis, geo-political confusion (who's an ally, what's an ally, a new Cold War, terrorism), societal breakdowns, even values questioned. We now look to BRIC nations for direction in forecasting and trend analysis (Brazil, Russia, India, China). In spite of their political turmoil, social unrest, and dubious alliances.

Education methodologies are being transformed, on-line this-and-that being offered with positive results thus far reported. Skilled trades are in vogue once again, as “managers managing managers” in cube farms have seen their masses fade away. Apprenticeships coincide with new demands for math and science, medical expertise. Collaboration has become one of the newest buzzwords, and in fact makes sense for a change, as a vehicle for business and entrepreneurial, scientific, as well as operations improvements. The old models for job promotion, even investing, are no more.

When I graduated from college, my fellow students saw life in a large Fortune 500 manufacturing company or quite possibly a financial service firm as the ticket to extended career success. Now healthcare, bio-technology, life sciences, even nanotech, seek out the best and brightest students graduating in new fields of academic study.

The social welfare contract concerning a person's pension, work week hours, unions, health benefits, flex time, retirement age (if any), life after work, second careers, are each and all under creative siege. And frankly speaking, this is a good turn of events.

Where are the next generation of industrialists, financiers, and entrepreneurs coming from? What will their formal education be? Work related training? Home country?

During the first half of the first decade of this new century (roughly 2000-2005/06), Americans kept the world spinning. True or False? I saw an article way back around late 2006 (*The Economist*, October 21st-27th, 2006 issue), in which the view in the sentence above would be tested “in the next few years.” Along with housing troubles and jobs. How prophetic, now that we can examine this collection of thoughts through the prism of 20/20 hindsight and declining GDP (Gross Domestic Product) growth, which accompany every daily newscast during the course of the last couple of years. Many economists expected a soft landing in the United States, in line with falling oil prices and low unemployment (again circa late 2006). Then, all heck broke loose in 2007-2008. Look where we are at now (mid-2009). I need not write any more perhaps. It's all been said.

But I shall – write more that is. The article was captioned, “America Drops, Asia Shops,” all the while Europe is gloomy. For the sake of constructive dialogue among my friends within the financial services industry, a debate then broke out as to the merits of the common view that the American consumer as the engine of the world economy is flawed. So much diligent financial analysis and forecasting uses this underpinning fact.

New Jobs, New (Old) Industries – Revitalized & Rejuvenated at Home

We are now in the throes of a wholesale repositioning of labor; no more “re-training” from factory millwright to computer technician or systems operator. It’s hard to train a person to become a player in molecular biology, nanotechnology – virtually impossible. The business models for once powerful and large-employer industries continue to be completely redefined. One thinks of airlines, basic metals, energy companies, mining, experienced consulting & market research firms, leisure & hospitality, automobile production, high technology, industrial distribution. A considerable amount of text is being devoted to books and news programs trumpeting the necessity of a national strategy to 100% re-build U.S. industry (and China’s S.O.E. companies), not unlike the nation and infrastructure restoration after WWII or the massive amounts of FDI (Foreign Direct Investment) into Mainland China. Even the Great Depression-era Civilian Conservation Corps (CCC), the Works Progress Administration (WPA), U.S. Interstate Highway Program, or NASA Apollo Space Program are all brought into discussion to jump-start constructive dialogue – and decisive action – to respond long term to this current economic stagnation and continuing crisis of confidence, in spite of the NYSE.

Steel & aluminum are still needed. As are cars & trucks, planes & trains, bridges, computers, light bulbs and washing machines, textiles, chemicals, oil (and refining capacity), homes – this list also is endless – and being provided from offshore resources.

I was looking through an old 2006 presentation, examining ideas for this paper, when I came across a presentation slide which included the following bullet point elements:

- Contrary to what Wall Street and politicians say, the United States is in the grips of a full-scale jobs depression, with no readily apparent solutions in sight.
- New global companies need to be grown from scratch – and they are, just not in America yet!
- China needs to find 15 million new jobs every year for its people.
- The only remaining job growth in America is coming from healthcare fields, while further declines continue in just about every other occupation elsewhere.
- Can any company simply, blindly rely on China (or any other nation) to build its future?
- Do you really believe that China (Asia) will let that happen by MNC foreigners?
- You need to be there, but at what price – and I do not mean the infamous “China Price” talked about by pundits and pseudo-Sino-expert consultants.

This was extracted precisely from my 3-year old financial analysts' overview, and seems as current as ever, doesn't it? 2006..... Déjà vu, or simply more of the same.

I reported to my audience that Wall Street was rejoicing over a September 2006 record climb, subsequently eclipsed in October of 2006, as the U.S. stock market hit the 12000 mark – and then I said, “Please explain that to me.” They didn't. They couldn't I guess.

Since then we have become numb to layoffs, large in quantity, and continuous. Noteworthy news items such as General Motors partnership with Nissan and Renault (do you even recall that effort?) was trashed. It seems rather obvious now, in mid-2009. IBM had just announced firings (2006) for 400 engineers – didn't I read something about another 5,000 receiving pink slips not all that long ago (spring 2009)?

Just when I was thinking about writing a piece on the lack of current corporate scandals on par with HP, Enron, Tyco, WorldCom, lobbyists, and the entertainment industry, I was awoken to what took place with our financial “services” (the newest oxymoron) debacle last year – and then there was The Bailout. And now Bonuses.

Perhaps someday, in the not-too-distant future, we shall once again be investing in companies that are created and identified with the founder's name. Will Americans once again see the likes of a Ford, Chrysler, Sloan, Vanderbilt, Carnegie, Dell, Firestone, Goodyear, Lear, Rockefeller, Parker, J.P. Morgan, Boeing, Pillsbury, Busch, Dayton, Field? A real name behind a real, profitable, organization. Sure, they were not all saints, but they built America. Will this be the engine of re-building a new middle class and a national social infrastructure? It's happening throughout the Asia-Pacific region. This is what investors crave. Always have, forever will. Geography, politics notwithstanding.

Okay, we are together to discuss Asia (via this paper).

In finally getting around to talking about Asia, the West, and the CFA investment community, mentioning companies such as Caterpillar Tractor or Boeing always come to my mind. They both represent the quintessential bright side of American manufacturing might and global reach. Each company did its homework relative to entering Asia, expanding international operations, succeeding with joint ventures, while developing long term product development & market entry strategies, thus pleasing Wall Street.

But what do we know and understand about Asian companies and the nations that fostered their spectacular rise in so many cases? We have come to know several Asian countries as the *Tigers*, “Asian Tigers” specifically. The lineage is summed up with the ASEAN (Association of Southeast Asian Nations) trading bloc, South Korea, Taiwan, and of course, Japan. They initiated this nation-building a half-world away.

Going back in history, and for prudent study here, we need to be reminded that back in 1965, Japan and the above-mentioned tigers accounted for 4% of the world's GDP. In 1985, it was a total of 13%. By 1990, combined GDP had reached 16%. Needless to say,

this is before things became truly interesting, as we said in the 1990s, and beyond. During this time, Korea had grown at 8% annually, Singapore around 8.4%, Hong Kong developed annually at 7.7% during the last quarter century. It is estimated, and in fact conservatively, that China (with a global output of only 4% in 2000) will account for 11% of the world's GDP by 2015. And even the quasi-Tigers of Thailand and Malaysia were not far behind during the 1980s and 1990s decades. It's safe to say that the world has never seen anything even close to the growth statistics coming out of Asia in the second half of the 20th century – this is not a recent Asian phenomenon – China's growth is not a myth or a miracle. Napoleon saw things headed this way a long time back!

As the quarterly reporting agenda of American finance and investing takes a back seat, at last, to much broader extended time frame thinking, we must additionally examine the 1980s, to derive some sense of perspective, especially for the **long term and borderless investor of today**. During the 1980s, actually by that time, the world's major industrialized economies were in recession (over-and-over, seemingly in a continuous pattern) while the Asia-Pacific region continued to grow near a record pace, and the "economic model" questions began to mount. Suddenly, the "Asian Growth Miracle" appeared as a new business/culture model in lecture halls, at conferences, and in many company learning centers and executive retreats. A hallmark of that surely had to be pretty much all that Toyota was doing on the factory floor. Whatever it was – it worked better than the consumer driven (debt financed) laissez-faire economic mindset of the Western democracies (collectivist harmony versus rugged – restless – individualists).

In The New Business Model of Asia, tight-knit corporations were not beholden to outside shareholders, and thus achieved better performance. Further, traditional Asian values and social cohesion made for a more optimal climate than the ultra-competitive "me first" Western (i.e. American), standard organizational doctrine. It includes taking a decidedly Asian long-term planning and strategy approach as opposed to a quarterly agenda, one that perpetually confused Asian business leaders and investors. A high value was placed upon technical education, sacrifice, savings & frugality, stable perseverance. Contrary to a university professor friend of mine contends, I do firmly and irrefutably believe that there seems to be a direct correlation between a savings rate of 30% and annual GDP growth of at least 8%, proven out time and again (over 25 years) in every Asian nation. These fundamental components are reinforced by Ohio State Professor Oded Shenkar, in his book, The Chinese Century, Wharton School Publishing, 2006. The economic events of the time period, 2006-2009 would validate that premise for doubters.

There is an opposing business model point of view.

It has been said that Asian firms succeeded by cheating. Including such as the notion that companies were force-fed cheap capital by state led banks. It is also concluded often that foreigners were not allowed to compete in Asian countries, and needless to say, I can verify that the field of play in global commerce is littered with failed Western corporate initiatives, throughout Asia, however successes can also be counted in the thousands. Much more evidence would seem to support the contention that exchange rates were, and

still are, hugely undervalued. Finally, the complaint that governments suppressed imports with unusual regulations and “safety standards” (for example Korea with autos) is not without merit.

That brings us to China Inc.

The perpetual question hasn't changed much in the two decades that I have been doing business in China, namely the concern that it might be a bubble economy propped up by a potent cocktail of free capital and distorted resource allocation. Or is it truly an unprecedented, world-beating dragon, a success story that is ultimately changing the region and the world? Is China the West's newest and most powerful adversary, staunchest ally, global superpower collaborator? How much longer is America #1?

It is a fact that to a large extent, China has gorged itself at the trough of FDI and jobs migration, at the expense of the U.S. and Europe. But is it ready to become an example for the world to emulate in world affairs: politics, environmental efforts, human rights, financial and legal system checks and balances (stability), corporate governance, and society at large? Such questions remain and impair continuing investments in China.

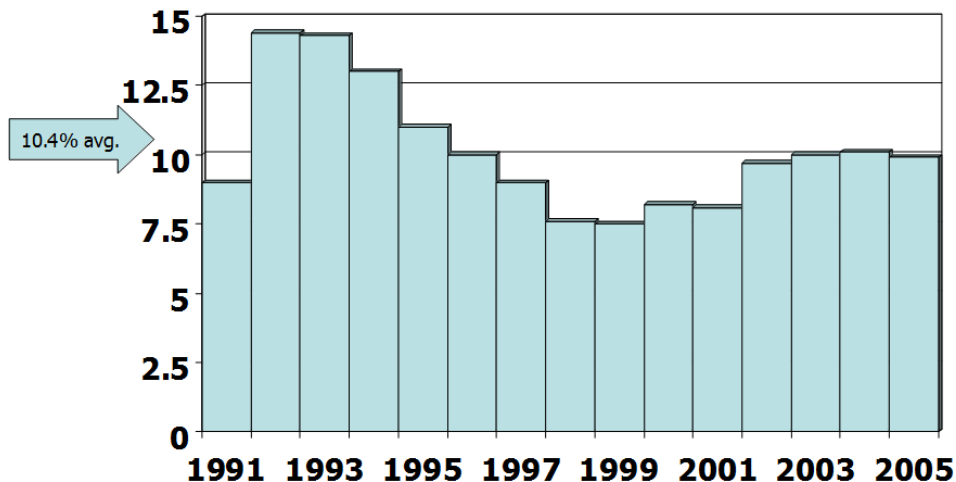
While living full-time in Shanghai, along with coming-and-going in various projects over the extended years, watching China is by many accounts (not just mine), seeing history unfold similar to America, but doing it all in 50 years as opposed to the United States' maturation over 150 years. Call it raw capitalism if you wish, undergoing a simultaneous change to remake the definition of the super growth miracle in the modern era. Comparing mainland China to the United States, we can easily visualize the robber barons of the late 1800s in America, the rampant speculative mania of the 1920s, as well as the mass rural-to-urban migration of the 1930s and into present day demographics.

China has embarked upon an advanced military build-up, not unlike the U.S. who was previously rather isolated as we approached the 1940s. After the war, America enjoyed the first car for every family, the first home, suburbs, first college education, first family vacation, first television, middle-class consumerism during the boom times of the 1950s. And we watch China do it almost in exactly the same pattern, only a lot faster, with a greater number of citizens. Even aspects of social upheaval, activism of the 1960s, nation-building of the 1970s, and a technology boom reminiscent of our own 1980s has taken hold throughout China's major metropolitan areas. Finally, we have also viewed China's efforts in core shifts in global economic thinking, similar to our 1990s period.

China's Ascent (from an investor perspective)

The biggest question overall has been, and continues to be among both the investment community and businesses worldwide, is whether or not China's meteoric rise over the past 15 years in particular is simply another case of an emerging economy on its way up, preceded by Japan and the Asian Tigers (South Korea, Singapore, Taiwan, Hong Kong), or something genuinely unique and world changing? Toss in the rapid growth of India with an average GDP growth rate averaging 5.8% for comparison, and quite possibly we see comparisons to long-term sustainable growth in the United States during the past century.

Can the Ride Last Indefinitely? China's GDP Percentage Increase



Source: Organization for Economic Cooperation and Development GDPs

Graph Data Source: IEMI Waymark Client Research

Average GDP: India 5.7%, but expanded 8.9% in 1Q06, due to domestic demand

2006 GDP: EU 2.2-2.7%, US 3.6%, Japan 2.8-2.5%, UK 2.4-2.8%

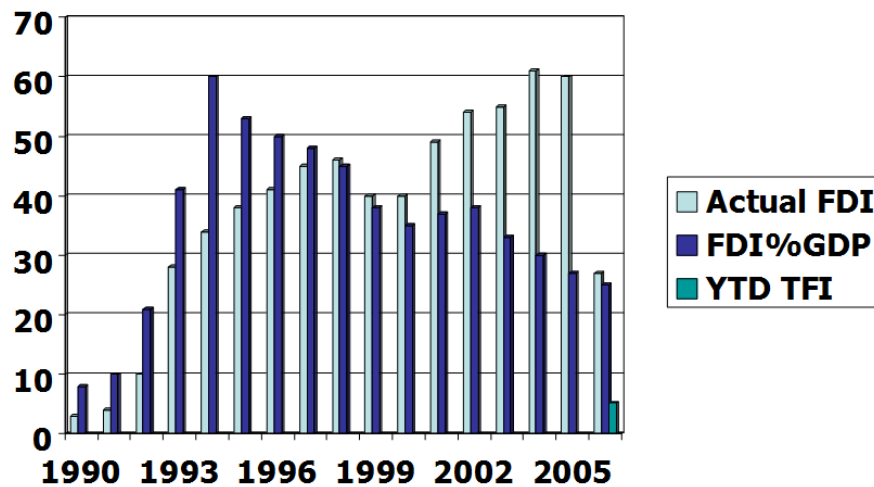
2007 GDP: EU 2.1% US 3.1%, Japan 2.2% UK 2.0% Germany 1.6%

The next sizable questions continues to plague the global economy, namely one of the extent to which the U.S. is heading down a path (our 20th century) not unlike that of Britain (in the 19th century), Spain, Portugal, the Netherlands, (15th-18th centuries) and global leaders from the past several centuries, currently stuck in what might be viewed as the inevitable maturation and societal decline pattern typical of so many of the earlier international economic powerhouses. China (their 21st century) continues to embrace political and cultural malfunctions as well as enlightenment, commonplace when a developing nation begins to gain traction as an economic and geo-political influence on

the world stage. We already know that China is called the world's factory floor, the global workshop, the newest superpower. But does that equate to U.S. and E.U. demise?

Is all of this due primarily to China's reliance on foreign direct investment? Does that give China strength or perhaps become a persistent weakness, even large dependence on outside assistance in financing and technology access measures? Most China observers and in-country business practitioners understand that in China, management talent is substandard – at least in many cases – to that of developed Western organizations. It is not only a matter of China's continuing corruption problems, but also can be told through stories such as concerns over continuous learning initiatives and training programs? Here, Chinese management will often times send subordinates to attend management and technical training seminars, with no intent for knowledge acquisition, instead attending lavish banquets and drinking parties, seen as a normal part of conducting the business at hand. And they see only the certificate of program completion as an award relative to enhanced status and prestige. We look for solutions and answers to unanswerable ideas. While Mainland China is about the same size in total land mass as are America's lower contiguous 48 states, that is where the similarities cease to exist in virtually every way.

Foreign Investment In China (\$B) [excluding financial sector 1990-2006]



AWSJ, August 7, 2006: China's National Bureau of Statistics; Ministry of Commerce
Japan, S. Korea, Taiwan FDI dropped 6.5% in 2005, down 31% in 2006, U.S. FDI down since 2003

What we are witnessing in China (having a ringside seat, as it were, for people such as myself) is a compelling story that has heralded the planet's entry into the 21st century. All of us can refer to this newfound economic legitimacy in China as a sustained and

dramatic growth effort of a future world power with unmatched resources, as maybe the August 2008 Beijing Olympics proved to be an informative test platform illustrating China's unmatched capabilities when summoned to marshal all of its human resources in construction, planning, manpower, and dedication to a specific national cause. It was not just building an incredible set of competitive sports venues, with design ingenuity unable to be surpassed anytime soon. Beijing built their international airport's massive Terminal 3 facilities to greet the world, additions to the city subway system that equaled the total rail capacity of most major world cities, as well as efforts to move entire factories away from the city's metropolitan area and replace 87,000 polluting taxicabs with increasingly modern environmentally friendly vehicles. And it was done, unlike Athens, Greece, on time with no delays or resulting loss of face and embarrassment. Will London be able to say the same thing after their Olympic Games? One has to doubt England's wherewithal.

The 2008 Beijing Olympics indeed becomes the continuing symbol for China's ability to gather the best talent from all over the world, becoming an attractive client for virtually any professional initiative. Their own technological prowess, relentless work ethic, and entrepreneurial savvy provide a difficult – some would say impossible – nation to compete against. In the decades of the 1960s and 1970s, even the 1980s we all talked about “Japan, Inc.” as the feared economic juggernaut. China has been referred to as Japan times ten, some would contend, Japan times 100. Couple that with the Chinese hold on America's debt burden and we can only guess as to what the future holds. As Westerners (yes, both America and Europe jumped into the fray) enjoyed the game of pile-on bashing, concerning Japan's earlier dominance, the China Threat has again become fashionable and perhaps even justifiable. From 1950-1980, Japan grew at an average rate of nearly 8%, more than two times the pace of its industrialized counterparts over the same period of time. In fact, in inflation adjusted U.S. dollar terms, the economy was doubling every 6-7 years. Does that sound strikingly familiar to China at the present? Look now at the economic stagnation that has caused Japan so much pain. Is China headed in the same direction eventually, further exacerbated with an intractable Communist Party driving long term planning more for control and social stability stopgap measures, conjoined with environmental disasters and preoccupation with aggressive military spending? Japan did not suffer to the same extent with any of these dilemmas.

The times are different to be sure. All-the-while pundits, consultant weenies, academics, and soothsayers try to compare and contrast Japan and China specifically, while casting aside other Asian countries' to simplify the on-going Asian nation model development and assumptions. Some contend that a new world order is gradually being formulated, but then again, we have been down that road before. However, the current mid-2009 recession foretells a substantial divergence from past economic downturns and the ascension of new forces shaping an entirely different and inter-dependent multi-national economy.

Improvements in transportation and communications make it possible to localize production chains, based upon comparative advantage, not geography. More trade in ideas, education, knowledge, tolerance, and trust rule the day. It sounds good at least. Unfortunately, the world is a whole lot more contradictory and messy than the contention

of free trade might otherwise suggest. And yet, I watch young professionals mix it up with nary a concern over who is what ethnic background – they think in borderless ways.

Dislocations Brought on by China's Advance

Here's the absolute core of the points to be continuously debated, or as one might say, to "cut to the chase" in the hyper-speak of some over-amped, excitement and ego driven executive. This conundrum relative to China's rise is not cyclical and temporary. The circumstances are vastly changed, there are different institutional and cultural metrics at work. The past 20 years' events, spanning several oceans and continents, represent a fundamental repositioning of key industries, infrastructure development, and a wholesale reformulation of the global business system and related models. Only \$200 dollar per barrel crude oil, and the resulting 8 to 12 to even 20 dollars a gallon gasoline, as a new book suggests, will significantly alter the momentum shift underway in the deployment of the world's assets, natural resources, and trade developments. Even people staffing.

We are awakening to a new business environment, new ground rules for competition, employment matters, aggressive consumption patterns, research & development, government intervention (reference the U.S. financial bailout and stimulus initiatives), financial institutions overhauls, even longer term foreign direct investment. Redrawn confrontation boundaries politically have become the norm, centered now around economic and not merely ideological attitudes and perceived cultural necessities.

When I was preparing the original presentation for several groups of financial planners and industry analysts around the world, there was much talk about where China was headed in the rankings of the largest economies of the world. And when China would surpass a certain nation, in their climb to the top position to eventually challenge the United States at number one. Three years ago, Japan was firmly entrenched in the number two slot, with Germany a solid third. France, Italy, and the United Kingdom were falling away quickly from the positions of fourth, fifth, and so forth. Korea was number ten or eleven, depending upon which body of statistical data one chose to pursue. It seemed that positions in the rankings for somewhere between 6th, 7th, 8th, and 9th places really didn't matter all that much. For everyone's preoccupation was China and the top four rankings. Well, in three short years, China now challenges Japan as basically in a tie for number two, more or less. The U.S. economy is still far and away number one, but the day will come eventually, when that status is also challenged, or so most believe.

10 Chinese Companies to Watch

BaoSteel	Steel, mineral resources	\$15.8 billion	Basic metals to special alloys, export/domestic
China Mobile	Telecom	\$30.1 billion	Brand building, home infrastructure expansion
CNOOC	Oil & Gas	\$ 8.7 billion	Global energy firm, acquisition of assets
Haier	Home appliances	\$12.8 billion	Establish a global brand and expand markets
Hisense	Electronics	\$ 4.2 billion	Global brand, market share growth, niches
Huawei	Telecom equipment	\$ 5.9 billion	Engineering and highly innovative products
Lenovo	Computers components	\$13.4 billion	Brand building and market share growth
PetroChina	Oil & Gas	\$ 9.1 billion	Alternative energy initiatives, acquisitions
Techtronic	Power Tools	\$ 3.0 billion	Niche markets, exports, acquisitions to be global
Xuzhou Machinery	Construction Machinery	\$ 1.0 billion	JV with CAT, foreign exports, product R&D

China's GDP growth has averaged roughly 10.4% annually going all the way back to 1990. The European Union's GDP growth during the same time has casually strolled around 2.0-2.5%, while Japan has hovered in a range during that time at 2.5-2.8%. The United States has remained better off in the area of approximately averaging 3.6% which by all accounts is better than most developed countries, although the current times offer up no better than a minus 2-4% shrinkage, with hopeful anticipation to regain GDP growth coming in around plus 2%. Maybe. Meanwhile, some observers suggest that China's growth numbers remain exaggerated occasionally, when published at 9-11%. However, the Chinese government realizes that this kind of growth is unsustainable and not realistic or necessary. Most economists, China watchers, and government forecasters report on Chinese economic GDP growth remaining somewhere between 6.5-8%.

Adjustments can also be made for purchasing power differentials, FDI intervention, global linkages, markets, and per capita growth. Reliance upon other supplemental data, such as energy and raw materials consumption, can imply even higher rates of growth.

China Foreign Investment Updates

Often times, the United States is viewed as the driver behind FDI into China, with the collective European Union equal in scope. Actually, the total investment from Japan, South Korea, and Taiwan combined has been calculated to be larger into China than either the U.S. or the E.U. All of this information actually requires the exclusion of one-time deals in the financial sector. But at a still-huge \$60 billion annually, China continues to diversify its industrial base and keeps attracting new money, albeit at a slowing pace. Foreign investment in the manufacturing sector had begun to slow and input into new manufacturing facilities is starting to decline. This is attributable to new interest in Vietnam, Malaysia, even Bangladesh and India. It is further fueled by the continuing problems with China's transportation and logistics headaches, corruption concerns that have not abated, as well as lingering issues with intellectual property protection and the lack of qualified & trained local personnel with quirky social skills. Cost controls and upward movement in wages has lessened China's attractiveness slightly. Please understand that this is not a cataclysmic shift, rapidly changing the dynamics at play in Mainland China, instead it's becoming a gradual and subtle movement into the rest of Asia's cumulative development. It remains difficult to buy a Chinese domestic company, as we have more recently seen in the beverage industry. Limits on participation in the various service businesses are also keeping those channels from becoming large new drivers of investment.

Once again, as a summary of sorts pertaining to China's major concerns and suspected clouds on the horizon for investor confidence, a brief listing can serve to highlight the hesitation by companies and investors. Here are 20 of the most often described reasons why capital movement into China remains a moving target, full of uncertainty.

- geography and climate – as with the recent earthquakes, blizzards, floods, typhoons
- culture, historical challenges, upheavals, Taiwan
- politics and economic centralized control
- declining momentum of FDI, trade
- manufacturing migration to lower cost areas, low-tech factory dislocation
- localization needs
- intercultural norms being contested
- state banking system and bureaucratic confusion, compliance issues
- organizational maturity obstructions
- environmental mishaps still largely unresolved, intentional, enforcement
- living standards increases, changing demographics, rural poor disconnect
- real estate and property ownership – both residential & commercial unrest
- IPO introduction and WTO compliance by Chinese companies – or lack thereof
- contract development remains way behind the development curve
- licensing and franchising reserved only for the biggest players

- economic development & free trade zones greatly overpopulated – too many of them
- transportation system still underdeveloped, however vastly improved
- energy independence, incessant demand, dependence upon unsavory regimes
- constantly changing and evolving consumer influence
- expatriate experiences, swine flu quarantines, disparities in visa issuance

In numerous annual surveys with regard to the ease of doing business in China, it is generally agreed that the situation is getting better, although there has been so much to be resolved that this work-in-process shows incremental advancements at an excruciatingly slow pace. Rankings in the last three years have not moved much, probably suspended in a zone of 93rd out of 175 countries reported on (this rank has not changed since 2006, not a good sign). The twenty pitfalls listed a moment ago, along with the unique – some prefer to call it troublesome, politely renaming it confusing I suppose – phenomenon commonly referred to as the *Bamboo Network*, become the strategic architecture for Chinese transactions. This is in many ways a simple inter-cultural notion that Chinese are suspicious of any and all foreigners, and thus look out for the well being of only Chinese. Perhaps a further extrapolation of the concept of **guanxi** – that social and commercial network of confidants, family members, close friends, politicians, school classmates, and a brew of who’s-your-buddy road blocks to the outside business world. This is the primary motivation in virtually every aspect of Chinese business protocol, and do not be told otherwise! It’s a fact of life not only throughout Asia, but worldwide.

40-20-10

There is an unusual paradigm shift (oops, I used that MBA-ism) taking place, alongside prognosticators’ needs to advance a theory for lively discussion. It is suggested that contained within increasingly assertive foreign policy rhetoric and planning, one must be able to succinctly distill this economic displacement into a numerical slogan or forecast. And so we have “40-20-10” in all of its glory. Convenient and concise perhaps.

The basic premise is that what took Japan 40 years to accomplish after World War II, required 20 years for South Korea to master in constructing a fully developed society, while for all intents and purposes, China drove a development agenda that saw the mission delivered in 10 years.

It took ten years for Japan to take over market share in light manufacturing, another 10 years to develop their electronics industry, and a third decade to switch out of low-end exports and into capital intensive industries. A final ten in terms of transportation and services. This was essentially the case for Taiwan, while Korea modified that timetable slightly, but had similar application for Japan’s 40 years of economic revitalization. This extended multiple-decade (30-40 years) time frame was mainly due back in the later half of the 20th century to the lack of today’s considerably more sophisticated international manufacturing, 24/7 instant communications, computer technology, and global financial

services developmental capabilities. That now China has at its disposal, not only enormous amount of FDI and technology-for-market-access knowledge, but the adjunct development systems to compress 40 years into not just 20, but in many cases, down to 10 years to capture a significant lead in many industries. This is in full alignment with China's rather public stated goals of moving from being the dominant player in labor intensive, low technology industries and into high technology, knowledge intensive industries that will drive the future world economy. The question remains as to how much of the low tech industrial base China is willing to let go of, perhaps to Vietnam, even Thailand once again. Statements continue to originate from China suggesting that they wish to maintain low technology work to support the migrant workforce population of over 170 million people. There are also the 800-900 million rural peasants, all of whom can't stay on the farm, and from which an abundant low cost labor pool continues to be readily available, with ominous social stability mandates, workplace compliance.

Another Formula: 11+25+10+4 = 50

Or quite possibly we shall see well over 60 very soon, likely within the next handful of years. In this elementary set of numbers, the implication is one of regional composite summation of the major Asian GDP figures with China leading the way chasing 11% of global GDP, while expectations are confidently poised in a 21% global GDP prediction. ASEAN, Korea, and Japan together represent 25% of global GDP, with the graph moving slightly higher toward 28% of global GDP, reflecting their somewhat mature-economies position. India, the other perceived growth engine, is targeting an ambitious 10% of global GDP, but holding steady at that point for a substantial number of years, given their unwieldy bureaucracy, lingering awful transportation systems, Pakistan tensions, and the impoverished masses that have had no impact on nation-building, unlike China's diverse and high energy labor pool of unskilled and semi-skilled workers. A national agenda in India just does not have the strategic plans in place long term, when compared to China. Finally, we have Thailand and Malaysia bringing in 4% of global GDP, and will tweak that number upwards of maybe 5%. Then the math becomes $21+28+10+5 = 64\%$ of total global GDP during the next 10-15 years, residing in the Asia-Pacific region, exclusive of Australia and New Zealand. Indonesia and the Philippines, with significant agricultural and natural resources production, are calculated into the ASEAN figures.

China's Financial Markets and Banking

In Chinese stocks, the letter "A" denotes a class of stock traded domestically in the yuan currency. It has meant aggravating as well as astronomical in terms of price earnings ratios. Corporate governance continues to be a major issue. There remains a lack of enthusiasm for Chinese stocks listed on the NASDAQ, trading at much higher multiples than Hong Kong and Mainland-listed small caps, thanks to eagerness of U.S. investors to be part of the China story. This changed slightly during the past 24 months, but has since returned to be par for the course, within investment circles.

China has since the current recession (2008-2009) began, reasserted itself as an extremely hot investment spot, but with that has come considerable hype. The notion of exorbitantly high valuations nor cases in which majority owners looted some Chinese listed companies have put off big foreign investors granted limited access to the market under a qualified foreign institutional investor, or QFII (quota at \$7.14B), program that gets around China's strict capital controls. At this stage, only a tiny number of the 1200 plus listed companies seem well managed and attractively priced. Chinese companies are now uncertain about a United States listing, due to Sarbanes-Oxley and the threat of litigation. The combined capitalization of China's two exchanges in Shanghai and Shenzhen is \$500 billion, but 60-70 percent of all shares are held by large state entities and thus are not traded. The government is expected to eventually allow those shares to trade, fueling fears that a flood of such shares could make prices collapse.

A hint of investors' appetite for China was given by the not-too-far-back sale of stakes in the major state-owned banks to overseas institutions that drew an additional \$12.1 billion in direct investment in 2005. While this pendulum has swung wildly due to the economic situation around the world in the past couple of years, the Chinese stimulus program has suggested that they have an active, on-going strategic plan and that the rest of the world's economies are not far behind in a full, but slow, step-by-step recovery. It has further been suggested that those kinds of landmark deals are unlikely to be repeated, and authorities are keeping limits on FDI in other key service sectors and shown reluctance to approve some major acquisitions. Chinese banks have long been considered to serve as cashiers for state-owned enterprises and instruments of Communist Party policies.

Chinese Companies/IPOs That Waymark is Watching Closely [on Shanghai (A), Hong Kong Exchanges (H)]

(Q: pre-IPO stakes cheap to strategic investors or ordinary share buyers are paying big prices)

Hong Kong has a Growth Enterprise Market, designed to provide capital-raising ventures
GEM has been outperformed this year by China's big cap shares, thus enthusiasm for the ICBC IPO

- Mudanjiang Hengfeng Paper
- Air China
- Shanghai Mailing (Foods)
- China Power International
- Sino Trans
- PICC Property and Casualty
- China Resources Power
- Dah Sing Banking Group
- Hopewell Highway Infrastructure
- Shanghai Automotive Industry Corp.
- ICBC (Goldman Sachs now has a 5.75% stake)
- China Shipping Container
- Shanghai Port Container
- China Minsheng Bank
- BaoSteel
- China Life Insurance
- Ping An Insurance
- Weiqiao Textile
- Denway, Geely, Dongfeng Auto

Source: Waymark Research,
IEMI

•Small cap stocks are attractive and being held for longer periods, as they are believed to be worth more than their market price.

•China's bank IPOs, while getting all of the publicity, and have logged quick gains, but have also been highly volatile. 29 are both A & H shares.

One of the prevailing issues and lingering concerns, in spite of major overhauls, is still the paramount task of reconciling billions of dollars in non-performing loans (NPL), once estimated conservatively to be upwards of \$750-850 billion (USD), then reduced to “only” \$450 billion. The Chinese government lifted off of the books and/or selling over \$170 billion of bad loans to asset management firms, which are slowly being disposed of at auction. The Chinese banks’ NPL positions are partially being resolved through the Ministry of Finance cash bailouts (dipping into vast foreign-exchange reserves) to provide fresh capital to the major banks. Banking reform is badly needed, although it can best be called slow but sure. To some extent, because of government currency controls, as banks grow more profit-oriented and competitive, they face tough challenges. Among the concerns:

- How to cope with too much money, everywhere?
- China’s soaring exports (only recently dulled by the global recession) earn foreign exchange revenue, but the money cannot freely exit from China.
- So, the dollars exchanged into ever-growing supplies of yuan that banks then lend out at super-low interest rates – sometimes for projects that do not even deserve funding – then leading to more bad loans piling up.
- Banks only recently began charging fees that at least start to reflect the risk involved.
- They are now venturing into smaller projects and individual needs.
- Mortgage lending markets have soared, and there is more retail financing.
- However, we must remind ourselves that when Beijing yells, it is stop everything!

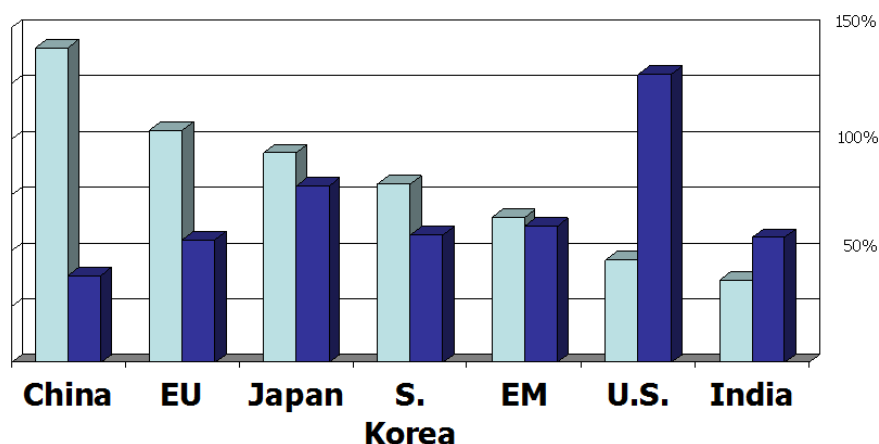
China’s Major Banks

- Bank of China (2nd in terms of assets, May 2006 IPO)
- China Construction Bank (ranks number 3)
- Bank of Communications
- China Merchants Bank
- Industrial & Commercial Bank of China (ICBC), is number one
- Agricultural Bank of China
- Minsheng Bank

Bank stocks are already generating extremely high prices, evidence that investors are enthusiastic about their prospects. New laws further fuel a new round of buying, and three major initial public offerings (IPOs) connect to already-traded bank stocks. U.S. financial stocks in 2006 traded at about 12 times expected earnings, Hong Kong-listed ones averaged 15 times, prior to the 2008-2009 financial crisis. Now, it is all over the board, with no discernable trend in sight, among the fewer survivors. Bank of China has been trading at 21 times estimated earnings during the past three years. Industrial & Commercial Bank of China has grown to 20,000 branches and 400,000 employees. China Construction Bank is trading at 16 times their earnings, and Bank of Communications at 19 times earnings.

In the third quarter of 2006, China enacted a new bankruptcy law. By now you can see that I reference that momentous year quite a bit, given its sweeping passage of landmark laws and regulations to shore up China's financial industry. China's new bankruptcy law does much to strengthen the hand of creditors in dealing with debtors. As such, long term investor's confidence in the country's high flying bank stocks continues to rise. Huge government infusions of cash also have created pre-2009 artificial stimulus and incentives. Called the Enterprise Bankruptcy Law, it finally addresses (12 years in the making) the Chinese economy's concern of being able to recover money from borrowers when business goes bad. Chinese banks' lending practices do remain doubtful. Many years of unchecked, built-up bad loans, as we have already outlined, did once upon a time amount to 45% of the Chinese banking industry's total extended credit, especially during the earlier years of China's explosive growth. By 2005, that figure was moving downward into the 21-25% range (official statistics were placed at 16.84%). The new law, while moving slowing during its first three years in action, does give tougher backing to creditors' claims on insolvent companies, creating a formal corporate bankruptcy process. Clouding the prospects for banks is still the possibility that China's current 3-decade boom (2008 notwithstanding) is merely disguising another build-up of doubtful loans that will go sour if the economy weakens. We shall examine all of this more closely as year-end '09 approaches and 2010 provides the investor with a glimpse as to how well China's stimulus program takes hold, accompanied by a consumer driven mindset and global economic recovery. Banks have been running at 90% of their loans tied to corporate lending, with the remaining 10% dedicated to individual loans. This figure has moved into an 85%-15% shift during the last 24 months.

Capital Formation Comparison



Source: WSJ, Citigroup, Moody's Investor Service

■ Bank Credit ■ Stock Market

- Chinese companies rely more heavily on bank lending than other countries; values listed as a percentage of gross domestic product (0-150% axis lines)
- Comparisons include 686 of China's listed companies, with 5,000 other publicly traded companies throughout the world. China corporate bond market non-existent.

Back in 2004, China scrapped an important restriction on foreign banking, saying overseas institutions can now open multiple branches a year, instead of just one annually. In addition, there has been a relaxation of capital requirements to establish new branches, though Chinese still reserve the right to not allow all applications. The 2007 WTO mandate that all controls must come off, to be in full compliance, has met resistance as we might have expected unfortunately. There are rules in place that still limit local currency lending and other businesses to 13 cities by foreign banks, now basically fully open, as of early 2008. The bottom line is however that foreign banks are still a small part of China's system. Foreign assets continue to grow, but remain at about 1-2% of the \$1.8 trillion asset base held cumulatively by China's four (4) biggest institutions. Foreign banks can own up to 20%, to accelerate local bank overhauls.

At Waymark, we continue to watch closely a September 2006, "temporary ban" enacted by China's Securities Regulatory Commission, for the purpose of halting brokerage growth. This WTO (i.e. temporary) measure established new rules on Sino-foreign joint ventures, laying the groundwork for future deals with the following requirements of foreign firms hoping to enter China. The specified intent has been since its inception, to consolidate the crowded – 152 – industry. At that point, the timing was uncertain, and still is just that.

- Foreign partners are limited to one-third of a joint venture.
- A single Chinese partner must hold at least one-third of the total joint venture.
- Foreign firms must have at least 50 people with industry qualifications.
- The foreign firm must have at least a 10-year history.
- A foreign firm must have a clean regulatory record in its home country for at least three years.
- A foreign firm's home country needs to have a regulatory memorandum with China.

Concluding Thoughts

There are any number of compelling arguments that can be made and delivered to a body of investors, trying to figure out China's investment opportunities and challenges. The U.S.-China trade imbalance results from the different points of the two countries along the same development curve, and will diminish as China progresses in its economic and social scales. In the same way that the United States reduced rural agricultural employment 50-100 years ago, and it is now reassessing low-end manufacturing jobs, replacing them with higher-end, knowledge-intensive, technical skills in manufacturing and service positions. It is widely suggested that China plays a positive role by relieving America to do what it does best: producing and implementing knowledge at the upper portion of the innovation and creativity pyramid. But now we see China also moving into that drive for technical superiority and world-class innovation, thus a shallow argument.

In addition, we hear things such as China and the U.S. overlap only on a narrow range of products, 10 percent according to the council on U.S.-China relations. In fact, the range of products in competition is much higher than 10% (anyone can clearly see that) perhaps growing by 3-5% each couple of years, to now be 50%. The range is also growing, in many sectors, due in part to massive technology transfers. And finally, that more than half of China's global exports are by foreign multi-nationals that have set up shop there to supply both home as well as localized – and growing – international markets.

China generally sees American innovation as the best in the world, however they also hold the persistent view that in the U.S. we have lost ground in levels of engineering education and a fundamental lack of personal savings, providing wood for the current financial firestorm debacle. Leveraged buyouts, private equity transactions' huge debt burdens, seemingly an infinite degree of falsely secure “transferable” management skills from unrelated industries, has unleashed an army of overpaid and unqualified business leaders without the basic knowledge of the company they now lead or the industry to which they have enlisted as a newcomer.

America is seen not as building organizations, but instead dismantling them. The wholesale destruction of not only companies and firms, but entire industries has not just China, but all of Asia wondering aloud, what has happened to the United States of America? There is no national agenda, and the current bailouts are not the ultimate solution. There continues to be little urgency in retooling any of our country's schools and factories, shipyards and airports, industrial sites renovation and/or national energy dependence. Yet another endless list, and not an enviable one for investors right now.

We shall see..... Where are you placing your patriotic bets, and money?