



## China's 2020 Vision

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### Executive Summary

For China, 2009 will be remembered as the year it took a permanent seat at the world's financial table. With much of the rest of the world stalled in recession, China launched a massive stimulus package, which not only stabilised its domestic economy but also helped to resuscitate global demand, especially for commodities. With a significant portion of the stimulus earmarked for infrastructure projects, China's stimulus simultaneously fuelled economic expansion and aggressive modernisation efforts, which were easily absorbed in the underdeveloped rural areas. With infrastructure spending carrying into 2010, China has already implemented rural land reforms and tax incentives to develop inland provinces hoping to duplicate the same "economic miracle" witnessed in coastal cities.

Understanding the elements that have contributed to China's economic success over the recent past is vital to understanding its future. What follows is a look at the evolution of China's development and describes what we believe will be the most significant investment opportunities over the next decade. China's growth prospects center on the urbanisation of areas in the country's western regions, continued growth of domestic consumerism and efforts to provide more social welfare programs. We highlight six investment areas we believe will benefit most from these trends:

- Infrastructure developments
- Rising consumerism in China's western regions
- Media and technology
- Healthcare
- Alternative and clean energy management
- China's renminbi internationalisation

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## Weathering the Global Storm

China's massive stimulus spending enabled the country to bounce back much more quickly and sharply than any of the world's other major economies, giving new support to the decoupling argument. Its revival of demand also helped recovery among its Asian neighbors and commodity producers.

By cutting interest rates and spurring bank lending, China also managed to stabilise and reinvigorate the property market, avoiding rising unemployment in construction sectors, while jumpstarting much needed infrastructure projects. Low borrowing costs and stimulus spending had an immediate impact, modernising archaic domestic transportation facilities as well increasing productivity and efficiency throughout rural areas (see Exhibit 1). By generating growth, China was successful in raising production levels throughout previously isolated areas, translating to higher income levels for residents there.

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**Exhibit 1 - China's Stimulus in 2009**

<b>Stimulus in 2009:</b>	<b>RMB bn</b>	<b>% of the Stimulus</b>	<b>USD bn</b>
Public Infrastructure	1,500	38%	220.6
Quake Relief	1,000	25%	147.1
Technology Advancement	370	9%	54.4
Sustainable Development	210	5%	30.9
Education Cultural Family	150	4%	22.1
Rural Development	370	9%	54.4
Social Welfare	400	10%	58.8
<b>Total</b>	<b>4,000</b>	<b>100%</b>	<b>588.2</b>

Source: China's National Development and Reform Commission (NDRC), March 6, 2009.

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## China by 2015

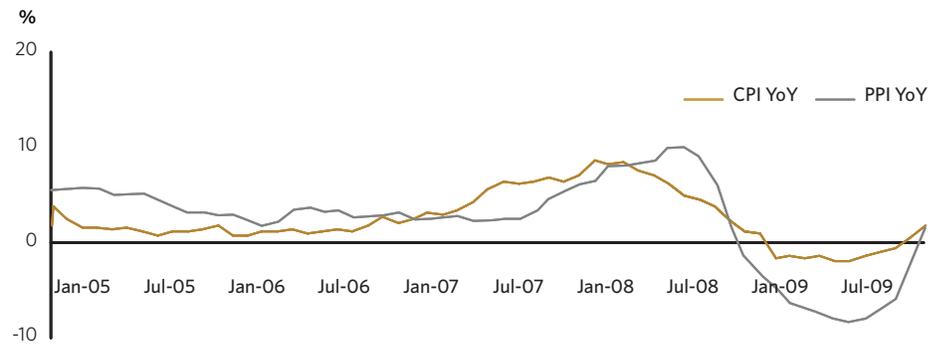
China's current five-year plan emphasises "sustainable growth." We believe looking at the goals and targets China actually manages to achieve by 2015 will provide better guidance for the country's long-term economic outlook. During the previous five years, China's consistent double-digit growth was an "economic miracle," driven by exports and foreign direct investment into China under the economy's "open-door" policy. However, rapid expansion has placed tremendous strain on social stability and welfare services as well as on the environment. During the past five years, China refrained from any policy initiatives whose immediate effects would threaten economic growth or job stability. This was reflected in China's reluctance to significantly revalue the RMB in order to shield its export industries as well as in its perfunctory enforcement of overall emission standards in order to protect developing industries.

The year 2015 will be a critical checkpoint for China's policy modernisation and reforms, testing China's capabilities to uphold the targets it set in 2009 and 2010. By 2015, China will further expand land reform and tax incentives to bolster economic

growth throughout much of its western and rural provinces. Exports will continue to be a major engine for the economy, although a shrinking trade balance should be expected as stimulus policies for the domestic sectors take hold (see Exhibit 2). Introducing pension programmes and social welfare subsidies will reduce households' need to save, which should translate into higher consumer spending. China is also expected to "internationalise" the RMB and let the currency gradually appreciate, helping reduce the trade imbalance, but not enough to completely re-shift the economic drivers. One would also expect capital controls to be reduced, allowing China to play a more dominant role in the Asian region.

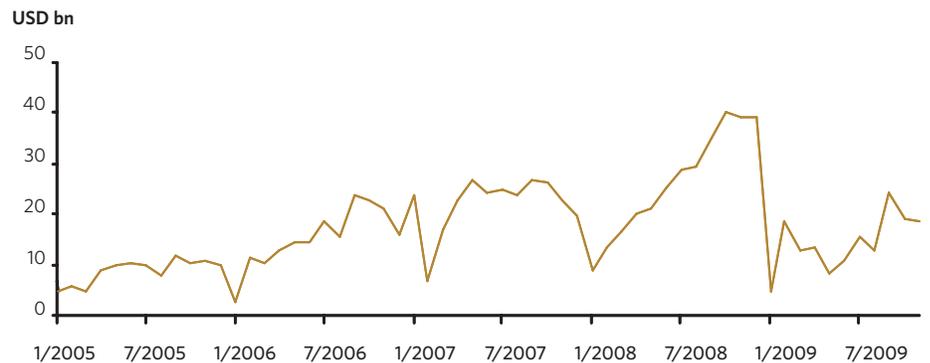
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**Exhibit 2 - China's Consumer Price Index and Producer Price Index growth year over year 2005 - 2009**



Source: Bloomberg

**China's Trade Balance in USD bn 2005 - 2009**



Source: Bloomberg

## China's Great Leap Forward

To imagine where China might be in 2020, it is helpful to recall how far it has come over the last ten years. The last decade has seen China move from a relatively inward-looking nation, that had just taken over the reins of Hong Kong and was building its initial steps towards entering into the World Trade Organisation (WTO), to a country holding a more central and active position in international affairs, global environmental issues and the direction of world finance and investment.

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Since 2000, China has grown its economy from US \$1.1 trillion to US \$4.8 trillion, averaging 16% per year, and has built reserves of US \$2.2 trillion from US \$155 billion. This has been a truly amazing economic performance for a country of 1.4 billion people with a median age of 34.1 years, where 72% of the population is between 15-64 years of age and 46% is under 35 years of age.

The Hong Kong Stock Exchange market capitalisation has risen from US \$1.4 trillion to US \$2.3 trillion, making it the fifth largest in the world, and has demonstrated resilience following both the bursting of the dot-com bubble and the global financial crisis of 2008. The number of Hong Kong-listed companies has grown from 700 to 1,300, while the Hang Seng Index has risen from 16,962 to 21,873 since 1 January 2000, an increase of 29%.

In China, the market capitalisation of the Shanghai Stock Exchange and Shenzhen Stock Exchange combined has grown from US \$1.8 trillion in 2000 to US \$3.2 trillion on 30 December 2009. If you combine the market caps of Hong Kong, China, and Taiwan, they comprise the second largest market in the world, half the size of the US market and double that of Japan.

In addition to Deng Xiaoping's reform and "open-door" policy, China's accession into the WTO in 2001 is considered one of the most significant accomplishments for the country. By joining the WTO, China has attracted substantial foreign direct investment, totalling US \$630 billion during the decade and averaging US \$60 billion per year. China has also liberalised both banking and financial sectors while lifting previous business restrictions, including capitalising three of its four major banks. No longer directed by the central government, many of China's state-owned enterprises are now encouraged to look for foreign capital and compete against other international companies, learning from the more established global competitors.

Over the last two years, China has moved to normalise and strengthen relations with Taiwan, reducing the threat of war between the two nations plagued by almost half a century of political tension. This rapprochement exists as not only a positive relationship catalyst for both China and Taiwan, but will likely replicate similar economic benefits that resulted when Hong Kong and the Guangdong Province signed a Closer Economic Partnership Agreement (CEPA) in 2003.

During the ten years ended December 2009, China has made the first moves to rapidly modernise its domestic infrastructure and alter its national economy through improved logistics, higher rural incomes levels and greater access to major domestic and international markets.

Over the coming decade, both public- and private-led growth will determine the sustainability and the transformation of China's economy, with government reforms and capital expenditure (capex) spending implemented by 2015 providing a better foundation for what the government hopes its economy will ultimately achieve by 2020. With China's aim to both urbanise and modernise its domestic economy,

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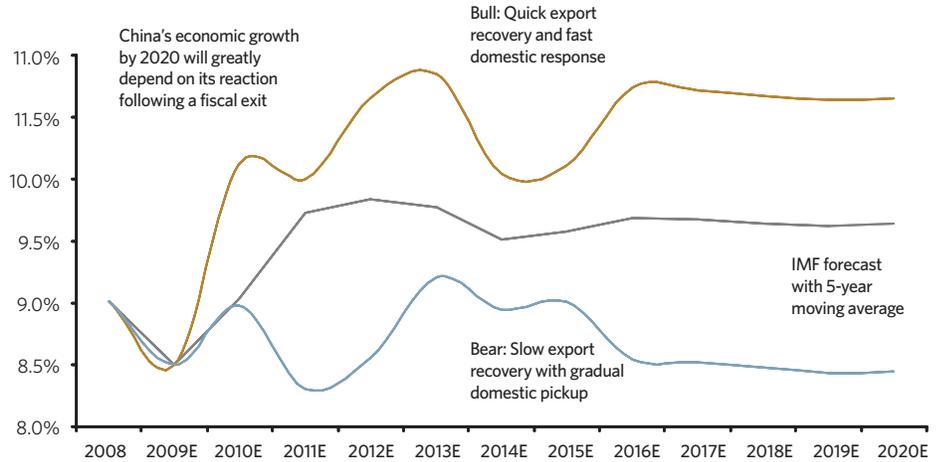
Much of China's reform is expected to emanate from its western provinces, where many of these towns will quickly develop into important metropolitan cities and commercial hubs as a result of improved logistics and access to global markets.

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investment opportunities exist in several long-term growth industries. Infrastructure development, domestic consumption, technology, health care and environmental protection all support sustainable in-country economic growth and job creation rather than through export demand. Much of China's reform is expected to emanate from its western provinces, where many of these towns will quickly develop into important metropolitan cities and commercial hubs as a result of improved logistics and access to global markets. Exhibit 3 shows a range of forecasts for China's growth over the next decade.

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**Exhibit 3 - China's GDP Forecasts**



Source: 2009-2014 GDP Forecast: International Monetary Fund  
 Bull-Bear Estimate: Hamon Investment Group  
 2015-2020: 5-year moving average

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## Investment Opportunities for China over the Next Decade

During the second decade of the 21st century, we believe Chinese leaders will strive to generate sustainable and structurally balanced economic growth while minimising social costs. Government reforms will continue to promote steady development of adequate housing, food and agriculture production, energy prices, education and healthcare provisions. Thus, investments that simultaneously bridge China's efforts to improve people's well-being, while also meeting the demand and supply function of a market economy, will offer the greatest return.

Demographics will remain favourable as China's top metropolitan cities such as Shanghai and Guangzhou grow into international hubs, while second-tier and rural provinces become important satellite centres for the country. Strengthening domestic consumption will also build in China's secondary cities, which were more resilient to the economic collapse than coastal provinces in 2008. Greater emphasis

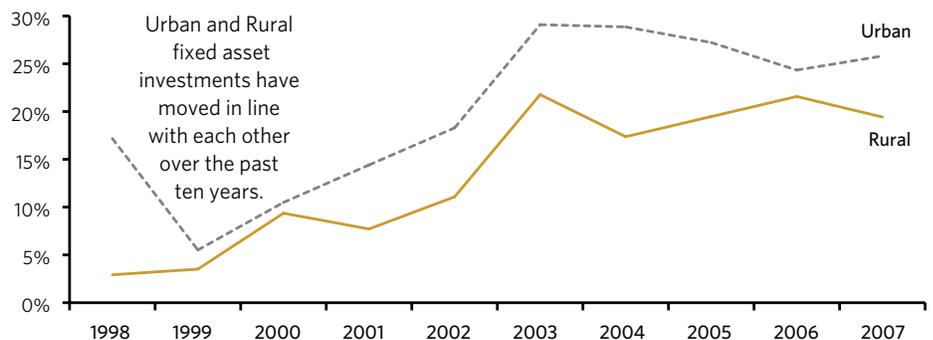
to reinvigorate China through science and education will continue to encourage a stronger push for technology and the development of information networks over the internet, creating “virtual infrastructure,” while healthcare sectors will expand on greater demand for higher living standards. China’s growth will be supported by the “internationalisation” of the RMB as the currency appreciation strengthens domestic purchasing power for Chinese households.

## Infrastructure Developments

Within a generation of economic reform, areas of China, most notably coastal provinces, have been transformed into leading commercial centres, while interior provinces have experienced much less change. Pushing industrialisation and construction efforts to the western areas is likely to transform rural consumers into more urbanized consumers with better job opportunities and higher living standards (see Exhibit 4). Infrastructure spending not only spurs job creation, but also establishes standardised road and transportation networks, allowing greater productivity and more efficient transportation, enabling the development of distribution and warehousing centres.

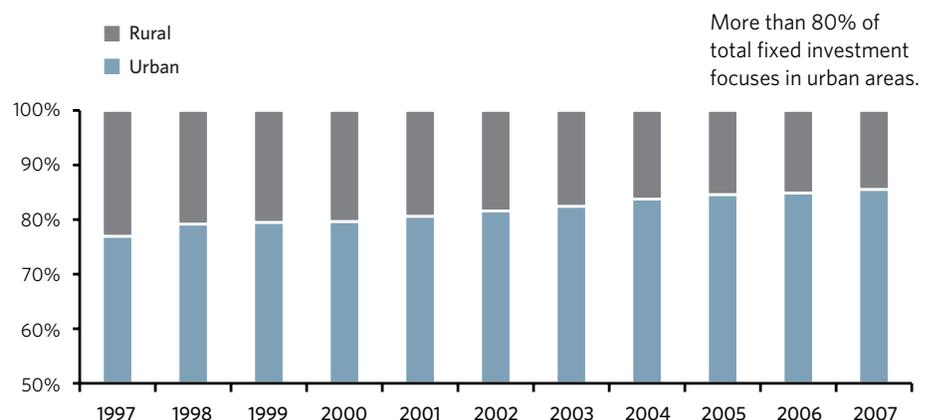
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**Exhibit 4a - YoY Fixed Asset Investment, 1998 - 2007**



Source: National Bureau of Statistics of China

**Exhibit 4b - Ratio of Total Fixed Asset Investment, 1997 - 2007**



Source: National Bureau of Statistics of China

While they had limited exposure to China's economic boom during the past 20 years, inland rural cities will now offer new market opportunities for capturing rising household wages.

Better transportation will improve the flow of goods and human capital as well as information, connecting other growing cities and bridging once isolated cities, essentially "shrinking" China.

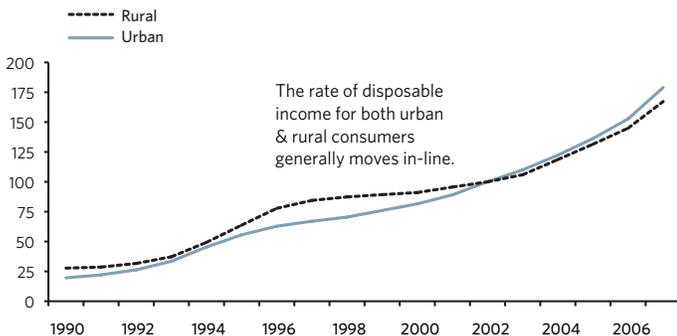
Among the projects worth highlighting are China's aggressive efforts towards developing both subways and high-speed railways, to connect outlying towns and regions to major cities. It is estimated that by 2012, China will have invested US \$300 billion towards expanding its current railway networks, adding 19,000 miles of track by 2015, with 8,000 miles specifically designed for high-speed trains. Urban metro lines are expected to expand dramatically from 620 miles to 2,800 miles over the next ten years, with the number of cities having such infrastructure doubling from 11 to 22. Besides connecting the vast landscape, the new rail lines can make travel costs more competitive, with an average airplane ticket between Beijing and Shanghai selling for RMB 1,258, compared with RMB 500 for the high-speed train. Studies suggest that travel time between major Chinese cities could be more than halved; for example, rail travel time between Beijing and Shanghai can shrink from 10 hours to 4 hours; between Beijing and Guangzhou from 20 hours to 8 hours.

## Rising Consumerism in Western Regions

Just as the last decade created consumer demand throughout the Pearl River and Yangtze Delta, we believe the western regions in China will be the growth driver for the next decade. Standards of living will continue to improve with rising income levels and increasing access to public welfare programs (subsidized education and healthcare). China's five-year plan aims to promote job creation, while additional policies look to maintain affordable housing, healthcare, and food production. Education reform is also expected to raise living standards and well-being, given correlations between high literacy rates and longer expected life spans.

While they had limited exposure to China's economic boom during the past 20 years, inland rural cities will now offer new market opportunities for capturing rising household wages. Although disposable income throughout rural China has improved, it has lagged gross urban wages as disposable wealth in major cities still remains more than three times the amount in rural areas (see Exhibit 5).

**Exhibit 5 - Per Capita Disposable Income Index (2002 = 100)**



**The Ratio of Disposable Income Levels of Urban Households and Rural Households**



Source: National Bureau of Statistics of China

As consumers from second-tier cities increase their consumption, they will still lag first-tier coastal cities that are purchasing international high-end products. Instead, we expect second-tier consumers will prefer “local luxuries,” a functional purchase that may exclude the international name brand appeal and focus instead on emerging brands. We believe Chinese branded goods will grow in popularity, while improving quality will meet broadening domestic demand and enjoy wider margins. As reforms take hold in rural areas, the once-coveted “Four Household Goods” of a colour TV, cassette player, washing machine and refrigerator will quickly yield to a flat-screen entertainment system, portable MP3 player, an internet accessible computer, as well as energy efficient home appliances or air conditioners and cars. In this new market, the definition of luxury will alter as these items become affordable. Purchasing a luxury car after already owning a standard automobile represents only a moderate climb up the social ladder, while car ownership after previously using a bicycle is a more significant status progression.

### Media and Technology

By 2020, China may have liberalised its media control and virtual information networks. We believe the heavily regulated sector will eventually succumb to deregulation, broadening awareness and expanding the use of internet and other social media for marketing and distribution. Exhibit 6 shows the expansion in telephones since 1990.

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#### Exhibit 6 - Communication

	1990	2000	2006	2007
Fixed Telephone Distribution Rate (set/100 persons)	1.1	20.1	63.4	69.5
Mobile Telephone Distribution Rate (set/100 persons)	0.002	6.8	35.3	41.6

Source: National Bureau of Statistics of China

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Improvements to the telecommunications sector will not only result in millions of new users but will also lift productivity and expand the channels of information and communication to underdeveloped areas. Besides the market opportunities affiliated with second-tier cities, better information access will improve knowledge and education. We are already seeing the first signs of China’s labour market moving away from traditional manufacturing sectors to service industries.

China currently has 10 teachers per thousand people compared with 22 per thousand in the US, suggesting that an additional 16 million teachers would need to be added to achieve comparable ratios. Until market incentives improve, it will be difficult to fill that gap, especially in second-tier cities and rural areas. Improving telecommunication networks, including liberalising internet content, information and education access, are possible alternative ways of nurturing China’s future talent.

## Healthcare

China's one-child policy, historically low household consumption and high savings were often precautionary moves, motivated by concerns over inadequate food production for the country's large population and uncertainty about healthcare and job security. In the beginning of 2009, China outlined a RMB 850 billion reform package to improve its healthcare system. Its main goal is to cover more than 90% of the country's population under a basic medical insurance scheme by 2011. Apart from improving overall access to healthcare, an IMF working paper concludes that government spending on healthcare would reduce urban household savings and raise consumer confidence.

Healthcare-themed investments, which include pharmaceuticals, traditional Chinese medicine manufactures and medical equipment makers, are likely to benefit from China's growth story and government healthcare reforms. Medical repayment programs, such as the essential drug list (EDL) and reimbursement drug list (RDL) programs will be significant cost controls. With the US and EU pharmaceutical markets plagued by budget deficits, we believe China's healthcare sector is well positioned for strong growth.

## Alternative and Clean Energy Management

China's efforts to clean the environment have taken prominent place in recent policy statements. In 2008, Beijing nearly met its "blue sky" days quota before the summer Olympics, while the emission cuts it pledged at the UN Climate Conference in 2009 seek to reduce emissions by 45% by 2020.

During the National People's Congress in March of 2010, greater emphasis was placed on both environmental protection and agricultural reform. Notable highlights include China's efforts to increase its energy-savings capacity by an equivalent of 80 million tons of standard coal. In addition, all newly built, renovated or expanded coal-fire power generating units must be equipped with and continuously employ de-sulphuring filters. With several Asian nations currently listed as the world's top gross polluters, continued focus on clean technology and energy management policies is expected, translating into clean investment opportunities.

Supported by public investments such as the "Golden Sun Project," China has already incorporated green policies into its sustainable growth strategy, including the installation of light emitting diodes (LED) throughout city streetlights, alternative energy farms, and hybrid electric buses to replace traditional coaches.

## Internationalising the RMB

Over the next three to five years, we believe the RMB will become a more freely tradable currency, as China opens its capital account. We expect the RMB will develop into a major trading currency in Asia, as China becomes even more pivotal with its regional trading partners. China has already instituted efforts to further internationalise its currency, including issuing offshore RMB-denominated bonds and allowing Hong Kong to offer RMB bank accounts. A strengthening RMB also bodes well for Hong Kong, as the financial hub further expands itself into an offshore currency market for China. We believe there will be especially interesting opportunities in banking, finance and B-shares (Chinese equities traded in foreign currency on the mainland), where a strengthening RMB will create new products and competition.

## Conclusion

With the developed world slowly trying to rebuild its domestic balance sheets, we believe emerging countries, and especially China, will continue to offer more attractive and stable long-term investment opportunities. During the 30 years of economic reform, China primarily served the developed world, producing low-cost manufactured goods and relying on exports to drive both the economy and employment. However, over the last decade of reserve accumulation, China encouraged foreign direct investment and fixed asset investment, modernising its domestic economy and infrastructure. China will use the upcoming decade to improve the living standards of its population and expand its domestic consumption to further strengthen and broaden its economic power.

Throughout the next decade, both private and public investments will become key drivers, expediting China's growth. Rising domestic income levels, throughout second-tier cities and rural provinces represent a potentially massive consumer market. Given the current trend, between 600-700 million individuals are expected to live in "small" urban cities in China. Public investment in healthcare and social welfare will continue to become a key element of China's modernisation, lowering the propensity to save and allowing for more domestic consumption.

Sustainable growth for China will also benefit its regional economic partners as well. Warming cross-strait relations with Taiwan will continue to be mutually beneficial, while also creating opportunities for China to increase its technology manufacturing capability. China will continue to progress towards more sophisticated, higher value-added productions in tech sectors, including manufacturing of advanced electronics, smart phones, clean energy (including LED bulbs, lithium batteries and water purification) as well as mass-produced computers and handsets. As investment restrictions loosen, Taiwan will likely become China's offshore technology centre, while Hong Kong will continue to serve as the financial capital for China.

As we enter the second decade of the 21st century, China's growth potential appears very appealing, supported by both attractive demographics and a favourable economic environment. China's urbanisation, modernising rural land reform, and expanding middle class seeking higher living standards offer a wealth of opportunity for long-term investors. Investments in infrastructure, domestic consumption, technology, healthcare and environmental protection that both fit China's growth equation and preserve national harmony will be key elements for China's growth. The country's momentum will continue to drive global markets, as China no longer merely seeks rapid economic expansion but instead focuses on sustainable growth.

### **Hugh Simon, Chief Executive**

Hugh Simon, Chief Executive, established Hamon Investment Group in 1989. He has been responsible for building Hamon's Asian regional expertise and institutional client base and has developed top performing relative and absolute return funds. In 1998, The Bank of New York Mellon Corporation became a strategic institutional partner to help broaden the client base of the group and offer Asian products to BNY Mellon's client base. Hugh is a former Managing Director and President, respectively, of Lazard's Hong Kong and Japan offices and a director of Lazard Investors in London. Before joining Lazard's in 1984, he worked for Schroders in London, Australia and Hong Kong for five years. He has over 25 years in Asian regional investments.

### **Christopher Chu, Research Analyst**

Christopher Chu is a Research Analyst with Hamon Investment Group and is responsible for research in Asian economics. Prior to joining Hamon, Christopher worked as a Graduate Analyst with CLSA Asia Pacific Markets in Hong Kong, and then served as an Economic Research Assistant with the University of Macau. Christopher graduated from Pitzer College in Claremont, California with a double major in Mathematical Economics and Psychology, and holds a Master's of Philosophy degree from Cambridge University.

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