Monthly Investment Commentary

Commonwealth Bank & Trust Company

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Domestically, both stocks and bonds generally had a good April. Equities carried their positive run into the second quarter of 2010. The large-cap Vanguard 500 Index was up 1.6% in April, while the iShares Russell Midcap benchmark gained 3.7%, and the small-cap iShares Russell 2000 surged 5.6%. Value also continued to outpace growth across all market-caps, most strikingly in the smaller-cap arena, where the iShares Russell 2000 Value benchmark returned 7% for April compared with a 4.2% return for iShares Russell 2000 Growth. The smaller-cap value benchmark is now up nearly 18% for the year so far.

The story was also a positive one on the fixed-income side as the domestic Vanguard Total Bond Market Index returned 1.1% for April, and high-yield bonds (as represented by the Merrill Lynch U.S. High Yield Cash Pay Index) posted a 2.2% gain.

Looking overseas, concerns over the EU debt crisis hurt the Vanguard Total International Stock Index, which is mostly invested in foreign developed market countries, as it dipped 1.7% for the month, while the Vanguard Emerging Market Stock Index was flat. The Citigroup World Government Bond Index lost 0.4% for the month, while emerging-market bonds (as measured by the JPMorgan GBI-EM Global Diversified Index) were up 1.6%.

China Holds the Key

China's recovery from the global recession has been sharp and striking, but we have been hearing different views on China's recent economic performance. The skeptics argue that China has generated dangerous bubbles in its quest for growth amidst a slowdown in the developed world, its key market. The optimists point to China's strong underlying growth dynamics and sound macro policies as factors behind its strong recovery, and do not see bubbles as a material risk in the economy. Given China's importance to emerging markets and developed markets we have been watching for signals from this market and wanted to share with you a very good interview that was conducted by Litman/Gregory, one of our research providers. We hope you find it interesting.

China Roundtable With Robert Horrocks and Vitaliy Katsenelson

Given the importance to the global economy, we wanted to get in-depth views on China from two very knowledgeable foreign investors: the optimistic Robert Horrocks from Matthews International and the more pessimistic Vitaliy Katsenelson from Investment Management Associates, who has studied, written, and spoken about the global economy and China, specifically. Excerpts from that in-depth discussion, conducted in Litman/Gregory's offices on April 13, are shared below.

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Robert Horrocks has been in the investment management business since 1994. He is the chief investment officer and a portfolio manager at Matthews International Capital Management, LLC. Before joining Matthews in August 2008, Horrocks was head of research at Mirae Asset Management in Hong Kong and served as chief investment officer for Everbright Pramerica in China. He started his career as a research analyst with WI Carr Securities in Hong Kong before moving on to spend eight years working in several different Asian jurisdictions for Schroders. Horrocks earned his PhD in Chinese Economic History from Leeds University in the United Kingdom and is fluent in Mandarin.

Vitaliy N. Katsenelson, CFA, has been involved in the investment business since 1995. He is the director of research and a portfolio manager at Investment Management Associates in Denver. He has written articles on various investment topics in the Financial Times, Barron's, BusinessWeek, Christian Science Monitor, Foreign Policy, and the New York Post, given speeches around the world, and is the author of the book Active Value Investing (Wiley, 2007). Vitaliy was profiled in Barron's in September 2009. He was an adjunct faculty member (currently on sabbatical) at the University of Colorado at Denver, Graduate School of Business, where he taught practical equity analysis and portfolio management classes. Vitaliy was born in Murmansk, Russia, and moved to the United States in 1991 with his family. He received both his bachelor's and master's degrees in science from the University of Colorado at Denver, where he graduated cum laude.

From a big-picture standpoint, what do you think are the key issues and expectations about China that investors should factor into their decision-making? Please address it for both longer-term investors, and investors with time horizons shorter than three years.

Katsenelson: A lot of China's growth was basically geared to the U.S. and European consumers, consumers that borrowed money against their houses to buy Chinese-made goods. That happened long enough such that the Chinese manufacturers were basically making assumptions that demand [for their goods] would continue growing at, let's pick a number, 6% a year. Let's say the natural growth of the demand should've been 4%. So the 2% came from basically just consumers leveraging up. But now that the U.S. and the European consumers are deleveraging, the natural growth is going to be lower. So you're going to have a lot of excess capacity in [China's] manufacturing sector because they're geared for a different type of growth.

In the midst of the financial crisis, when the global economy was contracting, the Chinese economy was growing. Growth slowed down, but it was still positive. At the end of the crisis, it came back [up] to 10% a year as if nothing happened. I'd argue that during the global recession the Chinese government lied about their economic growth. The hard data supports my argument. Electricity consumption was declining. Tonnage of goods shipped through railroads was down more than 25% in one year. [These numbers] told me they were lying and that their economy was declining.

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The bulk of the growth from the end of the crisis to today came from this incredible stimulus package [that] amounted to 14% of GDP. The Chinese government basically firehosed this incredible amount of money into the economy very, very fast. Fixed investment was basically responsible for 90% of GDP growth.

I'd argue that [even] before the global recession began, you already saw some signs that the quality of growth was not very good. You see some examples of that, such as the South China Mall, the largest shopping mall in the world, built in 2006 or 2007. Seven million square feet of it is empty. That tells you about the quality of the growth [before the recession].

Another example: [the] City of Ordos in Inner Mongolia was built for one million residents and it's empty. So, you do see the excesses and the low-quality decisions [that were made] before the recession began.

Horrocks: I think your two classes of investors probably have two different concerns, based on whether they're looking at a three- to five-year horizon or if they're looking out longer than that.

I certainly think that on a three- to five-year horizon, the sort of concerns that Vitaliy has in terms of credit growth in general and the question of whether the stimulus is effective or not, these will be important issues. I think the question of growth in the U.S. and the other export markets, like Europe, are going to be important issues over a three-year time horizon. Things like inflation are going to be an important issue too.

The issues that China [faces] in the long run are going to be much different. I do think we've reached a point in China's economic history where it is changing its model or certainly should [orient] its model to domestic [versus external] demand. I think a deepening of its own capital markets and an ultimate floating of the renminbi, with the undoing of capital controls, will be part of that. I think it means a different sort of economy, one that is more based on the free sharing of ideas. That has its own set of challenges. I think there will be a change in the way that the government relates to people, and there'll be more welfare spending—health care is one example. I think the way that enterprises achieve productivity gains will be different. I think it will not be so much driven by man and machine gains at the margin. That will still be an important part, but I think that will be much more based on the efficiency with which you use human resources because they are going to be far more expensive in the future.

In the short-term, I'm not as worried as Vitaliy is about credit growth in China and government spending. The reason is that I would agree qualitatively with what a lot of the bears are saying about the recent 12 months' growth in China. I would characterize it as 12 months of excess that had been preceded by a period—actually, from 2003 to 2008—where overall credit as a percentage of GDP had been pretty steady and where returns on capital have been rising.

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So, what you've seen recently is not the culmination of many, many years of a huge structural problem within the Chinese economy, but what was a response to the global financial crisis in late 2008. Although the spending is about 14% of GDP over the two years, the incremental spending ahead of what had already been announced amounts to about 2% extra in both of those years.

I think the Chinese would look back on it and say they [may have been excessive] on the monetary side. And you can see now that they're starting to step on the brakes, in terms of slowing down bank loan growth. So I think what you have in the coming 12 months is incremental tightening. I don't think that that will have a huge impact on the markets because valuations simply aren't in bubble territory for me.

So I would agree qualitatively with some of what Vitaliy's saying. But quantitatively, it's just not been four or five years of excesses. It's been a 12-month stimulus program that worked. It did a little bit too much, and now it's time to rein it in.

To gauge some idea of what the excesses in the economy might be, I look at total M2 [broad measure of total money supply] to nominal GDP, and it's about 15 percentage points up above the average of the last few years. So if all of that is excess, then you've got to work off that 15%. But in an economy growing in nominal terms in low to mid teens, that's not a huge bit.

What are the central government's biggest concerns and what can they do?

Horrocks: They're worried about local government debt. They're worried about property collateral for lending. They're worried about the amount that the banks lent. I think that in 2008 they said, "Oh, my God! The whole world is going down the toilet! We have to stimulate the economy."

And now they're looking back and saying, "I think we did a little bit too much." And now they're worrying about local governments. And they're worried about the property prices. And they'll try to bring them down. You could argue they're not doing enough.

They have the ability to ration credit quite severely, if they want. If you look at China's credit-growth numbers, they're definitely being managed within a channel. It was just last year where they broke through that channel. So I think they have the ability to manage it.

And if they tighten too much?

Horrocks: What I would say is that that's the nature of the problem they've got. They now have a macro-management problem that they have to try to tweak. It's not sitting on the end of a multiyear unsustainable boom.

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Now, they don't have as much finesse with the levers as you might have in the more-advanced market economies. So their policy can be more volatile, and that's a risk.

From an investment point of view, I would be more concerned if the valuations that people were paying for were excessive. But they're kind of average. Valuations overall are slightly cheaper in China even before you consider that long-term growth is likely to be faster in China than the United States.

What incentives are driving policy-making at both the central and local government level? That might determine when and how they would withdraw stimulus.

Horrocks: I guess their incentives are basically to survive. What allows the Chinese state to survive is maintaining growth and low levels of unemployment, and preventing political powers from growing up in regions that would be able to threaten it. I think therefore they have to make the calculation not only in terms of short-term growth, but in terms of long-term sustainability of growth. I think that's always been a part of what they've tried to do.

At the local level, I would suggest that the incentives are slightly different. They were originally incentivized based purely on the urbanization and the growth in manufacturing. Now it's more on a GDP-per-capita basis. But I think that is going to undergo a further revolution in the future, where the central government is going to pay more attention to environmental measures of performance, measures of customer satisfaction in their local governments, and measures of openness. That's another transition that has to take place—the relationship between the state and the people. You're going to see a lot more of that welfare service provision and efficiency of that provision being [factored into] government incentives.

At the moment, basically, it's been about GDP growth, i.e., the faster you can grow as a local government, the better.

Growth is every government's objective, but is there a certain level that they have to meet?

Horrocks: I [don't] think there are production targets as there used to be. It is [now] based on per capita GDP growth. It's based on manufacturing value-added as a percentage of local GDP. It's based on urbanization rate of the local economy. It's all of these things put together in a sort of formula.

There is one other incentive that needs to be talked about. That is the incentive to control land sales in the local government. Land sales are between 10% and 50% of local government revenues—depending on the city. As an incentive to keep the property price high they restrict

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land sales, which has two effects. It helps generate revenues for them, and it also keeps land prices high, which you use as the collateral for loans. I think that's one incentive that is dangerous in the current climate. And that's the one area where the central governments are really trying to crack down.

Katsenelson: I think the land value being used as collateral for loans [is important]. If land values decline a lot of the loans will be underwater. That's very true in the residential real estate. In commercial real estate, there are a lot of ways to circumvent that. For example, you can basically borrow the collateral from a different source. In sum, the property values have become very important in that economy.

Horrocks: It's certainly true that properties are used as collateral for loans, and therefore the worry is that the prices have gone up over the last 12 months and, as a result, banks have been willing to extend much bigger loans based on that collateral.

That's one of the things that the central government is trying to crack down on. I think that is the key risk. If this mechanism were to keep going, then you could build up huge excesses.

Going back to government growth targets, what is the goal?

Katsenelson: China doesn't have a social safety net. When you talk about millions of people moving basically from the countryside to cities, the government is concerned that those people will not have jobs and they'll be unemployed. Because of the lack of a social safety net, they'll be unemployed and they'll be hungry. And hungry people don't complain. They riot.

So China is concerned about political unrest. Therefore, the Chinese government basically decided to do everything it can to grow. If the economy is growing, it means there is no unemployment. It means they get to retain their political power.

I was born in Russia. It reminds me of the five-year plans in Russia. So when the federal government has a plan that local governments have to achieve, the local bureaucrat has to achieve it or he's going to lose his job. The easiest way to achieve those plans is by building things because building things requires less skilled labor. Almost by definition, you're going to have lower unemployment. So when you have a recession, you basically have a federal government that can force the economy to grow. But in the long run, it's an extremely inefficient way to grow, and there is a price to pay for that. I think China will pay the price for that.

Horrocks: I think where we differ is [that] in Imperial China, you were given these targets. If you achieved the targets, you were promoted. If you fell short of the targets, you were executed. If you did better than your targets, you were also executed. So there's always been this kind of a

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brake on fake growth in China. I will also say that if there had been inefficient growth in China, you would see it in the numbers by now. You would see it in returns on capital. You would see it in low total factor productivity. Actual total factor productivity in China has been 5% or 6%, an enormous number.

Katsenelson: I just don't know how the return-on-capital numbers are calculated. In an economy where you have a bubbly real estate market, it's very difficult. I understand what goes into the asset side. I'm just not sure what goes into the profit side. In other words, if you keep flipping the buildings and you make profits off of that, or if you keep selling office buildings that end up fairly vacant, you keep making money until you don't. However, when the music stops, that's when you find out what the true return on capital is. So it's very hard for me to say what's the true ROC in China today.

Horrocks: Well, we've looked at it not only from the macro data point of view, where we've excluded real estate [but] we've also looked at it from a list of companies and also the government survey of enterprises. What it shows you is that returns on capital are rising, asset turnover is rising, debt to equity has been largely flat in corporations, [and] net debt to equity has been falling. There just hasn't been a credit-fueled bubble that's evident in the data. Now, we get five more years of 2009, and that'll be a different story.

Generally, the banks can lend at rates between 5% and [roughly] 20%. But you're not guaranteed to get a loan. The cost of capital is controlled through credit rationing. Now the big state-owned enterprises are probably getting loans close to that 5% rate. If you look at the list of companies in the A-share market, their interest expense on debt in 2008 would've averaged out to around about 8%. And then in the informal sector of the economy, which is where a lot of the private enterprises have to go because of credit rationing and where you get a lot of working-capital loans, there your rates are more like 15% and even higher.

So when you put all that together and you get a cost of capital for China—it's still a little bit below the after-tax return on capital that I calculated—at around about 13%. I think the idea that China is a low-interest-rate economy is a bit of a myth because you've got the credit rationing. And you've got other things that are sort of administrative costs, which is another word for corruption and it also raises the cost of capital.

How widespread is the problem of excess manufacturing capacity mentioned earlier?

Katsenelson: I'm not sure what industries it applies to most, but it's probably the industries that make stuff that we consume. We'll be consuming fewer of those goods next year than we did three years ago.

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Horrocks: I definitely agree that there's been a growth shock to the global economy. Therefore 10% rates of growth for the next five years is [probably] over-optimistic. I would be more comfortable with 7% or 8% growth.

In terms of industries we're talking about, these businesses that run on low margins can't survive or can't easily survive a downturn in volume growth, but they're very low value-added. Therefore, they don't actually contribute much to GDP. We're seeing companies that used to supply Nike or Reebok or what have you now building their own brands, and trying to focus on the domestic market.

Katsenelson: The Chinese economy has a fairly high operational leverage. It also has a high financial leverage. If you put those two together, the degree of total leverage is fairly high. So if the global growth rate is lower, and suddenly the economy's not growing at 10% and is growing at a slower rate maybe if it grows at 8%, it would still be fine, but if the growth is slower than that there is a risk you're going to start seeing huge problems in the economy because manufacturers will have a hard time recovering their fixed costs. I don't know what number would bring the economy down.

I think there's a tremendous overcapacity on the industrial side. Let me give you this analogy. Let's say to build 10 bridges, you need one steel mill. If you were going to build 100 bridges over 10 years then one steel mill would support it. But if you decide that you want to build the 100 bridges over a one-year period, you'd suddenly need to build 10 steel mills. And once you build those bridges, you have the 10 steel mills that are now basically idle. This is an extremely simplistic example, but I think that kind of explains why there is excess capacity in the sectors that basically support real estate and infrastructure projects.

Horrocks: I think that there are definitely going to be some industries with overcapacity. I would still say that infrastructure in China is highly productive. The new high-speed rail that they're going to put in place, for example, will halve the travel time by train from Beijing to Shanghai from about 10 hours to five.

Katsenelson: My fear about the infrastructure thing is, how economical are those high-speed trains? There is a reason why the United States—the richest country in the world—in some areas does not have a lot of high-speed trains. The problem is that they did the numbers and found that they're uneconomical. I read that it would basically cost one or two weeks of pay for many people. So the fear is that they have these state-of-the-art trains that are incredibly expensive. The high-speed trains cost hundreds of billions of dollars to build. People just won't be able to afford it. Or, what the government would end up doing would be to lower the prices to an uneconomical level where they'd be losing money. You're going to have high utilization, but governments would be losing money.

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Governments generally haven't had good track records in allocating capital to generate a return, so why should it be much better in the case of China?

Horrocks: Because, China's had a massive growth in private entrepreneurship, and a lot more of the investment that takes place in the Chinese economy now is privately driven, not government-driven.

Again, if the capital-allocation process had been bad in China, then you would've seen that by now because you would have had 10 to 20 years of this capital allocation process and you would've seen the returns come down. There's been a much more efficient use of capital [and] labor. You've seen incomes rising over the period, and they continue to rise. So much so that on a recent visit, one of our colleagues came back saying, "There are now labor shortages appearing in some industries."

Now what will happen there is that they'll mechanize those industries, and the labor will then be released into the service sector. And the service sector part of the economy will grow. And you'll see, just as you saw in the United States, the manufacturing employment decline, just as the manufacturing output rises, because of the productivity increase. Those people will be redeployed into the service sector, and that side of the economy will grow. But that's the challenge. And there are political institutions that need to change in order to allow the service economy to be as vibrant as it can be.

This is why I think people didn't make enough of the Google question in China. If you can't have full and free passing of information to each other, then that next step of productivity is going to be harder to make. But it doesn't negate the fact that the productivity increases have been real over the last 30 years since [the economy] first reformed.

Katsenelson: This may be my Russian background, because I was brought up in Russia under the command economy, but I'm fairly skeptical of the government. Usually the government is not efficient in allocating capital. I think I'm going to agree that the private sector, which is probably 60% to 70% of the Chinese economy, is a lot more efficient.

Banks, who for the most part are controlled by the government, may [have large amounts of bad loans]. It's very hard to say how much right now because the economy is still growing. You don't see losses when the economy is growing. The losses show up when the economic growth slows down.

I'd argue that the Chinese government has a political agenda that they have to fulfill. They need to grow at any cost. Therefore, they're going to finance a lot of projects that shouldn't be financed.

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Second, Robert pointed out that there was this huge level of corruption. Therefore, you're going to have a lot of loans made based on political connections or simply bribery. That's probably the most inefficient way to allocate capital. The point is that you're probably going to have a huge amount of bad loans coming out of the Chinese banking system when that economy slows down.

Robert, you talked about how China is transitioning toward more service areas and more domestic consumption. Looking out three to five years, is the planned transition realistic both in terms of materiality and in terms of timing?

Horrocks: I think Vitaliy's point about the slowdown in the United States and Europe is a point well made and one I agree with. You should expect to see declining margins in the companies that service that, but it's not a big part of GDP.

Is the manufacturing capacity in sync with China in the future? I think there is an argument to say that there is a switching here of the economic model. There has to be a refocusing on the domestic consumer. That will require some businesses to exit, and some new businesses to be created. That will create frictions, I'm sure. I've always been very wary about the argument that somehow China will manage this transition totally smoothly. I'm just not as bearish as Vitaliy seems to be of what that means to China in the short-term.

Katsenelson: I think it's going to be incredibly difficult for China to manage their transition from an export-based economy to an internal-consumption-based economy. There are a couple of reasons for that.

One, the buying power of the consumer is diminished by undervalued currency. So if China were to significantly or meaningfully revalue its currency to increase the buying power of its consumers, it would negatively impact its export industry.

Second, if you add together the U.S. economy and the EU, it's roughly $30 trillion GDP. At two-thirds of these economies, the consumer is a $20 trillion force. China's [economy] is about $5 trillion and the Chinese consumer is one-third of that economy, so it's about a $1.6 trillion force. So the U.S. and the EU consumers are basically 12 times larger than the Chinese consumer. A very small change in consumption in the United States and the EU would have to be offset by a much, much greater increase in consumption in China.

Horrocks: I'm not sure whether I would agree with you, or with the way you phrase it. I don't think it would be incredibly difficult to make the transformation. Nor do I think it will be extremely painful, principally because predominantly what is feeding into the United States and Europe is low-value-added. We're already [seeing this] at a micro-level; companies changing from being suppliers to

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Wal-Mart, to being suppliers on the domestic consumer markets and building brands and as a result becoming far more attractive investments.

In terms of the size of the consumer market in China, I don't expect China's domestic demand to be able to pull the United States and Europe out of their funk. But I do expect incomes to continue growing in China, as they have been—at very healthy rates. Therefore, that will support consumption within the country. I think that's enough to drive China's economic engine, but I don't see it as a savior for the Western world.

We hear stories of pockets of massive vacancy in recently constructed areas. How widespread is that? And does that suggest a bigger issue that we should be concerned about?

Horrocks: Vitaliy raised one example of the city of Ordos that is largely uninhabited. How widespread is that phenomenon? I really don't know. The question with Ordos is with one million people—that's pretty much a village in China. But if that were to be replicated 10 or even 100 times across the country, then I think that quantitatively is a huge problem.

There are other examples. There are [vacant] shopping malls, as Vitaliy mentioned. [There are] little villages where there's a sea of small houses, and huge skyscrapers coming up in them. So there are definitely these anecdotal evidences. But I've never seen anybody aggregate it and say what the extent of misallocation could be.

Katsenelson: It's a very large country. It's incredibly difficult to follow this through. I've seen other examples where there are empty skyscrapers in big cities. Dubai is famous for a covered ski resort in the middle of the desert. And China has now a covered ski resort as well. I have read they have a Dubai-like island there.

When I think about seven million square feet in the largest shopping mall in the world being empty—it just blows me away. Just think about how much concrete went into that, how much capital went into that, how much labor went into that. If that were the only excess in China's economy, obviously that's nothing. But I think it's just a symptom of a larger issue.

Horrocks: Again, I think in the context of China's overall development, that's microscopic. So it would have to be magnified many, many times. But then I come back to the point that you would see it in the data, which you don't.

How much of the investment in the last 12 months was bad? Well, we'll find out in two years' time. But even if you make relatively conservative assumptions, it doesn't lead to a huge increase in NPLs [non-performing loans]. So if Beijing slows things down, as they appear to be trying to do, then

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the only way that you would have a huge NPL problem was if [for the] five years leading up to and including 2008, there had been [similar] excesses as in 2009. That is the only way that I think you'd see a huge NPL problem generated. I just don't see it.

Vitaliy, any concluding thoughts from you?

Katsenelson: I think that the overcapacity in the commercial/residential and industrial sectors in China will basically drive the commodity prices down in the long run. China was largely responsible for a very large portion of the incremental demand for many industrial commodities. Second, the demand from China for a lot of industrial goods will be lower because they'll be building less. Finally, and this is very important for the health of the U.S. economy, if China's economy comes down to earth, Chinese demand for our Treasuries will decline. That's going to drive our interest rates higher, which may prolong our recovery from the Great Recession.

So, those are the main points that as an investor I look at.

I have absolutely no opinion on Chinese stocks because I put most of my focus on U.S. and European companies. I think Robert is a lot better-qualified to do that. Even if/when the Chinese economy declines, I'm sure there are going to be some [stock-specific] opportunities in China. The views I have shared are on China's economy, not its stock market.

Do you see China as a country that will recover from these problems and continue on its higher growth rate trend? Or do you have concerns longer-term as well?

Katsenelson: I think China will recover to a higher-rate growth than the developed economies. Ten percent [is] not a sustainable growth rate. There were a lot of factors that basically artificially [inflated] growth. But I think the Chinese economy will probably be growing at a faster rate than the U.S. or the European economy.

The wildcard is the social unrest. If Chinese normalization becomes a lot more painful because of the high unemployment, I'd be concerned about what's going to be the state of China politically. I'm not sure what probability to put on that. If that doesn't happen, I think 10 years from now, China will be growing at a faster rate than the U.S. economy. Not 10%, but still at a very respectable rate.

Horrocks: Yes, I think China will grow at a fast rate. I tend to agree with Vitaliy that 10%, to me, is a little bit on the optimistic side.

I think if Vitaliy's scenario of falling commodity prices comes about, to me, that means machinery prices come down in the face of higher wages for labor. I think that means you get more people being replaced by machines in China. As you replace people with machines, then you have to

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find employment for them elsewhere. Again, I think the market economy has a way of reallocating resources. I think if people have more money to spend on leisure, it means eating out, tourism, media, people will be diverted into these areas.

Now the Chinese society has been a pretty good environment for a manufacturing type of economy. Can it loosen its controls on what people say and what people think? Can it develop the economy that is going to be a vibrant source of new media and entertainment in that sense?

Is the RMB undervalued versus the dollar?

Katsenelson: I think it's both undervalued and overvalued. Let me explain this.

I think that in the past it was undervalued. The only problem is, when the Chinese economy comes down to earth, there's a good chance there's going to be flight of capital from China. That may actually send the currency down rather than up in the short term.

Horrocks: I don't know how much it's overvalued or undervalued or what. I tend to think the rate of undervaluation is probably not very high.

Why do you think so?

Horrocks: Because a few years ago, people were arguing that it was 13% to 14% undervalued, and it's appreciated by about 15%.

But that's probably productivity benefits. That would explain all of that.

Horrocks: Had it been more severely undervalued, you would've expected inflation in China over that time period. I just haven't really seen it.

So I don't think it's of the order of 30% to 40% or anything like that. I think the Chinese might do a step repegging against the dollar. Probably less than 10% is my guess and likely less than 5%. Then they would repeg it again. They're not ready for freely-floating currency yet. The banking system does not want the currency risk on their balance sheets, so the government has to be the buyer of dollars.

Monthly Investment Commentary

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We have heard both your viewpoints. What, Robert, do you think could make you wrong? And then Vitaliy, I'm going to ask you the same question.

Horrocks: If we discovered that China was, in fact, more indebted than it actually is. That would make me worry.

What do you think the chance of that is?

Horrocks: Not high because there's so much agreement from so many different sources.

If the Chinese government is not proactive enough this year in slowing things down, that would then make the growth rates look more precarious. And I think we'd then be faced with higher rates of inflation. That would make things look less secure. I think those are the two areas that I worry about.

I also worry about protectionism.

From the U.S. or the Chinese side?

Horrocks: I think it could come from both sides.

Katsenelson: I think I'd be wrong if Robert's assertion that there were little excesses going into the recession [is right]. If he's right, then the correction will not be as great as I think today. If the Chinese government miraculously turns out to be an incredible capital allocator, then I'll be wrong.

Also, I will be wrong if for some reason the growth of the global economy is going to be higher than everybody expects. In other words, if the U.S. consumer deleveraging is going to be a lot shallower than everybody expects, and the U.S. consumer basically starts spending money, then I'll be wrong.

That would take care of the excess capacity that you see in China? The demand?

Katsenelson: Well, it's part of it. Remember, the very premise of my argument is that they have excess capacity because they're geared for much higher global growth. If that global growth actually ends up being high, then they don't have the excess capacity.

—CB&T Investment Team (5/10)