



Quarterly
Commentary

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China at a Crossroads: Brandes Analyst Insights

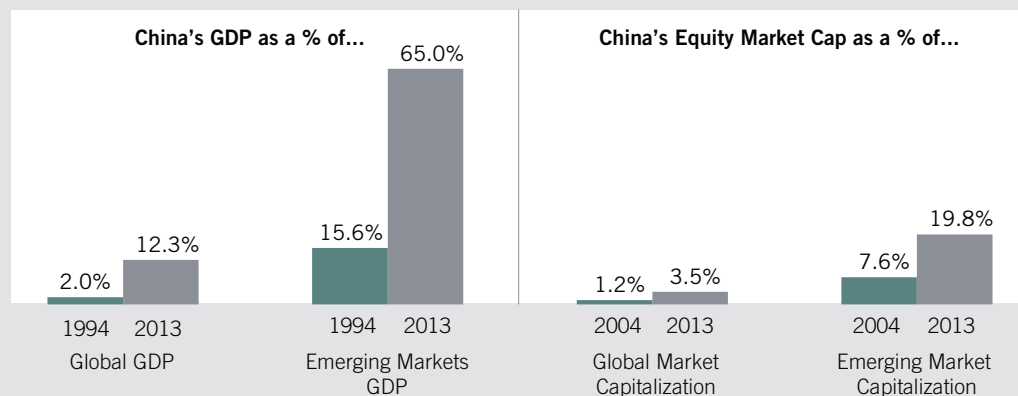
"I hear, I know. I see, I remember. I do, I understand". ~ Confucius

Brandes first invested indirectly in China more than 20 years ago when the primary way of gaining exposure to this vast and growing country was through investments in conglomerates listed on the Hong Kong Stock Exchange, such as Jardine Matheson, Hutchison Whampoa and Hopewell Holdings.

Today, the opportunities to invest directly in Chinese listed companies are vast and rapidly expanding (see box on page 8). Alibaba's recent IPO on the New York Stock Exchange indicates that some companies are even leapfrogging China's own markets in favor of more global ones. This improved market accessibility has occurred alongside China's rise as the most influential emerging market, as shown in Exhibit 1, and as the world's second-largest economy. In our view, the Chinese economy is currently at an inflection point as it has become increasingly clear that the fixed capital investment growth model of the past is becoming tapped out. As China transitions to a more balanced, sustainable and strategically focused economy, there could be profound implications for the global market.

Exhibit 1: China: Growing in Size and Importance

Share of Global GDP and Equity Market



Source: FactSet, Standard & Poor's and MSCI as of 9/30/2014; World Bank 2014 report; includes Chinese companies listed at the Hong Kong Stock Exchange. Global market cap measured by the S&P Global Broad Market Index; Emerging market cap measured by the MSCI Emerging Markets Index.



Q3 2014

To put the magnitude of its rapid investment growth into perspective, China has used more cement in the last three years than what the United States used in the entire 20th century.

As global value investors, we closely monitor and research China's developments because of their potential impact on the value of individual companies. By understanding China's influences, we can remain primed to identify when and where value could emerge. We devote this commentary to the findings and insights of three of our analysts who recently visited China: Jeffrey Germain, on materials; Ted Kim, on the auto industry; and Yingbin Chen, on technology.

First, let us set the stage for China's evolution and its impact.

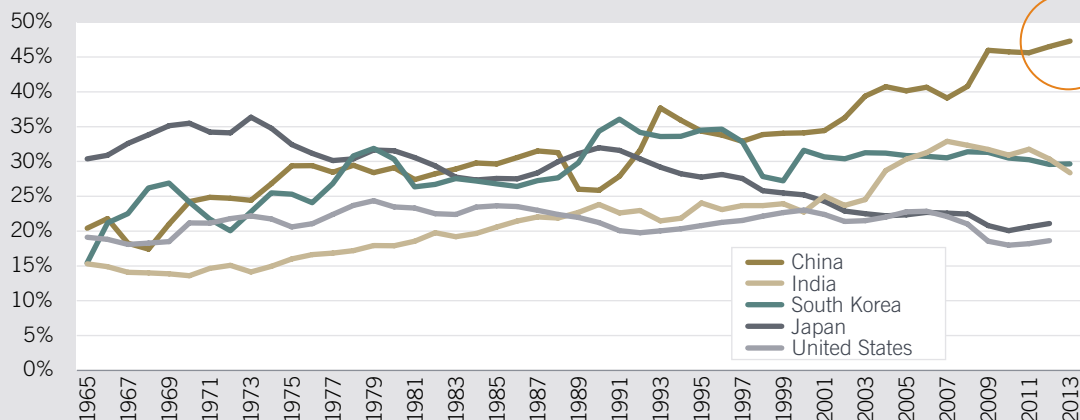
Materials Sector Insights: Jeffrey Germain, CFA, Brandes Senior Analyst, Basic Materials Team

Fixed-Capital Growth Phase Has Resulted in Excessive Investment

China's economic growth over the past 10 years was primarily fueled by investment in fixed capital. While large-scale investment in infrastructure, manufacturing capacity and residential/commercial real estate is to be expected in any developing economy, China's has reached historically high levels. Specifically, fixed-capital formation now represents over 45% of gross domestic product (GDP), which is considerably higher than other major economies and well above peak levels reached by other countries at the time of similar stages of their development. See Exhibit 2.

Exhibit 2: China's Investment Spending is at Record Levels

Gross Fixed Capital Formation as a % of GDP*



Source: World Bank as of 8/24/2014

*Data for China, India and South Korea are as of 12/31/2013; data for Japan and the United States are as of 12/31/2012.

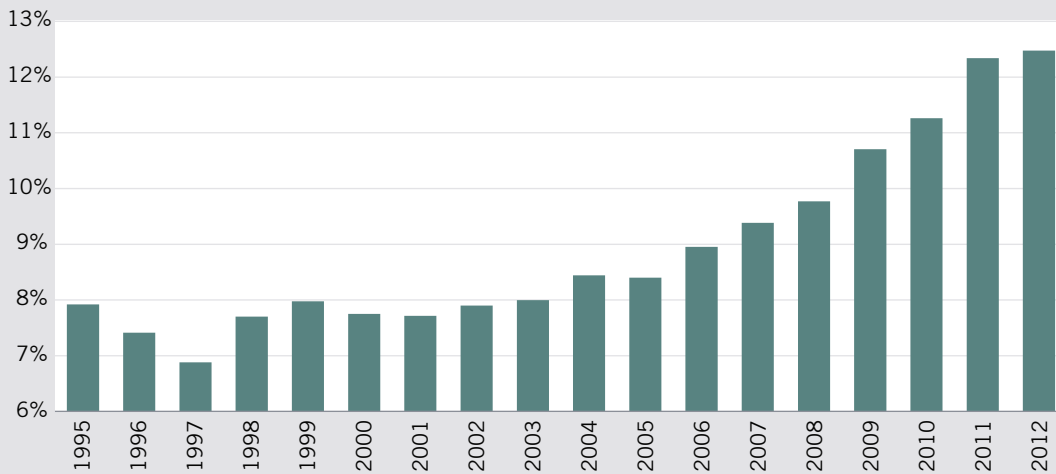
Evidence that this investment may have been excessive includes very high levels of overcapacity in many of China's basic industries (such as steel, aluminum and cement), a rapid increase in real estate investment, as shown in Exhibit 3 on the following page, that has led to residential property supply outstripping demand, as well as a rising incremental capital output ratio.¹ To put the magnitude of its rapid investment growth into perspective, China has used more cement in the last three years than what the United States used in the entire 20th century.²

¹ Sources: <http://www.forbes.com/sites/johnmauldin/2014/03/22/mauldin-chinas-minsky-moment/>; IUBS as of 5/5/2014
Incremental capital output ratio measures the marginal amount of capital necessary to generate an additional unit of economic output.

² Source: USGS, as of April 1, 2014; <http://www.gatesnotes.com/Books/Making-the-Modern-World>

Exhibit 3: Investment Has Triggered a Construction Boom

Total Real Estate Investment Accounts for More than 12% of GDP*



*Commercial and residential real estate from 1995 to 2012
Source: IMF; as of 6/30/2014

Compounding the overall investment issues is the fact that such questionable capital allocations were fueled in part by increasing levels of leverage across China. For instance, in just over five years, China's total debt/GDP has ballooned from 125% in 2008 to 200% as of June 30, 2014.³ Should the Chinese economy slow and be unable to absorb this excess level of investment in a timely fashion, credit quality issues could impact the country's banking system by pressuring earnings and capital levels.

In May, Jeffrey traveled to China for a metals and mining due diligence trip and investigated the excess capacity issue. He also met with consultants and officials to discuss policy issues and the options available to reduce excess capacity, commenting that: "It's clear overcapacity is a significant issue facing the Chinese economy. China's rapid fixed-capital buildup and resulting excess capacity has depressed returns for many industries and has greatly strained the environment."

Far-Reaching Implications of China's Commodity Demand

This rapid increase in investment for an economy the size of China's, with a GDP of \$9.2 trillion (compared with other emerging markets such as Brazil, with a GDP of \$2.2 trillion and India with \$1.9 trillion), has had a dramatic impact on a wide spectrum of industries and economies outside of China.⁴

Since 2004, one of the biggest beneficiaries of China's economic expansion has been the basic materials used in fixed-capital investments, such as iron ore, coal, copper, nickel and aluminum. Exhibit 4 on the following page, highlights just how significant Chinese demand has been for these major commodities. Specifically, it shows that for the materials represented, China has been the main incremental demand center since 2004. In fact, for some metals such as nickel and copper, China represented over 100% of the incremental growth during this period; which means that Chinese demand has more than compensated for a decline in consumption from the rest of the world.

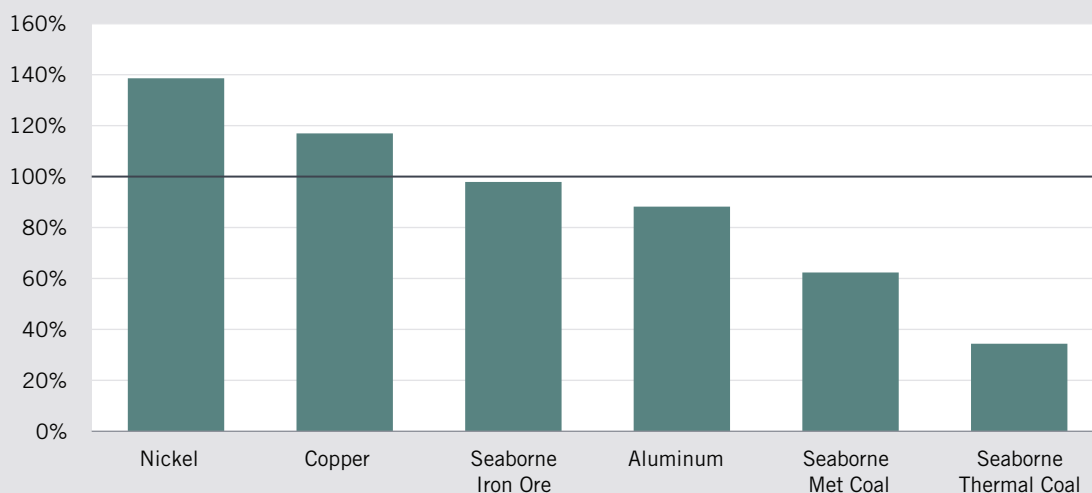
It's clear overcapacity is a significant issue facing the Chinese economy. China's rapid fixed-capital buildup and resulting excess capacity has depressed returns for many industries and has greatly strained the environment.

³ Sources: <http://blogs.wsj.com/moneybeat/2013/10/23/has-chinas-debt-crisis-moment-arrived/>;
<http://www.economist.com/blogs/freexchange/2014/07/china-s-debt-gdp-level>

⁴ World Bank, as of 12/31/2013

Exhibit 4: China's Metal Demand Accounted for a Large Share of World Growth

China's Share of 2004-2013 Cumulative Global Incremental Demand (in kilotonnes)*



As of June 30, 2014.

*A unit of weight or capacity equal to 1,000 metric tons.

Source: Brandes Investment Partners, Macquarie Securities

Australia is a prime example of a country that has benefited from China's rapid fixed-capital formation.

While China has some indigenous mining operations, generally, it is a net importer of most basic commodities necessary for heavy construction. Accordingly, the obvious beneficiaries of this increase in demand and price for materials have been both the mining companies themselves and the countries where they operate.

Australia is a prime example of a country that has benefited from China's rapid fixed-capital formation. As one of the world's largest exporters of iron ore and coal, the boom in commodity demand has resulted in a major rise in Australian exports⁵ and in mining-related investments to bring on new supply, as well as a strengthening currency.⁶

In addition, Australia's housing sector has also experienced robust growth amid this China-driven commodities-export boom. To illustrate, the Australian Bureau of Statistics' house price index of eight capital cities doubled from December 2002 thru June 2014.⁷ At this point, we fear that property prices have gone too far and that a correction could be in the cards as China tempers growth in fixed-capital formation. To underscore this concern, the Bank for International Settlements, which represents global central banks, stated in a news report that the Australian housing market is overvalued, with some of the highest price-to-rent and price-to-income ratios among 14 advanced economies. The agency warned of the risk of a correction in markets where house prices were more than 20% above their historical average.⁸

It is clear that Chinese demand has benefited industries and countries exporting to China in the last several years. Looking ahead, the sustainability of these gains is uncertain, especially if and when China moves away from the fixed-capital intensive growth model.

⁵ At yearend 2013, mining accounted for over 5% of GDP vs. pre-2000 average of 1.6%; Coal and iron ore exports to China in 2013 are four times what they were in 2005 (source: Australia Bureau of Statistics).

⁶ The Australian dollar appreciated 28% from 12/31/2008 to 12/31/2013; Source: Capital IQ-based on exchange rates on 12/31/2008 and 12/31/2013

⁷ Source: Australian Bureau of Statistics, as of June 2014

⁸ Source: ABC News Australia-<http://www.abc.net.au/news/2014-09-15/bank-for-international-settlements-warns-of-risk/5745660>

Auto Industry Insights: Ted Kim, CFA, Brandes Senior Analyst, Industrials Team

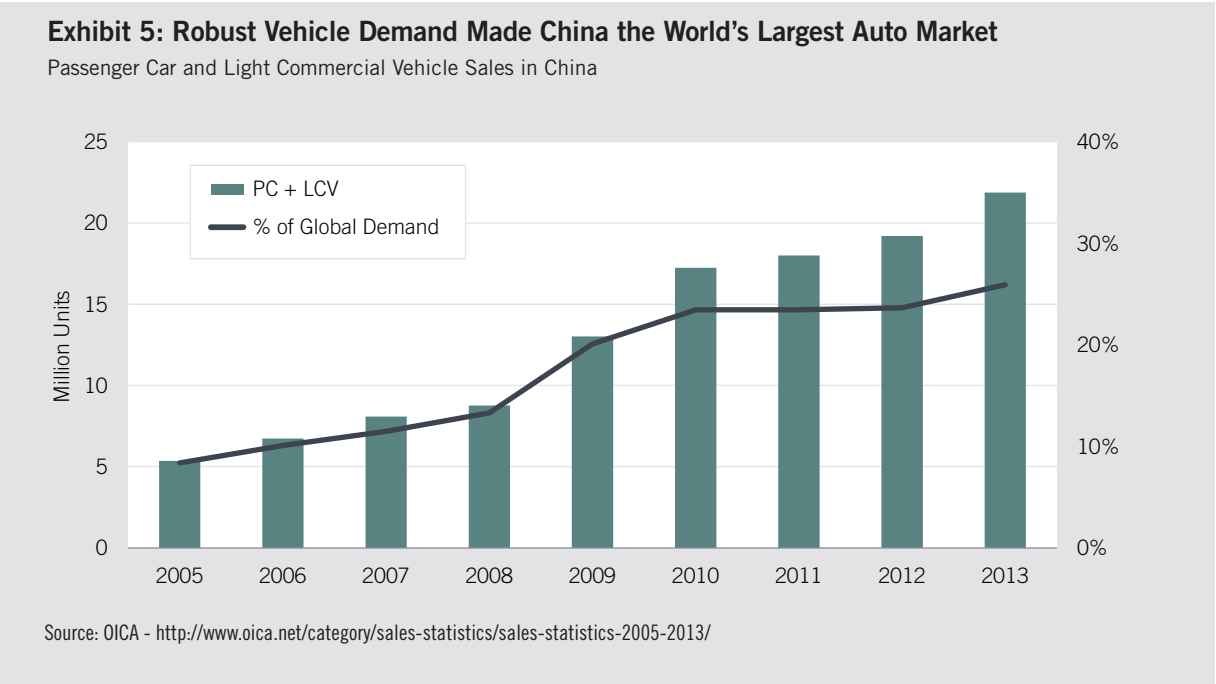
Beneficiary of Strong Economic Growth: Auto Industry

Another industry where China’s global influence looms large is the auto sector. Ted recently visited China to study the dynamics of its automobile industry and the global impact of the country’s immense demand for cars.

“When people talk about the growth in automobile demand in China, we often hear words such as ‘stunning,’ ‘unprecedented’ or ‘spectacular,’” Ted comments. “While other countries may have experienced a similar type of rapid growth as their economies grew strongly in the past, with China, what is unprecedented is the sheer size of the market.”

As shown in Exhibit 5 , passenger car and light commercial vehicle sales in China grew at a compound annual growth rate of almost 20% in the last eight years. China’s demand as a percentage of global demand went from 8% in 2005 to over 25% in 2013.⁹ “Because of the size of its market and rapid growth, China has become the largest automobile market in the world, and we expect it will remain so for the foreseeable future,” Ted points out.

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Understanding the Implications of Chinese Auto Demand

To not miss the sector’s biggest growth opportunity, all global automobile companies have been trying to establish their presence in China by forming joint ventures,¹⁰ introducing new vehicles, adding capacity and building distribution networks. For example, Germany-based BMW sold 20% of its vehicles in China in 2013—more than in any other country.¹¹ Investors looking to invest in a company like BMW need to understand the Chinese market as much as they do other key markets, like the United States and Western Europe.

Today, general consensus holds that strong growth in China will continue, though its rate may slow down. For strong demand to continue, the economy must grow solidly, since GDP per capita is a strong indicator of automobile purchase patterns, as shown in Exhibit 6 on the following page.

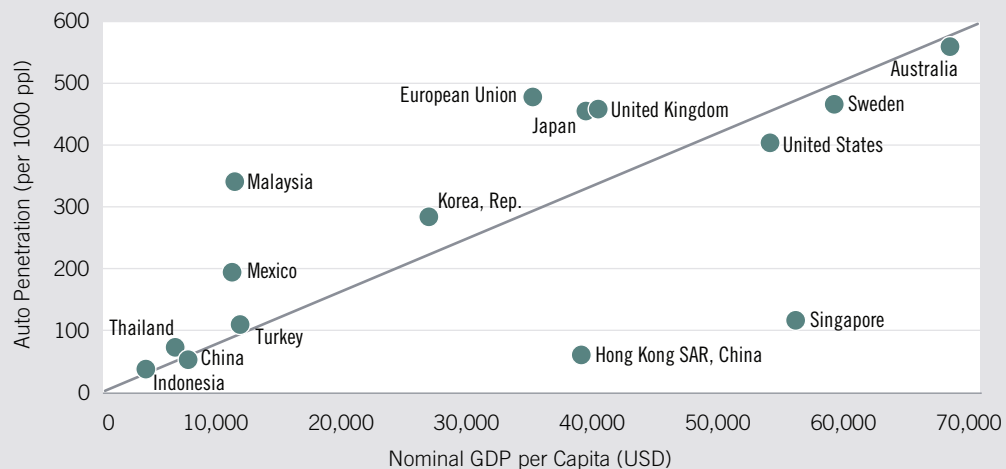
⁹ Source: OICA - <http://www.oica.net/category/sales-statistics/sales-statistics-2005-2013/>
¹⁰ In China, a foreign automobile manufacturer is not allowed to produce any vehicles without a joint venture partner and the foreign company’s ownership cannot exceed 50%.
¹¹ Source: BMW Group Annual Report 2013

Given the low vehicle penetration rate, seen in Exhibit 6, lack of widely available vehicle financing, and still developing infrastructure and used vehicle market, long-term prospects for the Chinese auto industry look very promising. The government also grasps the value of the industry—which has a wide impact on the country's economy—and will do everything possible to ensure its healthy growth.

On the flip side, many large Chinese cities suffer from extreme air pollution and overcrowded roads, competition is increasing in all segments and joint venture structures are often not ideal for global automobile companies. Therefore, while long-term automobile demand will be strong, the industry's future may be bumpier than what most anticipate and how its profits will evolve remains uncertain.

Exhibit 6: Low Vehicle Penetration Rate Points to Continued Positive Long-Term Prospects

World Auto Penetration Rates (2011) vs. Nominal GDP per Capita (2013)



Source: World Bank, 2012 and 2014 reports

Moving forward, China will increasingly become a source of global competition in certain sectors, including technology.

Technology Sector Insights: Yingbin Chen, CFA, Brandes Senior Analyst, Technology Team

Toward a More Balanced and Sustainable Economy

The Chinese economy has become the world's second largest by developing its domestic infrastructure and becoming the world's key manufacturer in many critical industries. However, in recent years, the government has stepped up efforts to steer the economy toward a more balanced and sustainable growth. China is working on developing a few strategic sectors, including technology.

Yingbin made an extended visit to China in the summer of 2014 to investigate firsthand the opportunities, challenges and implications of developing China's technology sector. "In the past, China was seen as a source of demand for global technology companies, and a manufacturing hub", Yingbin notes. "Moving forward, China will increasingly become a source of global competition in certain sectors, including technology." She outlines her observations on key areas affecting the technology sector:

- *Rapid pace of development* – driven by favorable policy, abundance of technical talent, less focus on the enforcement of intellectual property rights, and a large and expanding domestic market. The absence of dominant state-owned enterprises means that competition can be fierce.

The large domestic market becomes fertile ground for Chinese domestic technology companies to test their mettle and mature prior to entering the global market. In fact, we have already witnessed the rise of companies such as Huawei, a large Chinese telecom equipment company, as a global competitor.

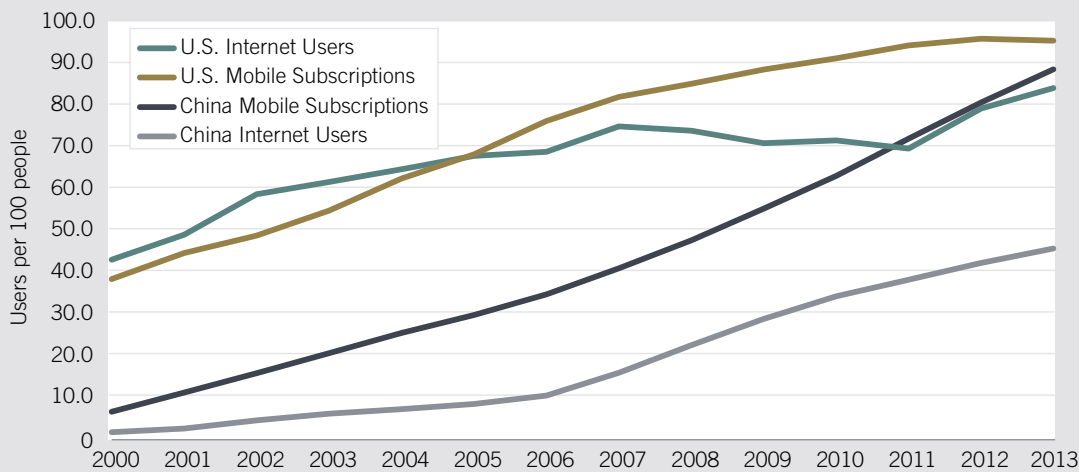
- *Government goal of having its own technology sector* – evident in preferential tax treatment, financing, R&D support, IP licensing/technology transfer, trade, and market access for technology companies. Such measures are rapidly encouraging innovation and entrepreneurship. Policies especially favor the semiconductor and software industries, which are seen as highly strategic in nature. These two segments still lag in competitiveness against

leading global technology companies at this point. Their progress, however, warrants close monitoring going forward.

- *Global expansion of China-based technology companies* – one industry that we will likely see greater impact on the global stage is the handset industry. There are several reasons behind this: A large and growing domestic market as China has become a mobile society where people use their smart phones almost constantly, as Exhibit 7 shows. China is the manufacturing hub for the world in smartphones, and leading Chinese handset companies are very cost competitive as a result of the intensive competition in the country. These companies are already suppliers to emerging markets, and their products will likely make their way to developed countries as well.
- *Technology with potential to leapfrog developed countries* – compared to developed countries, China's telecom, commercial and financial infrastructure is not as mature and developed, which actually stimulated the rapid development in mobile computing infrastructure. China can develop its infrastructure and applications for the mobile computing world rapidly without the restriction of having legacy systems in place. One example is the rapid growth of e-commerce and social networking companies like Alibaba and Tencent. Although their business is predominantly in China currently, there is also a chance that they will expand their reach to other markets and compete globally someday.
- *Government policy repercussions on foreign technology companies* – non-Chinese companies doing business domestically must understand and adapt to applicable government policies. For example, a U.S. telecommunications firm was recently investigated for monopolistic behavior and a U.S. software company was investigated for an anti-trust issue. Such moves have widespread implications for how foreign companies gain access to and expand in a market with enormous long-term potential but that operates with different rules.

Brandes looks at the impact China will have on its own companies and those around the world as a critical factor in understanding the evolving global economy.

Exhibit 7: Internet and Mobile Phone Use: China vs. United States



Source: World Bank; as of 12/31/2013

Summary: Brandes Is Well Positioned to Understand the Dynamics of Investing in China

Our three analysts have examined commodities, autos and technology to understand how China will influence economies and companies as it evolves from a fixed-capital investment-driven economy to one that is more strategic and based on consumer-driven needs.

As bottom-up, global value investors, Brandes is neither overly optimistic nor pessimistic on China as a whole. Rather, we look at the impact China will have on its own companies and those around the world as a critical factor in understanding the evolving global economy. As we closely monitor and research this dynamic country, we believe we can be ready to find value as we understand and incorporate the significance of China's influence.

Shanghai-Hong Kong Stock Connect Paves the Way for Greater Investor Access to China

Signaling an era of increased investor access to China's equity markets, the Securities and Futures Commission of Hong Kong and the China Securities Regulatory Commission announced last April that they will establish mutual stock market access between mainland China and Hong Kong. This will occur through the Shanghai-Hong Kong Stock Connect pilot program.¹² Here are five key takeaways on the new exchange:

- 1. When operational, institutional and retail international investors can trade 568 Chinese stocks (A Shares) with an aggregate market capitalization of US \$2.4 trillion, listed on the Shanghai Stock Exchange through Hong Kong brokerage accounts.** Prior to this program, only institutional investors with secured quota from the Chinese government can invest directly in China's domestic markets.¹³
- 2. Shanghai-Hong Kong Stock Connect is a mutual market access program, through which investors in Hong Kong and Mainland China can trade and settle shares listed on the other market respectively via the exchange and clearing house in their local market.**¹⁴
- 3. For the first time, mainland Chinese investors can buy H Shares listed on the Hong Kong Stock Exchange.**
- 4. The combined market capitalization of the Hong Kong Stock Exchange and the Shanghai Stock Exchange is US \$5.5 trillion.**
- 5. While considered a landmark development, there are lingering concerns on actual execution, which has delayed the program start date.** The two exchanges operate in different regulatory environments.¹⁵

Additionally, in a move seen to further open its capital markets, the Chinese government announced plans to launch a similar program in 2015 on the Shenzhen Stock Exchange.

¹² Sources: <http://www.forbes.com/sites/ninaxiang/2014/08/14/one-infographic-explains-the-shanghai-hk-stock-connect/>

¹³ Sources: HKE, as of 4/10/2014 and 6/30/2014 - http://www.hkex.com.hk/eng/market/sec_tradinfra/chinaconnect/Documents/Final_Northbound%20flyer_E.PDF

¹⁴ Source: Investor Education Center: <http://www.hkiec.hk/web/en/hottopics/stockconnect.html>

¹⁵ Source: cnbc.com, Aug. 18, 2014 - <http://www.cnbc.com/id/101915417;> <http://www.bloomberg.com/news/2014-10-20/hong-kong-brokers-left-hanging-with-no-date-for-shanghai-link.html>

The MSCI Emerging Markets Index with gross dividends measures equity market performance of emerging markets.

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Brandes Investment
Partners, L.P.
11988 El Camino Real
Suite 600
P.O. Box 919048
San Diego, CA
92191-9048
858.755.0239

