

CHAPTER 1

Journeys to China

In the summer of 2011, one of the most successful hedge fund managers of the century, John Paulson, made a bet that allegedly cost him and his investors \$500 million in a matter of months. It wasn't on some wrong-way bet on the options market or a commodities trade gone sour. If that were the case, it would be understandable because of the risks involved. No, it was a loss on the shares of a company called Sino-Forest (TRE.T). The company, as the name implies, was a Chinese company involved in the forestry business. A sound bet, it would seem, thanks to the booming market for commodities in China. Better still, the company's shares were listed not on some obscure exchange in Ulan Bator, but rather they were listed on a major Canadian exchange.

On March 31, 2011, the shares of Sino-Forest reached their high at \$25.85. On June 21, 2011, the shares closed at \$1.99. In the period between, a company that specializes in researching short-sale opportunities, Muddy Waters, released a report questioning the veracity of the claims that Sino-Forest had made regarding its land holdings. Here's what the founder of Muddy Waters, Carson Block, had to say about Sino-Forest:

It's a Ponzi scheme in that the company perpetually issues securities in order to fund itself. Even by its own fraudulent numbers, the company does not generate any free cash and has not done so in 16 years. Were the company unable to issue additional securities to fund itself, it would collapse. That, to me,

8 Where in the World Should I Invest?

is the definition or epitomizes the definition of a Ponzi. In this situation, the company appears to be investing for the twenty-third century. It's 16 straight years burning cash, no guidance as to what the rationale is to acquire so many trees so far ahead of customer orders. This is taking a capex fraud—we have found several of these in China—it's taking it to the next level where you're not constrained by the walls of a factory and no one is able to really see the movement of physical goods. It could grow to be infinite provided that the capital markets continue to fund it.

Now, whether Mr. Block was right is really not the point. The fact that one of the biggest and most influential fund managers in the world miscalculated on such a big stage is. Had Mr. Paulson consulted with me . . . or read what I had written after my first trip to China back in the early 1990s, it might have saved him and his investors a few hundred million dollars.

The First Journey: Wolong YuYe

My first journey to China, about 17 years ago now, was courtesy of an all-expenses-paid research trip funded by an investment group out of Florida. The outfit wanted me and a gaggle of other editors to provide some coverage of the “China story.” Yes, my friends, China was a story then, as well.

This was before the Asian financial crisis, when Chinese companies were going public in their local markets with the help of some shady Hong Kong business types. Hong Kong, if you were not aware, was born of illicit trade . . . and it hasn't changed since birth. It's just cleaner, smells better, and you now can say thanks in English before getting ripped off.

As my plane landed in Chengdu, in the Sichuan Province, I noticed that it was quite dark outside. I am more used to seeing the street light grids that illuminate most U.S. cities when I travel. There was not a single light in sight. It's hard to be all lit up when you don't have electricity in the rural areas. We landed. As we walked through the customs and immigration lines, I noticed that one of the agents had pulled over a cadre of Japanese businessmen and was giving them a good amount of grief. I guess old memories die hard in China.

The first thing I noticed outside the terminal was a huge sign for Jeep Cherokee—remember, this was circa 1995. A huge Mercedes pulled up and whisked us to our hotel, the Jin Jiang. I was beginning to get the feeling that China had really come of age. The hotel was arguably the best hotel I have ever stayed in, five-star all the way. Satellite TV, electric blinds, marble baths—these guys really knew how to live.

Tour of the Steel Mill

The next morning, I was ready for the tour of the steel mill that we were scheduled to visit. The mill used to be owned by the state but was now privatized and owned by a Hong Kong-listed company. Bicycles—I have never seen so many. Cars? I have never seen so few. As we navigated through crowded streets, it was apparent that China would have to do a lot more than a few hundred billion dollars in trade to get up to speed as a first-world country. All around us, poverty made its sometimes pungent presence known fully and completely. A chicken in every pot? How about just a pot first?

We reached the steel mill and were greeted by a huge turnout of employees and staff all wearing their Sunday best and smiling. They could smell the profits reeking from our first-world clothes. The Chinese had a weird sense of fashion. The up and comers wore Western suits—with the labels still showing—the sign of prosperity. We were led around the factory, given a tour of the smelter, offered bamboo hard hats (I still have mine), and warned about the dangerous environment. Apparently the amputees had the day off for this tour.

As we toured the facility, many of the upper-level executives who spoke very good English began to cozy up with us. The plant was spectacular, no? It was now the lowest-cost producer of steel in China—ever since the state let go. We were now on our way to see the local Communist Party head who agreed to give a little speech to mark our visit. We entered a building that was set up like a small amphitheater. The officials welcomed us with smiles and nods. I held on tight to my wallet. The head official said nothing of significance or worth remembering. But as he wiped his hair back, I noticed that he was wearing a real Rolex watch. (As a one-time

watch enthusiast, I can spot the real thing from a mile away—it's all in the magnification.) I asked myself how a Communist Party official could afford such a luxury on barely \$20 a month for a salary. Then I remembered that I asked myself the same questions in 1982 when I visited Russia as a younger, more naïve man. He must have gotten rid of the manila envelope by now.

The meeting ended. We were invited to a party with the party. At the party, the officials and executives were getting very friendly and anxious. They began extolling the virtues of the steel mill, its huge profitability, and the capitalist changes taking place in China. No one was biting. They loosened their ties and announced that it was time for some Wolong Yuye (not to be confused with Falun Gong). It was barely 2 p.m. and out of nowhere appeared a bevy of beauties with bottles and glasses. The beauties, as I learned later, were also a freebie. Wolong Yuye is the Chinese equivalent of moonshine . . . I guess. I don't drink alcohol (before 6 p.m. anyway) and so I declined to partake in this party with the party.

Pulling a Fast One

These Chinese were not shy about demonstrating their fondness for hooch. It was too late. An hour had passed and I was the only sober one in the room, probably in the entire plant. They started to spill their guts—figuratively. The plant was not owned by the Hong Kong company. It was still owned by the state . . . ha ha. The company executives in cahoots with Mr. Rolex had leased the plant to the Hong Kong company so they could pitch it to unsuspecting foreigners (read Americans who love a bargain) and then turn over their shares in the public company at a nice profit. If a few of the analysts and writers on the trip wrote about this Hong Kong small cap that also traded on the NASDAQ bulletin boards, their retirement would be set in stone, or better yet, U.S. dollars. Then, they could tear up the lease agreement and the state would be none the wiser.

The Second Journey: This Time It's Different

The trip ended badly in more ways than one. I left feeling that I had wasted my time. I came to the conclusion that the only people who would make money in China then were the Chinese. If you want to invest in China, be careful and look to experience.

John Paulson learned this lesson the hard way, as have many other investors over the years. Emerging markets offer a bounty of profits to investors, but most don't understand the inner workings or subtle cultural nuances that permeate every facet of investing in these markets. Being early is good; being right is better. Over the past 20-odd years I have visited, invested in, made money from, and lost money in many of the emerging markets that you are just beginning to read about in the financial press today.

There is money to be made, lots of it. But, making that money requires a better understanding of how these markets work, which markets work better than others, and where you can safely trade individual stocks in these markets. It all begins, though, with an understanding of the people and culture that you are investing in and with.

The China Experiment

China is on everybody's mind, as it should be. It is the single most important country for investors and non-investors alike in this century. As a burgeoning economic superpower it holds the key to growth in Asia. As a military superpower it threatens the world with its shrouded intentions. As an ideological superpower it can act in a manner that is often misunderstood by the West but clearly understood by its neighbors.

I'll begin my journey in Chengdu in the mid-1990s. As I spoke about in my introduction, it was a rude awakening from an investing standpoint. I arrived in China at a fairly early stage in its most recent growth spurt. I doubt that Chengdu today looks anything like it did just 16 years ago. The place was so polluted, I could barely see across the street. An industrial city, Chengdu is also the capital of China's Sichuan Province and one of the country's largest manufacturing centers.

On the main street people rode on bicycles as far as the eye could see. There were probably more bikes on that one street than in the whole of Amsterdam. There were no cars to speak of. Like worker bees, people rode to work at factories and steel mills early in the morning. All were dressed in the same gray, drab mandarin-collared Mao suits. I could barely discern male from female. On each corner an old woman wearing a Chinese cone field hat would

12 **Where in the World Should I Invest?**

be sweeping the sidewalk with a primitive bamboo sweep, moving the dust from sidewalk to street, only to return later and do the same again—probably with the same dust.

As I walked through the side streets of the hutongs, old men would be playing Weiqi or Mahjong while puffing on their cigarettes. Everyone smoked, adding to the already squalid air. There was little worth buying from street vendors, because there was not much for sale. Chengdu was not Shanghai. And, at that time, Chinese consumers barely had a pot to piss in, let alone extra cash to buy niceties.

But, there were great bargains to be had at state-owned shops. At the time, the renminbi was trading at just over 8 to 1 versus the U.S. dollar (compared to 6.4 to 1 today—see Figure 1.1) and the only place selling authentic treasures such as scrolls and paintings were the two-story government shops where there was no bargaining, no credit cards, and no toilet paper. All in all, it was a depressing place.

My visit to Chengdu and my meetings with the steel mill executives left me with a bad taste about China. Worse, I lost

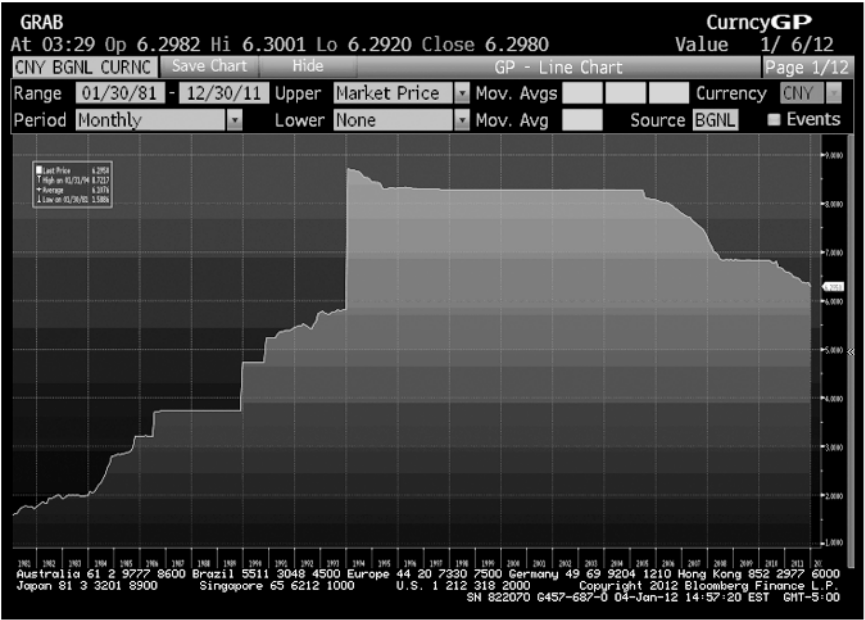


Figure 1.1 USDCNY Exchange Rate

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10 pounds on the trip because the food was unrecognizable at worst and inedible at best, unless sliced bull testicles appeal to your palate. It was a white rice trip. There were no McDonald's restaurants in Chengdu, no Kentucky Fried Chickens, and nothing that even resembled something I would like to eat. I survived on white rice and the excellent western breakfast buffet at the Jin Jiang. On my return home, everything in my suitcase, and the suitcase itself, had a distinct odor . . . it took me several trips to learn that it was a combination of green tea and mushrooms, neither of which I consumed!

The Third Trip: Fast Forward

In 1997 I made my third trip to China, well kind of. I landed in Great Britain, but departed from China, without traveling more than a dozen miles in between. It was July 1997 and I was in Hong Kong for the handover ceremonies, China's "coming out" party. The Brits were leaving and handing the keys to arguably the most prosperous city in China back to the Chinese. The city was painted red from head to toe. It was a miserable four days. Monsoon rains drenched the place. From my window at the Regent, I was supposed to be able to see the harbor. I could see nothing but droplets of water on the glass. The entire trip was spent shopping at stalls and markets while waiting for the ceremonies to take place. Most of Hong Kong was on holiday, and because the real purpose of the trip was to explore India, Hong Kong was just a timely stopover. It was exciting, however, as the Asian financial crisis was just beginning with the collapse of Thailand's economy and the Thai baht starting to make headlines.

The night of the handover ceremonies was no different than any of the preceding nights. Perched atop the stock exchange building we waited for all the pomp and circumstance to begin in the harbor. Remember the stories you heard about the Chinese trying to control the weather? Well, let me tell you that during the two-hour-long ceremony the skies cleared and the fireworks display went off without a hitch. Within minutes of the actual handover ceremonies ending, the skies opened up and it rained for the rest of the trip.

At the time of the handover and during the months preceding it, there was easy money to be made in the Chinese market.

14 Where in the World Should I Invest?

Exuberant Chinese and foreigners alike were pumping money into Hong Kong and China stocks en masse.

Earlier in the year, however, there were signs of a top. New World Development Co. set a record with its \$92 million purchase of a home atop Hong Kong island for redevelopment. Property bubbles often precede stock market crashes, as those in Japan and the United States are acutely aware.

I remember writing about it and recommending that my readers buy China and sell after the handover. I was right, but not for the reasons I thought. The handover coincided with the Asian financial crisis, and that was among the leading reasons that the Hong Kong and Chinese markets cratered so quickly after the event. They plunged but not for very long. What happened next is of note.

After the Hong Kong market began to crumble under the weight of margin, real estate speculation gone sour, and the domino effect of the Asian crisis, the government of Hong Kong, under the auspices of the mainland government, began to overtly buy shares on the market, crushing short sellers. At one point the government bought more than 10 percent of banking giant HSBC shares in an

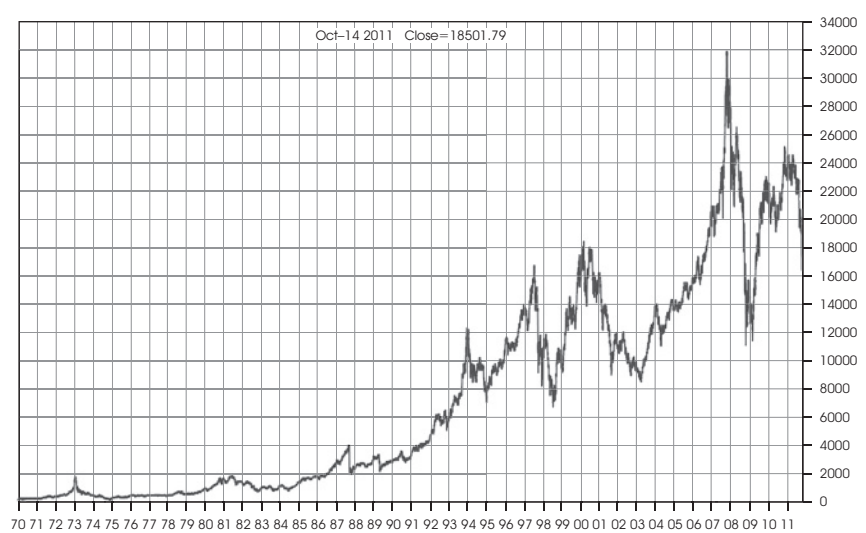


Figure 1.2 Hong Kong Hang Seng Index

Source: www.sharelynx.com.

effort to quell the tide of sellers. It worked, but at what price? After spending at least \$15 billion—a mammoth amount at the time—the government had convinced me, at least, that it would do anything to prevent a collapse or make sure that any collapse would be quite short-lived. The price for taking risks was not failure but government support. It’s a lesson that played out again in the U.S. financial crisis of 2008 to 2009. It also meant that valuing companies in the market was next to impossible during a crisis. More importantly, it set the precedent for how to trade emerging market shares, something I will talk about in more depth in a later chapter.

What I will miss most about the Hong Kong of 1997 was flying into the airport sideways on a 747 and almost being able to read the names on the designer labels of the clothes hanging to dry on the balconies. It’s an experience that will never be repeated, as the Kai Tak Airport ceased operations in 1998 to make way for the new Chek Lap Kok Airport that was built on reclaimed land.

The ETF Effect

Up until the early 2000s, there were few ways to invest in China comfortably. One of the most popular vehicles was closed-end funds. These funds operate similarly to mutual funds with respect to the fact that they hold a variety of investments in a particular sector or country. For a place like China, it was next to impossible for an individual investor to buy shares or other types of investments in anything other than a few of the “red chip” names. The problem with this is that most of these big name stocks had already been bid up by investors who didn’t take time to explore the other possibilities.

The big difference between closed-end funds and mutual funds is the way they trade. Closed-end funds issue shares that trade on an exchange. The share price is initially set based on the net asset value (NAV) of the underlying holdings. Mutual funds are priced the same way, but they do not trade during the day on an exchange and their prices are reset once each day for buyers and sellers. They also issue as many shares as needed on a continuous basis based on supply and demand. The price of a mutual fund reflects the value of the holdings every day and that is the basis for the price. These last two points are important.

Closed-end funds, by virtue of their real-time trading and their fixed number of issued shares, are subject to the whims of the market and supply and demand. This results in an unusual and unusually profitable way of playing the Chinese markets, or any markets for that matter, even today.

Closed-end funds trade at either a discount or a premium to NAV. If the shares trade at a level higher than the value of the holdings, that is a premium. If they trade at a level lower than the value of the holdings, that is a discount. This allows for some massive opportunities for the savvy investor. All of these closed-end funds have historical data that show the premium or discount they trade for. In the case of emerging markets it depends on how well the underlying market is performing. If it is doing well, the funds trade at premiums. If poorly, then discounts. Not exactly rocket science.

There have been many occasions during which you could have (and I did) purchased closed-end funds at discounts ranging from 10 to 35 percent off NAV. That's like buy one dollar's worth of investments for 65 to 90 cents. How can this situation exist?

Because closed-end funds trade like stocks in the market during the day, they are subject to investor supply and demand. During the Asian financial crisis, closed-end funds were pummeled as investors flocked out of them in droves. There is only one market mechanism to prevent an oversupply of shares during a panic: lower prices until equilibrium between buyers and sellers is once again achieved. The crisis lasted for months and during those months it was possible to buy closed-end funds at discounts of more than 25 percent. Within a couple of years, those discounts became premiums once again. It doesn't take balls of steel to make these investments, just a better understanding of why and when these opportunities present themselves. One of my favorite trading vehicles for China during times of crisis is still the Templeton Dragon Fund (NYSE:TDF) managed by Mark Mobius, a veteran trader of Asian companies.

A glance at the price chart of the fund (Figure 1.3) reflects major inflection points in the emerging markets. Take a look at how many opportunities you might have had in the past 15 years to double, triple, and even quadruple your money time and again. The secret is patience. If there are two common themes among



Figure 1.3 Templeton Dragon Fund

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emerging markets, it is that they are eminently tradable and prone to crisis.

Finding Bargains

There is one website in particular that I keep an eye on when I want to know when to buy and when to sell closed-end funds. It is www.closed-endfunds.com/. On this site you can type in the symbol of the fund you are following, TDF, for example. It will pull up all the pertinent information. You want to zero in on one line: the premium or discount line. There, it will tell you whether the fund is a buy or not a buy. It will tell you this by the amount of discount the fund's share price is trading to NAV. Here is my rule of thumb. If the discount to NAV is 25 percent or more, buy. When the premium reaches 10 percent or more it's time to sell. This trade can be replicated over and over again. There are two funds in particular where I employ this strategy. First, the Templeton Dragon

18 Where in the World Should I Invest?

Fund and second the Templeton Russia and Eastern Europe Fund (NYSE:TRF). I will talk more about Russia and Eastern Europe in the coming pages.

In Figure 1.4 you can see the repetitive nature of closed-end fund behavior during periods of crisis. I took two periods and isolated them for you. The first was during the Asian financial crisis and the period that followed. The second was during the global financial crisis in 2008 and 2009 after the housing bust in the United States. As you can clearly see, the opportunities for fast profits from emerging markets are not hard to achieve if you have even some modicum of patience and knowledge about which vehicles to use. As an aside, both the U.S. crisis and the Asian crisis followed a similar track. They both occurred after a long period of easy money due to low interest rates. If you are looking for a reason for bubbles to form, easy money is the biggest one that I have encountered. As for timing entry . . . well, that is easy as well. Wait for that



Figure 1.4 Templeton Russia and East Europe

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25 percent number to kick in; better still, average your buys into these funds starting at a 25 percent discount and adding incrementally with each subsequent 5 percent discount. As yet, I have never seen a 45 percent discount.

The Two Towers

Shanghai and Beijing: two more different cities could not exist on this planet. That they are both in the same country is a source of constant amazement to me. In Shanghai you feel as if you are in a western metropolis, while Beijing appears a staid, buttoned up, traditional city. Of course, history has a lot to do with this.

Shanghai has always been the bad boy of the Orient. A city built on the fortunes of opium, strong European influence, and the morals of a drunken sailor, Shanghai is a city where anything goes . . . and often does. Shanghai is the China that fools you into thinking that China is an open, capitalist country with unlimited potential. I have to say, the place is a blast and a half but as expensive as any western city.

Beijing, on the other hand, is the center of Red China. Tiananmen Square is crawling with tourists and soldiers alike. A massive picture of Mao hangs at the entrance to the Forbidden City. Not once have I seen a picture of Mao in Shanghai. Mao's mausoleum sits in the center of the square. Beijing is China's capital city; the place where secret ambitions are fostered; where policy is formulated; where the brain trust issues edicts on everything from population control, Internet accessibility, and price controls. It is the heart of China and while it cannot hold a candle to Shanghai and its modernity and riches, Beijing calls the shots.

The Center of the World

My first visit to Beijing was in the 1990s. The airport was old, no Jetways to the plane, bicycles still outnumbered cars, and few if any cranes were on the horizon. The ride from the airport to the city center took less than half an hour. Today, a trip into town will take at least an hour, and that's if traffic cooperates!

A note about getting around in China: There is a train that you can take from the airport, but for some unexplainable reason, you have to make a couple of changes in order to get to the city

center—avoid it. Take a taxi for somewhere between \$25 and \$30 or take a bus for less than half of that. Arranging private transportation is easy, but you will be paying western rates. If anyone speaks English, they do a great job in not revealing that fact. Always carry around your destination information in Chinese—this is a must. Cab drivers are honest for the most part (much more so than in Athens or Istanbul), and taxis are both cheap and metered.

There are six fully connected ring roads, beltways that make their way around the city. On my first visit just two were fully connected. Cranes are the national bird here and they come in one color—yellow—and they're mechanical. As far as the eye can see, in just about any city you visit there are cranes. On a recent trip from Xian Airport, I counted more than 100 cranes off the highway, and that was in poor visibility that only allowed me about 300 yards of clear sight.

Today, Beijing is one big traffic jam. There is a pecking order of cars. Volkswagens are popular, but Audis rule the roost. Most, if not all, are chauffeur driven and black. Once in a while you'll spot a Rolls Royce. It's a far cry from the days of the bicycle. Getting around town is very easy, but you need to leave lots of time. Rush hour begins around 6 A.M. and lasts until 6 P.M.—that's just the way it is. While China as a whole has spent billions on infrastructure, it just cannot keep up with the growth of automobile traffic. The casualty is time.

Most visitors to Beijing do not come here to do business. They come to see the sights and to experience Chinese history. In this respect, Beijing does not disappoint. The Forbidden City, the center of the world for the Chinese, is a fabulous complex that is relatively well preserved. It was the seat of power for the Middle Kingdom for centuries. Inside this complex there are thousands of buildings—some small and some very large. Not many buildings are open to the public, probably because they are in need of restoration. The ones that are have rooms roped off from visitor traffic. Some of the antiquities are on display, but many pieces were taken to Taiwan when Chiang Kai-shek fled the mainland in 1950 after the Communist rebellion. He ruled Taiwan until his death in 1975.

Following his departure to Taiwan, China transformed into the world's largest Communist country, led by Mao Zedong, the

chairman. It was likely the low point of U.S.–Chinese relations. In fact, Mao believed strongly that Chiang Kai-shek was nothing more than a puppet for the western imperialists. Here is an excerpt from the third paragraph of his opening address on September 21 at the first plenary session of the Chinese People's Political Consultative Conference:

In a little more than three years the heroic Chinese People's Liberation Army, an army such as the world has seldom seen, crushed all the offensives launched by the several million troops of the U.S.-supported reactionary Kuomintang government and turned to the counteroffensive and the offensive.

Old feelings die hard. Like the Japanese, toward whom the Chinese harbor the most hatred, the United States is by no means considered a friend. China has had to play the role of unwilling partner to the United States at the economic dance in order to accelerate its growth from third-world status. It has lost face each time the United States has shown support for Taiwan and for the Dalai Lama who they believe is trying to destabilize the “autonomous region” of Tibet.

As a consequence of this forced marriage between the United States and China on economic grounds, there has been a thaw in relations over the past two decades with the Chinese doing fewer bad things, publicly anyway, and the United States adopting a less critical stance toward violations of human rights, environmental policy, and trade. This marriage will not last forever, and the fallout could be devastating.

Many have asked me about China's vast holdings of U.S. Treasury securities and the impact they could have on the U.S. economy and population if the Chinese decided to dump their holdings and diversify outside the U.S. dollar. It's a valid concern, but one that really would not be in China's best interest. China has made a sort of deal with the devil and it is more vulnerable at this point than is the United States.

To understand how the two countries came to be in this unusual, somewhat symbiotic position, one must look at global dynamics. The United States is the world's wealthiest country by

far. It has a culture of consumption. We buy any and everything—whether we need it or not. Buying American-made goods means spending more money. Sweat is more expensive in the United States. In China, sweat is cheap, plentiful, and easily controlled. With a one-party system that is not concerned about how it appears to the rest of the world, it is easy to mobilize a massive workforce to toil in gigantic factories for a pittance, as long as that pittance is still more than the population is used to earning.

So, China became the world's factory. It produced goods at prices that were, and still are, incredibly cheap. Quality was not a concern. The West, especially the United States, bought these goods and by doing so held down price inflation. This low inflation in the price of goods benefited the West tremendously—especially the United States, which has seen a stagnation of wage growth for the middle and lower classes for more than two decades in real terms. So, Americans could buy more stuff and feel like their standard of living was not declining as measured by the number of TV sets, pieces of furniture, and knick-knacks they accumulated.

The problem for China was that in order to fully mobilize, it had to take in foreign currency at any cost. The yuan or renminbi (the Chinese currency) is not convertible. So, to buy things like natural resources, the Chinese had to use the single currency that is accepted by all: the U.S. dollar. At the time this began, the euro was nonexistent. The Chinese also needed to accumulate U.S. dollars because they knew that the U.S. dollar, as reserve currency, would not be subject to default fears (even though the events in 2011 surrounding the debt default fiasco must have made many in Beijing worry just a little).

Today, the U.S. dollar is accepted willingly in many places in China, especially the bigger cities and definitely the markets. In fact, I make it a point when I travel to carry a lot of small U.S. bills: \$1s, \$5s, and \$10s. They are not only accepted, but they are not susceptible to counterfeiting, as is the Chinese yuan, especially the 100-yuan note. I found this out the hard way; fortunately the 100-yuan note was

worth only about \$12.50 at the time. Counterfeiting in China is not just an isolated thing; it's a way of life.

I was staying at the Grand Hyatt in Beijing. It was 2006. There was a cash machine in the lobby, and I went to withdraw some local currency—about 1,000 yuan. Out came 10 crisp 100-yuan notes. Knowing that I would need small bills for the street I went to the hotel cashier to get some change. She politely informed me that three of my bills, which had come out of the hotel's own ATM right in front of her, were fake and that she could do nothing about it. That, my friend, is brazen counterfeiting!

In the mid-2000s, China pretended to bow under the pressure of Western criticism of its counterfeit industry. Prior to around 2006, on the streets of any city, you could openly buy any knock-off that you could dream of. Louis Vuitton, Gucci, Rolex, Cartier, Chanel—these are the favorites. For \$12 you could easily add a beautiful Chanel knockoff to your collection. The quality would surprise you. I was in the old market in Shanghai recently and I didn't see one knockoff purse anywhere. For a moment I thought the Chinese were actually taking it seriously.

Within five minutes, a well-dressed gentleman carrying a spiral binder approached me. He insisted, as is always the case, on showing me the contents. I really enjoy being bothered by the locals—it gives me a much better feel for what is happening at the street level. His binder was stuffed with high-quality, color laminate pages listing every model number of every purse from every designer imaginable. If I were interested, he would take me to see the actual purses and luggage. I was, and off we went. We walked through a series of narrow alleyways behind the market (yes, it was a little scary) until we reached a modest little home. The door opened and inside were a few family members enjoying tea and a couple of foreigners looking at the wares. What he showed me next astounded me. He opened a door to a room that had ceilings at least 20 feet high and each shelf from floor to ceiling was packed with merchandise. Mont Blanc briefcases, Louis Vuitton suitcases, even brands such as Tumi and Samsonite were being knocked off. And, the prices . . . well, that's worth another story.

How to Bargain in China

Know this: if you walk away from a vendor in China without any merchandise, it will be a rare event indeed. Bargaining with the Chinese is fun, exciting, and a game of sorts. There is no ill will, and they know that for every 1 hard bargainer there will be 10 who will reward them bountifully. I am that one. When I first visited China there was not much to buy, let alone bargain for. In subsequent trips it has been one shopping spree after another. On one trip I bought a designer suitcase for \$10. As I got on the coach I noticed that a fellow traveler had the same suitcase. I inquired. She paid \$120. I said nothing. She was happy as a lark. The same suitcase, real of course, retailed for more than \$1,000 in the United States.

The difference today versus just 10 years ago is the Internet. It's no secret that you can't log onto Facebook or YouTube in China (well that's not true either . . . if you are on a virtual private network you can get on just fine). You can however, log onto just about every other site and that means access to information about pricing. On my second trip a woman was trying her hardest to sell me a fake Rolex. I told her I wasn't interested. At one point she asked me a very surprising question. She asked me why we Westerners were so enamored of this brand. She had no idea what she was selling. I pointed to a colleague who was wearing a real Rolex. I had already gotten her down to around 10 yuan or about \$1.50 for one that one of my friends wanted to buy. Her cost was probably around 50 or 75 cents. I told her that the real Rolex that my colleague was wearing—it was a Presidents model—sold for about 160,000 yuan in the United States. Her jaw dropped. That was more money than she would see in her lifetime. She understood. And, now the majority of Chinese market vendors do, as well. Today it is much harder to get a great deal because so many people are online checking out prices for the real things—they are more informed, more educated, and make better margins! Good deals? They're still a dime a dozen. If you are looking for goods and services, China is cheap. If you want a great meal or hotel room, you'll pay U.S. prices.

In Beijing the place to score great bargains, with lots of selection, is a place called the Pearl Market. Yes, they sell pearls, lots of

them. A gorgeous 10-millimeter strand will set you back between \$30 and \$70. But, they sell more than pearls in China, much more. I buy all of my eyeglasses there. For around \$40 I can get a pair of rimless glasses, scratch resistant, with reflective coating . . . ready in less than one hour. In the United States it would be \$300 and two weeks. You can buy anything in the Pearl Market—glasses, purses, electronics, T-shirts, designer clothing, jewelry—and you have five stories' worth of shops to choose from. The higher you go, the better the quality. After one visit, you will have a very difficult time ever shopping at home, especially for precious and semiprecious stones. One necklace that a friend bought cost \$20. I saw the identical one at a gallery in the United States for \$400—identical! It's worth going to China just for the shopping—it will pay for the entire trip and more. It's also why there is absolutely no hope for any Western country to compete when it comes to manufacturing. Quality is an issue, but if you pay more you can get that in China as well, and it will still cost a third or less than in any western country. It's about sweat—in China it's cheap . . . for now.

There are a lot of places to shop in Beijing, street stalls and so on, but, I found the Pearl Market (16 Hongqiao Lu, Beijing, China, 010-6711-7429) to have pretty much everything in one place and it's quite safe and a lot of fun. It's also air-conditioned for those hot summer days. It's only about a \$3 cab ride from most places in the city center—just remember to take your hotel information in Chinese for the ride back!

The Great Wall

Without a doubt this is one of the wonders of the world—and the longest to boot. Beijing is a perfect staging point for visiting sections of the Wall. The section at Badaling is probably the closest and one of the best preserved. Be aware, the Wall is not for sissies. You will never get your mind around the amount of work, resources, and loss of life that it probably took to build the Great Wall. It snakes—over hills and mountains and its remnants can be found over a 3,000-mile stretch—imagine a massive wall from New York to Los Angeles!

The best time to visit is in the spring when the wildflowers are blooming on the hillsides, and when it's cooler. Beijing is oppressively hot in the summer and tourists begin flocking to the Wall in droves starting in mid-May. The winter is also a great time to see the Wall, but be forewarned, Beijing is cold in the winter and snow is not uncommon.

The Wall was constructed to keep invaders out of China and probably as a huge exercise in ego building. The steps of the Wall are not even. Let me explain. The risers can range from 2 to 14 inches and do so in very random order. It will cause a lot of lactic acid buildup in the thighs just to scale a small portion. If it's wet, it'll be slippery and very hard to climb. If you're going to climb the Wall, do it only if you are physically fit. You will likely run out of breath after a few hundred steps. The Wall at Badaling is about an hour and a half from the Forbidden City, and there is little on the way or out there except for a few souvenir stands. Be sure to eat well before your trip!

The Wall and the Forbidden City are two must-sees when you go to China . . . there are few such spectacular man-made structures in the world.

Badaling Great Wall/Great Wall of Badaling Section

Admission fee: CNY 45 (4/1 to 10/31); CNY 40 (11/1 to 3/31)

Cable car: CNY 40 (one way); CNY 60 (roundtrip)

Hours: 06:40 to 18:30

Entrance fee: RMB40 (11/1 to 3/31); RMB 45 (4/1 to 10/31)

Time needed to visit: One and a half hours

The Forbidden City

Admission fee: RMB40 in the off season (11/1 to 3/31), RMB60 in the peak season (4/1 to 10/31).

Hours: Oct.16 to April 31: 8:30 to 16:30. Latest time for ticket purchase: 15:30 April 16 to Oct.15: 8:30 to 17:00. Latest time for ticket purchase: 16:00.

Note: The prime area for sightseeing is the center area of the Imperial Palace, however, if time permits, you could also have a walk and visit the west areas.

The Real Pearl of the Orient

At the Long Bar in Shanghai's Waldorf Astoria you can kick back and enjoy a great cigar and possibly the best burger in town. In China everything has history. In Shanghai, that history has always been intertwined with trade, legal and illegal. Shanghai sits on the eastern coast of China at the mouth of the Yangtze River. A port city, Shanghai was the hub for Chinese commerce with the outside world. The city experienced a decline in fortune during communist rule, but after the reforms enacted by Deng Xiaoping in 1990, there's been no looking back. If you get a chance to experience the Long Bar, try to get a table close to the window. It is the power table. Back in the day, when the ships rolled into the harbor, Shanghai's merchant elite would gather at the bar (aptly named for the large single piece of mahogany) to count their floating profits. The richest merchants would sit closest to the windows and the less polished, further inside. It was at the Long Bar that I was able to garner most of my insights into what is happening in China today. More on that in a moment.

The city is a world-class metropolis with massive, efficient infrastructure, two huge airports, a major rail hub for high-speed rail, and it also boasts the fastest train in the world. It's a Maglev train, capable of reaching speeds of 500 kilometers per hour—over 300 miles per hour. The train is a bit of an anomaly since it only runs on a short dedicated rail to the Shanghai Pudong International Airport . . . but in order to ride it, you need to take a ride outside the city center—it's a novelty more than anything else. It's worth a ride, but as I noticed when I flew on the Concorde, the full impact of how fast you are actually traveling comes from a screen telling you how fast, not some bodily experience!

Shanghai is the financial capital of mainland China. It is also where you will find the money, big money. Mansions and apartments costing more than \$10 million are not uncommon. That money has to come from somewhere and in Shanghai, more than any other Chinese city, the money is old and very well preserved.

Leaps and Bounds

On my visit to Shanghai in 2006, I met with executives at several Chinese companies. Their presentation skills were impressive, and

I decided that I would take some time and “paper trade” their shares. The results weren’t that good. Only one out of the four companies that I met with made significant gains, the others languished. The universal pitch from all of the companies at the time was “we can’t lose, there are 1.3 billion people here.” Well, it’s just not that easy. If it were, then India and China would be the dominant global economies. The China population plays just don’t cut it. For one thing, the vast majority of Chinese are poor, very poor by Western standards. Their lot in life has gotten better, but the incessant inflation in China has eaten away at much of the gains for the poor. They still toil away on small farms or big factories, making little money and certainly not shopping at Shanghai Tang. For all the money that seemingly flows into China, the margins are very low—it’s about volume. And to stay competitive with up-and-coming neighbors like Vietnam, China has to keep prices low in the face of increasing costs for raw materials. It does this by exploiting its single largest asset: the workers.

In 2006 there was no talk or mention of labor unrest or social strife. Fast-forward to today and there are mini riots in some cities by workers complaining about both conditions and pay. There are no discounts if you’re poor. Some countries, like India, operate a two-tiered pricing system, one price for the locals and one for foreigners. Subsidies are the order of the day. Not as much in China. The price for a gallon of gasoline is the same as in the United States, maybe a little higher. Yet, it costs less than 30 percent of what it would cost to take a taxi the same distance as in New York; the difference is the cost of labor. There is no discount for locals to enter the Forbidden City or the Great Wall or even if they want to buy a bottle of water while viewing the Terra Cotta Warriors in Xian. Now, on my most recent trip in 2011, I found prices to be higher than before, much higher. I am not rich, but I am not poor, either. And if I noticed such things, then there is no doubt that the locals are being pushed to the edge. There is a two-tiered system for wealth, however, in China. Either you have it or you don’t. And, in Shanghai, if you have it, you flaunt it, much to the chagrin of the party officials in Beijing.

In Beijing, Volkswagens and Audis were the norm. In Shanghai, it’s Mercedes Benz, Porsche, Range Rover, and Rolls Royce that rule the roads. Even a Ferrari or two makes an appearance every

once in awhile. In Beijing, it's who you know . . . in Shanghai it's who you are. Some of my contacts that are well connected to the party intimated to me that the government is beginning to realize that the gap between rich and poor is not good for its image. China may be embarking on a capitalist agenda in public, but in private it is still the People's Republic and Communism is not quite dead. It cannot die just yet, not with the possibility of 1 billion angry workers who are seeing unimaginable wealth created, yet not participating in the fruits of what they consider their labor. The party is now sending out not-so-subtle messages to the wealthy to tone down their ostentatious public behavior and their over-the-top displays of wealth. It's just not good for business. China is not a meritocracy; it's a work in progress.

Party Time

The Shanghai elite knows how to party. My host on my 2011 visit was a high-level non-Chinese government official. I stayed at his residence and met with some great people in his business, government, and social network. For the sake of privacy I am not going to reveal any names—again, this is China that I'm talking about, and the last thing I want to do is to cause negative repercussions for individuals who provide me with great information and insight. And, in reality, revealing their names would not enhance the quality of the information I am providing to you.

Just before coming to the Long Bar on a rainy Friday evening, we had some drinks and appetizers at the new Portman Ritz-Carlton. It wasn't cheap. A few drinks and appetizers at the Flair Bar, located on the 58th floor, set me back over \$400, making New York's Peninsula Hotel look like a bargain. I should have known when I walked into the private elevator, which was itself unique. Its walls were made from the bottoms of black wine bottles, which made it appear you were entering a cellar. The views from the balcony of the Flair Bar are some of the best in Shanghai—you can almost touch the Oriental Pearl Tower, the most recognizable of Shanghai's skyscrapers with its bulbous onion-shaped dome near the top.

Seated in a circle around the power table at the Long Bar, we began our evening's banter. My goal was to pin down some of the

people and ask them questions that I knew would make them feel uncomfortable. But, I wanted real answers and not official fluff. I figured the time would be right after the third round of drinks.

The group consisted of three officials from foreign consulates, a real estate investor, the CEO of a public technology company, and a movie star. It made for interesting nonbusiness conversation, as well.

I had some issues I needed to clear up. The first was the perception that I had about China's overheated real estate market. The second was about the lack of trust and faith I have in the transparency of Chinese companies, especially those that are traded publicly. No pun intended, but there are red flags everywhere when analyzing Chinese companies. Source information is hard to come by. Auditors can be bought and sold. Accounting measures mean nothing, as the veracity of input information is suspect. And, documented corruption and graft by the Chinese government itself makes one pause.

In a web posting on the People's Bank of China site in June 2011—at the time of my visit—the Central Bank revealed that over the past 15 years, corrupt Chinese officials and employees of state-owned companies had absconded with more than \$123 billion in cash, much of it finding its way to Europe, North America, Hong Kong, and Macau, sometimes simply stuffed in suitcases. And this is just the incidents that are documented. The posting was not on the site for very long, and the bank was quick to note that it had been posted by mistake. Just a few weeks later, Moody's Investment Service came out with a scathing report about accounting and informational inadequacy at 61 companies it analyzed, causing a one-day downdraft on the Hong Kong stock exchange. What worries me is not what we know exists, but how much we don't know—and that is almost always a heck of a lot worse.

Real Estate in China

Chinese real estate can be expensive, very expensive. One might think that there are few people who can afford to pay upward of \$1,000 per square foot for real estate in what was not much more than a third-world country just two decades ago. One would be mistaken. In some places in Shanghai, Beijing, and other major cities

in China, \$1,000 per square foot would be a bargain. Paying \$1 million in cash for an apartment in Shanghai is not a rarity. There are 125,000 millionaires in Shanghai alone!

Commercial real estate is even pricier. It seems unfathomable considering the number of skyscrapers that make up the skyline of Shanghai and Pudong, just across the river. But, let me tell you, the Shanghai skyline is as impressive as that of Manhattan in beauty and in scope. That said, I often wondered if there was really anyone in those buildings. I put the question to my real estate expert. He has major landholdings in Shanghai, both commercial and residential, and even a golf course operation. His answers surprised me. On commercial real estate his answers made sense. There is less of a bubble than many think. The reasoning behind it goes back to the attitudes of the Chinese vis-à-vis their western counterparts. For the longest time the Chinese have plied their trade with a lack of concern about where they were plying from. Dingy buildings in trash-strewn neighborhoods were the norm for corporate headquarters. When meeting with westerners they would do it off property or at a hotel. Things have changed. A result of pride and more money has made the Chinese rethink their digs. Now, companies locate themselves and their top-level employees in grade A office space across the hall from their Western counterparts. This, in addition to the thousands of non-Chinese companies and non-Chinese government entities that must make Shanghai their China headquarters, accounts for much of the demand and consumption of the office space inventory. Judging by the massive increases in activity in and around Shanghai and China in general that I have witnessed over the almost two decades I have been traveling to the country, I am inclined to give my real estate friend the benefit of the doubt regarding his explanation.

On residential property he had a different take. His belief is that property prices and inventory are both too high, especially in Shanghai and its environs. And, he is liquidating some of his holdings for the first time in more than 30 years as a real estate investor and owner. Part of it is because of the bubble caused by new money trying to find a home. Until recent laws were enacted to cool the market, such as a 50 percent down payment, limitations on the number of properties one can own, and proscribed legal occupancy periods before one can sell, it was not unusual for investors

to put in bids for multiple properties. They did this with an amazing lack of risk because in many cases they needed nothing more than an indication of interest that they wanted to buy a property—no money for a deposit. They would then decide if they wanted to consummate the deal. They always did, which is why the system worked. But that is also because property prices continued to move higher by the month. Talk about good faith! If Chinese property values crash—and they have already slowed down—this good faith method of speculation will be entirely to blame.

We've Got Bad Accounting? You've Got WorldCom!

My discussions with the CEO of the public company were not as polite. Apparently neither one of us had drunk enough and the discussion was quite serious. I brought up my experiences with Chinese companies, the frequent use of public shell companies on the NASDAQ and Pink Sheets, accounting issues, corruption, and a general lack of transparency. He brought up WorldCom, Enron, Global Crossing, Bre-X, and Arthur Andersen.

Granted, we have had our share of fraud in the West. Definitely to a much bigger extent when measured in dollars. But, for the most part, we are comfortable with the transparency in U.S. companies and the accounting and auditing systems we have in place. The same cannot be said for Chinese companies. If it could be said for them, then the Chinese market would be the best-performing market in the world, not amongst the worst. Reality bites!

We talked about the accounting principles and he agreed that GAAP accounting was going to have to be observed by Chinese companies in toto at some point. His advice for investing in Chinese companies was actually quite simple. Invest in companies that are listed in Hong Kong (we're not talking about the big red chip companies) because they do have to meet strict requirements as compared to a lot of the crap that ends up listing on U.S. exchanges. His reasoning was that it was actually easier for the junk companies to list on U.S. exchanges because they would be too closely scrutinized in Hong Kong. In the United States the investment banks can get away with using a lot of boiler plate risk factors to cover their asses and then collect the fees that these suspect

companies are more than happy to pay. If you want to invest in Chinese companies, invest in the ones that are owned by the State—they always make money!

More than 10,000 corrupt Chinese officials collectively took \$120 billion out of the country in a 15-year spree of embezzlement, bribes, and defections, with some of the money ending up in Australia.

The revelations, laid bare in a report by the People's Bank of China that was never intended to be released to the public, shine an embarrassing spotlight on Chinese corruption, a problem seen by some as an Achilles' heel for the world's second-largest economy.

The report appears to have been mistakenly uploaded to an official website after winning a prize for the quality of its research.

Official corruption remains a source of disgust and frustration for the Chinese population at large.

The pervasiveness of money laundering outlined in the report offers a damning indictment of the government's wars on corruption in the run-up to the Communist Party's 90th anniversary on July 1.

A handful of prominent cases, including one that involved the Ministry of Railways, have rattled China since the beginning of the year, but just as destabilizing is the constant, low-level corruption that blights the lives of ordinary Chinese.

This week, at least eight new websites came online to offer increasingly infuriated Chinese the chance to vent their anger—on issues from gifts to doctors to encourage them to perform operations correctly to the rigging of trials.

The same angry online communities, riled by the palpably widening gulf between rich and poor, pushed last month for the death penalty to be given to Xu Maiyong, the former vice-mayor of Hangzhou, who was convicted of taking more than \$30 million in bribes and embezzlement.

The research, whose revelations of corruption are breathtaking even by Chinese standards, estimates that between 16,000 and 18,000 officials may have fled the country with monumental hoards of ill-gotten money between the mid-1990s and 2008.

In one paragraph, the report, which had the words "internal data, store carefully" on the front page, cautioned that unchecked corruption was putting Communist rule at risk. "It is a direct threat to

(Continued)

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the clean political structure of the Communist Party and harms the foundations of its power," it said.

Large amounts of the money, along with the officials who amassed it, headed for Australia or the United States.

Hong Kong was highlighted as a favorite springboard from which more senior officials could first leave mainland China and then flee to Commonwealth countries.

The defectors, according to the report, exploited both Hong Kong's status as an international aviation hub and the historic privilege of allowing residents to apply for visas on arrival in Commonwealth countries.

Less ambitious escapees, usually lower ranking malfeasants, made for Southeast Asian countries such as Burma and Thailand, while the more senior bribe-takers would head for tax havens in the Cayman Islands and Bermuda.

The most elite officials, said the report, would aim for Western countries such as Canada and the Netherlands, possibly moving through a small African or Eastern European country while documents were forged and time elapsed after their escape.

Some, revealed the People's Bank of China's 67-page report, smuggled money to the former Portuguese colony of Macau where it emerged, laundered through an accommodating casino, ready to fund a defector's life of opulence in Russia or Mongolia. The trail of officials bearing bags of banknotes and crossing from Shenzhen was described in the report as being "like ants moving houses."

The report, which was compiled by the central bank's money-laundering analysts and called "The Routes That Our Country's Corrupt Officials Transfer Assets Abroad," described eight main conduits for moving money out of China.

Methods ranged from the high-risk option of a suitcase full of cash and a dash to the border to convoluted networks of foreign intermediaries.

Senior managers from listed companies or state-owned enterprises, it said, would disguise the illegal transfers beneath legitimate remittances, cloaking the process with forged contracts and other documents that were destroyed.

The three-year-old document appears to have made it, fleetingly, into the public domain this week because the research was deemed so good.

The report won first place in the China Society for Finance and Banking's annual awards for financial research and, despite the warnings that it was for internal central bank consumption only, was put online as the winner of the prize.

It was removed from the People's Bank website moments after domestic media spotted it and began publishing its findings.

Leo Lewis, *The Australian*, June 17, 2011, www.theaustralian.com.au/news/world/accidentally-released-report-reveals-embarrassing-extent-of-chinese-corruption/story-e6frg6so-1226076938605.

Places

The Ritz Carlton Shanghai, 1376, Nanjing Xi Lu, Shanghai 200040 China, Phone: (86 21) 6279 8888 Fax: (86 21) 6279 8800. The Long Bar, The Waldorf Astoria, Shanghai www.waldorfastoriashanghai.com/english/maps_directions

Nightclubs of Note

Prive

Housed above the Dolce and Gabbana Bar on the Bund
6号 Zhongshan East 1st Road, Huangpu, Shanghai, China
(86 21) 3331 7585

The M1nt

www.m1ntglobal.com/club-shanghai

Investing in China

China is less of an emerging market than many others. Many argue whether it should even be categorized in the same company as countries like Cambodia, Thailand, or Chile. I would agree. Instead, it's probably better to categorize emerging markets as tiers. I like to use a three-tiered system for emerging markets.

Tier 1 countries are those that cannot turn back the clock and become real emerging markets. This means that they have the

financial wherewithal to defend their markets and populations against a major shock, the kind that Mexico has faced numerous times in the past half century. They can, in effect bail themselves out because they are not so indebted that their economies would fail without the intervention of outside countries.

Tier 2 countries are those that have made the jump from subsistence economies to functioning economies based on trade and commerce. They are not reliant on aid from the outside world just to keep afloat. Aid for commercial enterprise is different. These countries are still subject to shocks that will damage their markets, their economies, and possibly their social frameworks, as well. A good example is a country like Vietnam.

Tier 3 countries are basically the youngest emerging markets. These are markets with no real way of participating in global commerce without massive amounts of foreign aid. They have no real markets to speak of in terms of a stock exchange, and wealth creation is still in its infancy. These countries can tip back into the abyss of economic oblivion at the drop of a hat . . . and often do. Examples of countries that would fit into this tier would be Uganda or New Guinea or Nicaragua.

The Top of the First Tier

China is at the top of the ladder of first tier emerging markets. The only reason that it does not make it out of emerging markets status, despite its massive wealth, is that China is not a transparent economy and is still a country that is ruled by a single party without democratic aspirations. It also has a bad habit of cracking down violently on dissent and does not respect freedom of information.

China does offer several attractive reasons for investors to consider it, however. It is the world's fastest growing major economy. That presents opportunities. It does have functioning stock markets in Shanghai and Hong Kong. It needs to continue to grow in order to provide opportunity for its massive population, which is making a transition from third world to first world. This transition and the potential for social upset if it fails, is the driving force behind China's relentless growth policy.

The best way to present China is to use a SWOT analysis, followed by specific recommendations. SWOT refers to strengths,

weaknesses, opportunities, and threats. The recommendations that I will make will not be in specific companies. In my experience it is very hard for investors to make money in emerging markets with recommendations that are more than a few weeks or months old. These markets are by nature dynamic and most, if not all, companies lack transparency or track records that would make me comfortable in recommending them. Instead, emerging markets must be treated as trading vehicles until they finally leave the emerging designation behind and emerge. Singapore is a good example of such a country.

Strengths

Money. China sits on over \$3 trillion of reserves. It has more cash on hand than the annual GDP of most of the countries in the world combined. It boasts a large population base of fairly well-educated workers. China has over 300 million people that make up its middle class. These are educated individuals who are hard-working and ambitious. They are the backbone of China's emergence from an export driven economy to one that will be self-sustaining.

A one-party system. This allows China to forge ahead with infrastructure development without regard to dissent. For a country the size of China to grow as fast as it can and raise the living standards of all of its people in a span of just 20 years, the one-party system was and is invaluable.

History of capitalism and success. There have been few major empires since the Romans. China, Russia, India, Great Britain, France, Spain, Austria/Germany, and the United States are the major ones. China was at one time the wealthiest country on the face of the earth. It has history. It all came to a crashing halt in the latter part of the nineteenth and twentieth centuries, but the history is not lost on the Chinese. They have a chip on their collective shoulders and to them it's not a matter of "if" but "when" they once again regain their place of prosperity.

Markets. China has a well-oiled mechanism of public markets for commerce to take place. While Shanghai is the place that China wants as its global financial capital, in truth, Hong Kong is the more respected market from the point of view of the rest of the world. It's rare, indeed, for a country to have two major

financial centers and rarer still to have one country with two separate currencies, as well. Hong Kong has a reputation as a respected exchange; Shanghai does not. This is the result of the stronger regulations and established practices left behind by the British. Hong Kong still maintains a type of independence in certain matters from the mainland that allows it to be more part of the global brotherhood of markets. But make no mistake. While China agreed to allow Hong Kong to operate in an independent fashion for at least 50 years after the handover from the British, it is still Beijing that calls the shots. Under a “one country, two systems” environment, Hong Kong is allowed to maintain a capitalist system . . . as long as it does not create waves. The population of Hong Kong is quite fiercely independent and demonstrations are not unusual. However, I am certain that any serious affront to the powers in Beijing would be dealt with quickly and painfully.

The Hong Kong stock exchange is an outlet for Chinese companies that want to list on a more respectable exchange. It is also an exchange where foreigners can readily and easily trade shares of both mainland companies and Hong Kong-based companies.

Clout. As one of the world’s biggest consumers of resources—and on its way to becoming the single largest—China commands a lot of attention from producers. It imports massive amounts of raw materials daily to fuel its growth, and that gives the country a huge voice in the global community and the power to affect global pricing of commodities. In the past decade China has also embarked on a buying and investing binge, making major investments in raw material-producing nations, especially in cash-starved regions of the world like Africa and, closer to home, Mongolia.

Weaknesses

China is a political and social time bomb. As it gets richer and as its population becomes more educated, it risks more civil disobedience. For now, the government has been able to crack down on dissidence through the use of technology to restrict access to information that could be damaging to its reputation internally. For the most part the Han Chinese, the majority, are happy with the wealth creation and social mobility the country has experienced for two decades. However, the incidences of revolt against government

restrictions on freedom of speech are rising. The main reason for this is the perception amongst the population that the government is corrupt, especially at local levels. Wealth is being distributed unevenly and, while in a meritocracy like the United States that has not been much of an issue, in a place like China where class warfare has not been the norm, it is fast becoming an issue.

Ethnic strife is also an issue. China's population is diverse. The country is huge and in the outer provinces ethnic minorities are pressing for freedoms of religion and self-governance. Incidents of terrorism, rioting, and general public disturbances are growing, as these provinces have not bought into the homogeneity that Beijing is selling. And, because the majority of the wealth and commerce is being conducted by and between the ethnic Han Chinese majority, not everyone is seeing their fortunes rise. In fact, the Han are now moving westward into the less "Chinese" provinces and trying to homogenize them. Tibet is a good example. It is swarming with Han Chinese now that China has pushed for a policy to bring Tibet into China. Ethnic groups like the Uighurs consider themselves completely separate and distinct from the Chinese in every respect—from religion to race. China has been cracking down on this so-called autonomous region located in the southwest part of the country. A lack of understanding and tolerance by the Chinese of the non-Han groups presents a major stumbling block for China's ascent to first-world status.

Opportunities

China has more opportunities for wealth creation than any other place on earth. Most of this is by virtue of the massive population that is now mobilized to move upward economically. Now, those opportunities are largely internal and there have been very few Western companies that have been either successful or allowed to take part in this growth. For the most part, the Western companies that have made money from China are those in the resource sector that have been selling everything to the Chinese from wheat to copper to fast food chains!

This means there are a lot of companies in China, companies that you can invest in that can make money from the growth that is yet to come. As individuals, the Chinese are well behind the

developed world in per capita income. According to the World Bank, China's per capita income is around \$7,500, which puts it behind Ecuador and about 94th on the list. Average per capita income worldwide is around \$10,000. The United States is seventh at about \$48,000. Interestingly, Hong Kong would be eighth if not tied to China, with around \$45,000 per capita. But, on a country-to-country rank, China has surpassed all countries except for the United States and is second on the list. For per capita GDP, China ranks 94th again at around \$4,500 compared to \$47,000 for the United States. Therein lies the opportunity. China has massive amounts of consumption per capita left to go. Unlike other countries that have stalled out, China is still growing its GDP at near double-digit rates, and it has the economic and monetary muscle to continue. This makes the consumer sector a massive profit opportunity as the people in China are only now beginning to discover the luxuries that the West has enjoyed for decades—not necessities, but luxuries, like dishwashers!

Threats

China faces more internal threats than external. As a communist country it has to balance a fine line between freedom and control. Social unrest is the single greatest threat that can pull China into chaos. It has no choice but to keep the pedal on the gas to keep growing and assimilating its massive rural population into an urban population. The vast majority of the people, as they get educated, will clamor for more and a more even distribution of wealth—China is not a democracy that was weaned on wealth based on work, but rather on wealth based on the common good.

Ethnic tensions could spill over and cause serious, violent confrontations, which could damage China's global image. As the world's factory and largest exporter, China cannot afford a boycott.

China faces interesting times trying to convince the world that Taiwan and Tibet want to be part of its hegemony willingly. Tensions continue to be high at times and, as recently as July 2011, China expressed massive displeasure at the United States president for meeting with the Dalai Lama, the spiritual leader of Tibetan Buddhists.

Growth

China must grow to succeed. This means massive inflationary pressures will continue as it sucks up raw materials. Per capita oil consumption by the Chinese is a fraction of that in the United States. Yet, the Chinese are driving more, electrifying more, and consuming more. This has resulted in an increased average price per barrel of oil for almost a decade, and that trend is not going to reverse until alternate fuels are used.

Pollution

Much of China's water supply is tainted. It is the world's biggest factory and most days in the major cities you are unable to see more than a few hundred yards. The haze seems almost permanent. China faces major health concerns that are the result of people living longer but ingesting more pollutants. Chinese companies are routinely found to use harmful chemicals in the production of everything from consumer goods to baby formula.

Possibly the greatest threat China faces is itself. As a major force in the world and in the region that it occupies, China can have a massive impact on global events. The country's stature is growing daily, but it has yet to declare its intentions. At times, the country looks to be a strong part of the international community such as when it hosts the Olympics, for example. At other times it sides with known despotic nations like Iran or threatens military force against Taiwan. China is growing economically and politically, but it is not allowing itself to grow socially. The one-party system still dictates everything from shaping views on global warming to blocking e-mails of individuals it considers a threat. China is a wild card that has the power to become a first-world superpower economically, militarily, and socially, but it has to let go of its authoritarian bent first.

