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Country Spotlight: China and Hong Kong

CONTENTS

BACKGROUND

Hong Kong became a “Special Administrative Region of China” as part of a “one country, two systems” policy in 1997. For the moment, Hong Kong maintains its separate system, except when it comes to foreign affairs and defense. But there will be a slow convergence of Chinese and Hong Kong systems over the next 36 years, so it is important to look at these two markets both separately and simultaneously. This white paper looks at the background and mechanics of these two markets for US investors. There are clearly opportunities, but just as importantly, there are reasons for caution as these two markets become one.

China has always been appealing to investors given its vast population, its role in global outsourcing trends and its reputation for skilled, yet inexpensive, workers. Hong Kong has been remarkable with its large container ports and busy international cargo airports, among the largest and busiest in the world. For US investors, that appeal is underscored by the fact that America is now China’s biggest customer and China is America’s biggest supplier. In 2008, China also became the largest lender to the US, a position that Japan had previously held. China’s GDP has grown to more than $10 Trillion from $4.4 Trillion just since 2008. With China’s entry into the World Trade Organization (WTO) and their integration with capitalistic Hong Kong, the investor’s dream of fully tapping into the opportunities offered by China and Hong Kong is more real than ever. With a basic understanding of the stock markets where Chinese and Hong Kong securities trade, and extreme caution in interpreting financial statements, it is now possible to more fully participate in the China/Hong Kong growth engine.

SPEAKING POLITICS


New Hong Kong leader Leung eyes bigger state role in economy

By Enid Tsui in Hong Kong

Source 1 FT, April 19, 2012

While the “wedding of communist politics to capitalist economics”[1] began well before the 1997 transfer of Hong Kong by the British to China’s administration, the formal integration of China and Hong Kong is being closely watched for signs of success or failure. The theory that “Hong Kong would become part of China, but it would retain trappings of democracy,” may very well prove to be overly optimistic.[2]

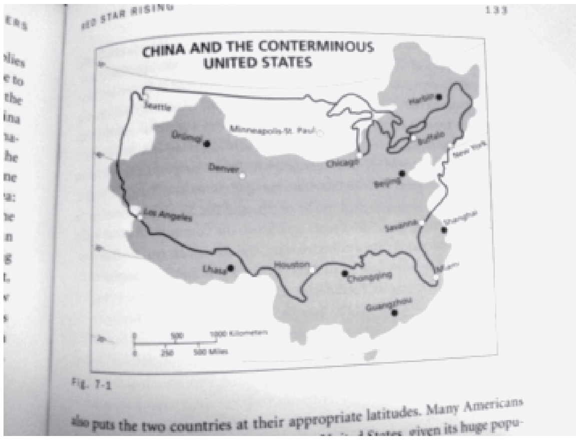
The Financial Times reported on Thursday, April 19, 2012:[3]

> *Hong Kong’s incoming chief executive says his government will play a bigger role in the economy, in a departure from the territory’s laissez faire tradition as he seeks to address risking public discord and worsening inequality.*

This new chief executive, Leung Chunying, won the competitive selection process in Hong Kong of the “election committee” comprised of 1200 members. While it might be troubling that the choice of the committee was effectively a directive from the mainland, the Chinese government did “promise” that the next election in 2017 would be “universal suffrage.”[4] Some comfort may also be found in the fact that Mr. Leung, despite his talk of more government involvement, is in fact British trained and an admirer of aspects of the Singapore system and London’s leadership position in world shipping. An understanding of Mr. Leung’s leanings cannot be overstated, particularly since Leung’s tenure will last quite some time - at least until 2017. Investors can also watch the change of both political and military leaders slated for later this year.

1 (Blij, 2005) p. 139.
2 (Blij, 2005) p. 143.
3 (Tsui, 2012) p. 1.
4 (The Economist, 2012)

GEOGRAPHY



Source 2 Blij, 2005

Harm de Blij, Distinguished Professor of Geography at Michigan State University, points out that, “Surveys indicate that American’s geographic knowledge of China remains dim, despite our deep involvement in the burgeoning of its economy.”[5] He shares with his readers a map of the US superimposed on China to scale and with latitudes:

> *Many Americans think that China is much larger than the United States, given its huge population. But in fact, including Alaska, the United States is slightly larger (3,717,796 against 3,696,521 square miles). In the east, though, China extends farther north even than the latitude of northern Maine, and farther south than Florida. China’s northeastern provinces have bitterly cold winters and short summers, and a sliver of Russian territory landlocks them from the Pacific Ocean. In the south, China is truly tropical: the island of Hainan lies in the general latitude of the Greater Antilles. Hong Kong and Guangzhou lie well south of Miami.*[6]

	Population (Millions)	Labor Force (Millions)	Labor Force as % of Population
China	1343	815	61%
India	1205	478	40%
US	314	154	49%
Hong Kong	7	4	57%

Source 3 CIA World Fact Book: Population as of 7/2012 and labor force data represents 2011 estimates.

While commonalities may exist when it comes to topography and climate, it is the trends in population where China, India and the US, the world’s three highest ranking countries in terms of population, diverge dramatically.

At first blush, it might seem that China has the advantage with the Chinese labor force less burdened with an aging population of only 9% over 65 years of age which compares favorably with 22% for Japan and 13% for Hong Kong and the US.[7] Unfortunately, this advantage is potentially impaired over the long term by China’s one child policy. The policy impact is very pronounced among the 0-14 year old population in which boys number 126 million and girls number closer to 100 million. As recently as 2010, the “birth” of boys exceeded that of girls by 18%. The estimated gender gap for 2030 is expected to be nearly 60 million persons. Furthermore, China’s “working-age” population is expected to increase by only 23 million in the next eight years, far less than India’s expected growth of 136 million persons.[8] All this is to say long term investors should be aware that these conditions may have unexpected and potentially adverse economic consequences over time.[9]

5 (Blij, 2005) p. 132.
6 (Blij, 2005) p. 133.
7 CIA World Fact Book, https://www.cia.gov/library/publications/the-world-factbook/rankorder/rankorderguide.html .
8 (The Economist, 2010)
9 (The Economist, 2011)

DEVELOPED OR EMERGING?

China and Hong Kong, “one country, two systems”, make for a fascinating and varied landscape for investors. Investment experts certainly see a difference between China and Hong Kong. Companies headquartered in China, often referred to as “The Mainland”, are considered as emerging market stocks while companies headquartered in Hong Kong are considered developed market stocks.

In the table below, we see how MSCI, one of the leading global index providers, classifies China and Hong Kong differently, as does S&P.

	Developing Markets	Emerging Markets
American	Canada, United States	Brazil, Chile, Colombia, Mexico, Peru
Europe & Middle Ease	Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Israel, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom	Czech Republic, Egypt, Hungary, Morocco, Poland, Russia, South Africa, Turkey
Pacific	Australia, **Hong Kong**, Japan, New Zealand, Singapore	**China**, India, Indonesia, Korea,Taiwan, Malaysia, Philippines, Thailand

Source: http://www.msci.com/products/indices/market_classification.html

Part of what signals this difference in categorization is the divide between Hong Kong and China in terms of GDP per capita and market cap as a percentage of GDP. For example, MSCI specifically looks at economic development, size and liquidity. While China might seem to out-size many developed countries in terms of total GDP, the value of their publicly traded markets is only 33% of their GDP, a relatively small share as compared to the US and Japan, a sign that their economy is not as liquid and open. In fact much of the $3.7 trillion in market cap is in the hands of the Chinese government. China’s growth is often highlighted in the media, but its 2011 GDP per capita of only $8400 ranks low at 120th in a global wealth ranking of 227 countries by the CIA’s The World Fact Book. Hong Kong, on the other hand, ranked 10th at $49,300 per capita ahead of the US ranked 12th at $48,100 per capita.

	Rank	GDP per Cap	GDP ($bill)	Market Cap ($bill)	Market Cap as of GDP
Singapore	5	$59,900	$314	$441	140%
Hong Kong	10	$49,300	$350	$911	260%
US	12	$48,100	$15,040	$16,099	107%
Germany	29	$37,900	$3,085	$1,174	38%
Japan	37	$34,300	$4,389	$3,398	77%
China	120	$8,400	$11,290	$3,763	33%
India	163	$3,700	$4,463	$1,061	24%

Source 4 GDP and rank data are CIA 2011 estimates, Market Cap data estimated by SGA based on Factset May 2012 data. .
https://www.cia.gov/library/publications/the-world-factbook/rankorder/rankorderguide.html

7 CIA World Fact Book, https://www.cia.gov/library/publications/the-world-factbook/rankorder/rankorderguide.html .
8 (The Economist, 2010)
9 (The Economist, 2011)

The economies of Hong Kong and China have always been closely linked by Hong Kong's role as a re-exporter of Chinese products. Furthermore, almost half of Hong Kong's exports go to China and 95% of Hong Kong's population is Chinese and speaks mainly Cantonese. Still, from an investor's point of view, these two countries are very different. Despite the fact that banking dominates their public companies, it is the industry sector and agriculture sector that are the majority of China's economy. For Hong Kong, it is the service sector that represents more than 75% its economy, similar to the US. In fact, Hong Kong has no agriculture industry at all. The 38% of China's labor force engaged in agriculture generates just 10% of the country's already low GDP relative to population size, partly explaining the poor economic conditions of the vast majority of the mainland population.

Differences in education further highlight the contrast between China and Hong Kong's profiles. While China reports an impressive 90%+ literacy rate, the average years to completion of school is only 11 years (11 for men, 10 for women), while Hong Kong is 15 years (15 for men, 16 for women). Hong Kong is closer to advanced economies such as the US where years of education average 16 years (15 for men, 17 for women). Looking ahead, as investors must do, it is important to see that China and Hong Kong are positioned very differently for the future.[10]

HISTORY OF THE EXCHANGES

Despite China's large size, the fact that Chinese stock markets are pretty much closed to foreign investors is also problematic. The only Chinese companies that investors can generally access are those that list their stocks on the Hong Kong and US exchanges.

The first exchanges on mainland China and Hong Kong were launched in 1891. The exchange on mainland China closed in 1941 during the Japanese occupation. For a short time, it began operations again after World War II but then faced closure again with the Cultural Revolution. It was not until 1990 that the Shanghai Stock Exchange (SSE, www.sse.com.cn) and the Shenzhen Exchange (SZSE, www.szse.cn) emerged as the mainland's two main exchanges. Meanwhile the Hong Kong Exchange (HKEx) survived from its 1891 start and spawned other Hong Kong exchanges. All of Hong Kong's exchanges eventually unified in 1980 and are now known as the Hong Kong Stock Exchange (HKEx).

Since the SSE and SZSE markets were off limits to US and other foreign investors, Chinese companies began making their stocks available on the Hong Kong Exchange (HKE) in 1993. Foreign investors have been welcome on the HKE for decades.

More recently, China has raised the foreign institution investment limit for mainland stock markets, but only to $80 billion from $30 billion which still provides little room to maneuver for most investors and fund managers.

[10] (CIA, 2011)

CURRENCY

Renminbi has reached fair value, hints China

Officials point to February trade deficit

By Jamil Anderlini in Beijing

Chinese central bank officials have suggested the renminbi is no longer significantly undervalued after six years of gradual appreciation, citing the country's big February trade deficit.

According to recent government figures, last month China

the Republican presidential nomination has said he would make that designation on his "first day in office".

The currency issue is likely to remain a potent one as the US moves towards elections.

"While China has allowed the RMB to rise minimally, we are still far from equilibrium," Sherrod Brown, a Democratic

Investors should be aware that Hong Kong and China operate on separate currencies, the Hong Kong Dollar (HKD) and the Chinese Yuan (CYN) or Renminbi (RMB). Both currencies maintain strong links to the US Dollar, explicitly in the case of Hong Kong and on-again-off again in the case of China. In July 2005, a decade old peg of the Renminbi to the dollar was removed, but was still limited by a .5% band around its daily rate against the dollar. This was enough room to allow the currency to appreciate 30% since then. In early April 2012, the Renminbi float band was widened a bit further to float up or down 1% from the "daily official rate against the US dollar." Pressure from China's trade partners, including the US, have been putting pressure on China to allow its currency to float freely so that it may appreciate to market levels. The appreciation of the Renminbi, even with this most recent loosening, seems to have leveled off, however, and even begun to show signs of weakening.[11] Analysts are watching China's trade deficits as a sign that some sort of equilibrium has been reached.

The RMB is being slowly introduced to Hong Kong residents as Hong Kong and China move forward in an increasingly close relationship with each other. In July 2010, the Hong Kong Monetary Authority extended the right to do business in RMB from individuals to companies and the RMB now accounts for 4.6% of deposits in Hong Kong.[12] China's leadership is widely viewed as targeting world reserve currency status for the RMB. However, investors should understand that reserve currency status is not easily achieved. The Japanese yen, for instance, represents less than 4% of "official global foreign exchange reserves," yet Japan's economy is about the same size as China's.[13]

While equity trading may be primarily in Hong Kong dollars (on HKEx) or US Dollars (ADR's and N shares), currency exposure for investors depends on the currency of the underlying stock and company. If a Chinese company trades on the Hong Kong exchange (HKEx) in Hong Kong dollars, investors should still be aware of potential exposure to the Yuan or RMB defined by the exchange rate between the Hong Kong dollar and the Yuan or RMB. Similarly, an investor who owns a stock that trades in US dollars, is still exposed to the Hong Kong Dollar as translated by the HKD/USD exchange rate. Furthermore, an investor who owns a Chinese company that trades in ADR's is not only exposed to the Yuan/USD relationship, but may also be exposed to the Yuan/Hong Kong dollar relationship depending on the currency of underlying security and company.

MARKET MECHANICS

As the primary market foreign investors can access, the Hong Kong Stock Exchange (HKEx) is important to understand. HKEx is the fifth largest exchange in the world and the third largest Asian stock exchange behind Tokyo and Shanghai. Hong Kong

11 (Anderlini, 2012)
12 (Anderlini, 2012)
13 (Cookson, 2012)

enterprises do not list on the Chinese exchanges. On the other hand, as noted earlier, many Chinese enterprises do list on the HKEx with shares referred to as H shares and traded in HKD. The Hong Kong exchange is the gateway to invest in nearly 1500 China and Hong Kong based companies approaching $3 trillion in value. This may sound like a vast number of companies to choose from but, in reality, most of that value lies in only about 200 stocks.

Similar to the New York Stock exchange, trading on the Hong Stock exchange is both on the floor and off the floor with execution generally based on continuous auction where best bids/offers are shown. Despite its sophistication, the Hong Kong Exchange does not have a closing auction, but rather "declares" the closing price based on the median of five snap shots of prices occurring at 15 second intervals between 3:59 and 4:00, the last minute of trading. All stocks on the Hong Kong exchange trade in Hong Kong dollars without taxes on dividends or capital gains tax.

Hong Kong has been a lucrative platform for IPO's. For example, Prada's IPO in Europe launched at around a 10x earnings multiple while in Hong Kong it was closer to a 40x multiple. In 2011, Hong Kong was the most popular exchange for IPO's for the 3rd year in a row in terms of market capitalization, only to be exceeded if we combine the two mainland exchanges.[14] While this is good news for the companies that offer their stock, investors need to be aware that they may be paying a premium in some instances.

TRADING CHINESE AND HONG KONG COMPANIES IN THE US

More than 600 Chinese and Hong Kong companies are available in the form of ADR's or N shares in the US. More than $700 billion, or 90% of the market capitalization of Hong Kong, is available as ADRs. More than $1.9 trillion, or nearly two thirds of the market capitalization of Chinese companies, are available as ADRs. Therefore, US markets offer excellent accessibility to China and Hong Kong.

ADRs are effectively US securities that trade in US dollars and represent an underlying "parent" security that is also traded either in Hong Kong or in China. A cautionary note, there are some instances in which investors may see a Chinese or Hong Kong stock that trades in the US, but does not actually have an underlying security that trades on either the Hong Kong or Chinese stock exchanges. This may mean that the company's management decided to bypass the Hong Kong and Chinese exchanges with an IPO in the US, either as an ADR or N share (see definitions above). Regardless of where the stock was initially issued, investors should review the financials carefully and be aware that currency exposure is tied to the underlying company, the currency in which it does business, and the currency in which its parent security trades (if there is a parent security). Even though ADR's and N shares trade in US dollars, the markets continuously adjust their prices to reflect effectively all the risks of the underlying parent company, including currency.

[14] (The Economist, 2011) p. 73

TYPES OF SHARES

Listed below are the variety of stocks related to China and Hong Kong. On the mainland exchanges (SSE and SZSE) there are two types of shares a Chinese company can issue: A shares which trade in China in RMB and B shares which trade in China but in HKD. In many cases, a company will choose to list only on the Hong Kong exchange where Chinese headquartered stocks are referred to as H shares. In fact, out of 447 H shares representing more than $1.3 trillion dollars in market capitalization, only 18 represent companies that also list as A shares on the mainland. While 18 is a small number, they do represent more than $400 billion in market cap. A comprehensive listing of the various types of securities is below, followed by a table summarizing the depth, breadth and trading characteristics of the securities.

Definitions:

A Shares - Common stock of China headquartered companies traded on SSE or Shenzhen in RMB.

B Shares - Common stock of China headquartered companies traded on SSE or Shenzhen in Hong Kong dollars.

H Shares - Common stock of China Headquartered companies traded on Hong Kong Exchange (HKE) in Hong Kong dollars. Generally, this represents the parent security even though there may be a related security traded on the SSE or SZSE exchange.

N Shares - China headquartered companies traded on US exchanges in US dollars generally representing the parent security. Generally related securities are not found elsewhere.

Hong Kong Ord - Common stock of Hong Kong headquartered companies that trade on the Hong Kong Exchange in Hong Kong dollars .

Chinese ADR - US traded securities where the underlying parent security is generally Chinese H shares. In some cases, there is not an underlying security, the ADR is the parent security.

Hong Kong ADR - US traded securities where the underlying parent security is generally a Hong Kong ordinary stock. In some cases, there is not an underlying security, the ADR is the parent security.

Share Class	Company Headquarters	Exchange	Underlying Security	Currency	Chinese Holidays Apply?	Trade Settlement	Round Lot	Number of Securities	Market Value of Securities ($bill)
A	China	SSE, SZSE	No, with few exceptions	RMB	Yes	T+1	100	2,344	$2,875
B	China	SSE, SZSE	No	HKD	Yes	T+3	100	52	$26
H	China	HKE	Yes, but only 18 with mkt cap of $409 bill	HKD	No	T+2	1	447	$1,358
N	China	NYSE, NASDAQ	No	USD	No	T+3	1	174	$12
Hong Kong Ord	Hong Kong	HKE	No	HKD	No	T+2	5 to 100,000	996	$804
Chinese ADR	China	NYSE, NASDAQ, OTC	H Shares	USD	No	T+3	1	282	$1,981
Hong Kong ADR	Hong Kong	NASDAQ, OTC	Hong Kong Ord	USD	No	T+3	1	181	$730

Sources: Strategic Global Advisors, Factset

Q&A

Do A& B shares only trade in China?
Yes, A& B shares are only traded in Shanghai or ShenZhen. A limited number of A shares also are available as H shares in Hong Kong.

Can US investors buy A or B shares?
US investors can trade B shares if they are QFII and have an ID to trade B-shares. Furthermore, there are only 52 Companies that offer B shares, representing a minute fraction of the Chinese Universe. Similarly, a very limited pool of US investors can access A shares generally as a designated fund and have a quota which takes years to get from the government. Investors may see improvements over time.

Are B shares also available as H shares on the Hong Kong Exchange?
Generally no, approximately 18 A shares that represent over $400 billion in market cap.

Are Chinese companies that list on the HK exchange subject to Chinese or Hong Kong holidays?
No. There are about 174 N-shares which refers to Chinese companies listed as the parent common stock. They are not ADR's, but do trade in dollars on the NYSE, NASDAQ or the American Stock exchange. The term N stands for New York. These companies may or may not be incorporated in China, but they have their main businesss operations in mainland China.

What are the types of underlying shares for ADR's?
Yes, A& B shares are only traded in Shanghai or ShenZhen. A limited number of A shares also are available as H shares in Hong Kong.

Tapping into the Growth

What drives economic growth may be debated when it comes to China and Hong Kong. The Central Planning Committee in China, the key mechanism of communist "value add", is alive and well and implemented its 12th Five Year Plan in March 2011. The ongoing use of five year plans suggests that "mandating" economic progress and the allocation of resources in a complex global economy has not yet been abandoned. Nonetheless, there seems to be evidence of an awareness of market forces on the part of Chinese officials. For example the plan includes reducing dependence on foreign demand as a goal. This tacitly acknowledges the fact that G7 demand is undergoing a long term decline as a source of demand for China. Turning towards its own domestic demand may be not just a communist response, but a decision consistent with the realities of the market. Liberalizing the movement of Chinese investment capital was also part of the plan, allowing Chinese businesses to invest more outside of the country.

In order to understand the investment opportunities further, it is important to understand how businesses are financed. A fully developed and regulated financial market is the hallmark of an advanced economy. For the China/Hong Kong region, the financial center is not Shanghai, but Hong Kong, "Hong Kong remains China's biggest capital market because it has its own fully convertible currency and sound infrastructure."[15] In fact, Hong Kong's financial sector represents 90% of their GDP. In contrast, China's banking sector is not as ubiquitous. China has some private banks that lend to smaller business but the "official" banks prefer to lend to "well-connected state firms" leaving the entrepreneurs to find credit in the shadows with what are referred to as "shadow banks."[16] In certain cases, the rules for businesses obtaining private financing are so strict the death penalty may apply and for other cases, such as default, rules and remedies are conspicuously absent. The recent credit squeeze has officials rethinking these policies. Chinese premier, Wen Jiaboa, announced a goal to break "the monopoly" of the largely state owned big banks. Only time will reveal the substance behind these declarations. At best, progress will likely be slow and targeted.[17]

Awareness of state control, which accounts for 80% of China's stock market capitalization (versus 60% for Russia and 35% for Brazil), is critical.[18] The Real Estate, Materials and Industrials sectors are among the main sectors in China and Hong Kong and all three are dependent on financing from the banking system described above as well as the intermittent government stimulus.[19] Even a small country the size of Singapore could be a challenge to Hong Kong's dominant position in shipping and logistics. Investing directly in China and Hong Kong is of course not the only way to take advantage of investment opportunities.[20] Opportunities are available through

15 (Sender, 2012)
16 (The Economist, 2012)
17 (The Economist, 2012)
18 (The Economist, 2011)
19 (Budaghyan, 2012)

investment in companies that successfully access and compete in China's domestic market.

VW says it is opening dealerships in China at the rate of two a week. BMW is adding at least one dealership a week there and will have 350 by the end of the year, the same number as in the US. China surpassed the US as the Munich producer's biggest market in the first quarter.[21]

It is important to approach investing directly in China and Hong Kong with caution. For example, news publications are still reporting that "China may be the world's largest car market, but China has yet to build a car industry to be proud of. Foreign carmakers dominate the market, and the local industry is losing market share."[22]

Investors seeking to increase their holdings in Chinese and Hong Kong based companies should also take inventory in their existing portfolios of the rise in acquisitions by large state owned Chinese companies of controlling interests in a variety of foreign companies from autos (Volvo) to natural resource companies (Southgobi). China represents close to 6% of total global Foreign Direct Investment. While China is still far from US and UK historical global FDI peaks of nearly 50%, China is trending in a positive direction and not far from Japan's peak of 10% around 1990. In some cases, acquisitions by China may translate into significant opportunities for the acquired business to penetrate the consumer markets on Mainland China. But there may be adverse consequences to profit objectives and employee satisfaction which can impact stock prices over the long term. What is clear is the confusion about who is in charge of the acquiring Chinese.[23] The Economist quotes sources as saying, '"You can feel it," says one. "In China you're dealing with the government," says another. "In India you're dealing with companies."'[24] So investors, before adding Chinese and Hong Kong companies, should weigh the exposure they may already have to Chinese owned and managed companies in their existing holdings.

While investors see the myriad of "red flags", they are encouraged by the fact that China has nearly $2.8 trillion in reserves, which compares favorably to the mere $132 billion in the US. Furthermore, while the level of US debt is reaching $14 trillion and 100% of GDP, China's foreign debt is only $428 billion. Similar to China, Hong Kong operates on a budget surplus of 2.9% of GDP and debt of only about 17% of GDP and shrinking.

20 (Shih, 2011)
21 (Reed, 2012)
22 (Waldmeir, 2012)
23 (The Economist, 2010)
24 (The Economist, 2010)

CONCLUSION

> *"Countries as huge and complicated as China can underachieve or collapse under their own contradictions."* - The Economist, 2010

The "Basic Law" that governs China and Hong Kong relations stipulates that by 2047 the two systems will operate in harmony. Still, investors need to keep an eye on the changing landscape of China and Hong Kong markets as 2047 approaches. Many questions remain unanswered. Will the dominant currency at that time be the Hong Kong dollar or the Chinese Yuan? Will foreign investors continue to be welcome participants on the Hong Kong Exchange? Will the favorable tax laws on dividends and capital gains in Hong Kong survive or revert to mainland policies? Both optimists and realists may say that the benefits of open markets may be well understood in China by then. That would translate into greater liberalization of the Shanghai and Shenzhen markets and robust use of Hong Kong's well developed market.

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ADVISORS, LLC

We welcome your inquiries

100 bayview circle, ste 500
newport beach, ca 92660
ph 949.706.2640
fx 949.737.7703