Weekly Market Commentary

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China's Economic Engine Still Running After Stocks Stall

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Highlights

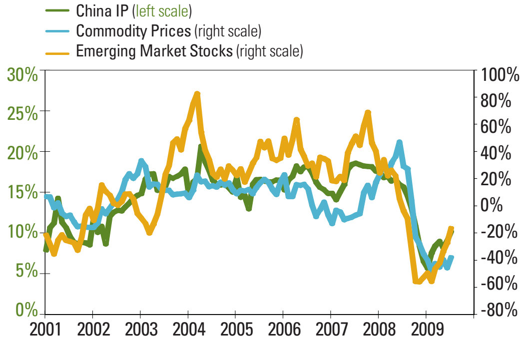
The recent return of volatility in the Chinese stock market after a 100% gain raises a question about potential volatility in the underlying Chinese Economy after an explosive 16% GDP growth rate in the second quarter.

Fortunately, China's stock market is not necessarily a leading indicator of its economy. Despite concerns over renewed central bank note issuance, slumping foreign investment in China, and potential regulatory changes, Chinese money supply growth has continued to expand and leading indicators of economic activity remain on the rise.

In general, we continue to recommend emerging market stocks and commodities exposure despite China's stock market volatility.

1 Chinese Economic Engine Drives Emerging Market Stocks and Commodity Prices

Year-Over-Year Change in China's Industrial Production (3 month moving average), Commodity Research Bureau Commodity Index, and MSCI Emerging Markets Index



Source: LPL Financial, Bloomberg

China's stock market, measured by the Shanghai Composite Index, fell 19.7% from August 4 to August 19—narrowly avoiding the 20% decline often referred to as the threshold for a bear market. After climbing more than 100% during the nine months since the low on November 4, 2008, a 20% pullback is not all that alarming or surprising, and the index regained one-quarter of the decline late last week as it rebounded off of a key technical level. However, the volatility in the Chinese stock market raises a question about the potential volatility in the underlying Chinese Economy after an explosive 16% GDP growth rate in the second quarter and the resulting impact of a potential Chinese economic slowdown on emerging market stocks and commodity prices. (Chart 1)

China's 16% GDP growth in the second quarter was in large part the result of powerful stimulus in the form of loan growth. In the United States, banks have been slow to lend, and demand for loans is soft. But in China, where banks are directed to lend and state owned companies are compelled to borrow, over $1 trillion in loans were made in the first half of 2009 (compare this amount to the roughly $80 billion spent so far this year of the U.S. economic stimulus package, the American Recovery and Reinvestment Act of 2009). This lending compelled powerful growth in economic output. Fear that the lending was going to fade triggered the stock market slide. The three catalysts were: renewed central bank note issuance, slumping foreign investment in China, and potential regulatory changes.

- Central Bank Note Issuance – The Peoples Bank of China (PBoC), the central bank–or Federal Reserve counterpart—of China, released the second quarter Monetary Policy Report in early August. The report contained the market moving information that the PBoC had required 10 banks to buy 100 billion Yuan of 1-year notes issued by the PBoC in July for the first time in nearly a year. The effect of issuing these notes is to pull cash out of the banks, limiting their capacity to lend. Fears surfaced in the markets that lending would soon stall out; however, this interpretation misses the fact that more than 425 billion Yuan of previously issued notes were retired in July, leaving the banks with a net additional 325 billion Yuan. **As a result, banks actually have more capacity to lend as a net result of the PBoC note transactions in July.**
- Foreign Investment - The largest one day drop during the August decline in the Shanghai Composite was 6% and came on the day it was reported that foreign investment in China slumped in July. China attracted $5.4 billion of investment capital into Chinese businesses by foreign businesses. The pace of investment inflows slowed for the 10th

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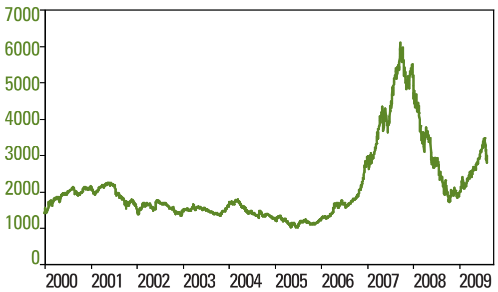
2 Back to the Bubble?

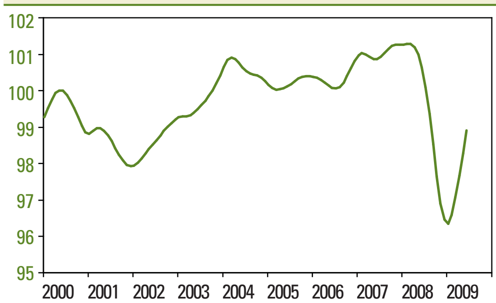
Shanghai Composite Index



Source: LPL Financial, Bloomberg

3 China's Leading Economic Indicators are on the Rise

OECD China Leading Index



Source: LPL Financial, Bloomberg

consecutive month. However, any fear that China's companies might run short on funding from foreigners ignores the fact that Chinese businesses get most of their capital from exporting. Chinese exports to the United States have expanded each month since the low in February and now total nearly $24 billion per month ($18.4 billion net of Chinese imports from the United States). **As long as the U.S. economic recovery stays on track, the Chinese will continue to see inflows of funds from exporting to the United States continue to rise.**

- Regulatory Changes – Even after the powerful loan growth in the first half of 2009, banks remain well capitalized. However, a draft of new regulations was sent to Chinese banks last week potentially limiting their ability to lend. These accounting rule adjustments limit banks' ability to count certain types of debt as part of their reserves and require them to either come up with additional capital or reduce their lending to stay within mandatory capital adequacy ratios. However, bank regulators are not necessarily trying to slow down lending as much as they are trying to control where it is being directed. The massive lending in the first half of the year has certainly pumped money into the economy, but not necessarily in the areas where it is most needed, and has led to stock and real estate speculation. Adjusting the accounting rules for assets is likely to encourage banks to be more aware of the projects they lend to reduce the potential for bad loan bubble. **Rather than being a sign of an impending credit crunch for Chinese businesses, the potential regulatory change may result in more lending flowing to businesses and away from less productive uses of funding.** (Chart 2)

We believe the actions discussed above may begin to limit the re-inflating Chinese stock and real estate markets but are unlikely to materially weigh on China's economic growth or demand for commodities in the second half of 2009. Supporting this notion is the fact that economically sensitive commodity prices such as copper barely moved during the swoon in Chinese stocks, indicating demand remains strong after imports of commodities including oil, iron ore, and coal broke records again in July. In addition, Chinese money supply growth has continued to expand and leading indicators of economic activity remain on the rise, such as cargo handled at ports. Fortunately, China's stock market is not necessarily a leading indicator of its economy. In general, we continue to recommend emerging market stocks and commodities exposure despite China's stock market volatility. (Chart 3)

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

Stock investing involves risk including loss of principal Past performance is not a guarantee of future results.

Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise and are subject to availability and change in price.

High yield/junk bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.