

Stefan Hofrichter, RCM Senior Strategist

Global View Renminbi—Substantial Appreciation in Real Terms Ahead

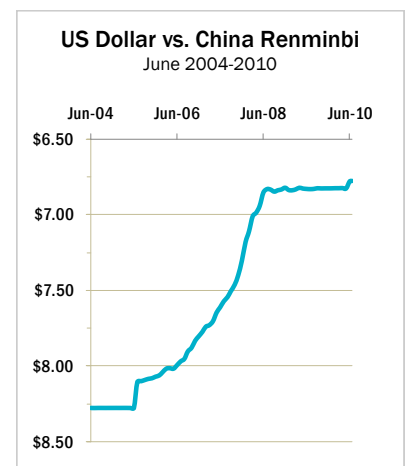
The US is repeatedly demanding an appreciation of the Chinese renminbi. While it is difficult to anticipate the timing of a nominal appreciation of the Chinese currency, as this is actually a decision to be taken by Chinese policy makers, we have a strong view that the renminbi will appreciate substantially in real terms over the coming decade. An appreciation in real terms takes place either via nominal appreciation or via higher inflation relative to its trading partners.

According to *The Economist's* Big Mac index, which estimates purchasing power parity based on a single product—the Big Mac—the renminbi is currently roughly 50% undervalued compared to the US dollar (but less so compared to other developed currencies). Most other emerging market currencies are undervalued too, albeit less so than the renminbi, on average around 20%. Over the last five years, the renminbi has already appreciated against the US dollar by around 25%. This is the so-called Balassa-Samuelson effect at work. This theory explains why, based on higher productivity growth from a lower level and wage growth rates compared to developed economies, emerging market currencies tend to be structurally undervalued and appreciate in real terms against developed market currencies.

The Outlook for the Renminbi Going Forward Let us assume that the renminbi undervaluation converges to the average undervaluation of other emerging market currencies. By additionally applying a quantitative estimate for future real appreciation based on estimated growth differentials and assuming Chinese real growth to be around 6 percentage points higher than US growth going forward, we come to the conclusion that the renminbi could appreciate by around 5% per annum (more than 60% cumulatively) against the US dollar over the next decade.

This may sound a lot at first sight, but it fully matches the development of the Japanese yen post 1960, i.e., 15 years after Japan began to rebuild its economy. Until the mid-1990s, the yen appreciated against the US dollar by almost 300%. Until the mid- to late-1970s, the real appreciation primarily took place via a widening inflation differential, thereafter only via nominal appreciation. Since 1994, i.e., 15 years after China decided to modernise its economy, the renminbi has appreciated by less than the yen in a comparable period of time. If indeed the renminbi managed to appreciate by 5% in real terms over the next decade, the cumulative appreciation would merely equal that of the yen between 1960 and 1985. Hence, this estimate is indeed realistic.

The Implications of an Renminbi Appreciation in Real Terms For China, it implies a trade-off between nominal appreciation and rising inflation. If the nominal exchange rate remains unchanged, we would expect inflation to pick up substantially. Indeed, strong money growth in China is consistent with inflation rising to a high single-digit number later this year already. Ultimately, the renminbi will also have to appreciate in nominal terms. We believe it is most likely that China will opt for a gradual increase of renminbi flexibility, as indicated by recent measures, rather than for a one-off appreciation. Otherwise, the risk of huge speculative inflows would be too high. For the global economy, a renminbi appreciation in real terms would likely help to rebalance economic activity, as it would induce less current account surplus in China at the benefit of stronger domestic demand—exactly what we believe is needed.



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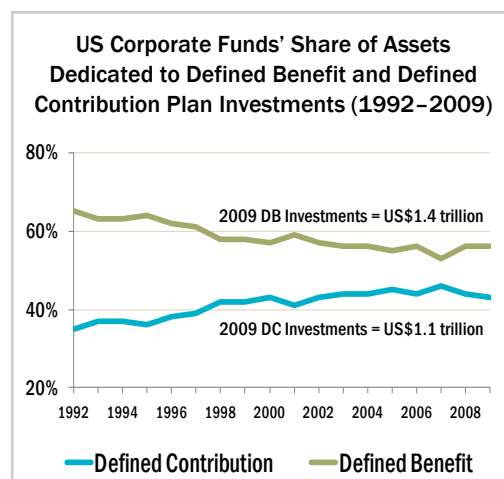
Udo Frank, RCM Global Chief Executive Officer

Viewpoint

Should Defined Benefit Pension Plans Be Saved from Extinction?

Given the importance of an affordable, sustainable, fully funded retirement solution in any society, a renewed effort should be made to provide a model that preserves the many valuable elements of a DB scheme while integrating some of the flexibilities a DC model offers.

Defined benefit (DB) pension plans, for decades a great success story in the US and a model copied in many other countries, are under serious pressure, especially in the private sector. While plan participants embrace this benefit as an outcome-oriented solution for their need for a lifetime income after retirement, a combination of regulatory and accounting rule changes; increased mobility of the working population; demographics; volatility in capital markets and last, but not least, irresponsible applications, in particular in the public sector, have made it too expensive to continue in its current format. For years, no private company in the US has established a new defined benefit plan; many are frozen or have been terminated, and there is momentum building in the public sector that would suggest a similar trend is underway or at least a switch to hybrid models over the next decade will be considered. Companies representing the top 100 DB Plans in the US contributed about US\$40 billion to their plans in 2009 and achieved an average funding ratio of 84%; a continued recovery in financial markets or a rise in interest rates is likely to speed up the termination of plans as more companies will come within reach of a fully funded status and thus have this option. In its place, defined contribution (DC) models have become the name of the game, whether in the US or internationally.



Source: Greenwich Associates 2009 US Investment Management

Unfortunately, we are less than well prepared for this ongoing change of what typically is the single biggest benefit an employer is providing. The shift in responsibility for providing a lifetime income in retirement from the employer to the employee leaves four major shortcomings. First, what has been a pool of assets invested in a well-diversified way by professionals as fiduciaries, with professional oversight by a pension board and typically professional advice from consultants and actuaries, will be turned over to plan participants who will be experts in many things but only a few in the field of long-term investing. Is it realistic to believe that between educational efforts and offering tools, individual investors can be equipped to make choices wisely? And is it realistic to assume that access to all asset classes can be achieved with comparable quality? Research suggests that investment returns on DB plans are at least 1 percentage point higher than those of DC plans*. Second, lifetime income as an integral part of the pension benefit will now have to be bought individually; in which way exactly is still discussed. Third, society in aggregate is likely to lose in this move, since interpersonal and intertemporal risk transfer is no longer part of the system and, as a consequence, the ability to take on investment risk and a longer-term investment horizon is compromised. Last, but not least, a DC system is significantly more expensive to run, reducing returns to beneficiaries. While disclosure rules will increase competitive pressures, the structurally higher expense basis will remain.

Given the importance of an affordable, sustainable, fully funded retirement solution in any society, a renewed effort should be made to provide a model that preserves the many valuable elements of a DB scheme while integrating some of the flexibilities a DC model offers. The following elements deserve consideration:

- The creation of a reliable, clear regulatory and accounting framework that minimises ambiguity in determining the value of liabilities, future expected returns and funding levels as well as acknowledges the long-term nature of pension liabilities in solvency tests. Furthermore, transparency with regard to the value of pension benefits to an individual as well as the cost to the employer.
- A reliable framework to manage costly, yet desirable, plan features such as inflation or real income adjustments.

* E.g., Towers Watson in a report comparing 401(k) and DB returns for the years 1995-2007; similar results reported in a Center for Retirement Research report, issue #52 from September 2006.

Perspective US

Scott Migliori, RCM US Chief Investment Officer

It has been noted in several recent articles that correlations between individual US stocks and the overall US equity market have been running at historically high levels. This is largely due to macro questions dominating individual company fundamentals. Specifically, questions and sentiment about the sustainability of the economic advance, and the prospect of a double dip recession, have and are likely to continue to have a large influence on the direction and magnitude of individual share price performance over the coming weeks irrespective of company specific earnings results in the second quarter. In order for individual company ("bottom up") factors to have the dominant impact on share price performance they historically have had, the market needs greater comfort that the current recovery will be self-sustaining, albeit at a slower pace. In that regard, there are reasons for optimism as credit markets remain much more stable and accommodative today than they were in 2007–2008, making the prospects of a true double dip unlikely. In addition, sell-side economic forecasts are in the process of being sufficiently lowered for second half 2010 so that by the fourth quarter of this year the economic surprises are likely to once again be to the upside. Under this scenario, individual company fundamentals will start to matter once again as we enter the fourth quarter, and the overall direction of the market at that point will likely be biased higher into year-end.

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Sound Bites from Research

Joshua Smith, RCM Asia Pacific Product Specialist

The developing countries of Asia comprise almost half of the world's population, but despite the disproportionately high prevalence of energy and export-intensive industries in these economies, they make up less than 27% of the world's energy consumption. China, at the forefront of escalating energy demands, surpassed the US as the world's biggest energy user in 2009, despite a per capita energy consumption of only one-fifth of that of the US. We feel that, with energy consumption only poised to rise in the region, to avoid the taxing effects on growth caused by pollution and domestic energy constraints, Asian policy makers have little choice but to complement investment in developing hydrocarbon-based energy infrastructures with significant investment in infrastructure geared toward energy efficiency, clean technologies and pollution control.

Reassuringly, advancements in clean energy technologies make up at least one of many emerging Asian nations' top policy goals, paving the way for a robust investment environment in the region. For example, in addition to high-speed rail plans in Korea, Singapore/Malaysia, Taiwan and Thailand, China plans to have the largest high speed rail network in the world with ~19,000 km of track connecting ~200 million people by 2014. China also plans to invest a total of CNY¥227 billion (US\$33

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GrassrootsSM Research

Andreas Bartels, RCM Europe GrassrootsSM Research Analyst

GrassrootsSM Research has been monitoring the impact of the Soccer World Cup on betting activities in Germany, Italy and the UK. After interviewing store managers of betting stores as well as nearly 400 consumers, it became clear that betting volumes in all countries were up significantly in June 2010 compared to a typical month. Most store owners in Germany and the UK expected this level of increase, while store owners in Italy said volumes were higher than anticipated. Interestingly, throughout Europe, we found that increased betting activity for the World Cup is not dependent on the success of the home team.

Another trend that we are following closely is the migration from traditional betting shops toward online betting platforms. Today, almost all of our interviewed store owners negatively feel the impact of an increasing number of customers moving to online platforms. This is true especially of a younger customers. Most popular sports betting websites include BWIN in Germany, Snai in Italy and William Hill in the UK.

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... Viewpoint

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- A simpler framework for plan mergers and the creation of transferability for individual rights under certain conditions to facilitate quality, economies of scale and scope as well as an element of competitive striving for best in class.
- The same private sector regulatory and accounting framework applied to the public sector, i.e., aligning FASB and GASB.

While these points have been discussed on occasion, unfortunately not much traction has been achieved. Rather than accepting the extinction of the DB scheme as a given, a renewed effort by employers, regulators, industry associations and beneficiaries to create a hybrid that is fit for the future is the better option.

... Sound Bites from Research

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billion) on its smart-grid network while also constructing or planning 63.5 GW new nuclear reactors by 2020 with an additional 120 GW of capacity in the pipeline. Korea's nuclear export ambitions have been flourishing with recently-reached reactor-export relationships with the UAE, India, the Philippines, Mexico, Turkey and now Argentina, amongst others. We are confident that, in addition to the strides being made in nuclear, high-speed rail, and smart-grid, the region's technological and productivity advancements in solar, wind, batteries, LED, hydro, LNG, and geothermal, as well as water filtration and wastewater treatment, represent just the beginning of the region's transition toward a "green economy"—even if out of necessity more than out of conviction at this point.



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(All data sources RCM as of 30 June 2010 unless otherwise stated.)

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