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Pay to Play: What China's Rising Wages Mean for Investors

BY JASON SIMPKINS, Managing Editor, Money Morning

There's a sea change underway in China's economy - one that's evident in soaring prices, shrinking trade surpluses, and higher property values. And it's being driven by higher wages for workers that for decades have been grossly underpaid.

From the country's fast-growing urban centers to its frontier countryside, wages are rising rapidly across China.

China's 31 provinces boosted minimum wages by an average of 24% last year, according to Yin Weimin, China's minister of human resources and social security. Meanwhile, the average monthly income for migrant workers rose 13% to $256.89 (1,690 yuan).

Six provinces already have raised minimum wages this year, and labor shortages and government mandates will likely compel the remaining 25 to follow suit.

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The central government is targeting an increase in minimum wages of 13% a year through 2015. Additionally, Chinese Premier Wen Jiabo aims to increase per capita household income by 7% a year in real terms during that period. He's also pledged to improve the social security and healthcare systems to help low-income households and raise the personal income tax threshold - all in an effort to give the country's 1.3 billion people more spending power.

But that's not all. Labor shortages have driven up wages, as well.

Dong Tao, Credit Suisse Group AG's (NYSE: CS) chief regional economist for the Asia region excluding Japan, told ***BusinessWeek*** that China is fast approaching the so-called "Lewisian turning point" - a critical moment in a developing economy when its surplus labor supply dries up, prompting hikes in wages, prices, and inflation. In China, demand for workers will outstrip supply by 2014, Tao's team calculated in a January report.

"When historians go back and describe 2010, the big story will be the massive increase in salaries that will redefine the global manufacturing model and redefine the inflation outlook for the next 10 years," said Tao.

Indeed, rising wages - while improving the quality of living for many Chinese - have accelerated inflation, both domestic and global.

Chinese inflation topped expectations at 4.9% in the year to February. Food prices alone rose 11% in February. The producer price index - a measure of inflation at the wholesale level - rose 7.2% in February, the biggest increase since October 2008.

Premier Wen places most of the blame on higher commodity prices and lax Western monetary policies, but he acknowledges that his country's rapid growth is at least partly responsible for rising prices.

"There is an inseparable connection between the pace of economic development, employment and inflation," said Wen. "When the pace of economic development is fast, there is more employment, but inflationary pressures are also bigger."

China wants to keep inflation below 4%, while maintaining an official economic growth target of 7% per year for 2011-2015. However, the government's 7.5% target for 2005-2010 was exceeded on a routine basis, and inflation will likely prove equally inextinguishable.

Manufacturers Moving Out

Higher wages have fanned inflation, but they're draining the country's gorged manufacturing base.

Indeed, Chinese workers are no longer at the bottom of Asia's pay scale. In 2009, monthly factory wages in Ho Chi Minh City, Vietnam were about $100. They were $148 in Jakarta, Indonesia and $47 in Dhaka, Bangladesh. Monthly wages in Shenzen, China by that point had reached $235. And now they're likely significantly higher.

Higher wages for Chinese laborers have directly translated to higher prices for finished products. Because China manufactures so much of the world's apparel, Chinese inflation is especially evident in higher clothing prices.

Next, Britain's second-biggest retailer, said in January that higher labor costs in China will contribute to an 8% increase in prices in the first two quarters, ***BusinessWeek*** reported. And trading group Li & Fung of Hong Kong, a top apparel supplier to Wal-Mart Stores Inc. (NYSE: WMT), says the price of Chinese exports will rise as much as 15% this year as workers earn more.

"The pressures aren't subsiding," Randal J. Konik, an equity analyst at Jefferies & Co. (NYSE: JEF) in New York, said in a research note. Konik identified luxury handbag maker Coach Inc. (NYSE: COH) and women's clothing retailer Chico's FAS Inc. (NYSE: CHS) as having "high exposure to Chinese manufacturing."

Coach in January announced a four-year plan to move the production of handbags and wallets out of China and into countries with cheaper labor. About 85% of the company's products are made in China now. But Coach plans to cut that to 50% to 60% by 2015.

Ironically, the higher wages that are driving Coach out of China have made that country the company's fastest growing

market. Coach is still new to the Chinese market, but sales there rose by double digits on a percentage basis. China sales make up less than 5% of China's total business, but that's expected to rise to 10% by 2014.

Beijing is comfortable with that trade off, as China's central government aims to make domestic consumption the main driver of economic growth, rather than exports.

Trade Balance

While wages in China are on the rise, exports are on the decline.

In fact, China reported a $7.3 billion monthly trade deficit in February - its largest in seven years - as imports climbed sharply but exports lagged. Imports rose 19.4% year-over-year in February, while exports edged up just 2.4%

The February results may have been influenced by the Lunar New Year, but there also is a larger pattern developing.

Last year marked the second consecutive year that China's trade surplus shrank, falling 6.4% from 2009 to $183.1 billion. Imports rose 38.7% from the year before while exports increased 31.3%.

China's trade surplus accounted for 3% to 4% of the country's gross domestic product (GDP) in 2010, down from almost 11% in 2007.

Furthermore, the central government said in its most recent five-year plan that China aims to double its imports by 2015, reducing its trade surplus to zero.

"They believe now China's economy has gotten to the point where it can handle this kind of transformation," said ***Money Morning*** Chief Investment Strategist Keith Fitz-Gerald. "Many people continue to believe that China will live and die by its exports to the United States. Not so - exports account for only about 30% of its GDP and even less of its growth as that nation shifts to internal consumption."

Chinese domestic consumption grew at an average rate of 15% between 2001 and 2010, positioning the country as the world's second-largest importer in 2010, according to ***China Daily***. And the State Information Center forecast China's imports to rise 20% in 2011 while exports increase by 16%. That would trim the trade surplus by 13.2%.

Cashing in on China's Consumerism

Investors should brace for China's transformation by moving away from companies that have a large manufacturing base in China and into companies that sell to its increasingly powerful consumer class.

McDonald's Corp. (NYSE: MCD) and Yum! Brands Inc. (NYSE: YUM) are two food operators profiting from China's growing consumerism.

Some luxury brands, like Coach, will also benefit - so long as they move production out of the mainland. Burberry Group PLC (PINK: BURBY) and Compagnie Finciere Richemont (PINK: CFRUY) are two luxury retailers currently growing their sales in China.

There's also the Claymore/Alpha Shares China Small Cap ETF (NYSE: HAO), which has a large percentage of its holdings in consumer-focused firms. Consumer staples and consumer discretionary sectors represent 9.3% and 15.8%, respectively, of the funds holdings.

Finally, ***Money Morning***'s Fitz-Gerald likes the **Morgan Stanley China A Shares Fund (NYSE: CAF)**.

"I particularly like CAF because small business ventures in China have the most to gain and most of those companies are traded only in China A shares," said Fitz-Gerald. "And CAF is the only fund that gives U.S. investors 'direct access' to the A-shares."

CAF is one of the best ways to profit from China's shifting growth model. A recent portfolio allocation of the fund showed 28% of its holdings were in consumer goods and services, 26% were in financials and 18% were in basic materials.

CAF also holds shares in companies that make auto components and beverages, among other products, and has numerous stocks in the metals and mining sectors.

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