The Issues

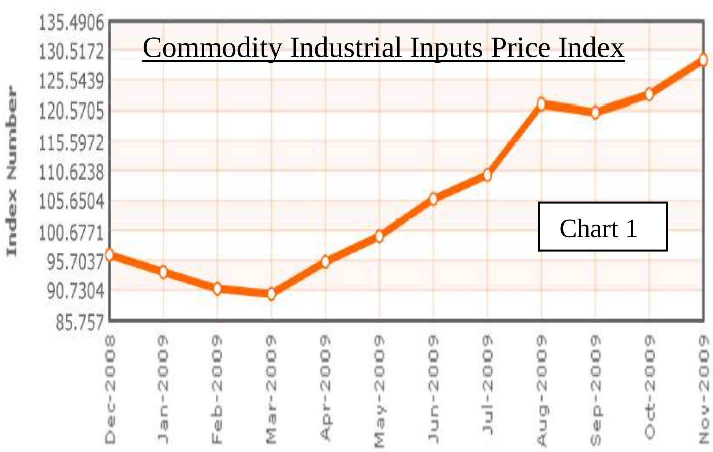
January 2010

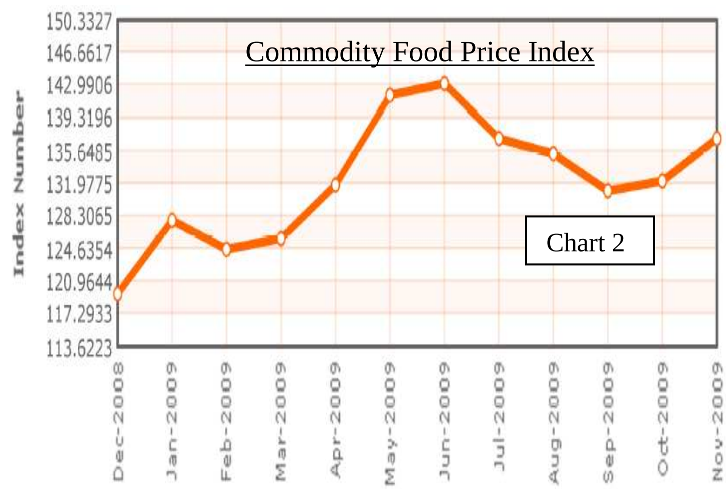
INVESTMENT OUTLOOK 2010

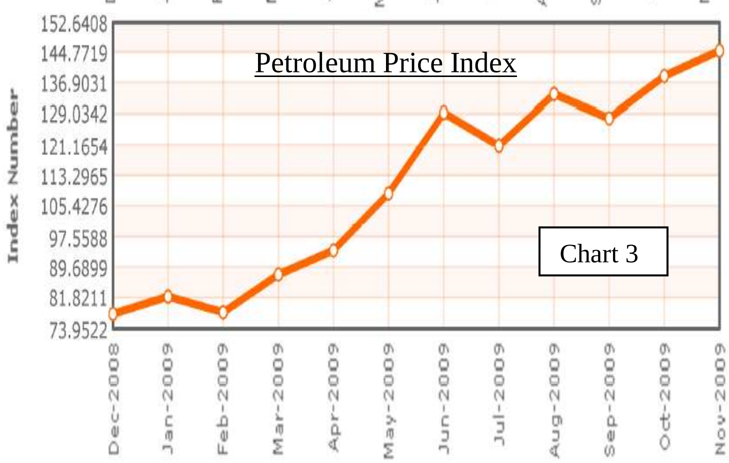
One of the issues facing emerging economies as a group is that they are farther ahead in their economic upturns than major developed economies. For instance, China is already into a property price bubble (especially land prices, as discussed in our December 2009 *Issues*), and its economy is booming. High public confidence, combined with plentiful liquidity (from trade surpluses, capital inflows and lax central bank policies biased toward pro-growth), will ensure buoyant domestic consumption and investments over 2010. The same situation, with some variations, applies to most other emerging economies. In stark contrast, the U.S., western Europe and Japan are still at nascent stages of emerging from their recession/deflation economic cycles, and economic recovery there is likely to remain slow.

At issue is the current, very low interest-rate structure in emerging economies with currencies either pegged or semi-linked to the U.S. dollar. They are following, in varying degrees, the interest rate policy of the U.S. Fed. While it is appropriate for interest rates to stay low in the U.S., as the overly indebted system deleverages, the current, low interest-rate structure is looking increasingly incompatible in a number of emerging economies, China being one example.

Rising CPI in Coming Months? We think a risk currently not yet discounted by markets is rising interest rates driven not by exit strategies of central banks (withdrawing liquidity pumped into the system to counteract the global tsunami) but by rising inflation and the development of negative interest rate**s**. The following charts (Source: IMF) show 12-month trends in commodity prices. It is clear that we are likely to see sharply higher YOY price increases in a host of commodities and, hence, a jump in emerging economies' CPI in 1Q10 given their high index weightings in food and energy.







All Indexes, Base Year: 2005 = 100

The Commodity Industrial Inputs Price Index includes price indexes for agricultural raw materials (timber, cotton, wool, rubber and hides) and metals (copper, aluminum, iron ore, tin, nickel, zinc, lead and uranium).

The Commodity Food Price Index includes price indexes for cereal, vegetable oils, meat, seafood, sugar, bananas and oranges.

The Crude Oil (petroleum) Price Index is a simple average of three spot prices: Brent, Dubai Fateh and West Texas Intermediate.

A rise in the CPI toward low- to mid-single digits may well lead to a negative interest rate environment in places such as China and Hong Kong. Thailand, Indonesia and Korea have higher nominal interest rates, but their economies cannot escape the impact of higher inflation and expanding asset bubbles as investors channel low-yielding cash into properties. Thus, as 2010 unfolds, we expect to see increasing pressure on these central banks to hike interest rates and adopt other counteractive measures to deflate the property markets. China may plug capital control loopholes to curb hot money inflows (much of which are conducted by Chinese firms and overseas Chinese entities) and raise tax on property gains.

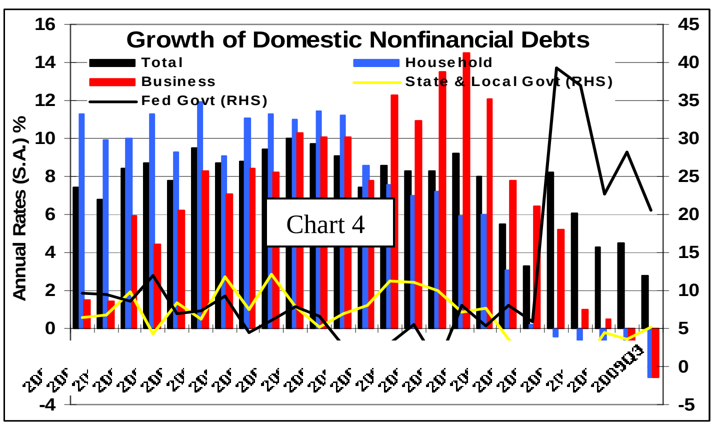
Have the equity markets discounted a sudden jump in CPI and domestic pressure on interest rates to rise in these markets? Probably not; higher CPI has disparate impacts on different economic sectors. Some are beneficiaries while others will see a margin squeeze. This will likely be one of the themes/issues equity markets have to deal with in 2010.

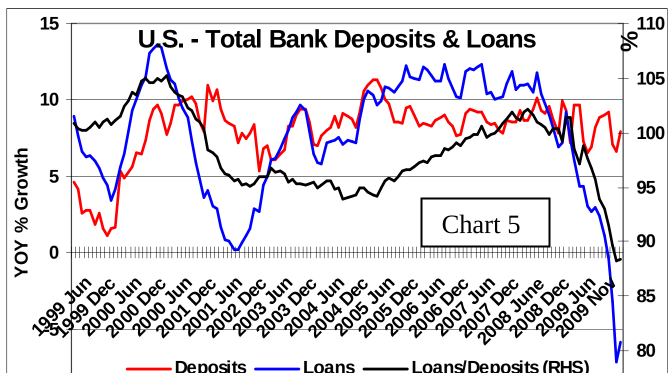
Course of the U.S. Dollar. Another influential variable affecting the outlook of equities in Asia Pacific is the course of the greenback. As discussed in our November 2009 *Issues*, we believe that a gradually weakening dollar is bullish for equities and vice versa; a strong dollar is negative. The underlying thesis is that the U.S. remains the key provider of liquidity for the global economy (emerging economics, in particular) through its current account deficits and capital outflows from U.S. investors seeking higher returns abroad. A weakening dollar reflects a lessening of risk aversion and a shift of funds out of low-yielding dollar cash into potentially higher- yielding assets as investors convert dollar cash into, for example, overseas equities, commodities and gold.

A strengthening dollar would reflect the reversal of the above flow of funds, i.e., a rise in risk aversion. That happened during the global financial tsunami. Our interpretation of the latest dollar strength in December 2009 reflects not a rise in risk aversion but the closing of books and the unwinding of trades funded in U.S. dollars--witness the concurrent weakness in Hong Kong and China stocks, most major overseas bourses, and commodities including gold.

A scenario under which the dollar can keep on strengthening, aside from the above-discussed flow of funds back into dollar cash as safe haven on a rise in risk aversion, is a U.S. economic recovery that's gathering strength. A strong economy would drain liquidity out of financial assets into the real economy. At the same time, rising rates of return on U.S. assets as the economy strengthens would drive capital flow back into the U.S. rather than out. This development would not be favorable for financial markets outside of the U.S. How likely? Not very, for the following reasons.

U.S. Still Deleveraging. Chart 4 shows both household and business sectors in the U.S. were still reducing debt in 3Q09. Despite a 20% annual growth rate in federal government debt, total nonfinancial debt in the U.S. grew by a paltry 2.6% annual rate for 3Q09. Chart 5 shows loans of the U.S. commercial banking system shrinking by nearly 6% YOY in Nov 2009. The system is thus still in a deleveraging mode. No credit growth in the private sector means individuals and businesses are not increasing spending and investment. As long as that remains the case, U.S. GDP growth looks anemic.





Source: Charts 4 and 5, Table 1 – U.S. Fed Flow of Funds.

The Rise in Debt 2004 - 2007	(US$tr)	The Funding Channels		
Nonfinancial Sector	6	ABS+MBS	2.9	Securitization 4.1
		GSE	0.2	
		Corp Bonds	0.6	
		Others	0.5	
Table 1		Bank Loans	1.9	

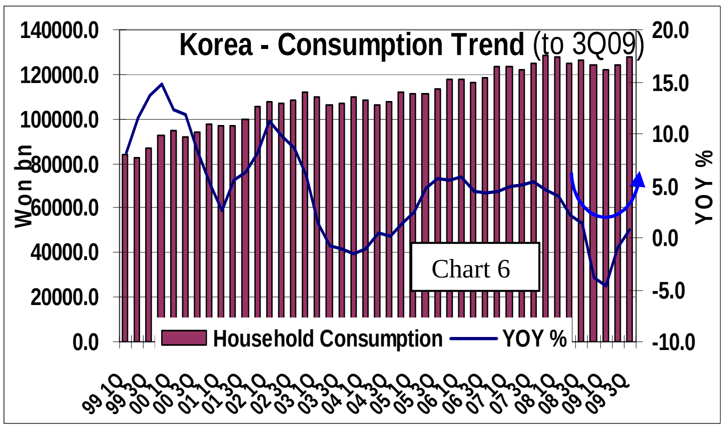
ABS = Asset-Backed Securities; MBS = Mortgaged-Backed Securities

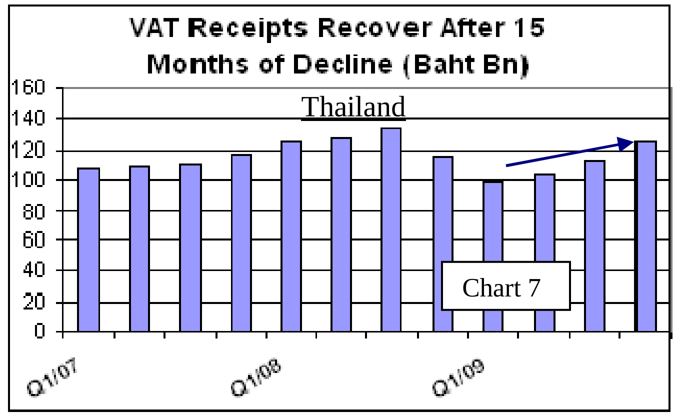
<u>Securitization accounted for two-thirds of total nonfinancial sector credit created during the 2004-07 credit boom.</u> Banks originate the loans; securitization raises money velocity. As long as the ABS credit conduit remains clogged, two-thirds of the system's capacity to create credit is frozen. This does not bode well for GDP growth.

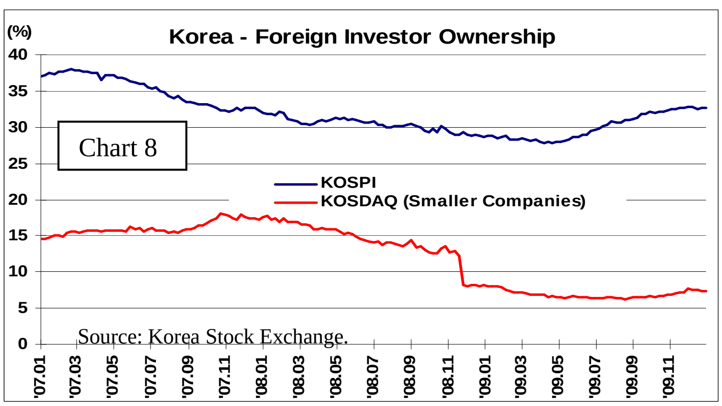
Summary. The degree of rise in CPI over coming months in emerging Asia Pacific markets may surprise investors. Rising inflation will likely put pressure on central banks to raise interest rates. The longer a central bank resists, the bigger the asset price bubble (in property, especially land) in that economy. China is a prime example.

Rising CPI will differently impact different sectors of an economy: some will be beneficiaries, others will suffer margin erosion. This will have obvious implications for sector selection. The continued threat of rising interest rates and government policy responses to deflate the asset price bubble is likely to widen the discount factor of share price versus net asset value per share of property developers, casting a cloud over sector share prices.

Governments in Asia Pacific economies from China to Korea and from Thailand to Indonesia are likely to pursue domestic policies to stimulate/sustain private sector consumption as a key driver of GDP growth in 2010-11. Charts 6 and 7 (Sources: Bank of Korea; Bank of Thailand.) show Korea and Thailand as prime candidates for consumption recoveries.







"Buy Emerging Market Theme." The lack of window dressing buying at year-end 2009 reflects that most funds are no longer underweighted in Asia Pacific ex Japan bourses. They've done their buying.

Korea was one of the big recipients of the "buy emerging markets" theme (albeit Korea is no longer classified as an emerging market), with a huge flow of funds in July-August 2009. It remains a favorite for large funds that want exposure to Asia because its market is liquid, and large Korean companies are one of the most leveraged plays on global recovery.

Foreign ownership of the Korea bourse (Chart 8) is now back to 33% (vs. 38% in early 2007 and a low of 27% in March 2009). The case for liquidity-driven momentum runs in 2010 looks weaker compared to last year.

Sector beneficiaries of domestic consumption in Asia Pacific economies are therefore one of our investment focuses. Ditto, sector beneficiaries of rising inflation and interest rates. Rising rates *per se* are not expected to derail stock market rallies because they reflect rising economic growth, which is positive for overall corporate earnings. But sector and stock selection will be key to making money in 2010, as markets are likely to turn more selective. Given the big rebound in 2009, overall market levels can no longer be considered to be in cheap territory.

The Net Asset Values GSI Asian Capital Growth – US$23.95 The Long/Short Fund – US$22.28 (Dec 31, 2009)