



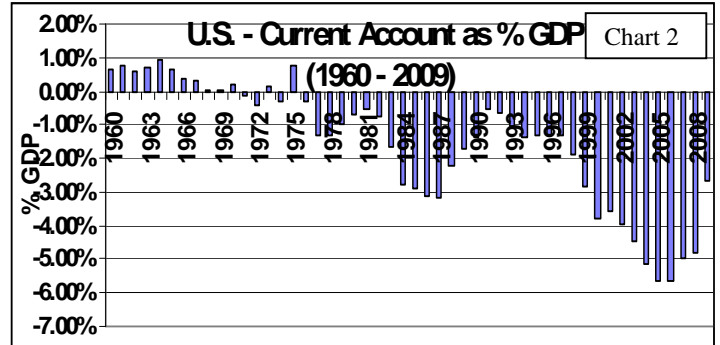
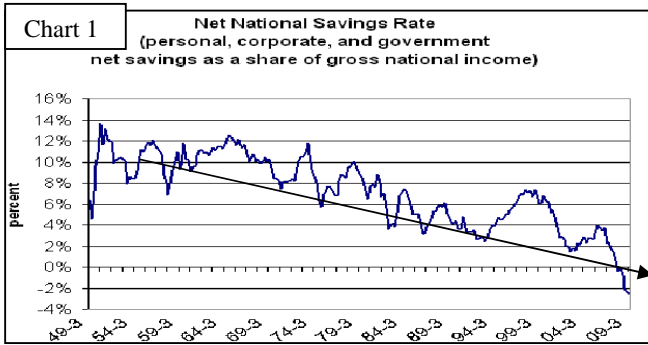
PRIVATE SECTOR SURPLUS MINUS GOVERNMENT DEFICIT EQUALS CURRENT ACCOUNT BALANCE

Our title this month is an accounting equation based on the national accounts of an economy. It can be used to analyze some of the current issues facing a number of economies--from the U.S. (will sufficient funds be available to finance the huge US\$1.6 trillion deficit in 2010?) to the problems facing Greece and others such as Portugal, Italy and Spain (will the sovereign risk issue snowball?). As discussed below, an economy's current account balance is its key tipping point.

The U.S.

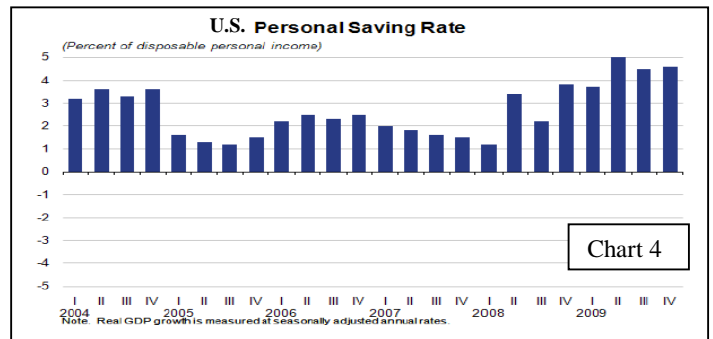
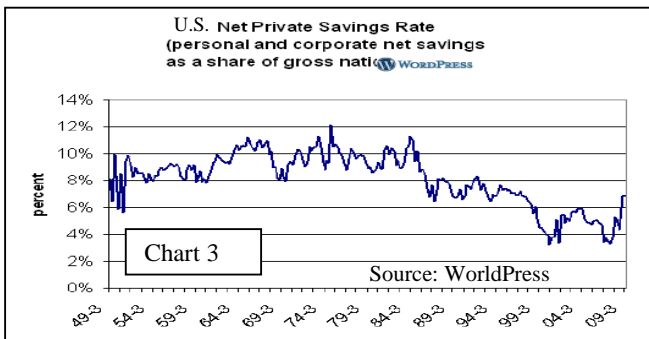
The net national savings rate in the U.S. has been in decline since 1949 (Chart 1). Since gross national savings (which equals gross domestic investments) = private savings + public savings + current account deficits, the decline in personal and corporate plus government savings as a percentage of GDP means a secular decline in investments, the key driver of value-added products, services and gains in productivity. Falling investments is the reason middle-class America has been shrinking and average wage earners have been seeing little growth in income on a secular basis.

The decline in savings also explains why at roughly the same time the current account deficit in the U.S. (Chart 2) has been rising significantly since the 1980s (cyclical factors aside), as a rising share of U.S. consumption is met by imports.



The above issues are secular, which is very different from cyclical ones driven by the ups and downs of economic cycles. On a cyclical basis, the net private sector savings rate in the U.S. has now risen back to ~7% of GDP (Chart 3), mostly from a rise in personal savings (Chart 4). But as households spent less, recession followed, and the current account deficit shrank to ~3% of GDP. Had the public sector run a deficit less than ~10% of GDP, the recession would have been deeper—dollar for dollar, each 1% reduction would have resulted in an approximate -1% fall in GDP.

In short, each dollar of public spending is finding its way into the pockets of the private sector, much of which is saved and thus available to fund public sector borrowing. In net terms, the dependence of the U.S. on foreign capital is small, at ~3% of GDP (the current account deficit). Therefore, we believe the 2010 U.S. public deficit of US\$1.6 trillion will have no funding problems.



Source (Chart 1, 2 & 4): BEA, U.S.

Sovereign Risk Issue in Portugal, Italy, Ireland, Greece and Spain (PIIGS)

Greece has a problem. Its current account deficit is ~12% of GDP, as is its public sector deficit. In short, Greece is very

dependent on foreign capital to fund its public sector deficit. This dependence is the tipping point that's breaking the economy. With Greece's public sector aggregate net debt already over 100% of GDP, foreign appetite for more Greek bonds is limited. Fortunately, Greece represents only 4% of the EU's GDP, too small to drive a contagion snowball-- unless bigger EU economies possess similar problems.

Applying the current account balance equation in our title, Portugal, with a sizable current account deficit of 9% of GDP and public sector debt of about 70% of GDP, is the second problem area. But Portugal's GDP is smaller than that of Greece, and Ireland's is even smaller, with a population of only 4 million. The bigger economies in PIIGS are Italy and Spain. The former actually runs a primary public sector surplus of ~2% of GDP, indicating public sector finance is improving. With household debt at ~45% of GDP, Italy has sufficient domestic savings to fund its public sector borrowing. Not surprisingly, Italy's current account deficit is at a low of around 3% of GDP.

Spain's current account deficit is high, at 6% of GDP, making the economy dependent on foreign capital. But it's offset by low overall public sector net debt at only 40% of GDP. Thus, on a cyclical basis, Spain's sovereignty has room to fund the economy's cyclical current account deficit and, hence, the time needed to pursue secular reform of its rigid labor market and supply-side economic policies and turn its dynamics around for good.

Non-Japan Asia

The same current account formula can be used to explain the Asian financial crisis of 1997-98. Thailand, Indonesia, Malaysia and South Korea all over-spent and over-invested (well above domestic savings), producing sizable current account deficits as a percentage of their GDPs, i.e., they had a high dependence on and vulnerability to foreign capital outflows. When foreign capital retreated, these economies imploded with a domino effect.

Most Asia-Pacific ex Japan economies now have positive current account balances, low public sector debt as a percentage of GDP and high domestic savings rates, a complete reversal of the situation in 1997-98. In stark contrast to the current cyclical issues facing the U.S., the EU and Japan, Asia Pacific ex Japan economies are currently witnessing buoyant domestic consumption and investment amply funded by domestic savings.

Global Growth in 2010-11

Cyclically, the U.S., most of the EU and Japan are all constrained by large public sector deficits, leaving little room for further fiscal stimulus. In the U.S., the private sector is still undergoing degearing. The problem for the weak economies in the EU is similar to the 1997-98 Asian financial crisis. The common issue is a pegged exchange rate (Asian currencies pegged to the dollar at the time, and weak EU economies pegged to the euro currently) → mispricing of money → over-spending/over-investing → large current account deficits → high vulnerability to foreign capital outflows.

To stimulate exports and turn current account deficits around, Asian currencies had the option to devalue, which they did, but today EU countries are straight-jacketed by having adopted the euro as their currency. However, the crisis in Asia involved large economies so the impact of contagion was much greater, whereas the vulnerable EU economies today are relatively small as a percentage of EU GDP. Accordingly, we do not see the Greek crisis snowballing, but since most large EU economies are concurrently running both sizeable budget deficits and government deficits, they have no stimulus options and, thus, EU GDP growth is likely to remain anemic.

When applying the same equation to Japan, we find low domestic investment and the surplus in savings have been funding large public deficits and net lending to other economies (current account surpluses). GDP growth will remain sluggish until Japan sees changes in the underlying social dynamics/behavior behind savings and investments.

Together, the U.S., EU and Japan constitute two-thirds of global GDP. The outlook for global growth in 2010-11 is thus not encouraging. Against this backdrop, Asia Pacific ex Japan is riding on an economic up-cycle, driven by domestic spending and investment and will be performing increasingly well, in stark contrast to the developed world. We expect the flow of funds into Asian bourses from global investors to regain momentum at some stage over the course of 2010.

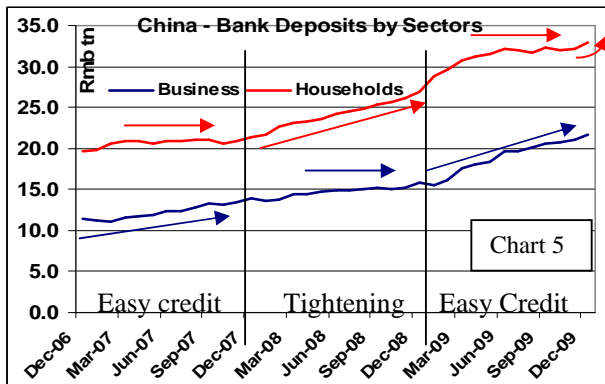
CHINA'S CREDIT TIGHTENING

Chart 5 shows the absolute levels of bank deposits of households and businesses in China. Notice how business deposits grow during an easy credit period (bank credit extended to firms = a rise in deposits held by firms) while, at the same time, household deposits have stayed relatively stagnant. The reason has to do with the way the system functions in China.

The start of a year is a new accounting period. Credit flood gates open and firms take out as many loans as they can, in advance of actual needs. By the second half of a year, banks have historically over-extended guidelines on loans from the central bank, forcing the latter to shut the gates.

Thus, firms often sit on the cash from loans for awhile before they spend/invest it. During a tightening phase, they cannot delay longer, hence the flattening of business deposits as they spent. The cash goes into the bank accounts of individuals--the firms' workers and service providers, resulting in accelerating household deposits. Indeed, with the recent tightening measures, household deposits are now turning upwards (Chart 5).

In short, when tightening occurs, China's economy can actually accelerate for awhile as firms spend/invest their cash, and households, with rising cash on hand from gains in income, sustain their consumption growth pattern.



Source Chart 5 - 6, and Table 1: Wind Data.

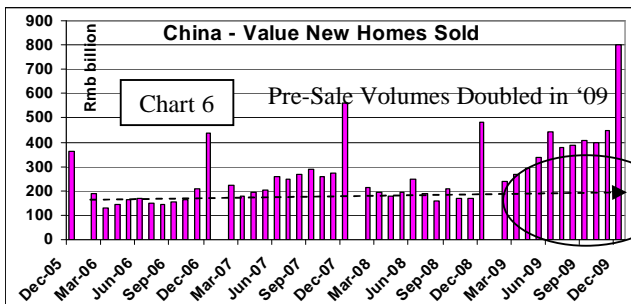
% GDP	HH (Year-End)	
	Deposits	Business
2006	92%	53%
2007	83%	54%
2008	89%	52%
2009	98%	65%

Table 1
 Note drop in household deposits as % GDP in 2007--a strong GDP year.
 +13% of GDP

Table 1 shows corporate bank deposits at ~65% of GDP at end 2009, up by the equivalent of 13% of GDP, thanks to the bank loan surge of 2009. Thus, ample liquidity remains in the system. What's going on at present in China is a credit slowdown, not monetary tightening.

Implications

China's economy will continue to grow at a robust pace, propelled increasingly by private consumption. The government, in particular, has singled out consumption and investments in the rural economy (population of over 650 million) as one of the growth engines. Sectors and companies exposed to these segments of the economy will be key beneficiaries.



We can expect a few property developers who overextended on land purchase commitments to suffer cash flow issues. The top-down policy now is to curb land hoarding, forcing the supply of homes to rise. Chart 6 shows pre-sale volumes doubling, especially in 2H09, over the pace of the prior three years. Home construction activities will thus be very buoyant in the next 18-24 months as pre-sold homes are completed. But with a rising supply, home prices are set to decline moderately. Property developers will suffer, but real estate agency businesses will prosper.

Investment Conclusions and Our Policy

Global markets have been correcting, partly on profit-taking given hefty gains in 2009. We think one of the risks is that current expectations of global growth in 2010-11 are still too high. And Wall Street, aside from having to discount a slow growth scenario, has to face the probability of a political impasse for the Obama administration, which if it occurs, will not help public confidence.

We do not see much risk of Greece's problems snowballing, but continued weakness in the euro is likely, to the discomfort of external sectors of the U.S. and Japan. Market volatility is therefore likely to continue until these risk factors are discounted. Our regional funds have cash in the mid-teens, waiting for better buying opportunities.

As discussed, Asia Pacific ex Japan is on an entirely different economic cycle. Once global macro and political uncertainties are discounted, we expect a renewed flow of funds into Asia, which will drive a renewed bull run in these bourses. However, using China as an example, the right sector and stock picking will be keys to outperformance in 2010.

The Net Asset Values GSI Asian Capital Growth – US\$23.23, Long/Short Fund – US\$21.57 (Feb 25, 2010)