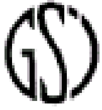


The Issues

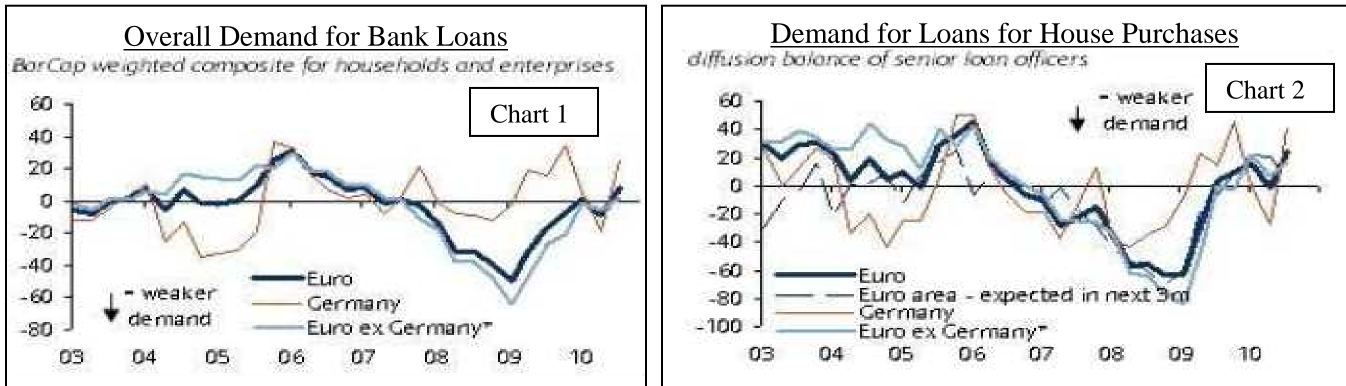
August 4, 2010

TWO-TIER ECONOMIES AND THEIR TWO-TIER STOCK MARKETS

EUROZONE In last month's *Issues,* we discussed the evolvement of a two-tier economy in the eurozone, with the creditor countries, led by Germany, getting stronger while debtor problem economies, led by PIG (Portugal, Ireland and Greece), were immersed in recessions.

Creditor countries in the eurozone are also the strongest exporters. For instance, exports to non-eurozone areas amount to 16% of Germany's GDP. A weakened euro is thus providing a boom for the export-driven industrial sectors. Second, by taking subpar interbank loans and PIGS (Portugal, Ireland, Greece and Spain) government debt from creditor banks directly onto their books, the ECB (+ the currently being formed European Financial Stability Facility [EFSF]) are helping reliquefy and strengthen the balance sheets of the former.

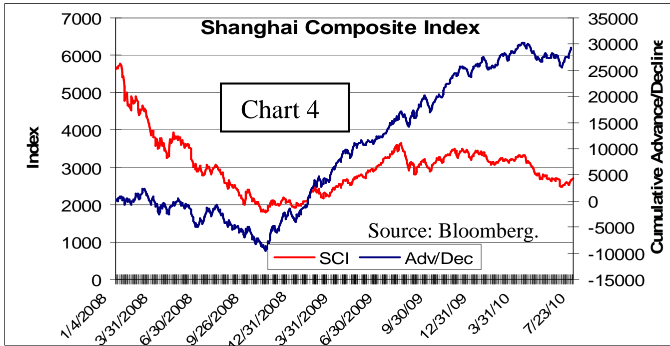
Before long, these bankers will relend the liquidity recycled from the ECB, especially in their home base, and when that happens, money velocity will rise, which is stimulatory. Indeed, reports indicate a rise in property purchases in Germany. Note the uptick in loan demand in Germany (Source for Charts 1 and 2: Barclays Capital Survey).



In contrast, GDP growth in PIGS economies will continue to shrink. The intended policy is to raise national savings and shrink the current account deficit as public spending is cut and the private sector boosts savings. PIGS exports to non-eurozone areas are weak, in low single digits as a percentage of GDP. Thus, no scope exists for an economic impetus. For now, the liquidity recycling role of the ECB has calmed financial markets. But at some stage, the size of reduction in income and wages in absolute terms, plus mounting unemployment, will test social cohesion, and the risk of a problem debtor nation opting out of the euro will very likely resurface.

The two-tier nature of eurozone economies is driving two-tier stock market performance with creditor countries outperforming (Source for Chart 3: Bloomberg). Recent rallies in Greece and Spain are classic sucker rallies.

CHINA China's bourse is also showing a two-tier situation but of a different sort—strong market breadth, as indicated by the cumulative advance/decline (A/D) vs. the ~30% fall in the main Shanghai Composite Index since 3Q09 (Chart 4).



The top 50, making up ~70% of the market cap-weighted main Composite Index, is dominated by financials and materials. Indeed, the 30% bear market fall of the main index since 3Q09 has masked the bull run of small to mid-caps into April 2010, driven by high overall local confidence.

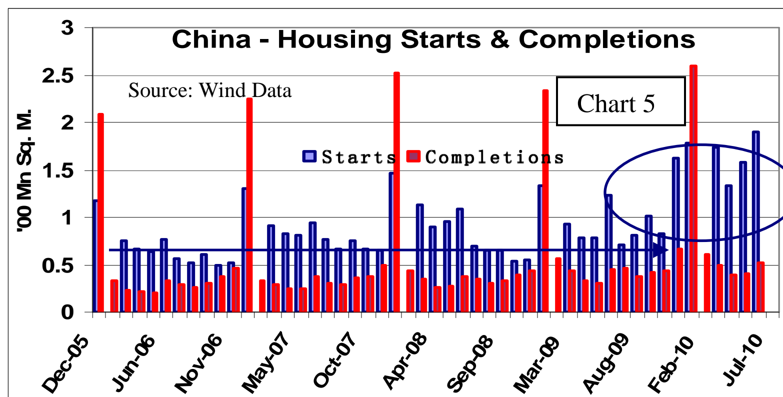
Over 1,500 listed stocks are on the Shanghai bourse. The cumulative A/D line tracks the running total of the number of daily advances vs. falls in this universe. The A/D line indicates very good, broad market strength.

The double-tier stock market performance reflects the two-tier macro policies of the government. Macro credit tightening is targeting property speculators and forcing companies hoarding commodities to unload their bloated inventories in ferrous and non-ferrous metals. However, local investors in China are betting authorities will not let China's GDP growth rate fall too much. Confidence remains high, liquidity is plentiful in the system, and consumption is buoyant on the back of policy incentives such as subsidies and tax cuts by authorities. Domestic economic momentum is strong. Those looking for a marked economic slowdown in China and, thus, another round of policy stimulus, will be disappointed.

Housing Boom in China: Local Officials and Developers Sharing Similar Interests

The property market boom in 2006–1H09 was primarily a price boom. Growth in the volume of housing starts and completions were limited (Chart 5). In China, developers pre-sell housing before completion and collect 100% of proceeds when buyers sign sales contracts, mortgages having been prearranged with local banks. Regulations on presales are set by local governments, often to maximize the revenue stream from land sales and to favor developers. Some were so lax that developers could pre-sell on the receipt of a building permit with little construction begun. Since 2H09, most require completion of a foundation (~30% of construction cost). Only a few, limited cities, e.g., Shanghai, require topping out of buildings (70% to 80% of total cost).

With prices rising, the industry had found little need to increase supply. Strong cash flow to developers under this business model enabled developers to hoard land and build a land bank. Since 3Q09, the central government has severely cut off bank credit supply to developers, forcing them to increase the supply volume of presales for cash flow.



Note the huge surge in housing starts in 4Q09 through 1H10 (Chart 5). Housing starts in 4Q09 will have foundations completed during 1H10 and be ready for pre-sell launches. The jump in supply volume over the coming months in 2H10 will be 2x to 3x the volume of recent years.

The market has probably discounted a 15% to 20% drop in housing prices. Risk of more downside than that exists, given the coming, huge volume of supply.

Chinese Communist Party Put

Markets are betting that when signs of slowdown materialize, the central government will relend and loosen policies again in favor of growth. Shares will then have another run.

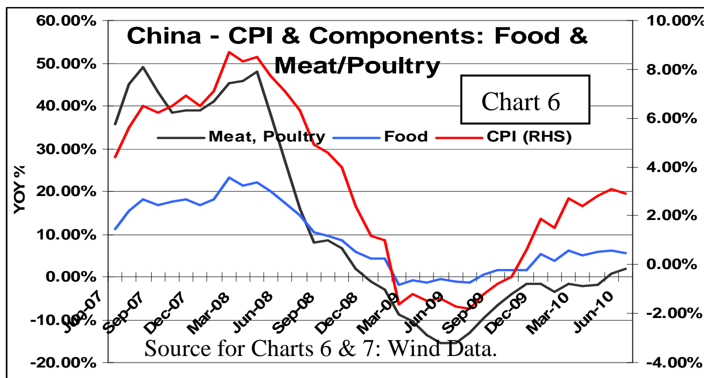
This bet is equivalent to the "Greenspan put" of lowering of interest rates every time the economy slows. But as we all know now, the problem is the bubble becomes successively larger each time. For China, the key dynamic is the fight between the central planners and local officials: the former are concerned with macro issues such as socially affordable housing and corruption, the cancer of the Communist Party. But most local officials want to maximize vested interests on

their own agenda, while they still hold power in their current positions under the five-year term limit. Once the credit taps are back on, there will be no shortage of vested interests eager to take funds from willing bankers, their local cronies.

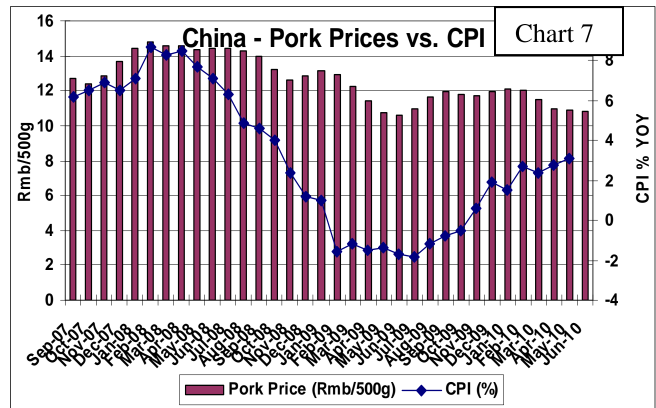
Can the central planners risk facing another run of excesses and, thus, an even bigger bubble in 2010 from loosening prematurely? No. They cannot risk volatility in 2011, ahead of the 2012 changeover year of Hu/Wen as president/premier and the entire government hierarchy for a new five-year term. Any loosening in 2H10 will likely be very, very gradual.

Risks of Rising Inflation

CPI in China has risen to +3% YOY, driven by an increase in food costs (grains and vegetables thus far). Meat items are still in deflation, which helped mask inflationary pressures of food costs on the overall CPI (Chart 6). The risk is a cyclical upturn of the pork cycle, a major basic meat item. At current historical troughs for pork prices (Chart 7), farmers are losing money on each pig raised. At some point over the coming months, supply will turn into a deficit, the cycle will turn and, coupled with higher grain prices and a rise in service sector inflation from double-digit wage rises, will likely drive CPI to rise past mid-single digits. Such an event will aggregate the negative interest rate situation and force China to raise interest rates. At present, market sentiments are very complacent about inflation and negative surprises are likely.



Source for Charts 6 & 7: Wind Data.



HONG KONG AND SINGAPORE The following numbers illustrate the two-tier nature of the "haves" and "have-nots" in the housing market. Medium household income in Hong Kong is HK$18,000 per month. A 20-year mortgage at 2% for 70% of a HK$4 million flat (size 400 to 600 sf, gross, <70% net usable) equates to HK$15,000 in monthly mortgage payments. Each 1% rise in interest rates adds HK$2,333 a month in interest. Affordability is very stretched for the have-nots and entry-level local buyers.

No other economies in Asia are more exposed to negative interest rates than these two countries. Mortgage rates in Hong Kong are available at a paltry 0.7% spread above the local interbank Rate (HIBOR) of 0.7%, i.e., 1.4% total. Singapore is not far behind. With rental yields ranging from 2.5% to 4.5%, property prices have surged in the mass market. High-end properties have long ago taken off into the stratosphere.

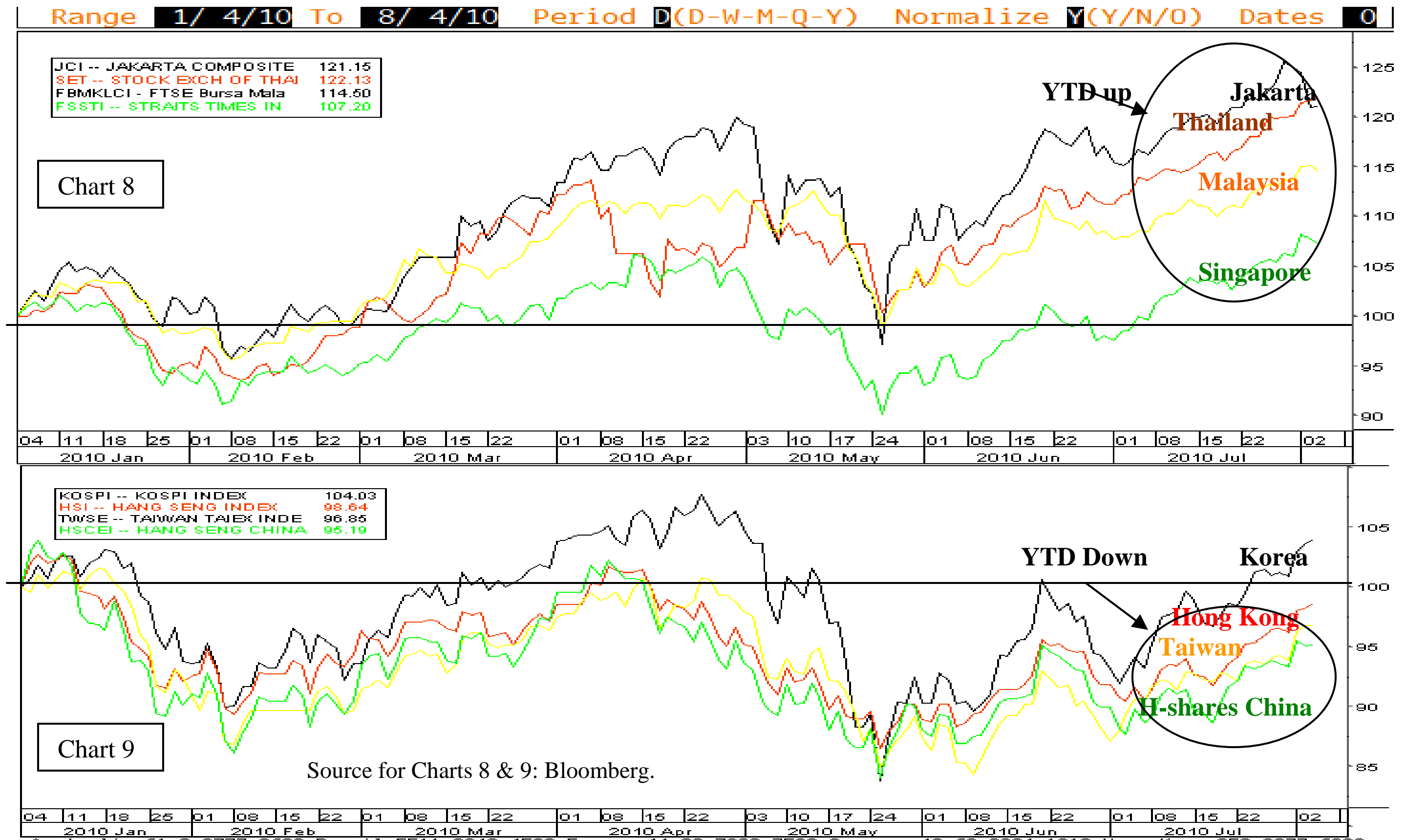
So, who's buying? The haves—for investment purposes, renting to the influx of young professionals and workers with technical skills from abroad. Immigrants with money to invest are also buyers. Both Hong Kong and Singapore have pursued an open-arm policy of attracting young professionals, aspiring entrepreneurs wanting to set up businesses, and those with money to invest, which is making work visa and residence applications an easy process.

Out of Singapore's 5 million people, 1.2 million have come from abroad over the past 10 years—including from India, Malaysia and China. Hong Kong has 50,000 migrants a year from China. Many now operate small businesses, from restaurants to retail and service trades, and have bought their own flats. An increasing number of Europeans and Americans have also come to Hong Kong and Singapore in search of better opportunities.

Rising social discontent about high housing costs has divided the social strata into those who have and those who don't. The governments may eventually succumb to social pressure and increase the supply of socially affordable housing, but it won't address the issue. Low interest rates are the culprit. As long as very low interest rates persist, which is likely to be the case as long as the U.S. economy remains sluggish, the asset bubble will not deflate. An eventual, meaningful rise in interest rates will easily pierce the bubble as all mortgages are on floating rates. But, prior to that, we can expect social discontent to mount and property markets to turn into political footballs.

ASEAN Will we buy property stocks in Hong Kong and Singapore? No. On a risk/reward basis, property stocks in Jakarta and Bangkok offer equal, if not better, upside potential as they rank better in terms of fundamentals such as valuations and housing affordability, and government policies there are conducive to broadening home ownership.

Property is just one of the sectors with good fundamentals in ASEAN markets. Others include infrastructure investments, distributors of consumer goods, financials, auto and consumption-related sectors. While China's economic cycle is quite mature and the central planners are fighting excesses, consumption and investment cycles are just beginning to pick up momentum in these economies. Liquidity is plentiful and current accounts are strong. ASEAN markets are therefore in the sweet spot of money x confidence. This explains the two-tier market situation in Asia Pacific, with ASEAN bourses outperforming while China, Hong Kong and Taiwan are down year-to-date to end July.



Source for Charts 8 & 9: Bloomberg.

CONCLUSIONS AND INVESTMENT POLICIES As discussed above, the two-tier nature of stock market developments is driven by economic fundamentals, which have not yet fully played out. For instance, we expect rising inflation to continue to restrict the outlook for China stocks. At the same time, authorities have seen what happened in 1H09 when the credit gates were opened, and are still grappling with reining in the excesses from that policy error.

We expect AEAN bourses to continue to outperform in the region, driven by the beginning of their economic cycle upturns and supported by plentiful liquidity and rising local confidence. Our regional funds are over 40% invested in ASEAN. The target is 50%, pending identification of more stock and sector buy candidates. Our ASEAN exposure has been a major contributor to our YTD, positive portfolio returns.

The Net Asset Values GSI Asian Capital Growth—US$24.52 The Long Short Fund—US$22.51 (Jul 29, 2010)