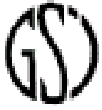

The Issues

February 3rd, 2011

THE YEAR OF THE RABBIT

As 2011 begins to unfold, *The Issues* finds a number of similarities in the overall stock market environment between the current Year of the Rabbit and the Year of the Monkey in 2004. Not that monkeys and rabbits are alike, but they do share certain similarities. Both are highly sensitive characters, easily excited and jumpy. Markets were jumpy in 2004, and a similar backdrop seems likely in 2011.

The year 2004 arrived on the back of a major 2003 bull stock market on Wall Street, fueled by a massive dose of liquidity from the U.S. Fed, which drove the U.S. Fed Funds rate from 2% to near zero. In addition, the U.S. economy was recovering from the hangover of the dot.com/IT bubble. Markets were faced with prospects of the Fed withdrawing surplus liquidity and raising interest rates. China began 2004 suffering from rising inflation, thanks to high credit growth in the prior two years, which forced authorities to tighten. These events made markets jumpy.

Substitute 2011 for 2004 and "credit" for "dot.com," and we move back to the future, i.e., the present with a similar set of circumstances: a Wall Street rally the year before; Fed Funds rate at near zero; and signs of recovery in the U.S. economy. China is again witnessing rising inflation, thanks to high credit growth in the prior two years, and authorities are faced with a choice between the devil (runaway inflation) and the deep blue sea (take the plunge and tighten up).

The Past—The Monkey in 2004

What did the monkey do in 2004? The Chinese tightened and the U.S. Fed started to raise interest rates. For much of 2004, stock markets were "monkeying" around, performing a number of swings that turned out to be false rallies, with each peak successively lower than the previous one. The lows got lower and, by fall, most market indexes were under water by single to double digits, versus the start of the year. And just when most fund managers, worn down by the swings, were about to give up, Wall Street, rallied by sharp double digits, did a final monkey-king type catapult in 4Q04 and leapt out of the cage to lead global markets back on a roll that lasted well into 2007.

The catalyst? The market read the signs of the Greenspan "put." The market was conditioned by Volker into "don't fight the Fed. When the Fed starts to raise rates, be careful." Under Greenspan, the market learned over time to ride his put—a U.S. Fed policy designed to keep the good times going, which ended with 2005-07 witnessing one of the biggest credit bubbles in U.S. monetary history. It was caused by securitization run amok, i.e., the growth of the shadow banking system.

The year 2004 taught investors to stay sensitive, agile and flexible, all character traits of a healthy monkey. Monkeys like to swing around, so the trick is to remain aware of the big picture and not be fooled by shorter term market swings.

The Present—The 2011 Rabbit Is Political

As in 2004, stock markets in 2011 started off in a bullish, secure mood on the back of fantastic gains the year before. But very quickly, as we are still deep in winter days, the rabbit character of insecurity is settling in, in varying degrees among markets. After solid gains in 2010, most markets, accustomed to the run of generally positive economic news, have become sensitive to any potential rise in uncertainty. Although a number of Asian bourses were first to show jumpiness on worries over inflation and rising interest rates, we think the tendency for investors to become more jumpy is universal.

We think the big picture in 2001 will likely be driven by political trends. In particular, politics has the potential to produce black swans: something totally unexpected (not a Chinese Zodiac animal) that, on sight, can scare the living daylights out of the rabbit. In *The Issues* of January 2010 titled "2011 Outlook: Politics Matters," we discussed the political dynamics at play in China. This month's *Issues* discusses key political factors globally and in various Asia Pacific ex Japan economies.

Global Issues

Eurozone—Issues remain about what to do with over-indebtedness and whether PIG will expand into PIGS by engulfing

Spain. With debts at over 130% of GDP (or above), mostly externally funded, and foreign debt servicing at over half of foreign exchange earnings, resolutions for these heavily indebted economies require drastic measures.

One option would be a long period of suffering via sharp declines in real wages in debtor economies relative to wages in creditor economies that could restore external competitiveness and raise foreign exchange earnings to repay debt. Another option is, in essence, a bailout by the taxpayers of the creditor economies—disguised as financial stability packages and ECB lending by eurozone politicians—to help debtor nations pay off creditor banks and bond investors, Or, debts could be restructured, which the same politicians have hitherto desperately tried to avoid.

To maintain the current *status quo* of the euro, public backing is essential, meaning the willingness 1) of the public in debtor nations to sacrifice and suffer a sharp decline in real wages; or 2) of taxpayers of creditor economies to bail out debtor nations. Political factors will determine the outcome. The situation is thus fluid and could turn messy if public backing wanes for any of the governments concerned. A messy outcome could cause the euro to plunge, and the resultant surge in the dollar would zap Wall Street, as it did in May 2010. A weak dollar is a key earnings driver of the S&P 500.

<u>Middle East</u>—If another black swan were to appear, this is where its presence would be felt globally. The social and political movements emerging in certain Middle Eastern countries are the substance of revolutions. We need no physical blockade of the Suez Canal. A tightening of political tension in the region will be sufficient to send the price of black gold up further, as user countries with small strategy reserves will continue to build inventories (e.g., China). Speculator buying will add fuel to the fire. The rise in fuel oil will hurt the rich as well as the poor (unlike food). Perhaps that may be the final-straw to snap politicians into pass laws to regulate activities of financial speculators in physical commodities.

Politics in Asia Pacific ex Japan

<u>China</u>—Previous credit tightening occurred when a new team of managers/officials took over in 2004 (2003 being the start of a new five-year term) and in 1H08, the start of the next five-year term. Like new managers taking over control of a firm, the first target is to purge prior excesses. Although March 2012 is the official date for a new team to take over the running of China, members will be nominated during 2011. The core team, once nominated, can essentially influence policy directions by 2H11. If inflation remains pressing over coming months, as it most probably will, tough credit tightening will be a reality. If the new team does not squeeze hard, they risk facing runaway inflation and social instability by the time they take office. Our investment policy in China remains strictly sector- and bottom-up stock selection.

<u>Thailand</u>—The political divide between yellow shirts and red shirts is still unbridgeable and remains potentially explosive. Thailand is likely to have a general election sometime over the coming months and pressed by rising inflation, it is likely to be sooner rather than later. To prepare for the election, the ruling Democrats have been pursuing populist policies and spending since 2H10, and on a greater scale than in the Thaksin days.

Assuming they win, will they continue spending or tighten their belts to curb demand and fight inflation? We think the latter is more likely. And if they lose? The market will not like the prospects of more witch hunting—this time the "reds" going after the "yellows." Thus, we have halved our Thai exposure since end 2010, preferring to wait until the clouds settle. The economy is fine, the credit cycle is moving back up, and FDI is active, led by the auto-related sector as well as rising direct investments from China. We will take advantage of better re-entry points later on.

<u>South Korea</u>—President M.B. Lee, with two years remaining in his term, is increasingly being regarded as a lame duck. But the wild political card here is North Korea. Unlike his predecessor, Lee's tough stance on the North, with a reduction of financial and other forms of aid, might have in fact contributed to the latest military-related skirmishes initiated by the North. The South is now restarting talks with the North, but the situation remains a potential black swan. In the Koreas, a clash of egos can greatly complicate the political landscape. Our exposure to Korea is small.

<u>Malaysia</u>—Malaysia's political cycle looks quite positive for financial markets. PM Najib has been pursuing more liberalization and reforms to harness public support and, so far, reaction has been positive—witness the increase in local confidence exhibited by the sharply rising stock market turnover and rally in the Malaysian bourse. Some of his policies are populist, e.g., commencement of the underground railway construction project and various other civil works. But part of his liberalization is also a definitive move forward: Foreign banks can now own 70% of Malaysian commercial banks

(up from 49% previously); and the residual 30% can be owned by any Malaysian entity, not just Bumiputras, the indigenous ethnic Malay group. We like the progress and have raised exposure in our regional funds to over 20%.

The oil services-related sector in Malaysia offers a good hedge against geo-political uncertainties in the Middle East, as does their counterpart in Singapore. We have already built a position for our funds in this sector and will add more.

Taiwan—Politics have been moving in the right direction for the local stock market, with the ruling party winning three of the five city mayor elections in December 2010. Since then, the Taiwan stock market has been an outperformer in the region (the largest exposure by market—over 23% plus in our regional funds and over half in our Greater China Fund). This outperformance is likely to be ongoing over coming months, as we expect the ruling party to continue pursuing populist policies and measures conducive to economic growth, laying the ground for political campaigns that will gather momentum in the second half of 2011 in the run-up to the presidential election in March/April 2012.

Indonesia—Inflation has crept up to 7% YOY and the central bank is behind the curve in raising interest rates. Indonesia is further along the business cycle curve than other ASEAN nation so interest rates will have to rise, as inflation in this cycle likely has already troughed when it touched 5% YOY in late 2010. This market has done very well, and we have already halved our exposure, preferring to stay selective for the time being.

One of the sectors we remain keen on is property, particularly companies with strong land banks for their inflation hedge feature. For historical perspective, over past decades when inflation and interest rates were in double digits, the value of land for property development in Indonesia's has also advanced at double-digit rates p.a., matching or in excess of inflation rates. Domestic politics? We see no negative developments of note.

The Future—Is 2011 the Year of the Rabbit or the Hare?

Rabbits burrow underground for protection, set up their warrens and thrive in colonies. They hop in and out of different holes but go back to the same warrens. They are like finicky investors and momentum followers benchmarked to indexes who hop in and out, over- and underweighting subcomponent index-constituents but with their funds essentially stuck in the same investing warrens of the mix of indexes against which they are measured. Flow-of funds by momentum-driven funds benchmarked to indexes was a key contributor to the liquidity/momentum-driven bull market runs of 2003 and 2010. But when good news is largely discounted and uncertainties surface, fund flows *in* and *out* of major index constituents becomes a major driver of market volatility—and 2011 seems to be heading that way.

Hares live by themselves in nests above ground, have much stronger hind legs and taller antennas (longer ears). In the face of event-driven danger, they prefer to run fast, like the Speedy-Gonzales jackrabbit cartoon character, and charge toward greener and safer pastures elsewhere. We would prefer 2011 to be the Year of the Hare. At the same time, because 2011 is likely to be events driven (as opposed to liquidity/momentum driven 2010), our investment strategy will focus heavily on events-driven situations, e.g., Malaysian and Taiwan markets fueled by their oncoming elections, sectors such as oil and gas services, and specific bottom-up situational stocks. We are prepared to make active use of cash (currently at 13% to 15%, which will be raised or lowered as appropriate according to market conditions) to hedge against shorter-term downside volatility from adverse external events.

The shift in market nature from the liquidity/momentum-driven mode in 2010 to an events- and specific situations-driven one has important implications for asset allocators. For instance, at over 65%, China and Korea were major recipients of the total momentum flow of funds into emerging markets in Asia in 2010 (and over 25% into India). As events risks surface in 2011 and risk aversion rises, momentum-driven fund inflows will cease. In fact, the reverse may happen; fund outflows from e.g., China and Korea. But this will lead to opportunities elsewhere. Benchmarked funds that must remain invested in the warren of Asia Pacific ex Japan indexes will seek to hop out of their riskier northern Asia holes into safer havens within the region, rotational moves that will likely allow Malaysia and Taiwan to continue outperforming as they are currently.

The Net Asset Values GSI Asian Capital Growth – US$29.19 & the Long Short Fund – US$26.75 (Jan 27, 2011)