MARKET TRUTH

BRIDGEWATER

April 2007

Economic Review

TAKING SHELTER IN CHINA

After the recent global market jitters starting with the Shanghai mini-crash of 27th of February, there is still much confusion prevalent among investors as to the outlook for the global economy in general and China and the Yuan in particular. It is especially hotly debated even among the most well educated economists and analysts whether the real problems in today's financial markets lie in China or in the United States, and whether or not China's economy would be able to withstand the onrushing collapse of the United States economy, or go down with it.

This confusion is not surprising, as with today's abundance of daily noise of financial news all around us it is becoming increasingly difficult these days for investors to calmly filter out the garbage and stay focused on the big picture. Only a few outstanding economists have retained this ability, such as the internationally renowned financial author Bill Bonner, who remarked on this issue:

> **"Asians make things and sell them to Americans, who borrow money from their suppliers (on the inflated value of their houses) in order to continue living beyond their means. Asians take their profits and either re-lend them to Americans... or use them to buy more productive capacity, in America and elsewhere. For those who wonder where this trend will lead, we offer a guess: The average American will be left with a shoeshine kit and instructions on how to say "please" and "thank you" in Chinese." – Bill Bonner**

And indeed, when we now look at the recent market volatility, it should be noted that it was NOT actually caused by bad economic numbers out of China, but rather by the first tremors of an impending financial and economic crisis in the United States, where the unravelling of the machine-tool industry and mortgage market is now starting to affect the wider economy, with traders from Goldman Sachs Group Inc., Merrill Lynch & Co and Morgan Stanley being quoted by Bloomberg as valuing their own securities firms as "barely more creditworthy than junk bonds" and the state of Michigan facing a "fiscal train wreck" according to an Emergency Financial Advisory Panel assembled by Michigan's Governor Jennifer Granholm.

Yet these developments in the United States stand in sharp contrast to the Asian economies, the growth outlook for which was revised upwards to 7.7% for 2007 by the Asian Development Bank this week. China in particular continues to roar ahead, sporting a February trade surplus of $23.76 billion, which was three times the amount economists expected. At the same time, the Chinese Yuan, according to IMF data, is undervalued by 420% against a basket of the world's other major currencies, when adjusted for purchasing power parity. So it's not really very hard to see whether one should buy US assets and the US Dollar now or Chinese assets and the Yuan… clearly, we suggest the latter. Of course, the Chinese government knows these things too, and the real reason why they were purchasing huge amounts of US treasuries is not because they were seeking to buy a good investment, but rather because they were seeking to buy time. Time to build up the productive capacity that is being dismantled in the United States, and time to develop their own consumer market so as to be able to withstand an export fallout in form of a US economic collapse.

The recent comment by China's central bank governor Zhou Xiaochuan that "we do not intend to go further and accumulate more reserves", however indicates that this time is now up, since the debt burden of the United States has grown beyond where interest on the debt can be served, and since China's and Asia's domestic consumption has significantly strengthened. So investors who are still US heavy today should make a swift move into China/Asia and/or tangible assets or risks watching the value of their assets depreciate significantly. But while investing in China and Asia to gain exposure to their economies and currencies is therefore now a must, it's also not just that easy, and clearly such investments would at this moment also imply several serious risks that investors should be aware of.

First of all, it should be noted that over the past years many investors, banks and funds have been using 'cheap' money borrowed in low-interest rate currencies such as the Japanese Yen or the Swiss Franc, to invest in 'higher-yielding' assets such as US mortgage-backed securities. With the US mortgage bubble house of cards now coming down, these carry trades may unwind and result in the exit of speculative money, and rising exchange rates of the Swiss Franc and Japanese Yen. Some of this speculative borrowed money also went into Asian equity markets, no question, and therefore further corrections are possible. Secondly, although China's domestic consumption has been growing rapidly, a US crisis would still hurt China and Asia, in particular the exporters. Thirdly, there is a rising risk of a war between the United States and Iran, which could have an adverse impact on the global economy, and, last but not least, China faces increasing challenges with regards to pollution and water supply.

What investors should do to account for such risks, when investing in China and Asia at large, is not to invest on a leveraged basis, especially not with loans taken in Yen or Swiss Franc, to invest only for the medium-long term, not for short-term speculation, to seek out value focused and local inter-Asian demand oriented strategies as opposed to high growth exporters, and to hedge any Chinese/Asian equity exposure via the ownership of precious metals as a financial crisis protection, a bit of oil as war protection and via investments in direct agricultural commodities to hedge against water shortages (since 70% of global water consumption is being used in agriculture). It should be noted in the latter regards that both precious metals and agricultural commodities are still trading at very substantial discounts today when compared to their 1980's highs, and that for both sectors the fundamentals are extremely positive. South Africa's gold production has reached an 84 year-low, Australia a 13-year low, while grain stockpiles stand at 25-year lows, well below the safety-buffer recommended by the United Nations Food and Agriculture Organisation.

Getting it Right

LONDON IN ITS 13TH STRAIGHT YEAR OF THE PROPERTY BOOM !

Whenever I used to speak with colleagues about the incredible property booms in Australia, the US and the UK, 6 or 7 years of unbridled growth would always be mentioned. It wasn't until I was studying the Halifax UK housing data that I actually realized that we are in the 13th consecutive year of their unbelievable rally. When people start talking of 'unbelievable' that is definitely the time to slap yourself with a cold towel and ask if it is really the Magic Kingdom, or a Utopia where Estate Agents are the master race?

I was studying the data trying to work out just how much air had been forced into this balloon and my first glance at the data suggested that if you did not like loud bangs, it's probably better to rent just now. I was actually on a mission to try and work out why so many of our 'traditional' asset classes have looked decidedly peaky for some time now, but just keep going up.

With housing I believe I found the most conclusive evidence, and it strongly suggests that Newton might have been highly intellectual but not much of a property investor. I have reason to believe that the 'must come down' bit referred to his apartment and not his apple. This article wasn't really meant to be about property, so I'll try to briefly explain my concerns;

In the past we have had many property booms with growth considerably exceeding inflation and generally lasting between 5 and 8 years.

Just above the inflation line (RPI or Retail Price Index) sits the National Average Earnings Index (NAEI). Common sense suggests that if you need a mortgage to buy a property and the maximum mortgage is limited to a multiple of salary, then when the average property price is considerably above most people's maximum mortgage, potential buyers will become scarce. Combine this with many who squeezed themselves dry frantically getting on the rising property ladder only to see interest rates innevitably go up, they will be in big trouble. It is customary at this point for prices to start falling through lack of confidence/demand, leaving mortgage debt levels unchanged and the dreaded negative equity ensues, fuelling a spiralling drop set to continue for years.

Consider these figures relating to the last big expansion of Greater London Property prices which ran out of legs in 1988;

Growth.	130% above RPI over previous 5 years.
Drop.	60% below RPI, and lasting for 6 Years.
Calendar years required to regain previous high.	10. Total return over the period 47% below inflation

What is the position now?

Growth.	235% above RPI over previous 12.5 years, 1994 to 2007.
Drop.	Refer to above for guidance.
Time to recover to previous high.	Refer to above for guidance.

Of course we don't know for sure that there will be a drop, but we are staying very light in these traditional assets. With Equity Markets appearing to be held up by pure Will power and huge amounts of cash sloshing around the globe (not least within the super rich Private Equity Funds) there seems to be a lot of artificial support for current prices. Diversification away from these assets must make sense if you want to protect your wealth.

If you do have an unbridled desperate love of all things bricks and mortar, don't highly leverage, think of Property funds which provide liquidity or consider switching from your overpriced low yielding residential property and look for the far more realistically priced commercial property or land.

For the rest of us there is a vast array of high quality non correlating assets in the market place now, most of which were not even a twinkle in their custodian's eyes 15 years ago.

We are going to be looking at these over the coming month's, starting with Hedge funds. These looked to provide the answer for everyone, but then 2004 came bringing lousy returns, funds began closing just so they could restart and jump back on the previously distant performance fee train, others simply lost fortunes because risk control was boring! And of course the American fund managers fought tooth and nail to avoid being regulated by any authority.

It doesn't sound like a good area! But much is inaccurately reported and if you can access the knowledge required, there are many superb funds out there which are not currently waiting for the inevitable what goes up (too quickly and too far) theory to be proved yet again. Hedge Funds are here to stay because of their undoubted qualities, we'll be holding seminars to demystify the Hedge fund universe and provide practical guidance on many of the key risk areas to be aware of. We'll also be writing about it next month.

INVITATION TO BRIDGEWATER FORUMS – APRIL 2007

Venue - Bridgewater Conference Centre
1902 Cheung Kong Center, 2 Queen's Road Central

Tuesday 22 May 2007, 6.30pm to 7.30pm; and
Saturday 26 May 2007, 2.00pm to 3.00pm

STILL DON'T TRUST HEDGE FUNDS? WE DON'T BLAME YOU!

It seems strange that whilst record inflows continue to be added into Hedge funds with major Institutions, Pension Schemes and even the Harvard Endowment fund only too happy to take considerable exposure to this asset class, the individual investor is still very cautious and reticent to commit his or her capital.

At a time when the traditional asset classes are looking decidedly shaky, undoubtedly having great potential to provide substantial losses to the unfortunate unwary investor. Economic objectives seem set on promoting an incredibly cash rich global market place where even the worst companies can (for the time being) make profits. It has never been more important to create diversity and offer real protection for your wealth.

Hedge funds should be one of the ideal asset classes to gain exposure to, after all how many are there which can actually provide enhanced returns in times of political and economic turmoil?

However only the institutional investors are really gaining exposure, but why?

We believe it is too much information from the media and the Industry. A strange comment, but we see that the information is often woefully inaccurate! Secondly only the big boys have the knowledge to carry out meaningful due diligence and gain access to that small clan of exceptionally talented Hedge Fund Managers.

Our seminar which recognizes how difficult the job is for the ordinary investor, will provide a unique insight from within of what is fact and what is fiction, together with those areas which are crucial to access and monitor if you are going to find those solid funds which offer the sought after consistency of performance which very few managers can provide.

We are delighted to be providing you with the unique opportunity to gain some of that knowledge from Brian MacDougall, who has years of experience in the hedge fund industry and has frequently been sought for his ability to understand what is key in the due diligence process and identify where shortfalls exist or future problems may arise. Brian is Executive Director of 3a Asia, part of the Multi Billion Swiss Banking Group, Banque Syzte.

PLEASE BOOK YOUR PLACE by e-mailing us at forum@bridge-water.com, or by calling us on 2525 3639, or by faxing a copy of this page, with your details below, to our office on 2525 3679. All information received by us will be treated as private and confidential.

Please register me for your forum on (please tick): ☐ Tuesday 24 May 2007, 6.30pm to 7.30pm
☐ Saturday 26 May 2007, 2.00pm to 3.00pm

Name: ____________________ Phone: ________________ E-Mail: ______________________________