

June 2010

House Commentary

## THE SECOND PHASE OF THE GLOBAL FINANCIAL CRISIS

As we have been warning for a while, the 2008 financial crisis was never resolved. The problems back then were merely transferred from the balance sheets of insolvent Western banks to the balance sheets of already-struggling Western governments. This has led to a debt/deficit crisis in most Western countries, that is now showing not only in the southern European countries of Portugal, Ireland, Italy, Greece & Spain (the PIIGS countries), but also in France, Germany, the UK and the USA.

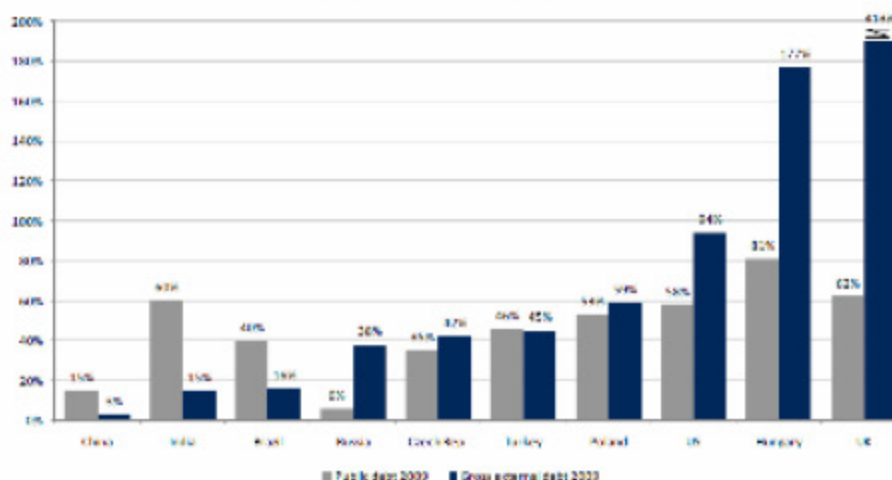
What is important to understand is that during the first phase of the crisis (in 2008) investors panic-sold commodities and stocks (the perceived high risk asset classes) and sought shelter in the perceived safe heaven of Western sovereign bonds and cash.

In this second phase of the crisis however (now centered around public debt and sovereign bonds) we may actually witness the opposite development, i.e. investors panic-selling Western sovereign bonds and currencies, and seeking shelter in various commodities, starting with gold, as well as other inflation-proof assets. This may include stocks as well, because stocks often represent real assets such as resources, factories, land etc.

When screening the globe for investment opportunities in equities at a time when interest rates appear set to rise and a Western sovereign bond crisis appears imminent, one should target countries with relatively low debt figures, where a contagion of a debt crisis appears less likely.

Two important criteria in this regard would be a country's total public debt as a percentage of GDP as well as external debt (or foreign debt) as a percentage of GDP. (External debt is that part of the total debt in a country that is owed to creditors outside the country, with the debtors including the government, corporations or private households.) A high external debt figure can be a warning sign, as it makes a country vulnerable to sudden capital flight.

### BRIC's debt manageable whilst UK at risk



Overall, when looking at these figures, it appears that the debt of BRIC countries is quite manageable, with a relatively low risk of sudden capital flight. This is starkly in contrast to a number of developed countries, particularly the United Kingdom.

We therefore maintain our preference for selected equity positions in a number of emerging markets over the Western 'developed' world.

*Investment Committee, Tyche Group Ltd*

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## Investment Overview

### Will the Mainland property market go burst after the strict policies by Central Government?

In the wake of the European Sovereign Debt crisis, and the introduction of new measures by the Chinese Central Government on the local property market, mainland stock markets were hit sharply. The Shanghai Composite Index has dropped 21% to 2,592 by the end of May this year, which is one of the worst major stock market falls other than Greece.

The Mainland stock markets have been plagued by real estate policies. The property market had a significant impact on the domestic economy. In 2009, China's GDP was RMB 33.5 trillion, an increase of 8.7%. Urban Fixed Asset Investment came in at RMB 19.4 trillion, which has increased by 30.5%. This produced a significant effect on overall economic growth. Real estate investment by itself contained RMB 3.6 trillion investments, accounting for nearly 20% of the overall investment in fixed assets.

Therefore, interpretation of the government's policy on the property market has become a hot topic. China's Premier Wen Jiabao has repeatedly emphasized that the government will "stem the sharp rising of house prices in some cities", and launched certain policies to suppress the over-heating of the local property market. However, the property market keeps rising regardless.

On 17 April this year, the State Council of the PRC released "Ten New Rules", including a stricter mortgage policy. For a second home purchase, the deposit cannot be less than 50% of the total value and the mortgage rate shall not be less than 110% of the base rate. It rises sharply for a third home purchase. Mortgage lending will be suspended for non-residents who are not able to provide more than one year's certification of local tax payments.

In addition, for the first time, the responsibilities of local government for the property market have been clearly stated. Local government is to increase land supply, speed up public housing construction, penalize land developers for unused land, and to investigate price pushing and speculation. The market was shocked by this unprecedented announcement and the Mainland's property market is cooling down, following the detailed measures from Beijing and Shenzhen.

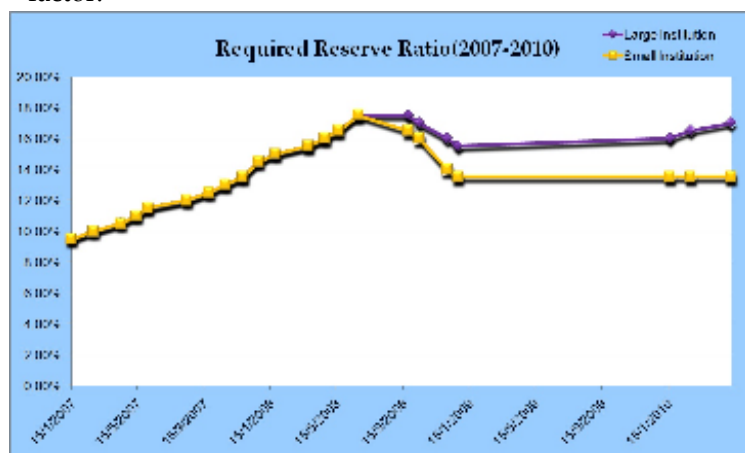
Investors are getting worried about the drop in property prices as a result of these regulatory changes in the real estate market. In fact, the real estate market and local government debt are bound together.

In response to the financial crisis in 2008, the Central Government launched a RMB 4 trillion economic stimulus package, with the majority of funds raised by the local government through borrowing from financial institutions. The China Banking Regulatory Commission estimated local government loans to the end of 2008 were RMB 4.3 trillion, rising sharply by 70.4%, to RMB 7.4 trillion by the end 2009.

Local government is highly in debt; part of the debt ratio is more than 200%. Land is used as collateral for financing by most of them; therefore they have to sell the land at a high price, to repay the debt. As a result, the local governors' passive response to the policies of Central Government has created a vicious cycle for the "sell high, buy high" phenomenon.

China's Real Estate Bluebook, (2010) published by the Chinese Academy of Social Sciences on 5 May, stated that due to increasing inflation expectations and demand / supply imbalance, the house price will only slow down its acceleration.

On Jun 1, the State Council of the PRC stated clearly that they will implement the property tax reform. It is predicted that the first trial will be in Shanghai. Undoubtedly, the property market will be under pressure, but it also eliminates a major uncertainty factor.



The people's bank of China has thrice increased the required reserve ratio to 17%, almost reached the latest high of 17.5%. This implies the chance of further raise will be minimal. Given the current uncertainties, the Central Government will probably monitor the development of the property market, and will not raise the interest rate in a short period of time.

The latest release of the house price of 70 large and medium cities in April recorded the historical high increase of 12.8%.

Therefore, the effectiveness of the policies was doubted. However, it is only a hysteresis effect and we expect the effect will be gradually appearing. With the rapid economic growth and rising income level, the demand for property will continue for a long period of time. The strong in capital inflow and lack of way out, the Mainland's real estate market will be more attractive in the long run, after the short term adjustment.

*MPF Division, TYCHE Group*

## MPF Management

### Will I suffer a loss for switching MPF scheme?

According to MPFA, there are about 3.3 million preserved accounts by the end of last year. Currently, members can freely switch their preserved account to another scheme. As the MPF Semi-Member Choice is going to launch next year, members are more flexible to select their desired scheme. One of the most common questions we were asked is whether they will suffer from a loss if they decide to switch the MPF scheme.

Suppose there was HKD 150,000 in a MPF account, holding 100% of Hong Kong equity fund in 2008, before the financial crisis. After the sharp drop in the stock market, the account is left with HKD 100,000 only. If the members switch the scheme, they feel that the loss is realized. However, as people are prone to risk avoidance they hesitate to make the decision.

In economics, there is a term called "Sunk Cost", in which the cost has been paid and non-recoverable, and this can explain the psychological factor in the case above. In this case, the loss of HKD 50,000 had been incurred regardless of the switching. Members should

treat the MPF account as cash and actively seek a better alternative by reviewing the fund choice of different schemes, instead of holding the same fund and waiting for the market rebound.

For instance, if we sell the Hong Kong equity fund when the Hang Seng Index is at 20,000, and we buy another Hong Kong equity fund at the same time. With no switching fee, theoretically we will not suffer any loss. Of course, the switching process from one scheme to another scheme may take 5 to 7 working days, and the investment will be temporarily pulled out from the market. However, the impact is insignificant, compared to the higher potential return in the long run.

The performance of constituent funds varies significantly, instead of wishing the current fund perform well suddenly, you should switch to a more appropriate scheme. However, you should consider factors like risk tolerance, fund performance and quality of the management team, to pursuit a better return on the investment.

## MPF Movement

### MPF contributions are being reviewed

- The MPFA is currently reviewing the upper and lower limits of the MPF monthly contribution, including an increase to the monthly contribution from \$ 5,000 to \$ 5,250 and the annual contribution from \$ 20,000 to \$ 30,000.
- The committee members generally oppose the suggestion; especially the discussion of minimum wage had not yet been finalized. In addition, if the upper ceiling jumped from \$20,000 to \$ 30,000, the monthly contributions will be raised by 50 %. Therefore, a phased increase in the contribution is recommended.

### System testing will be held by trustees early next year

- MPFA Executive Director Diana Chan said a computer system testing will be carried out for the 17 trustees by the 1<sup>st</sup> quarter next year, to ensure that their system can accommodate if more than 2 million members do the switching.
- Diana Chan claimed that 5 guidelines may be implemented for the trustees, including shortening the switching procedures, unifying and fund switching form, listing relevant information like trading price, and strengthening the monitor for intermediaries as well as promoting investment education.

We welcome any questions regarding MPF, including investment management and regulation, etc. We are pleased to share our views with you. We believe managing your pension fund place an important role for your future. We can be reached at:

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## TYCHE FORUMS

Wednesday, 23 June 2010, 18:15 registration for 18:30 to 20:00

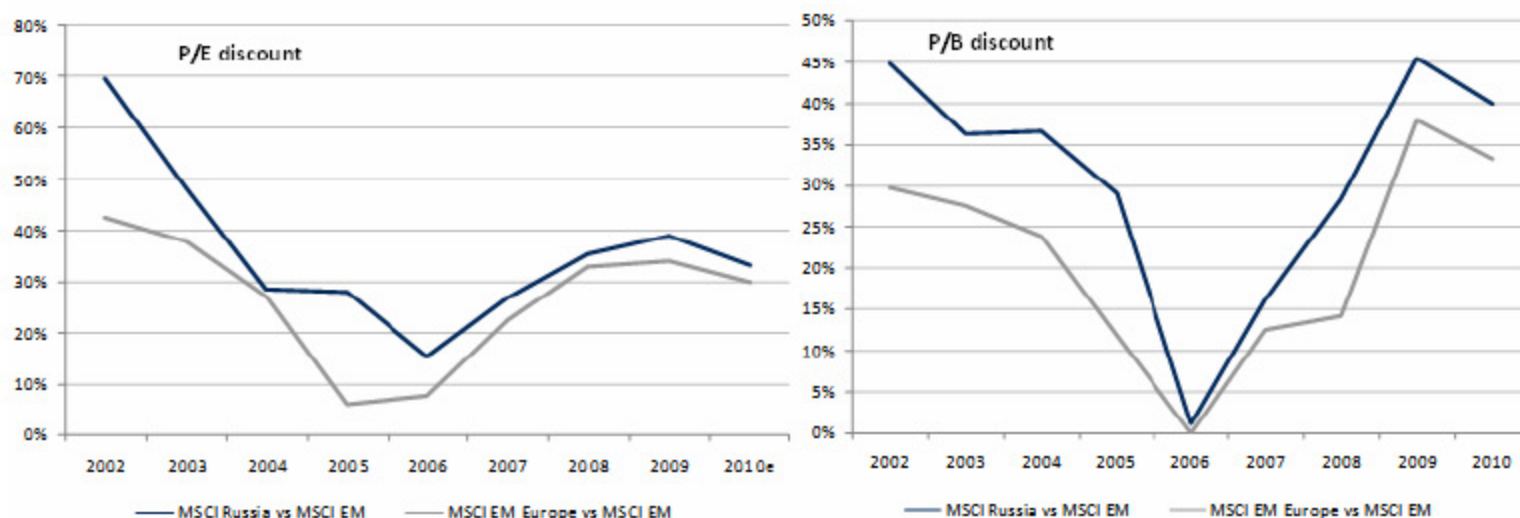
Podium Floor, at the Central Plaza Executive Club, Central Plaza, 18 Harbour Road

### IS RUSSIA BEING OVERLOOKED?

With its high dependence on oil prices, Russia suffered more than other BRIC members during the recent global economic downturn, and underwent the worst recession in 15 years, shrinking almost 8% in 2009. However, with the recovery in the oil price and various stimulus programs, the country grew by 2.9% in the first quarter of 2010, and it is projected that the expansion for the whole of 2010 may reach over 6%.

While this figure is still lower than the growth of many other emerging markets, it should be noted that increasing trade and economic integration with Asian countries, in particular China, as well as the relatively cheaper Price to Earnings and Price to Book valuations that can be found in Russian equities makes this market worthwhile to explore and consider (some exposure to) as part of a diversified portfolio.

Russian stocks trade at 30% P/E and 40% P/B discount to global emerging markets



At our Seminar this month our guest speaker will be a Russia expert who has deep knowledge and insight in these markets. This promises to be a very popular event with a longer than normal question and answer session so that you can ask direct questions to the people who are actually at the centre of the Russia story.

The Seminar will be presented in English by Mr. Julian Galvin, Associate Director, Tyche Group and our guest presenter for this Forum will be Mr. Michael Hanson-Lawson, CEO of East Capital Asia Ltd, who will be discussing the Russian Market Outlook and Russia investment strategies.

**Our seminars are often oversubscribed, so please register early for you and your friends to avoid disappointment. Please register in any of the following ways: phone (852) 2525 3639; fax (852) 2525 3679; or e-mail [forum@tyche-group.com](mailto:forum@tyche-group.com)**

Please register me for your seminar on (please tick):

Name(s) (please print) .....

Phone ..... e-mail .....

#### About TYCHE Group

- Tyche Group is a premier independent financial advisory firm based in Hong Kong. Its principles and practices can be defined as the process of providing advice and assistance to clients for the purposes of achieving financial goals.
- Tyche Group specializes in holistic financial planning and investment advice. We offer a one-hour meeting with an SFC-registered adviser to your overall requirements and objectives, at no cost to you and with no obligation to proceed further. To arrange a meeting, register online or call or fax us. We will contact you.

#### Disclaimer

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