

CHINA: BOOM STORY OR JUST THE NEXT BUBBLE?

Few can argue that the swift and uncompromising ascent of China to the world economic stage has been anything short of historic. Not a day goes by that we are not given yet another reason this juggernaut is leaping ahead in its quest to rise to the top. In the course of the past ten years, the economic output of China has thrust the nation quickly up the ladder of world economic superpowers. China is expected this year to surpass Japan to become the second largest economy in the world, as measured in GDP—if it hasn't done so already. China is now the world's largest market for consumer staples such as automobiles, personal computers and mobile phones. Just recently it also cruised past Germany to become the world's largest exporter. Its population is going through a great leap forward as hundreds of millions of individuals are at long last able to enjoy the comforts of being middle class for the first time. But mass migrations from the largely agrarian countryside to the heavily industrialized urban and coastal areas are straining even the most carefully planned public services. As a result, property prices in these areas continue to rise at a dizzying pace while many Western property markets have yet to recover from the losses of the past few years with a handful still continuing to fall. China's stock markets have recovered in value nearly all of their pre-Lehman collapse, and their economy is racing along at an eye-watering 14% annualized growth, according to the most recent estimates. But the million dollar question remains: *is this growth sustainable or is yet another bubble just being inflated?*

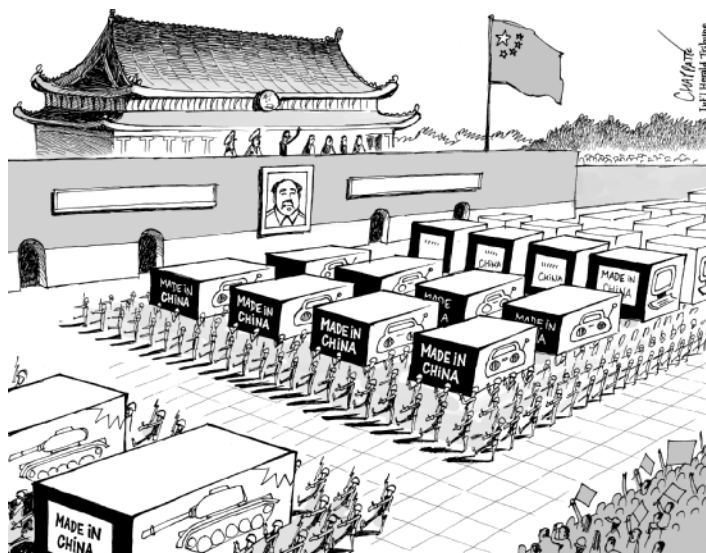
One needs to look at this seemingly simple question from a number of angles to draw an objective conclusion. Firstly, let us consider the broadest of measures for an economy's health: GDP. Growth rates in China have exceeded 10% per annum since 2003. Only briefly did they drop below this level (to 9%) in 2008. As noted above the current growth rates are much higher. It should be stressed that these are *officially released* growth rates. Many economists believe the true numbers are even higher, due to the fact that some areas of the economy are not represented fully in government statistics. The Chinese government, while encouraging high levels of growth through massive infrastructure development and lending to large firms from state banks, is also sensitive to being perceived as allowing growth to overheat. Indeed the government has implemented a number of efforts to reign in excessively frothy growth levels by raising interest rates, putting capital controls in place to restrict the free flow of money, and also increasing the percentage levels of capital that Chinese banks must hold on reserve. It is a delicate balancing act, as the authorities are very aware that the growth rate needs to stay above the crucial figure of 8% just to keep up with the massive amounts of urban migration and growth of the labor force. Considering that we have just lived through one of the harshest recessions in nearly 70 years and China has come out relatively unscathed should lead most to the conclusion that from an economic growth standpoint, there appears to be little evidence of an imminent collapse.

Secondly, and perhaps of more immediate concern to investors, is the current state of the countries stock markets. Since

reaching their highs in October 2007 the Hang Seng and Shanghai Composite stock indexes are still down by roughly 30% and 45% respectively. This being said, they had not only experienced excessively rapid growth on the lead up to this, but they also fell much steeper than most markets during the worst days of the financial crisis. Since their lows they have nearly doubled in value. Pundits have gotten on both sides of the fence here with some saying that they still have a ways to go and should see more recovery, while others are warning they could still drop back quite sharply again. Two things are important to remember when thinking about the Chinese markets. First, as they are at the forefront of the emerging market economies together with Russia, India and Brazil they are very prone to *sentiment*. When international investors get the impression that there is danger in a fall—for whatever the reason—sometimes sentiment alone can sweep the markets due to the sensitivity of this “hot money”. As this tends to be an area towards the higher end of the risk scale in terms of volatility, it is often the first area that is dumped in any panic. The other side of the coin is that it tends to grow faster when money is pouring in and sentiment is positive. Additionally the vast majority of mainland listed stocks are held by Chinese investors, due to current restrictions on what foreign investors are allowed to purchase. The Chinese government is acutely aware of this fact and has stepped in when necessary to ensure that the Chinese public believes the government will intervene when necessary to avert a crisis in confidence. This has proven a strong psychological buffer to the markets at times of low confidence or panic.

Finally, one cannot overlook the bottom line of China's balance sheet: more than \$2.4 trillion in hard foreign currency reserves. This combined with the fact that their own currency the renminbi is broadly seen as being undervalued means that there is a lot of room for the government to react if necessary to support the economy or the markets without immediately stretching their financial resources. This colossal war chest is in and of itself enough to move world markets and currencies when there is the perception they are re-diversifying their holdings. So needless to say that it should be more than enough to buffer any panic induced downturn should they need to use it.

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(story continued from previous page) China's growth has been stratospheric—this much no one denies. And with these levels of growth there will naturally be times where pullbacks and corrections will be necessary. This is normal and to be expected with any volatile emerging market. Indeed to not have these drawdown periods would only fan the flames of overheating more. Therefore, we would not only expect these, but would welcome them more frequently. This would allow investors to reconsolidate their positions, take their profits and bring the most over inflated prices back down to realistic levels. The most important question the investor must ask themselves is this: when including a very high risk and volatile area such as Chinese equities in your portfolio, is the amount allocated small enough to remain within your overall risk/return profile? If the answer is no then the holdings need to be cut. Lastly, holdings need to be pared back as they grow to maintain a level percentage of allocation within a portfolio. Otherwise they will grow to a disproportionate size and skew the portfolio to risk levels that are unacceptable.

WHAT CURRENCY DO YOU THINK IN?

As any expatriate knows, currency fluctuations can have a large impact on many aspects of one's life. Considering all the possibilities of one's inflows and outflows while working overseas, the question of which currency to hold, invest, spend or even "think" in can be problematic. Perhaps you are a British national who always thinks in pounds sterling, but works for an international company earning in Euros while living and therefore having expenses in Thai baht but plans on retiring in Australia. The variations on this scenario are endless given the variety of backgrounds and situations that expatriates find themselves in, and on top of this these situations change often.

The wisdom that should prevail when considering the myriad options of currencies is to effectively match your outgoings with your income so that you minimize the effects that currency (FX) movements have on your ongoing expenses as well as your overall financial plan for the future. Ask yourself where you intend to spend your money in the future. This should be what currency you are "thinking" in when planning for that goal. Therefore using the above example, if you plan to retire in Australia then your strategy should focus on reaching a certain amount of retirement savings in Australian dollars, irrespective of what that might be worth in other currencies at the time. This might entail beginning to save in Australian dollars in a drip feed manner, or it could mean starting a long term retirement investment with a lump sum in Australian dollars using other currency you might be holding at the moment. The crux of such a strategy is that you should aim to minimize the impact that unforeseen currency fluctuations would have on your overall financial goals. This means that the savvy investor should also revisit currency issues on a regular basis to ensure that their plan does not need to be adjusted to take into account FX movements.



Many investors would like to seek gains by leveraging currency movements to their advantage and therefore making profits by positioning themselves actively in different currencies at different times. This is a strategy that is much more difficult to achieve than might be obvious, and there are many reasons for this—the first of which is the notoriously fickle direction of the currency markets themselves. The FX markets, being by far the most liquid and widely traded markets in the world (with average daily turnover exceeding \$4 trillion equivalent) mean that the number of players in the market is inconceivably large. They are infamously difficult to predict and can be influenced by nearly any kind of news or data that are released throughout the 24 hour trading day. Many times mere sentiment alone can sway a currency one way or another, with this evaporating days later for no reason just to move to yet the next "big news" that comes out. Another reason for the difficulty in playing the currency markets for profit is the fact that each currency quote is a relationship between two currencies only. Therefore the rate may be moved by a weakness in one or in the strength of the other, or perhaps some combination of both. Additionally, as each currency has any number of different possible other currencies to compare it to, there is no one single market for pounds or Euros. An investor might say that they feel that the "Euro will be strong"—but against what? Euro strength against the USD might not mirror what the Euro does vis-à-vis the Japanese yen. Finally, unless investors are working with huge amounts of institutional money, frequent currency switches will most likely result in any would-be profit being eroded by the "spread" which banks charge each time an FX switch is made.

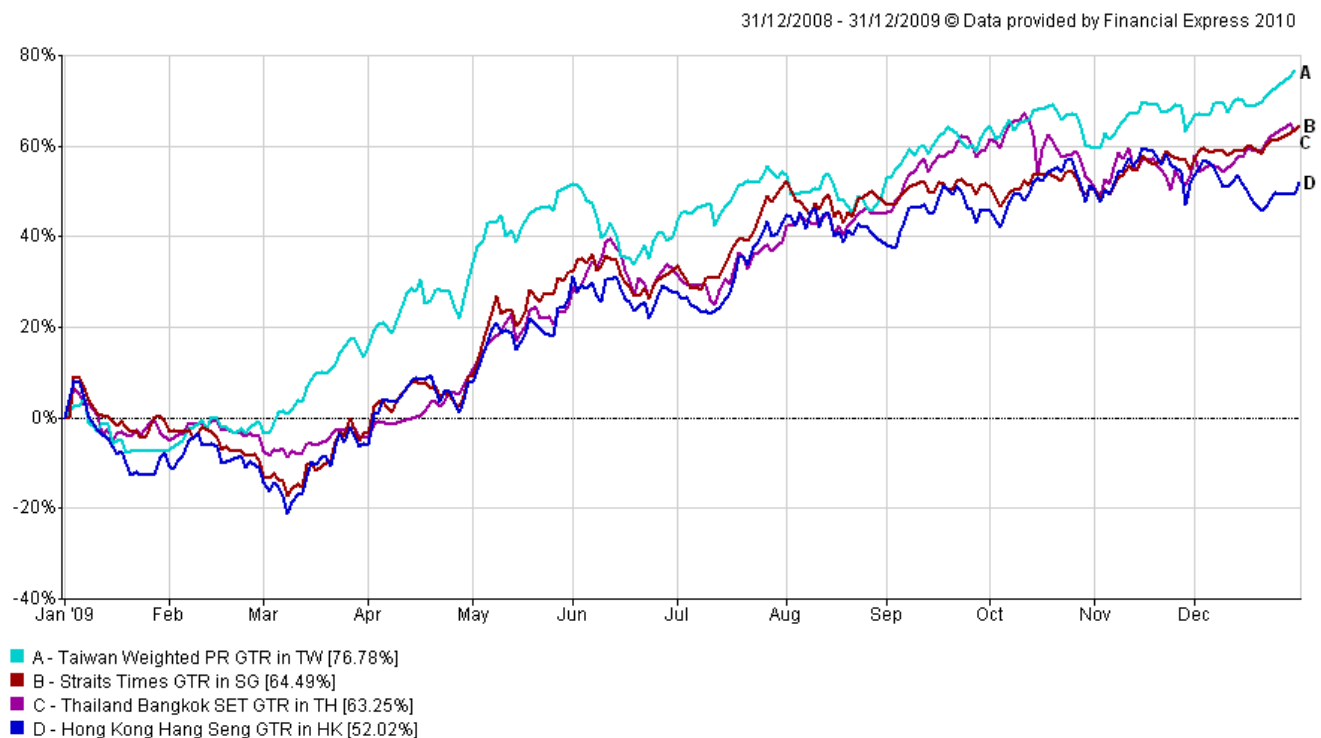
Sometimes investors, due to the currency they are investing in, will be forced to make a decision about whether or not to invest in funds outside their own because the area that they wish to get exposure to is not available in their own currency. This is a situation that needs to be considered carefully and the answer might not always be to avoid such situations. Instead, each instance should be seen through the lens of opportunity cost. Put simply, could the amount of return which is expected be eroded or even eclipsed by losses in the currency exchange rate? Here again, some examples could illustrate this decision making process. Let us first consider an investor is considering investing in some high growth areas outside their own currency. The expected return is greater than 20%. There is little chance that a

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(story continued from previous page) currency movement would be able to wipe this return out as currencies tend to move slowly in trends over time. However take another example where someone is considering a fixed income investment outside their own currency because it is yielding 3% more than their own currency. In this instance, the excess return could be easily erased with a negative currency movement and therefore the prudent investor might think twice before taking this chance. This is even more the case when investments are locked in for longer time frames such as fixed deposits or structured notes. In

these cases, should currencies start to move against you, it would be impossible to switch out of this back into your own currency without breaking the term, which would most likely result in loss of return or perhaps even penalties. For this reason, investments outside the base currency of an investor should mostly be those which could be disposed of quickly should they need to be. It goes without saying that a regular review of the currency impact on an investor's portfolio is part of any sophisticated financial plan.

2009 END OF THE YEAR REPORT
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