

GREECE: EUROPE'S WEAKEST LINK

The recent buildup of anxiety over the Greek debt crisis and the subsequent shockwaves that have rippled through the global financial markets give us reason to pause and reflect on the situation's causes and the implications going forward. This seemingly small player within the Eurozone (when measured in GDP) would not normally have the ability to cause such unrest within the European Union as a whole, much less in markets as far flung as Hong Kong and New York. It remains to be seen if the contagion shall continue to spread to other Eurozone countries with shaky deficit and debt positions. One thing is clear, however. Greece, a country of only 11 million people is proving to be the ultimate register of interconnected Europe's health.

First let us examine the causes of the crisis. It is not an unknown fact that Greece has had chronic and spiraling budget deficits. This can be attributed to a very generous social safety net combined with a difficulty in collecting taxes from a good deal of the population. To this add a general lack of transparency and over-the-top corruption in the state and private sectors. This recipe for fiscal irresponsibility, which has been allowed to build up in spite of clear breaches of Eurozone policy, has finally reached a bursting point. To put numbers to this, current Greek deficit is running at roughly 13% of its GDP. The limit for economies within the Eurozone is supposed to be only 3%. As a whole, total Greek debt stands at 114% of its GDP with 70% of that debt being foreign owned. Contrast this to a country like Japan which has an ostensibly higher debt of 200% of GDP; however has the enviable position of knowing that 95% of its debt is held by its own people, within its own borders. In Greece's case, confidence by the broader world is what's at stake here, and with banks throughout the EU broadly exposed to Greek debt, the tackling of this problem has become a top priority.

Normally a country in such a position as Greece would be able to solve this problem by allowing its currency to depreciate, which would immediately take pressure off financing the debt burden. Greece, as a member of the Eurozone, shares a currency with 15 other EU states and unilateral depreciation is not an option. This forced Greece to ask directly for a bailout to allow itself breathing room to refinance its debt. But even a bailout will not fix the problem completely, which can only be solved by drastically slashing the government's budget combined with the assured restructuring of their debts down the road. This restructuring will mean that investors will need to book losses in the future while at the same time seeing the duration of their investments extended. The proverbial can cannot be kicked down the road any further at this point. Over €8.5 billion in Greek debt comes due on May 19th and nearly €50 billion will come due in 2010 alone.

Structural weaknesses of the EU have been laid bare for all to see given the problems in getting the bailout passed. Firstly and

perhaps most importantly the EU lacks a federal government which can make decisions for the union as a whole, and all negotiations on solutions involve the agreement of a great deal of national governments—all of which have their own interests to protect and are subject to the domestic politics underlying them. A more logistical hurdle is that even when passed, there is an absence of a formal mechanism for the transfer of money within the EU itself. The IMF has been brought into the solution as well, but it has taken the backing of all members in late night weekend meetings in early May to actually force a credible package of assistance and loan guarantees. This was necessary because a number of other Eurozone members including Portugal, Spain, Italy and Ireland risked sparking their own crisis of confidence as international investors began to shun their debt issues as well, demanding much higher rates for what was perceived as high risk investments in government debt based on shaky financing.

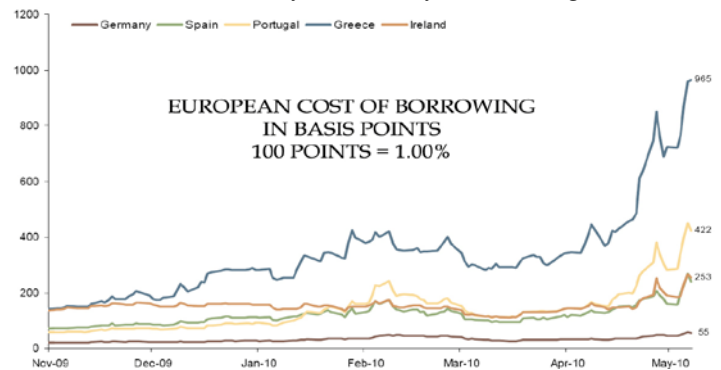
As the contagion of fear emanates outwards beyond the borders of the Greece and even the EU, markets around the world who once felt unthreatened by their exposure to the seemingly localized crisis are now getting huge spikes in volatility. Stock markets in the United States witnessed their largest drop on record within a single trading day, and this was largely attributed to investors' frayed nerves as a result of worries of a Greek default. New issuers of equity in Hong Kong were faced with a chilly market and have seen losses right out of the gate. In some situations, companies in Asia have postponed their new listings out of fear that the investment climate has been poisoned by the Greek crisis. Only an extraordinary effort which lasted into the early morning hours of the weekend was able to bring about agreement by all parties to provide nearly \$1 trillion in new loans and extensions of existing programs. This was planned to coincide with market openings of Asia on May 10th to assuage global investors that all players in the EU, with the support of the IMF, were now not only admitting that something had to be done, but cleared the way and put the money where previously only their mouths had been. Proof of the seriousness which the situation is being taken, the governments of the US, Canada, Britain and Switzerland are working in concert with the European Central Bank (ECB) to open up huge instruments



known as swap lines to further ease pressure on European banks and money markets. Markets initially have reacted positively and many analysts wonder why it has taken so long to force this issue when doing so earlier could have probably averted this acute crisis of confidence. The additional action from players outside the EU is testament to the fear that the fragile global recovery could be thwarted by a crisis in confidence stemming from Europe. Finally the acceptance of the ECB to be willing to intervene in the government and corporate debt markets to provide liquidity—so called “quantitative easing”—is proof that the moment for action has come. While already taking place in the US and UK, the ECB has long been reluctant to this support strategy which is essentially printing money.

Back on the ground in Greece, labor demonstrations have in some cases boiled over into outright riots as the government took the necessary but unpopular task of passing extremely strict austerity measures, which will slowly begin to reduce the Greek deficit position. In addition to a rich social safety net, Greeks have long enjoyed generous subsidies for key industries such as farming and shipping, as well as having a disproportionately large armed forces and government. Greeks

will be forced to make do with much less in the future. Previously it was as if being Greek, with a tax rate slightly lower than that of France, was like wielding a credit card you never expected to pay off. Now, alas, the balance is coming due, with interest, and Greece’s neighbors are coughing up their tax Euros to pay for Greece’s profligacy. “The aim of man is to create joy,” Zorba the Greek once famously said. A surplus of joy maybe, but a deficit on the current account also. Now the misery is spread evenly across the European Union. Time shall only tell if this financial “shock and awe” solution shall avert an outright cascade of defaults and any market mayhem that might result.



GOLDMAN'S TANGLED WEB UNRAVELS

Deep in the caverns of Wall Street in early 2007, a prominent hedge fund manager and client of Goldman Sachs met with executives there in their structured finance division to discuss putting together a new product. The client was John A. Paulson, who had at that point become somewhat famous in the hallowed hedge fund universe for making boatloads of money by shorting the housing market way before it was vogue to do so. His project was simple. He wanted to put together a product of mortgages that he could earn money on if the value of them fell. This “short strategy” required the creation of what is known as a synthetic collateralized debt obligation (CDO). This was a popular form of derivative at the time whereby

investors who purchased them could earn interest payments regularly as long as the underlying portfolio of mortgages continued to perform. Mr. Paulson’s strategy however was to play the other side of that bet. And he needed Goldman to put together a product that he himself had designed in essence to fail. Not only would he need to create the product, but he would then need to ensure that it got top grades from the ratings agencies and that it was distributed widely to investors. After all, every short transaction needs someone on the other end actually buying the product, lest there be no way to earn money on its decline. This particular product would be sold under the seemingly innocuous name of Abacus 2007-AC1.

According to a civil fraud lawsuit brought against Goldman last month by the Securities and Exchange Commission (SEC), followed shortly by a federal criminal investigation into the matter, Goldman not only knowingly put together this product that it knew would fail but then got it top-tier AAA ratings and proceeded to sell it to a wide variety of retail and institutional clients throughout the world, mainly in Europe. When less than a year later the product plunged in value to become nearly worthless, these investors who had purchased it were out billions of dollars. And Mr. Paulson and his hedge fund, along with Goldman Sachs themselves, had profited nicely from the very product they had designed to fail. The fraud and criminal allegations stem not from the fact that the product was created—that was entirely legal. The government claims the dishonesty took place when Goldman misled ratings agencies and investors purchasing the product that an outside manager had chosen the underlying portfolio of mortgages, when in fact Mr. Paulson actually hand picked them.



This case underlies an extreme case of conflict of interest in a lightly regulated area. If successful in their prosecution, it is guaranteed that other similar deals will be scrutinized and other

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banks will be similarly blamed for being dishonest. More importantly the case allows us to clearly see the interwoven web of players who could make this happen, and highlights how each, acting in their own self-interest, could collectively cause such destruction and loss. Goldman's conflict appears clear. They were taking one large client's custom designed zombie product and selling it to others who unwittingly thought it was a quality security.

But how did the ratings agency fit into the picture and how could they have given such high ratings to something that was essentially a toxic pile of assets? Firstly their naïve models did not take into account the possibility that housing prices could fall. Of more key concern however is the "issuer pays" system that prevails in the ratings agency business. Decades ago ratings agencies made the majority of their money off of regularly publishing thick books of ratings for a variety of securities that investors might be interested to buy. In this increasingly digital age, this business model clearly wouldn't work and so now the vast majority of their earnings come from the companies that are issuing the securities. That is correct: the very firms that created the products are paying the ratings agencies to rate them. The ratings agencies in turn would skew their assessments to please their banking clients. The banks could choose among several rating agencies. They could direct their business to whichever agency was most likely to give a favorable verdict, and threaten to pull business from an agency that tried too hard to do its job.

Beyond that, the ratings agencies, claiming transparency, actually shared the details of the formulas and models used to judge these types of complex securities with the banks that were producing them. Furthermore, banks such as Goldman were actually hiring former agency analysts to work at their firms to help create these products. This gave bankers the tools and staff to tinker with their complicated mortgage deals until the models produced the desired ratings. As proof that this relationship was clearly destined to fail, of all the AAA rated mortgage-backed securities that were rated in 2006, 93% of them

eventually failed.

During last month's high-drama U.S. Senate hearings on the case, hundreds of pages of internal emails from Goldman revealed that executives at Goldman were fully aware of what was going on and were about to make "some serious money" betting against the housing markets by using the firm's own money alongside their hedge fund clients who were employing the same shorting strategy. This allowed Goldman to not only mitigate their losses as the overall housing market deteriorated, but in some cases make wild amount of profits by doing so. Meanwhile European banks and institutional investors saw their investments in the doomed Abacus product virtually wiped out.

It did not appear to be a secret in the industry for this type of scenario to play out. One Goldman salesman went on to write a book called "How I Caused the Credit Crisis", and one Deutsche Bank structured finance banker actually handed out t-shirts that read "I'm SHORT your house". While initially coming out in full denial of the charges with the intention to fight tooth and nail to get the case dropped, it now appears that Goldman is changing its tune. Last week their chief counsel met with SEC authorities to discuss a possible settlement payment. Clearly they have no interest in going through a fully publicized court case, especially if it meant that they would in doing so further tarnish the sacred Goldman brand name to little more than "toxic" itself.

All players in this macabre dance of deceit could equally claim innocence if not viewed in the perspective of the whole, and how their own self-interest pushed them to make decisions that collectively doomed the entire deal. Until comprehensive overhaul of the ratings system and its associated parties is passed, investors should be wise to take all those AAA ratings with a rather large pinch of salt. Only time shall reveal when the next shoe will drop in this murky area of high finance and further shady deals are brought to light.

"SUPER PROFITS" TAX RATTLE AUSSIE MINERS

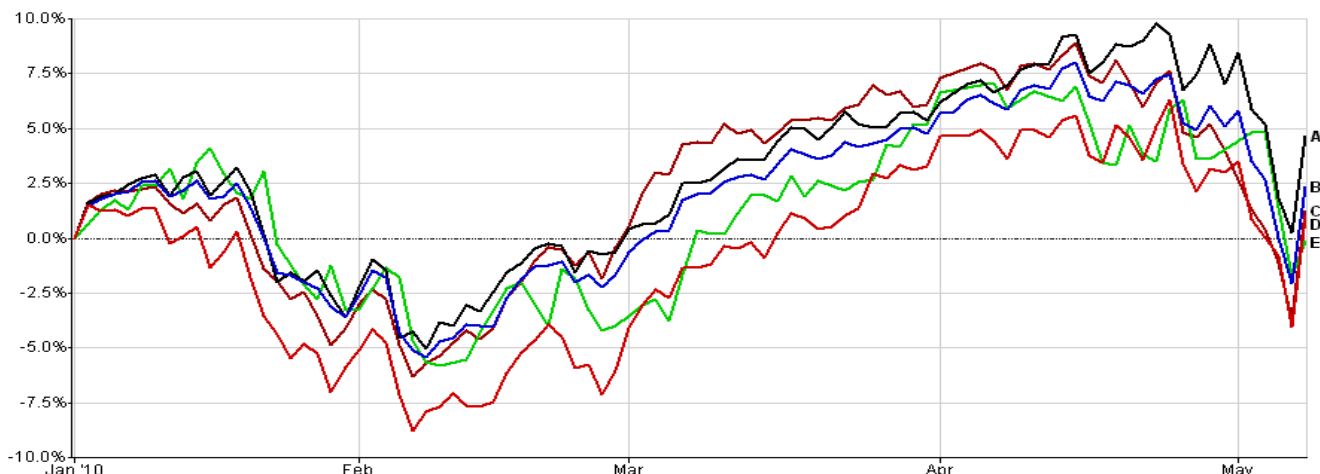
The Australian government's announcement of a tax on "super profits" in the resources sector in early May has been greeted with a great deal of backlash. Although the details have yet to be disclosed, the tax, which is due to begin in 2012, will place a 40% levy on profits of Australian miners, who are responsible for the largest amount of the country's exports. In some instances this tax will be offset by reform of the corporate tax code, possibly benefitting other sectors. A number of large mining companies have already announced their intentions to put on hold or cancel projects currently under development in Australia due to the unexpected introduction of the tax, which ostensibly will help to fund the Australian government's pension program. The Minerals Council of Australia, whose members include global giants BHP Billiton, Rio Tinto and Vale, took out full-page advertisements in the nation's broadsheet newspapers criticizing the so-called "super profits" levy. Prime Minister Kevin Rudd has lashed back stating that

he is not concerned over the objections, claiming it is "a lot of crying wolf" from a "few billionaires". It remains to be seen if his popularity will fall as a result of this tax, which is quickly becoming a hot-button issue.

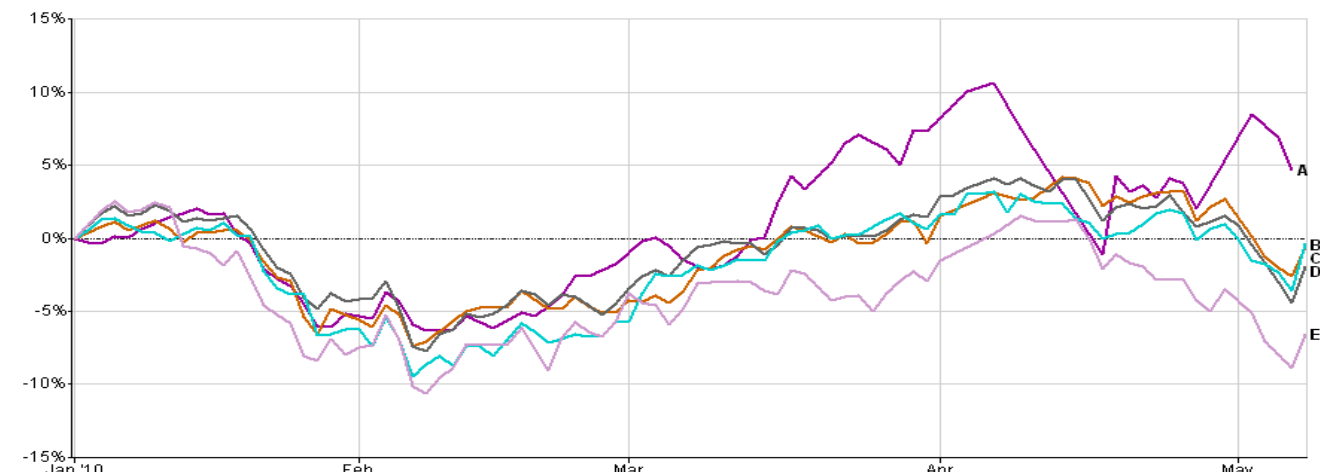
Global credit ratings agency Moody's said the changes would be broadly credit negative for the resources sector and heighten uncertainty over the short-to-medium term. However, it assessed the impact to larger companies such as BHP and Rio as low or neutral and said some mature projects could be relatively better off. Meanwhile, energy company Santos told investors it would defer for six months a decision on a proposed \$15 billion liquefied natural gas terminal in northeastern Australia due to confusion about the tax. Cape Lambert Resources has already halted all exploration in the resource-rich Pilbara region. Billionaire mining magnate Clive Palmer said he had halted all further exploration activity in South Australia and cut back expansion plans in the country's west, adding that his Chinese investment partners were "very disappointed" in the tax plans. Even Xstrata has cancelled \$30 million worth of copper exploration in the state of Queensland.

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2010 INTERIM YEAR-TO-DATE REPORT
GLOBAL STOCK INDEX PERFORMANCE



■ A - S&P 500 GTR in US [4.67%]
■ B - MSCI THE WORLD INDEX GTR [2.34%]
■ C - FTSE 100 GTR in GB [1.25%]
■ D - Xetra DAX GTR in EU [1.02%]
■ E - Nikkei 225 GTR in JP [-0.15%]



■ A - Thailand Bangkok SET GTR in TH [4.63%]
■ B - INDIA BSE (SENSEX) 30 SENSITIVE GTR in IN [-0.37%]
■ C - Straits Times GTR in SG [-0.59%]
■ D - MSCI EM (EMERGING MARKETS) GTR [-1.96%]
■ E - Hong Kong Hang Seng GTR in HK [-6.61%]

PRICE-TO-EARNINGS MARKET SCORECARD

Argentina	13.5	Czech Rep.	11.0	Ireland	21.1	Pakistan	10.2	South Korea	18.4
Australia	16.0	Denmark	27.3	Israel	18.2	Peru	30.5	Spain	10.7
Austria	20.2	Finland	18.7	Italy	14.2	Philippines	16.3	Sri Lanka	23.3
Belgium	13.8	France	17.9	Japan	29.5	Poland	16.5	Sweden	12.6
Brazil	16.3	Germany	17.0	Luxemburg	18.0	Portugal	13.0	Switzerland	15.6
Bulgaria	7.9	Greece	11.1	Malaysia	17.8	Romania	13.7	Taiwan	15.2
Canada	19.6	Hong Kong	15.0	Mexico	14.1	Russia	9.7	Thailand	13.4
Chile	18.4	Hungary	14.7	Netherland	23.0	Singapore	15.0	Turkey	12.5
China	13.8	India	20.9	New Zealand	20.2	Slovenia	17.6	UK	11.7
Colombia	21.8	Indonesia	18.0	Norway	17.5	South Africa	16.3	USA	18.5

Source: ThompsonReuters Date: May 10, 2010

- 0-10** Undervalued or earnings are thought to be in decline. Alternatively, current earnings may be substantially above historic trends.
- 10-17** For many companies or markets a P/E ratio in this range may be considered fair value.
- 17-25** Overvalued or earnings have increased since the last earnings figures were published. Alternatively, earnings expected to increase substantially in future.
- 25+** Markets having a very high P/E may have high expected future growth in earnings or may be the subject of a speculative bubble.

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