

**What Mattered
This Past Year –
And What Will
Matter Next
Year?**

The four major concerns of investors coming into 2012

Second fear was that US economy would encounter a 'double-dip' recession

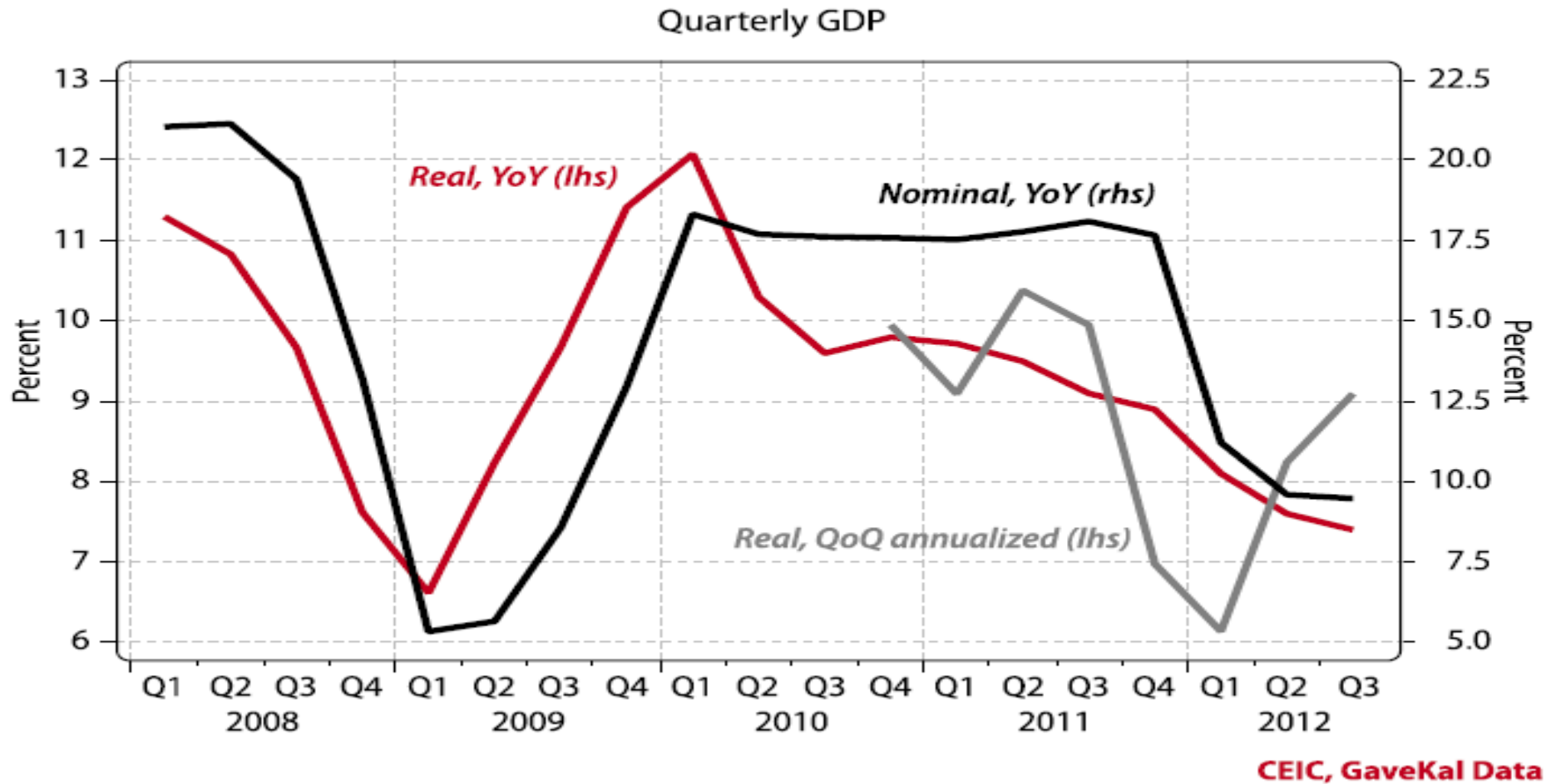
United States, Conference Board, Business Cycle Indicators, Leading Economic Index (LEI), Composite Index, SA



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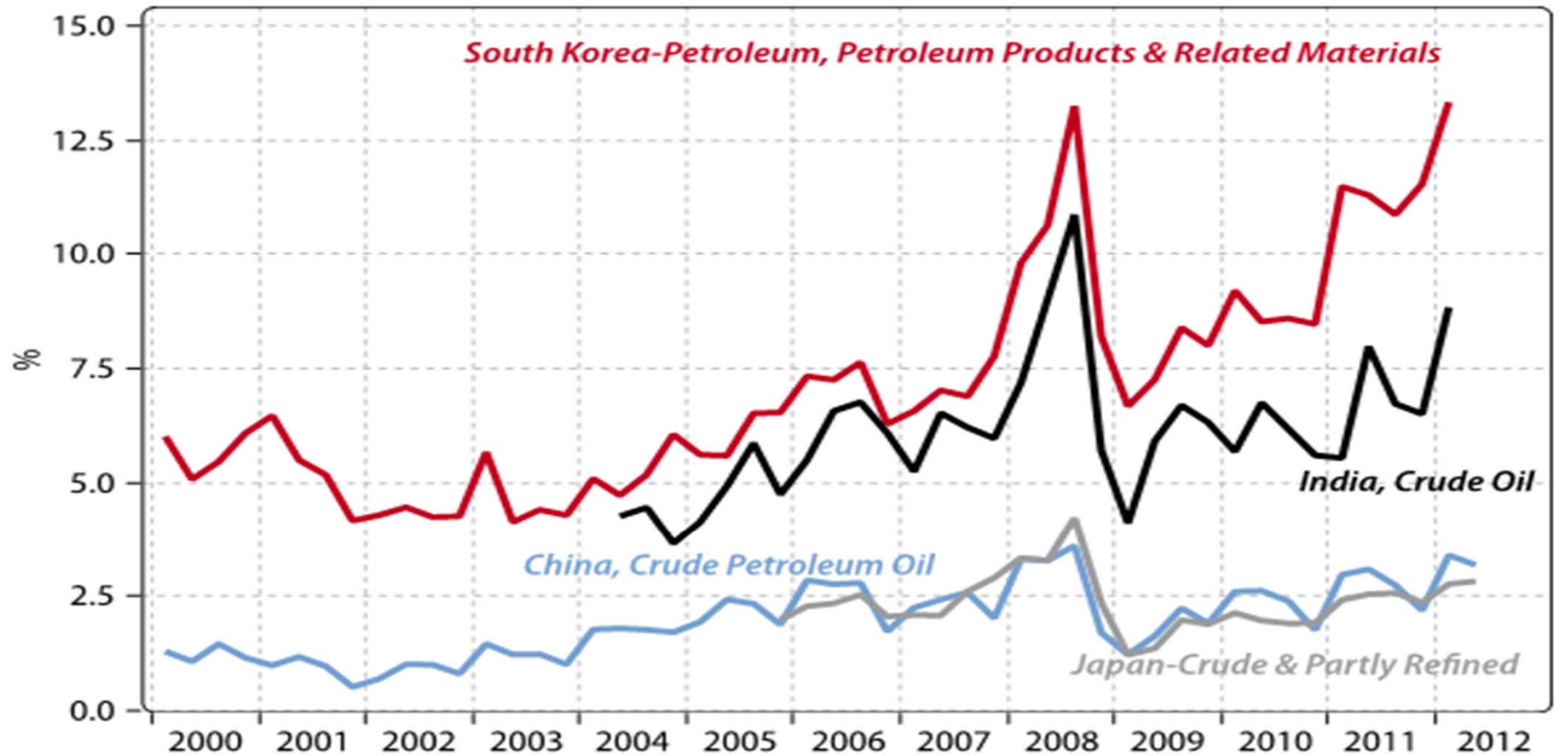
Third fear was that the Chinese economy would hit a wall

China is now past the worst of the decline in growth



Fourth was that Middle-East would flare up, triggering a surge in oil prices

Import of oil as % of GDP



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The benefits of hindsight: what mattered in Europe

The decision of the SNB to peg the CHF was an important change

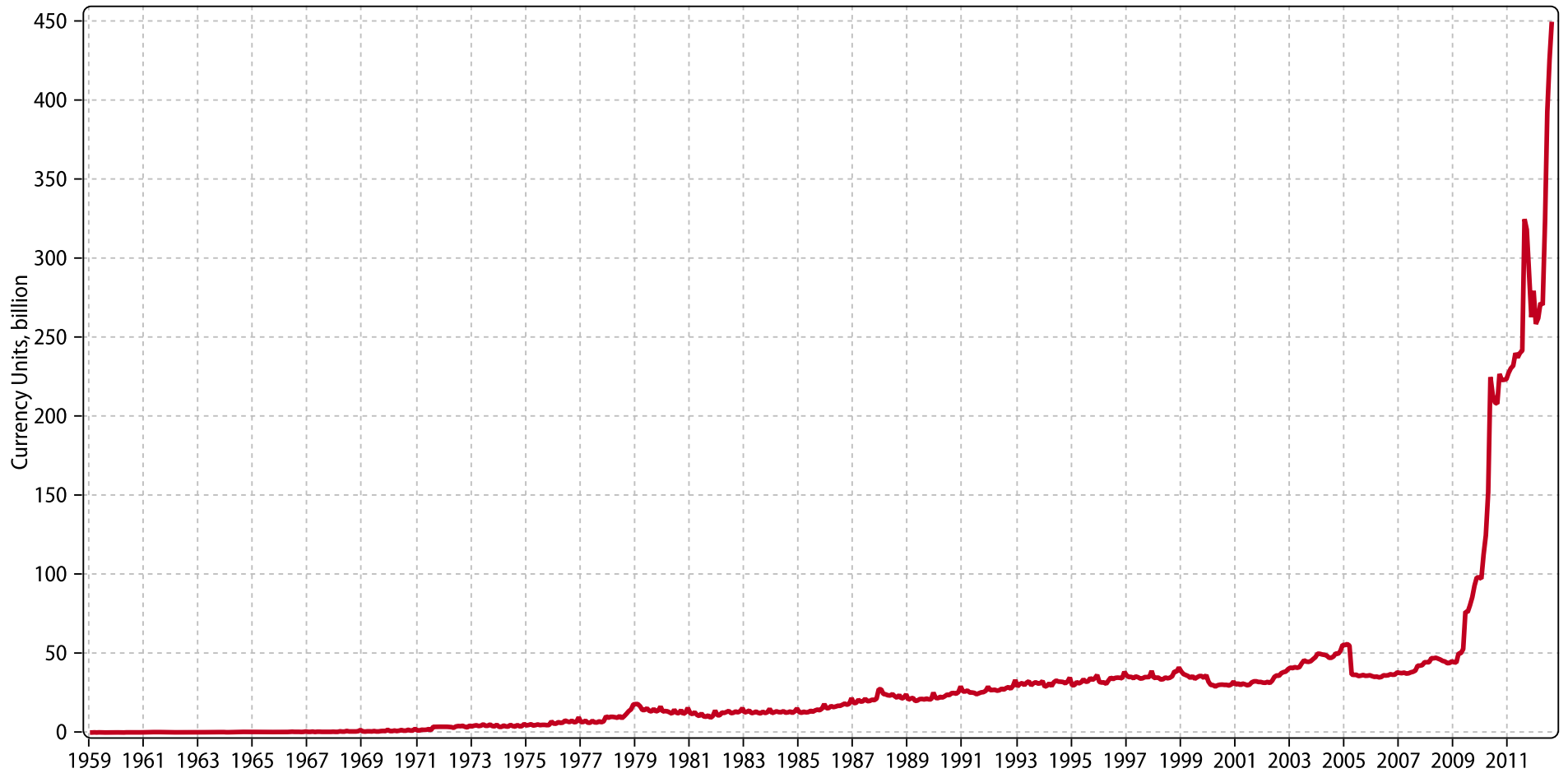
Switzerland, FX Spot Rates, ECB, CHF per EUR, Fixing



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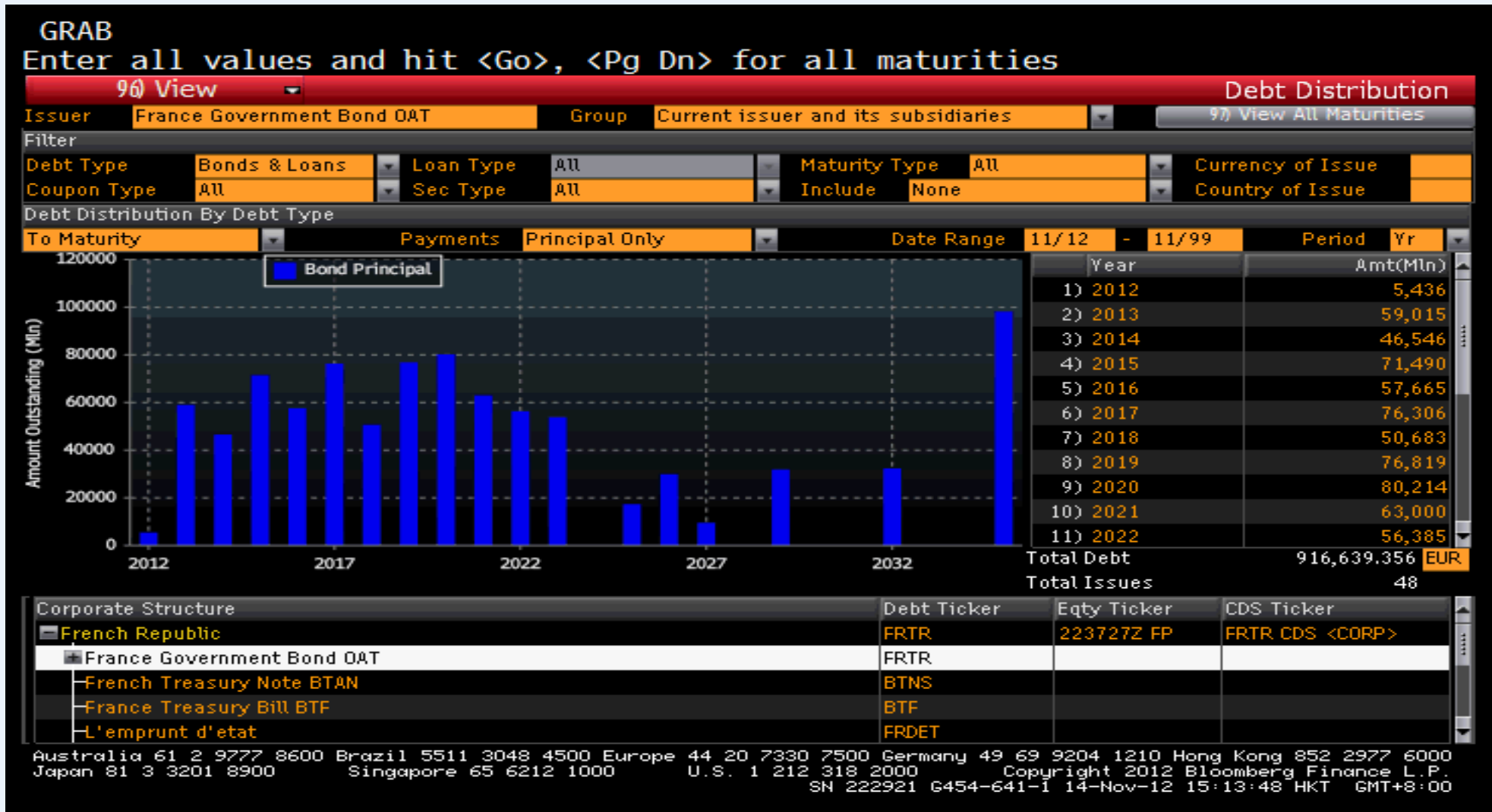
The SNB basically became a forced buyer of Euro 300bn of EMU debt

IMF IFS, Switzerland, Total Reserves Minus Gold, USD



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That's enough fire-power to help out even France roll-over debt



Combine that with Draghi's Activism, and the Euro lives to fight another day

ECB balance sheet: a 12 month, Eur 1.2tr expansion



— Euro Area, Consolidated Balance Sheet & Flows of MFI Sector, Eurosystem, Total Assets & Liabilities, All, EUR

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The benefits of hindsight: QE3 has been a dud

Excess liquidity growth should have been a positive catalyst



But QE3 has been a complete dud

A few more down days and the DJIA will be flat for the year



— United States, Equity Indices, Dow Jones, Industrial Average Index, Price Return, USD

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Is it because investors were already too aggressively positioned?

US Equity L/S Gross and Net Leverage (Non-Beta-Adjusted)



Source: Morgan Stanley Prime Brokerage

Or are investors selling the big winners before capital gain tax increases?

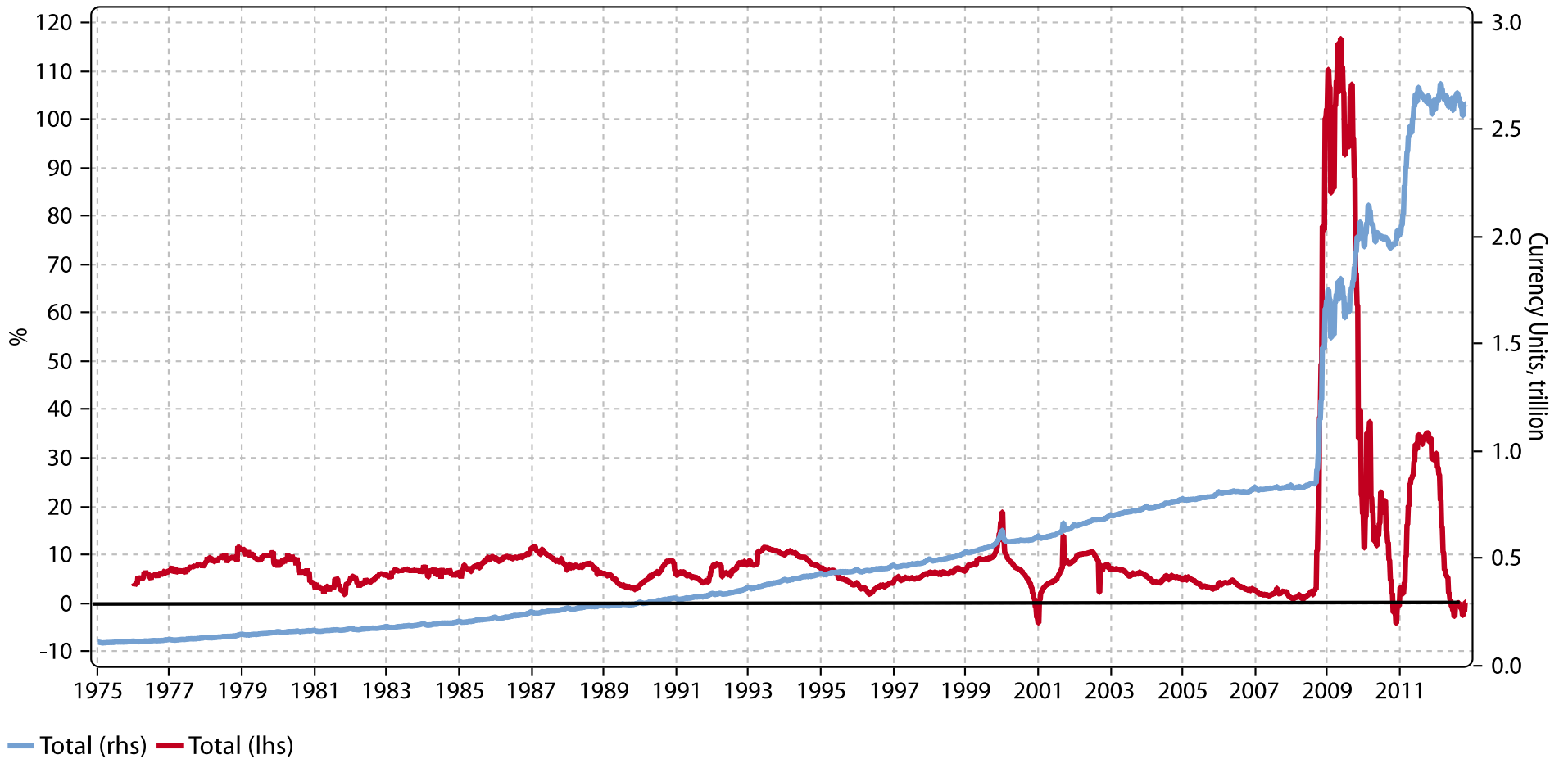
United States, Apple Inc., Close, USD



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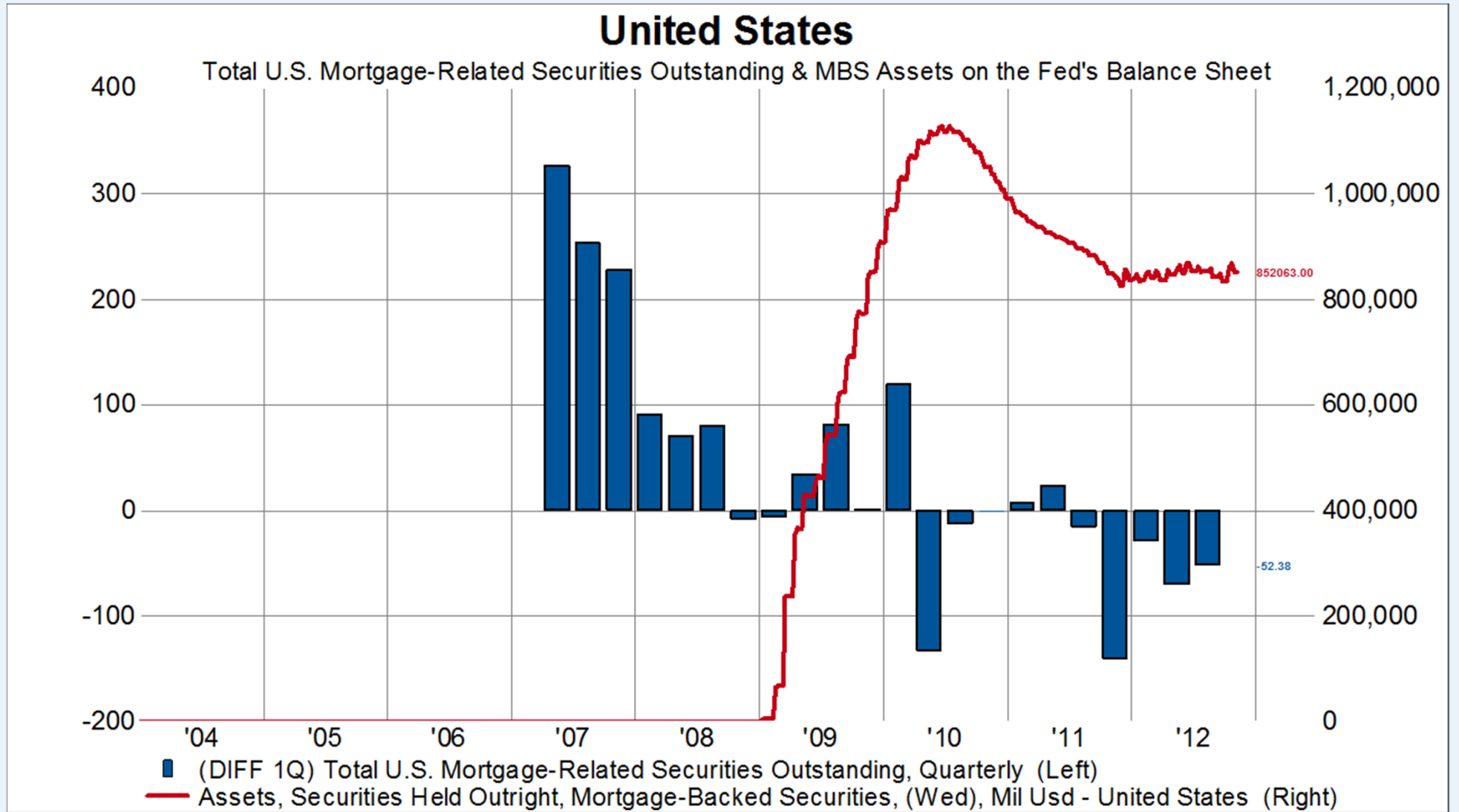
Or perhaps, the Fed has simply not added the liquidity it promised?

United States, Monetary Aggregates, Monetary Base, USD



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The Fed has yet to buy the mortgage bonds it promised



What would a less dovish Fed do to the USD?

United States, FX Indices, ICE, U.S. Dollar Index, Close

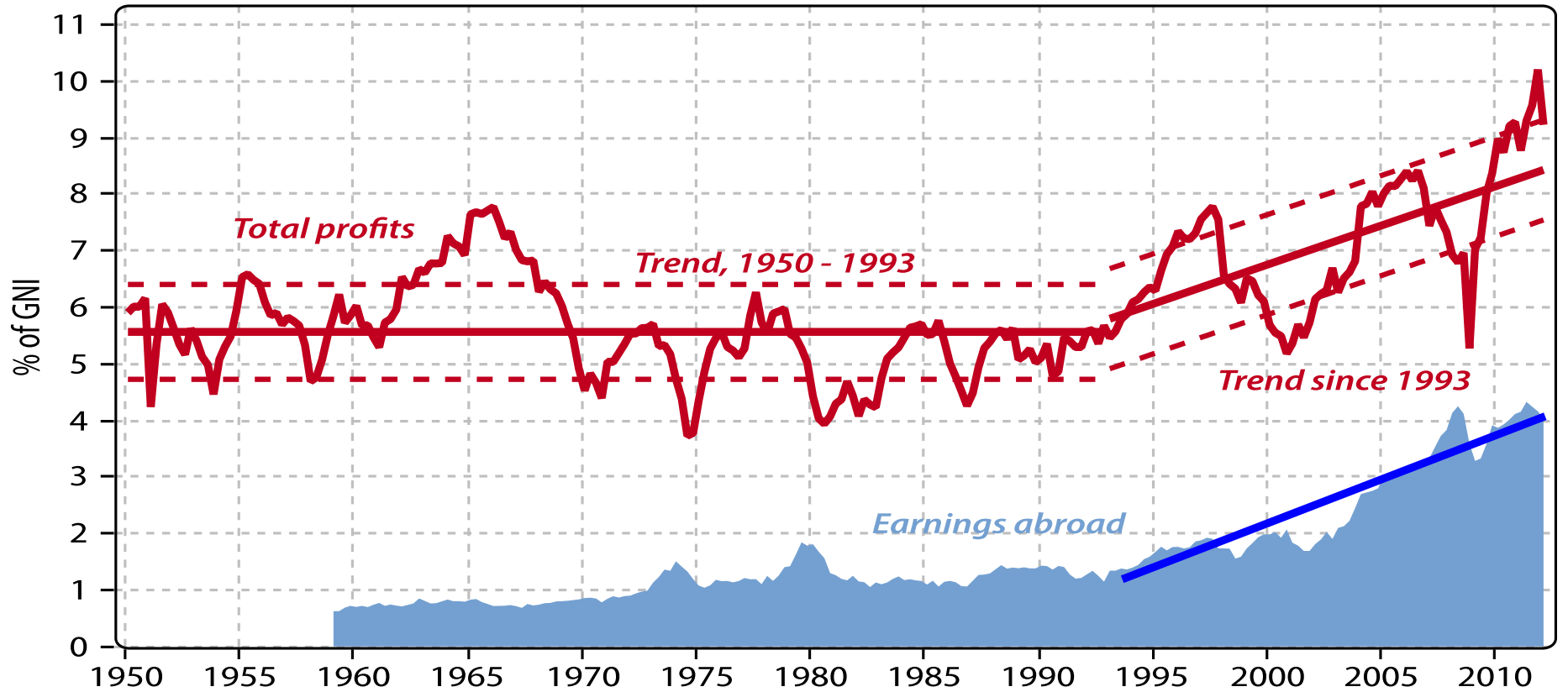


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Would a stronger USD hit the current record high earnings?

Foreign earnings have driven US profits higher

US "national" corporate profits (after tax with IVA & CCAdj) as % of Gross National Income

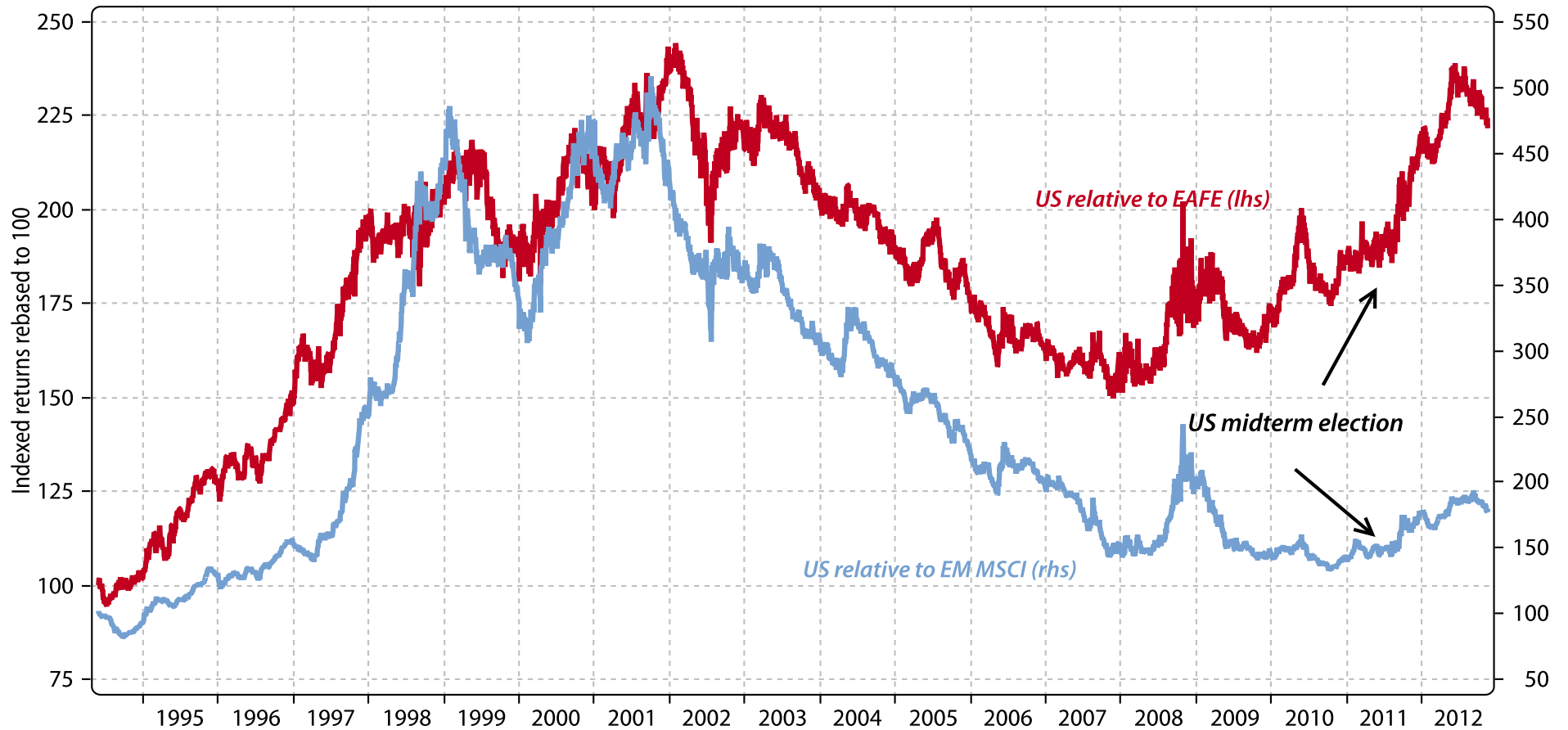


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If so, what would that do to US equity outperformance?

Was political paralysis that bad? US has outperformed everyone since the mid-term elections

MSCI: US relative to EAFE and EMs

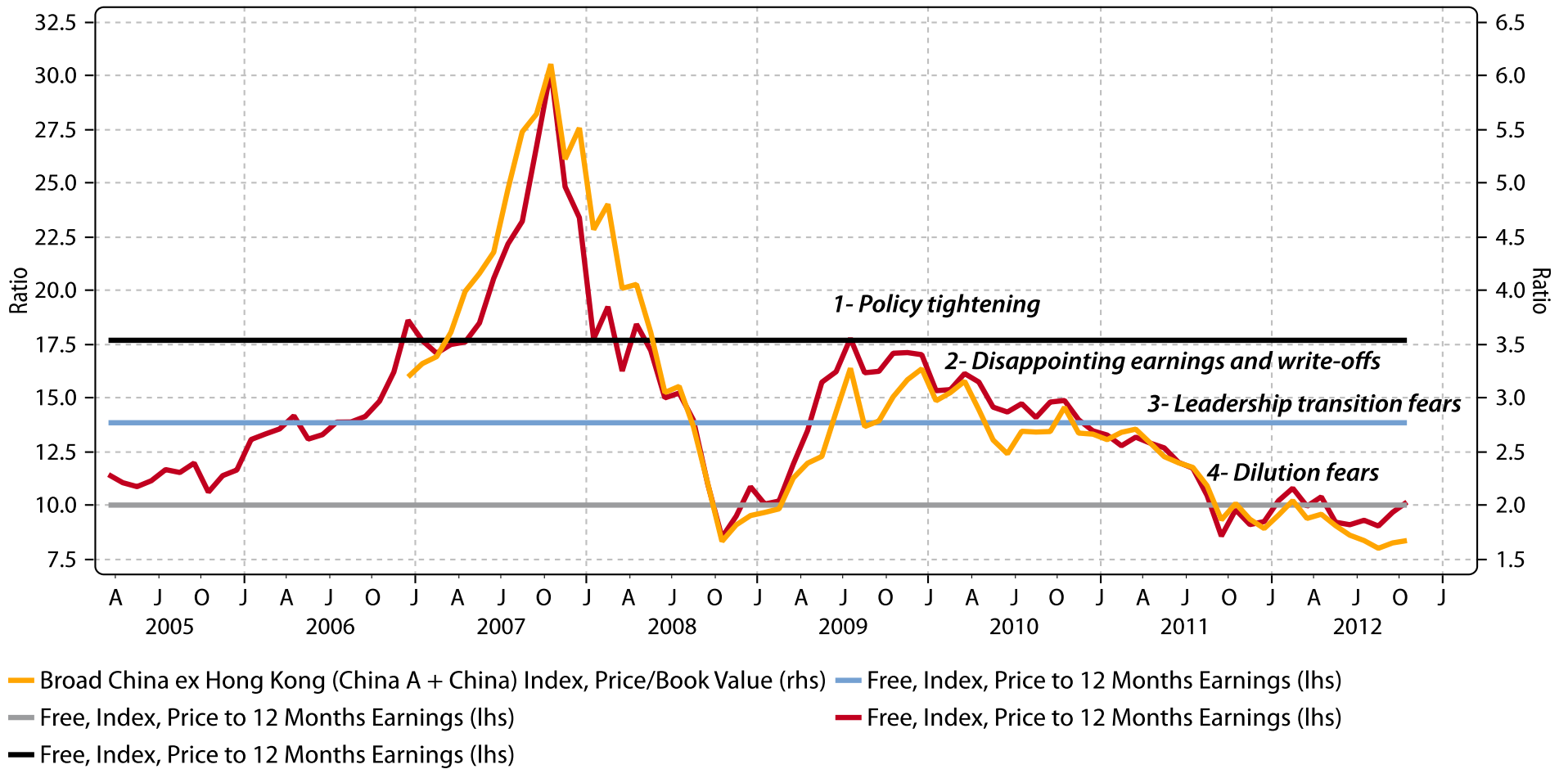


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The benefits of hindsight: China derated but did not implode

Four reasons behind China's de-rating

The Derating in China A + H shares, Price to Earnings & Price to Book

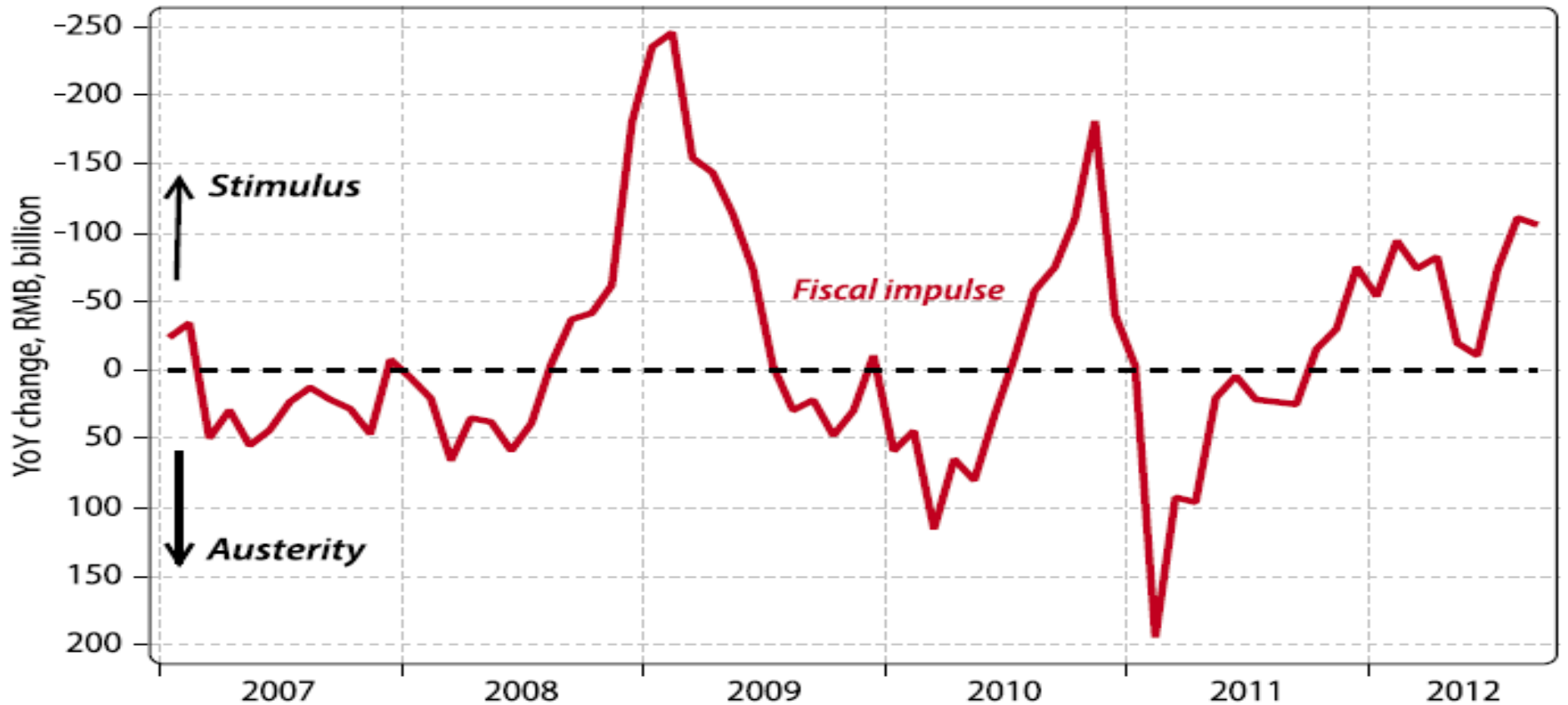


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Policy tightening is now over

After a soft patch, China's fiscal policy is now firmly expansionary

Change in general government budget balance, 3mma

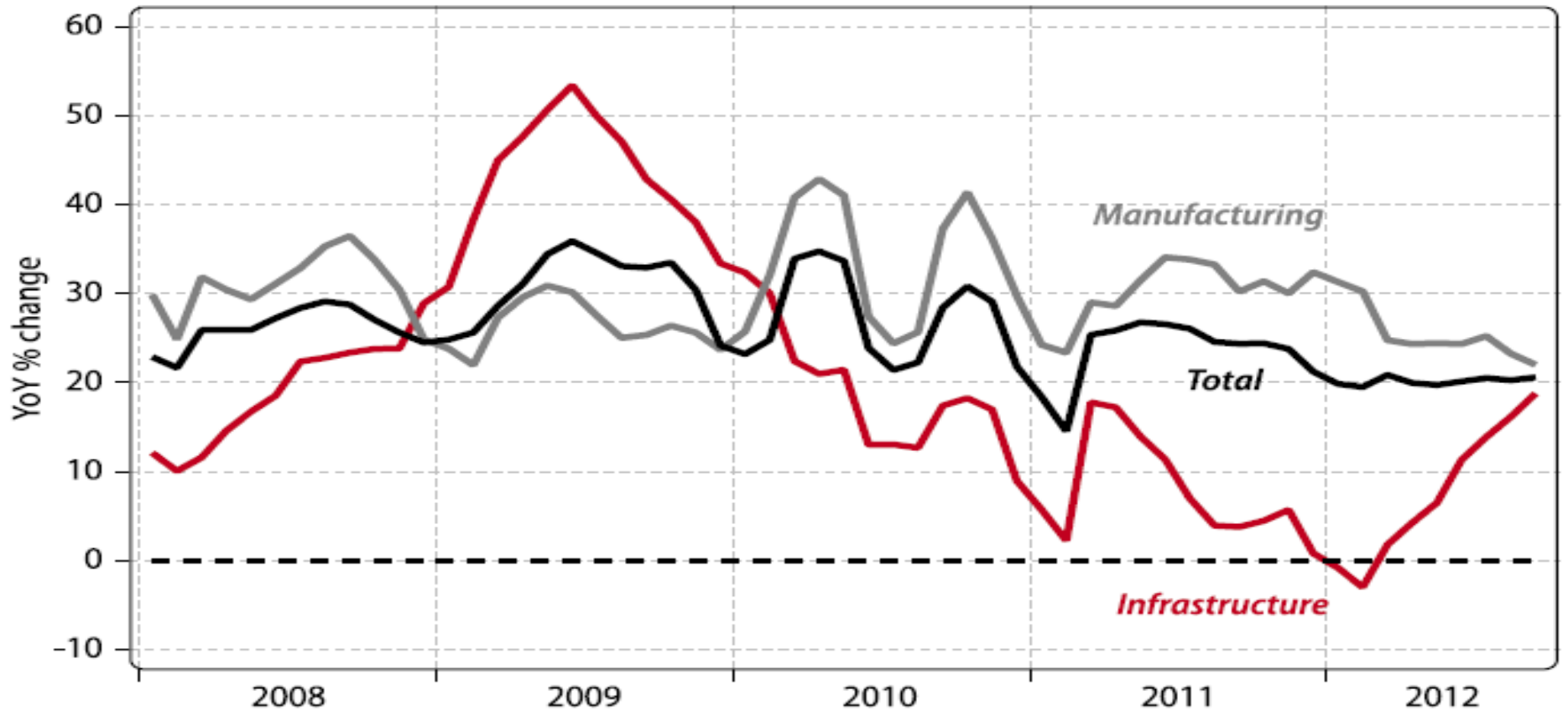


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And the economic landscape is returning to familiar territory

A rebound in infrastructure spending is helping steady China's investment

Fixed-asset investment by sector, nominal, 3mma



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Party Congress meetings matter

- Following the 14th Party Congress in 1992, Jiang Zemin and Zhu Rongji pushed forward a wave of liberalization that culminated in entry into the World Trade Organization in 2001.
- Following the 16th Party Congress in 2002, the new team led by Hu and Wen set a different trajectory of giving greater support to state-owned enterprises, reducing the burdens of farmers, and expanding social welfare programs.
- So will the 18th Party Congress of 2012 also see China adopt a major shift in economic philosophy? There are two possible ways to answer that question. The first is to look at what we know (fairly little!) of the new crop of Chinese leaders. The other is to look at the recent past and extrapolate the current path.

The Leadership Transition: Out with the Old, In with the New

Reading the political tea leaves

Most likely members of the next Politburo Standing Committee

	Born	Current Postion	Education	Home province	Notable parents	Factional ties	
Current Politburo Standing Committee members							
1	Xi Jinping	1953	Central Military C'tee Vice Chair, Vice President	Engineering, law	Shaanxi	Xi Zhongxun	Jiang Zemin
2	Li Keqiang	1955	Executive Vice Premier	Law, economics	Anhui	–	Hu Jintao
Current Politburo members							
3	Liu Yandong*	1945	State Councilor (sci-tech, education, culture, sports)	Chemistry, political science	Jiangsu	Liu Ruilong	Hu Jintao, Jiang Zemin
4	Yu Zhengsheng	1945	Shanghai Party Secretary	Engineering	Zhejiang	Jiang Qing [†]	Jiang Zemin, Deng Xiaoping
5	Zhang Dejiang	1946	Chongqing Party Secretary**	Economics	Liaoning	Zhang Zhiyi	Jiang Zemin, Xi Jinping
6	Zhang Gaoli	1946	Tianjin Party Secretary	Economics	Fujian	–	Jiang Zemin
7	Liu Yunshan	1947	CCP Propaganda Dept Director	Party affairs	Shanxi	–	Hu Jintao
8	Wang Qishan	1948	Vice Premier	History	Shanxi	Yao Yilin [†]	Zhu Rongji
9	Li Yuanchao	1950	CCP Organization Dept Director	Math, economics, law	Jiangsu	Li Ganchang	Hu Jintao
10	Wang Yang	1955	Guangdong Party Secretary	Engineering	Anhui	–	Hu Jintao
Other potential candidates							
11	Meng Jianzhu	1947	Minister of Public Security	Engineering	Jiangsu	–	Jiang Zemin
12	Ling Jihua	1956	CCP General Office Director	Business	Shanxi	–	Hu Jintao
13	Zhou Qiang	1960	Hunan Party Secretary	Law	Hubei	–	Hu Jintao
14	Hu Chunhua	1963	Inner Mongolia Party Secretary	Chinese	Hubei	–	Hu Jintao
15	Sun Zhengcai	1963	Jilin Party Secretary	Agriculture	Shandong	–	Wen Jiabao

*Female **Replaced Bo Xilai, March 2012; previously was Vice Premier. [†]In-law

Sources: Xinhua, Chinavivae.com, GK Dragonomics

A constant evolution

Younger and smarter

Trends in Politburo membership, by Party Congress

	12th (1982)	15th (1997)	16th (2002)	17th (2007)
Average age at term start	72	63	60	61
College educated	0%	71%	88%	92%
Engineers among college educated	–	82%	77%	48%
Military experience	80%	13%	16%	12%
Regional slant	Interior	Coast	Coast	Coast
Women	4%	0%	4%	4%

Sources: Xinhuanet, Chinavita.com

Will the new leadership start with an anti-corruption fight?

China corruption plays up 14x since 2003

Equally weighted index, quarterly rebalanced; Rebased 2003=100

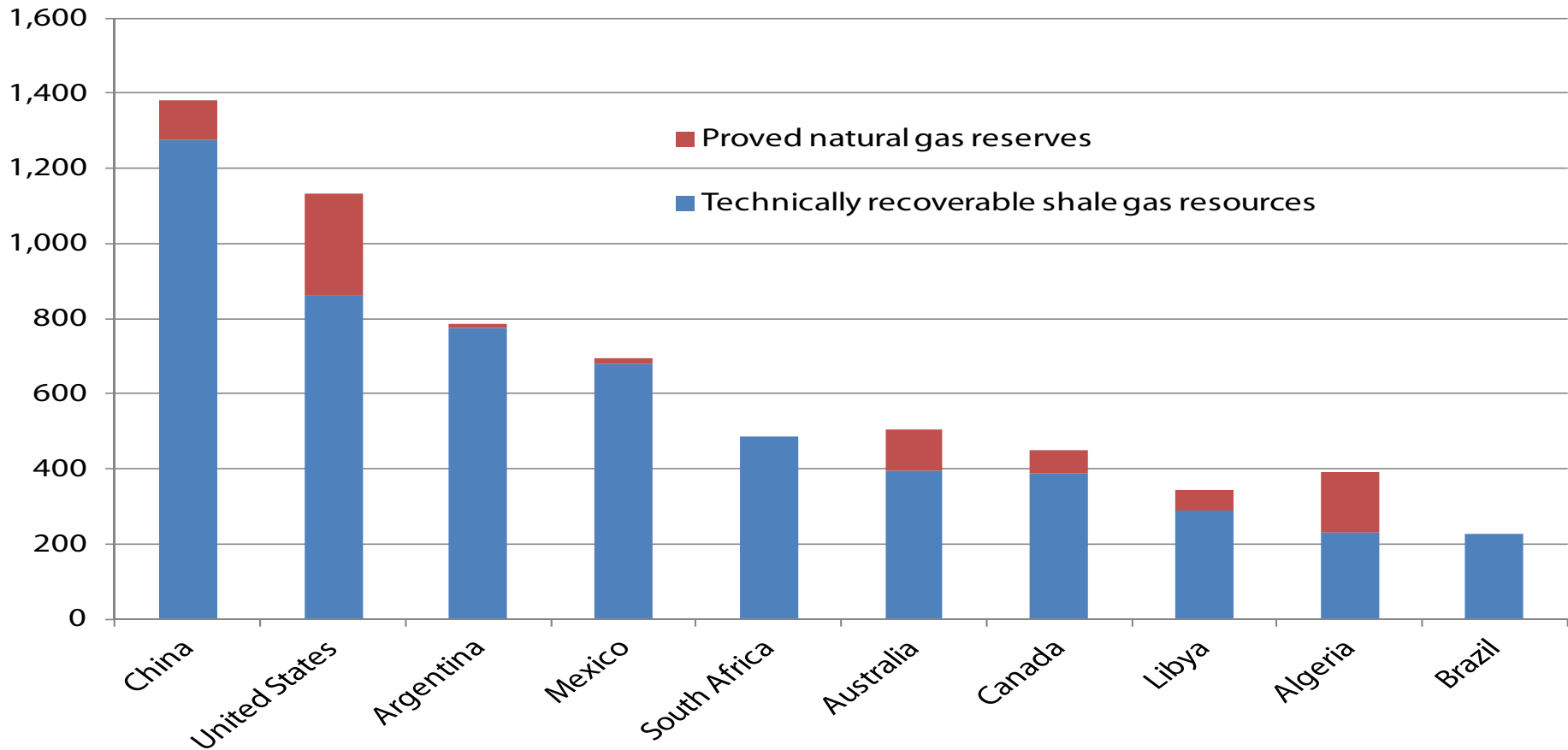


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Will China abandon coal for natgas?

Proven natural gas reserves vs technically recoverable shale gas resources

(per trillion cubic feet) - EIA 2009



If so, what will that do to oil prices?

Oil prices move in long-term steps

Annual average crude oil prices since 1880



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Will the new leadership remain committed to financial deregulation?

Important developments on the political front

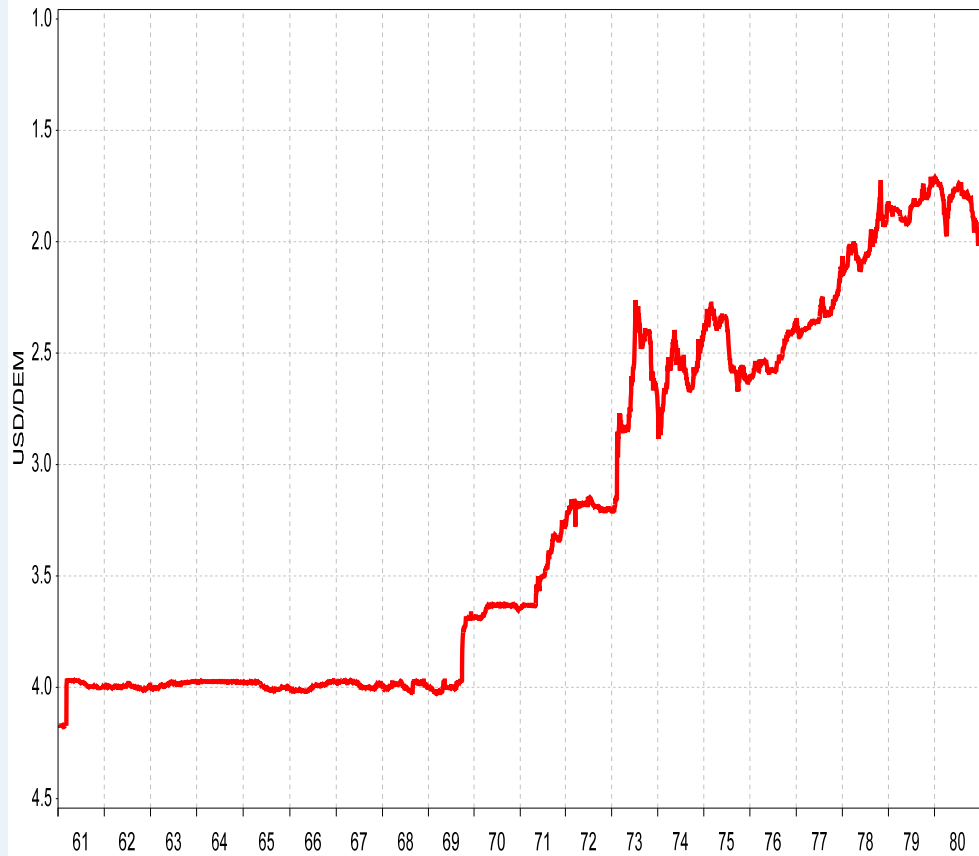
- Guo Shuqing, a noted reformer, is nominated as head of the CSRC
- Bo Xilai, a noted 'hardliner', is arrested
- Premier Wen declares that the monopoly of big 4 banks needs to be broken up in order for smaller companies to get better access to capital
- Tax reform bringing capital gains tax to zero starts being discussed

Concrete measures

- SSF (a US\$150bn provincial pension fund) receives government authorization to increase equity holdings from 20pct to 40pct --implying 30bn US\$ of new investments. Other pension funds are said to follow
- Stocks which qualify for margin lending for retail are raised from 20 to 250. Margin loans now growing at 100pct YOY from a low base
- QFII quotas for foreign institutions raised to US\$ 80bn dollars from US\$ 30bn dollars
- QFII minimums changes from US\$5bn to US\$500m and from 5 years to 2 years
- RQFII started and quotas raised for retail investors in HK/Japan. Predominantly debt focused
- For the first time in over a decade, rules on IPOs are eased. Rules on corporate bond issues are also eased
- IPO pricing process standardized (too allow for pricing low enough to let investors make money on IPOs)
- Targeted delisting of 10pct of companies listed to improve quality/transparency of market
- New Asset Management products to be approved in 4 weeks (vs 6 months prior) by CSRC
- Wenzhou pilot scheme to allow domestic investors to invest overseas (pilot scheme)
- Launch of a private sector pension system (pilot basis)

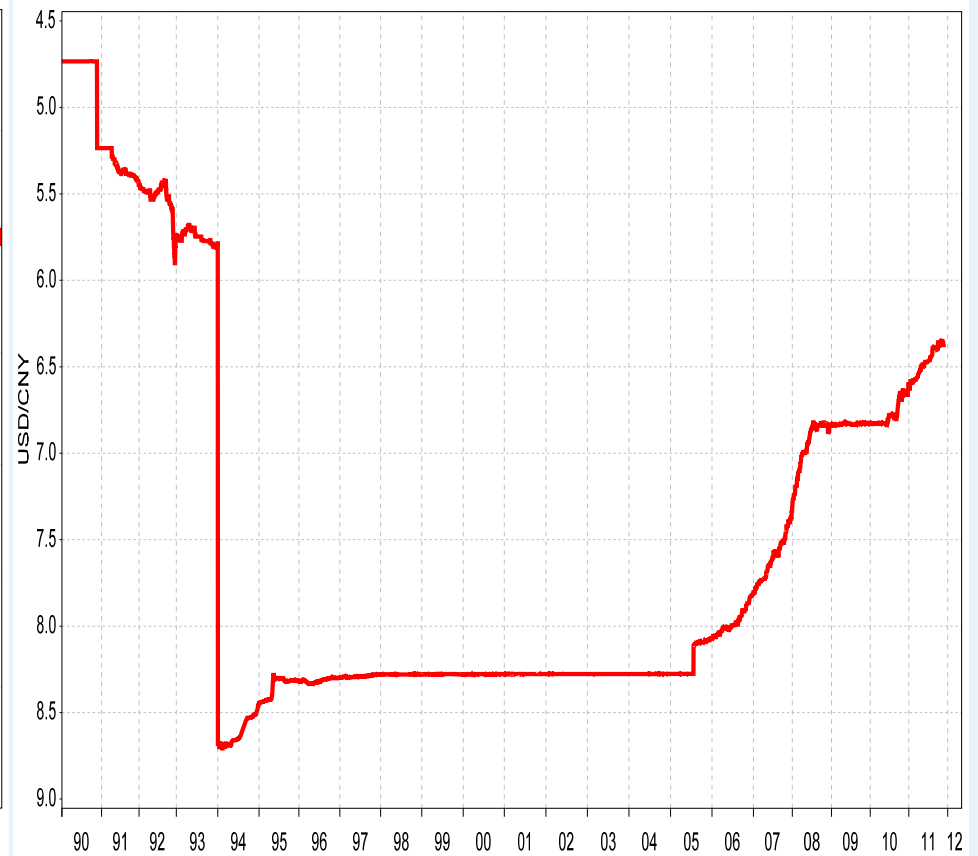
Can RMB become EM trading currency? If so, RMB will need to be structurally strong

Germany, Spot Rates, USD/DEM, Close



Source: Reuters EcoWin

China, Spot Rates, USD/CNY, Close

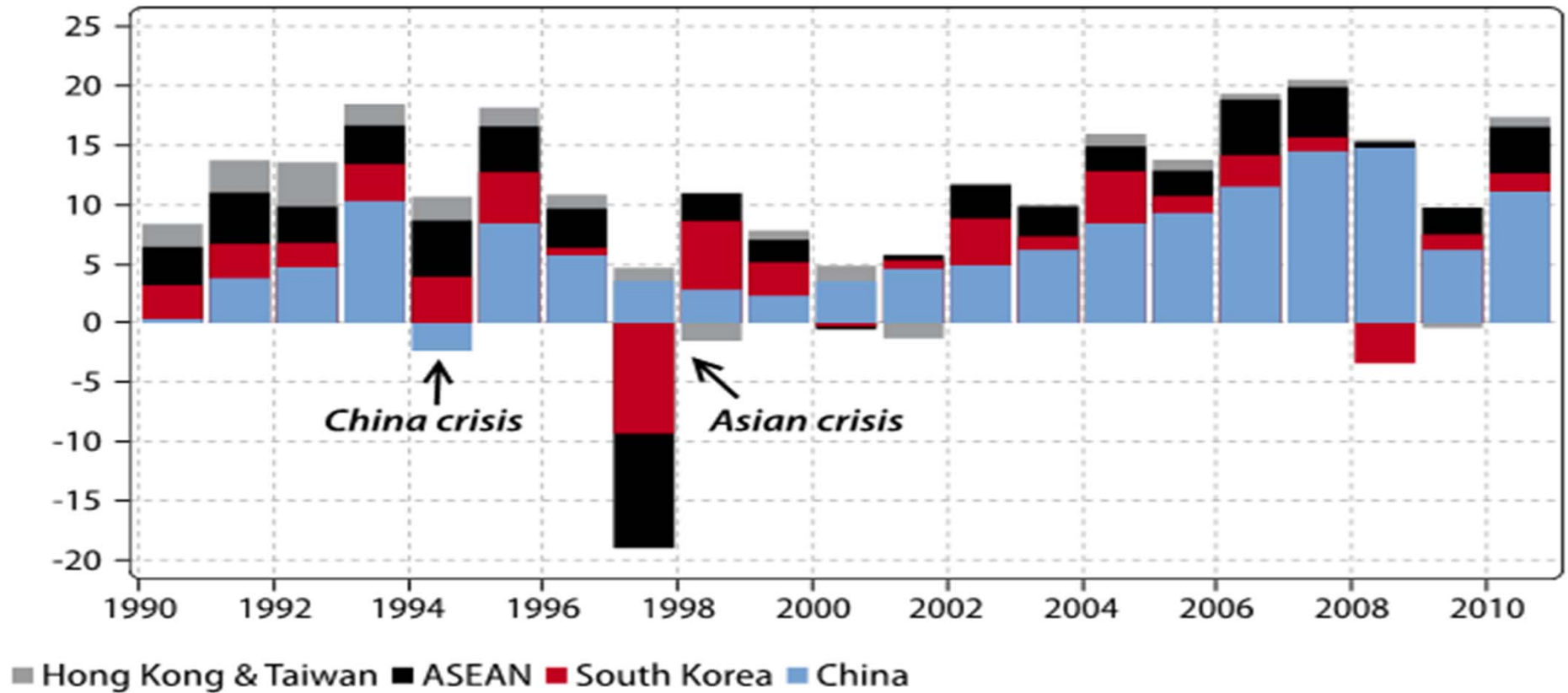


Source: Reuters EcoWin

Asian countries may have no choice but to embrace RMB as a regional currency

Now It Is All About China

Contribution to Asia ex Japan GDP Growth, in Nominal USD

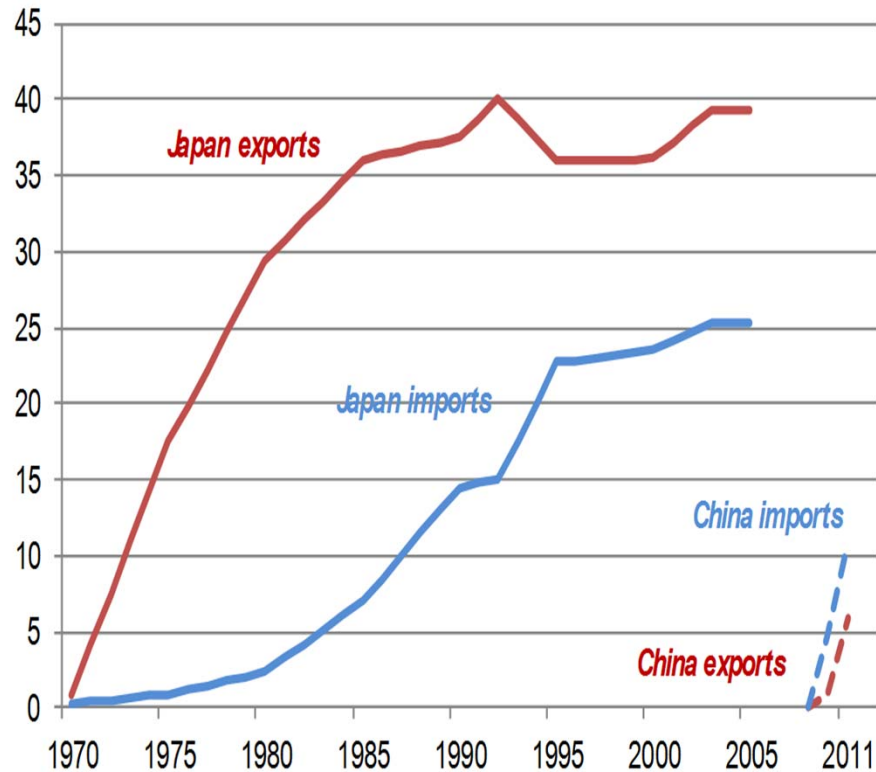


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RMB internationalization is now very rapid

Follow the yen?

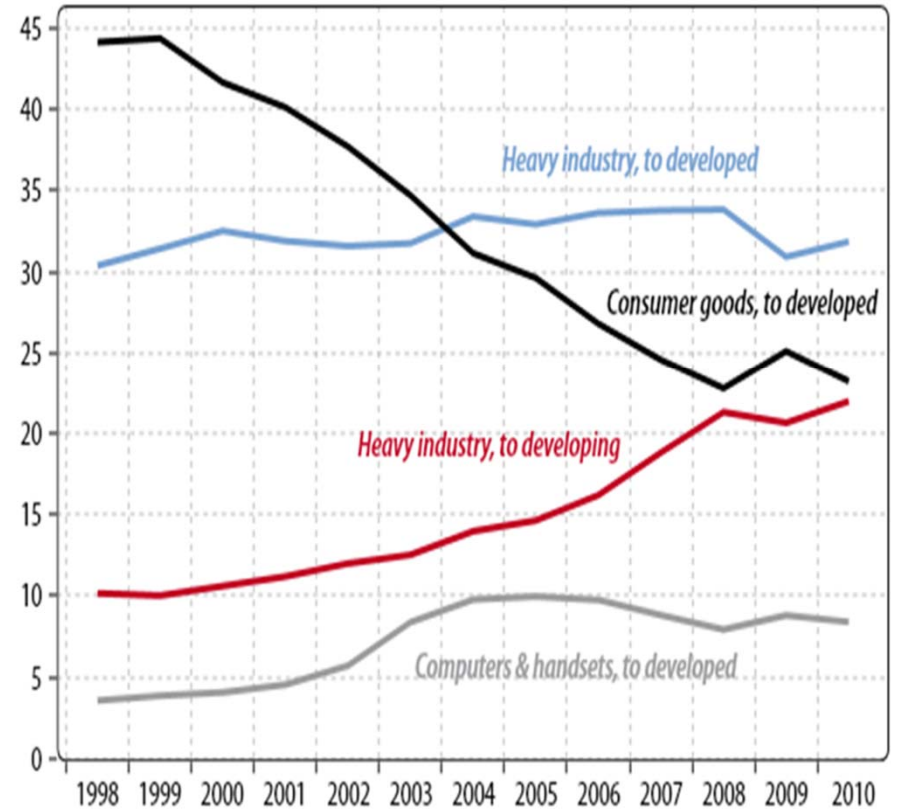
Share of trade invoiced in local currency, %



BIS, PBC, GK Dragonomics

China shifts from rich-country consumers to poor-country producers

Merchandise exports by category and destination, share of total



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The opportunity in dim-sum bonds – yield pick up and RMB exposure

Investment grade bond yield spread

Dim sum bond yield minus global



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A proxy for expected CNH bond yield - effective yield + currency expectation

Merrill Lynch dim sum indices, adjusted for CNY 12m changes implied by NDR



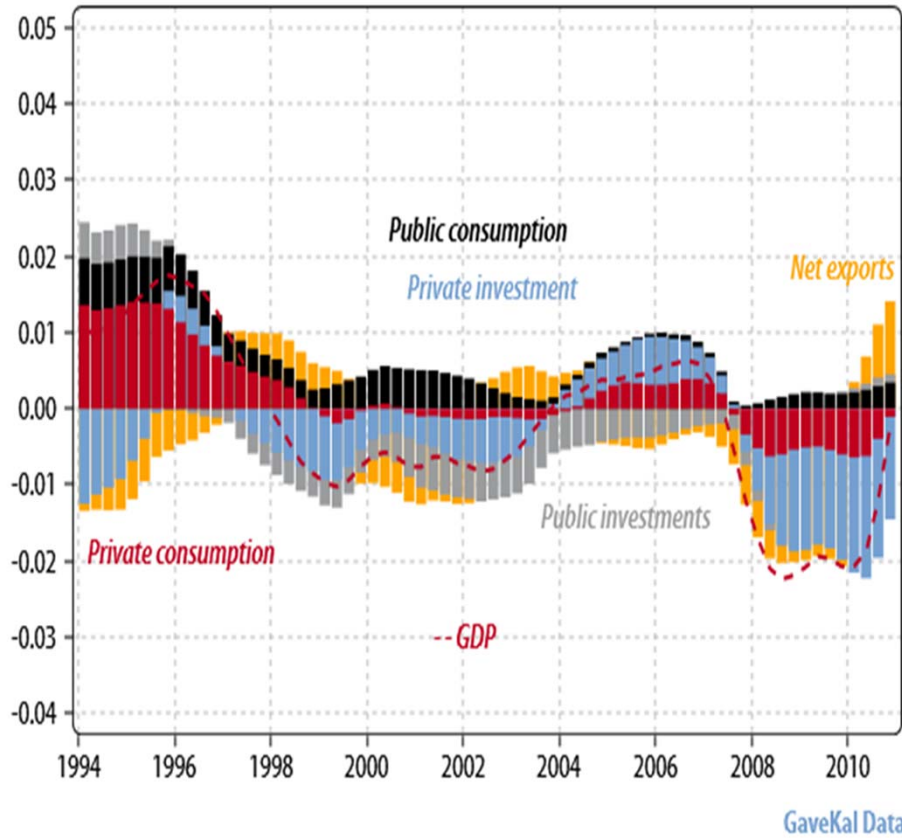
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Another key question for Asia: A year of policy changes in Japan?

Catalyst for change: Can Japan survive a strong Yen & falling exports to China?

Japan's private economy continues to drag on growth

GDP per capita, contribution to growth, smoothed 3 years

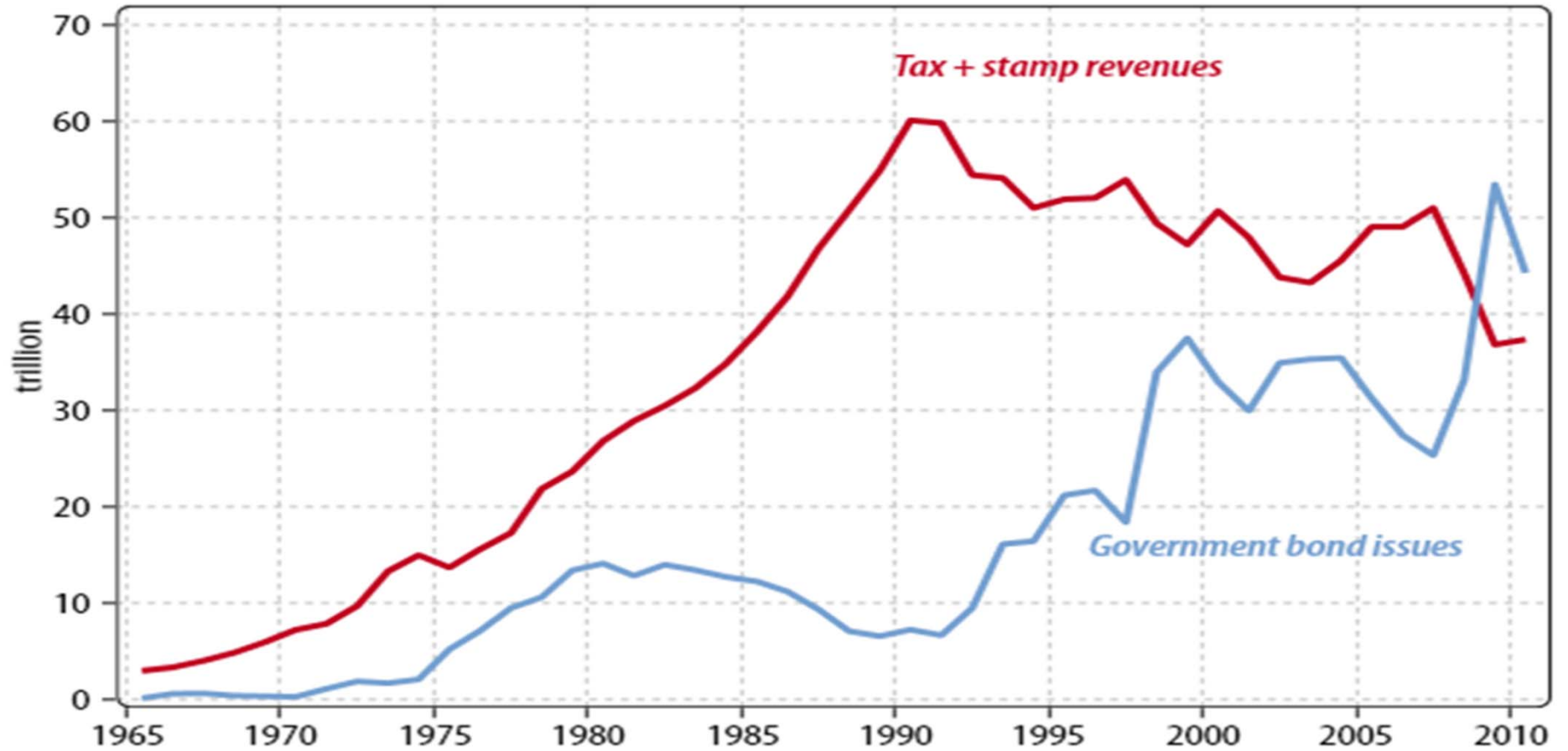


The Japanese Yen is approaching new highs



The fight between the BoJ and MoF

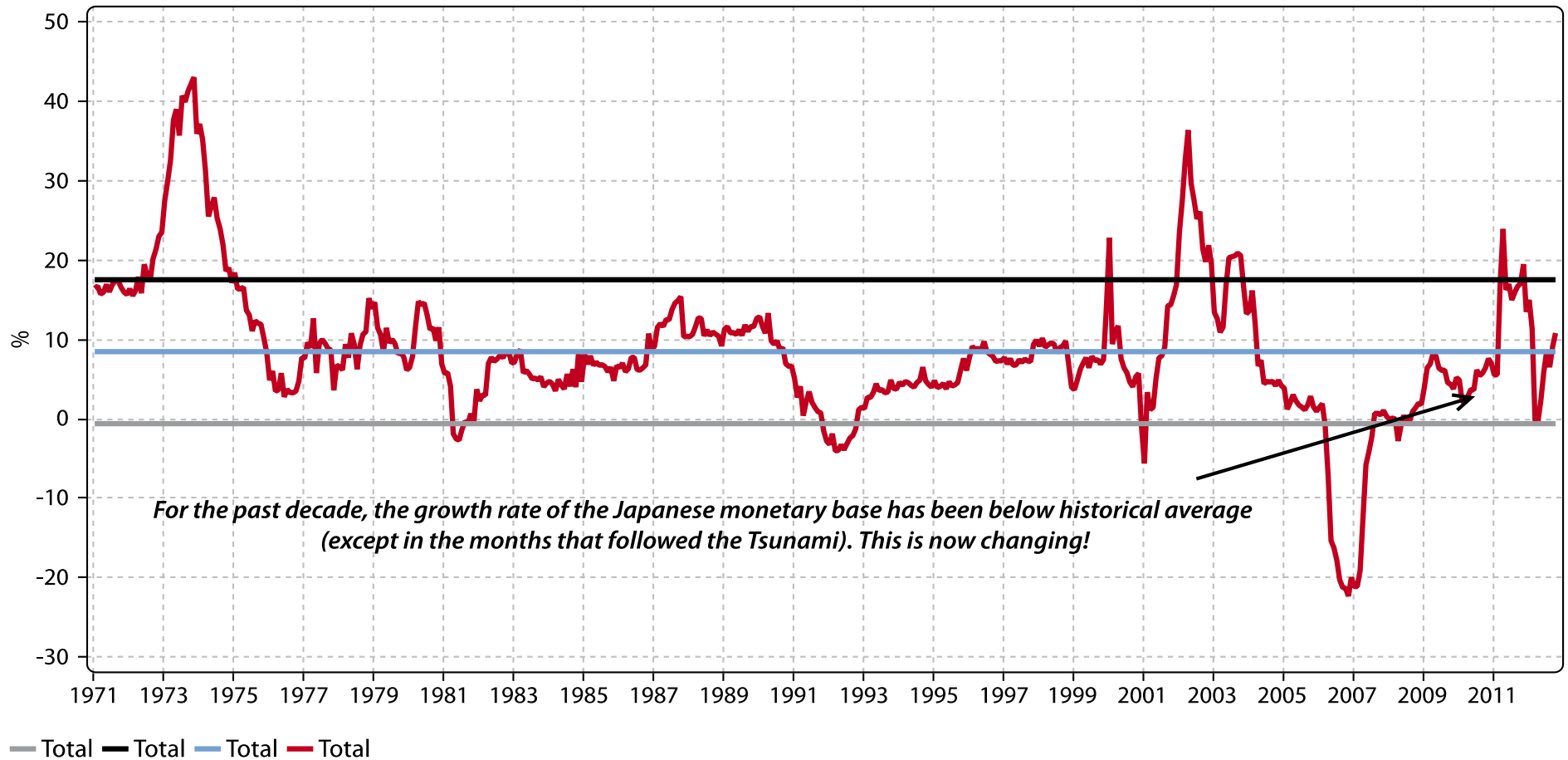
Japan issues more debt than it collects in general revenues



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So far, the BoJ has sat on its hands – but could this change?

Japan, Monetary Aggregates, Monetary Base, JPY



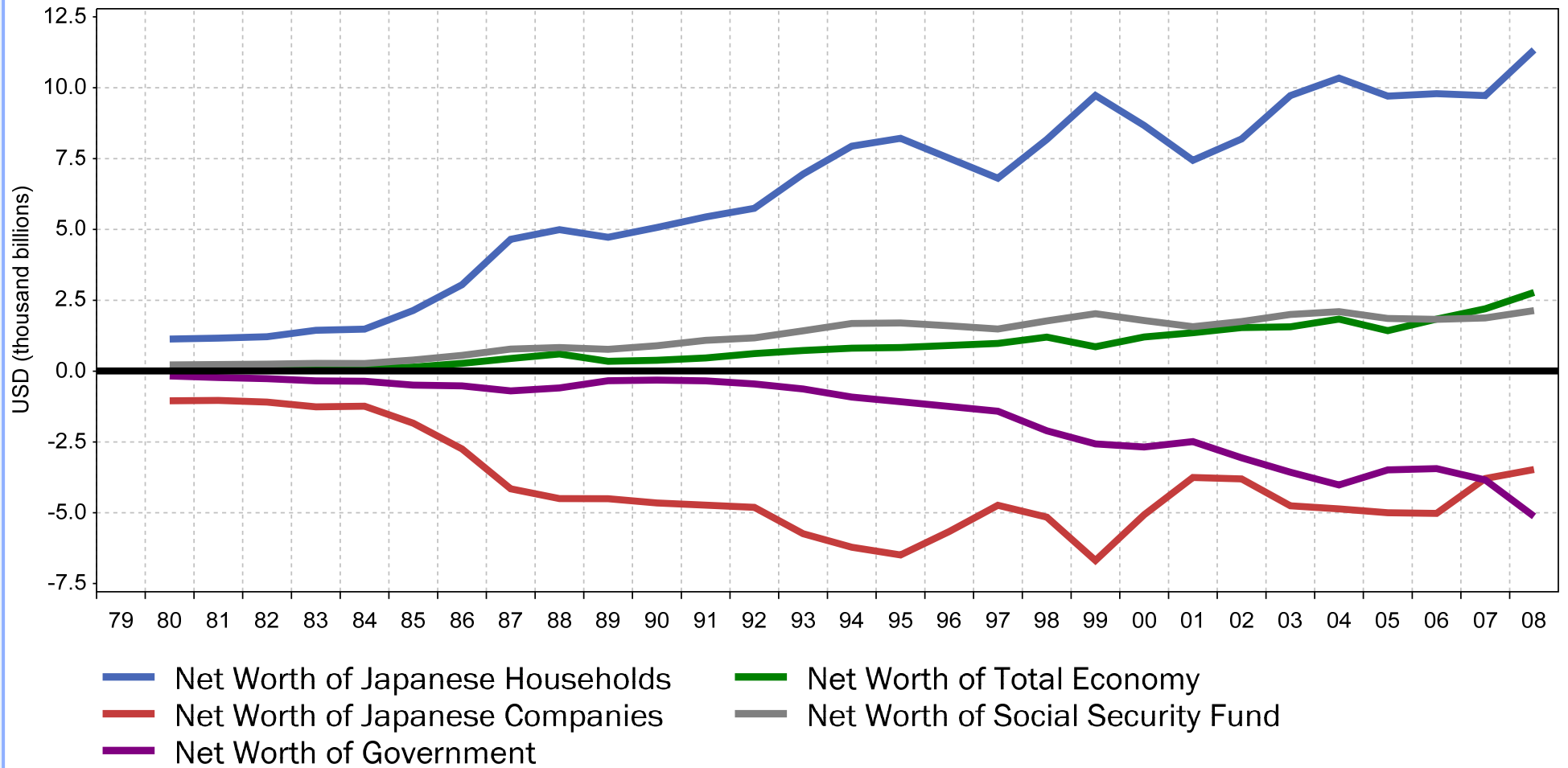
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Japan is not Greece

	Greece	Japan
Debt to GDP	High	High
Demographics	Poor	Very Poor
Exchange Rate System	Fixed	Variable
Budget Deficit	Negative	Negative
Ability to Raise Taxes	Non-Existent	Very High
Current Account	Negative	Positive
Inflation	Positive	Negative
Private Sector Capital Flight	Yes	No
Financing of Debt	Foreigners	Locals
Private Sector External Assets	Debtor Country	Creditor Country
Central Bank Reserves	Non-Existent	Very High

Japan is a very rich country

Net worth of Japan

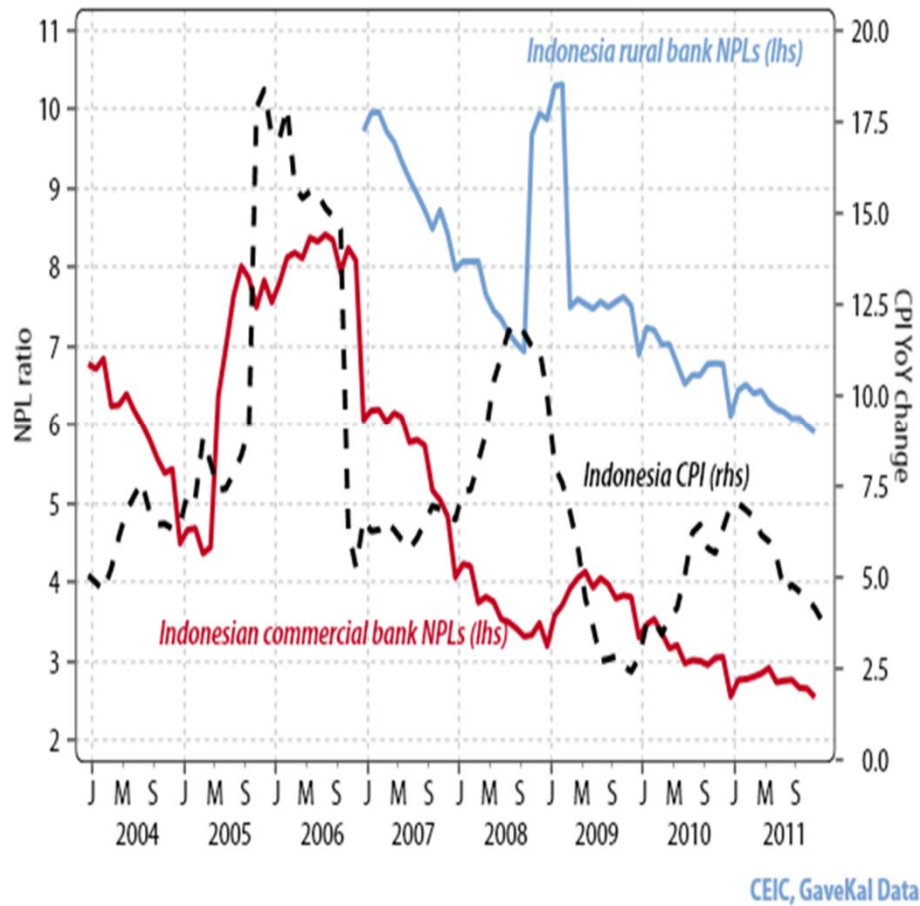


Reuters EcoWin

Will ASEAN remain Asia's Hotspot?

The move away from coal could prove damaging to Indonesia

Indonesia commercial & rural bank NPLs versus CPI YoY change

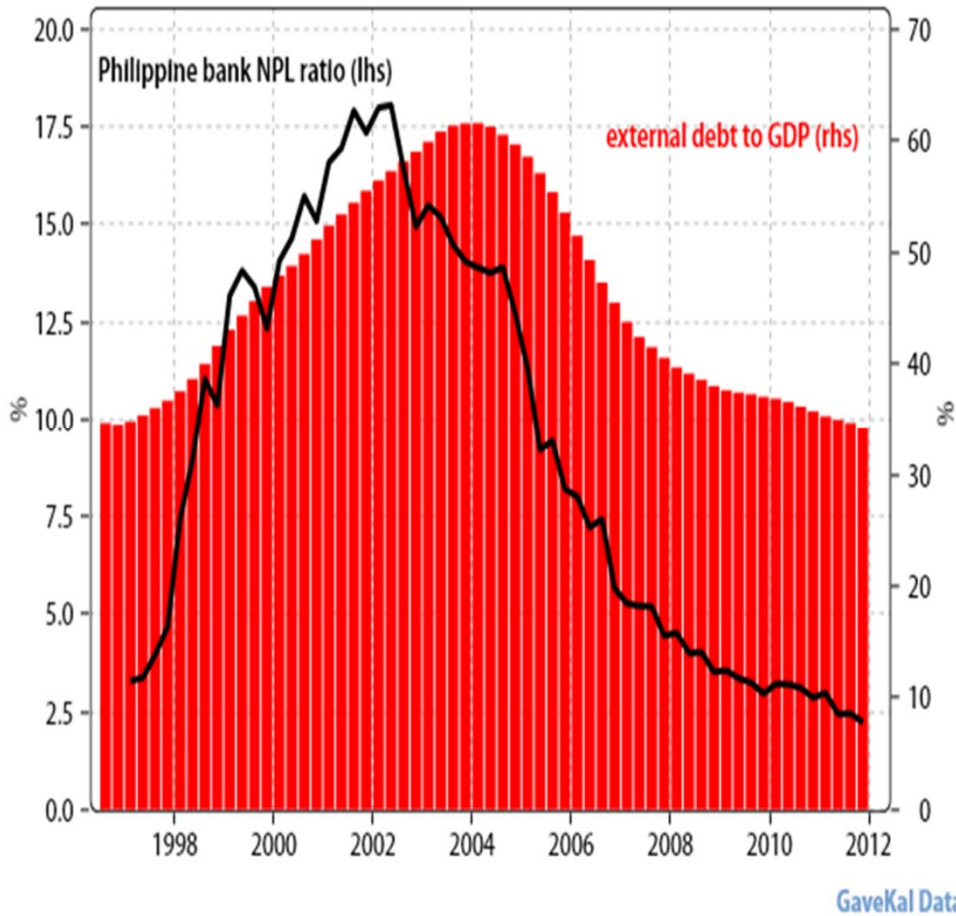


Indonesia, Government Benchmarks, 10 Year, Yield

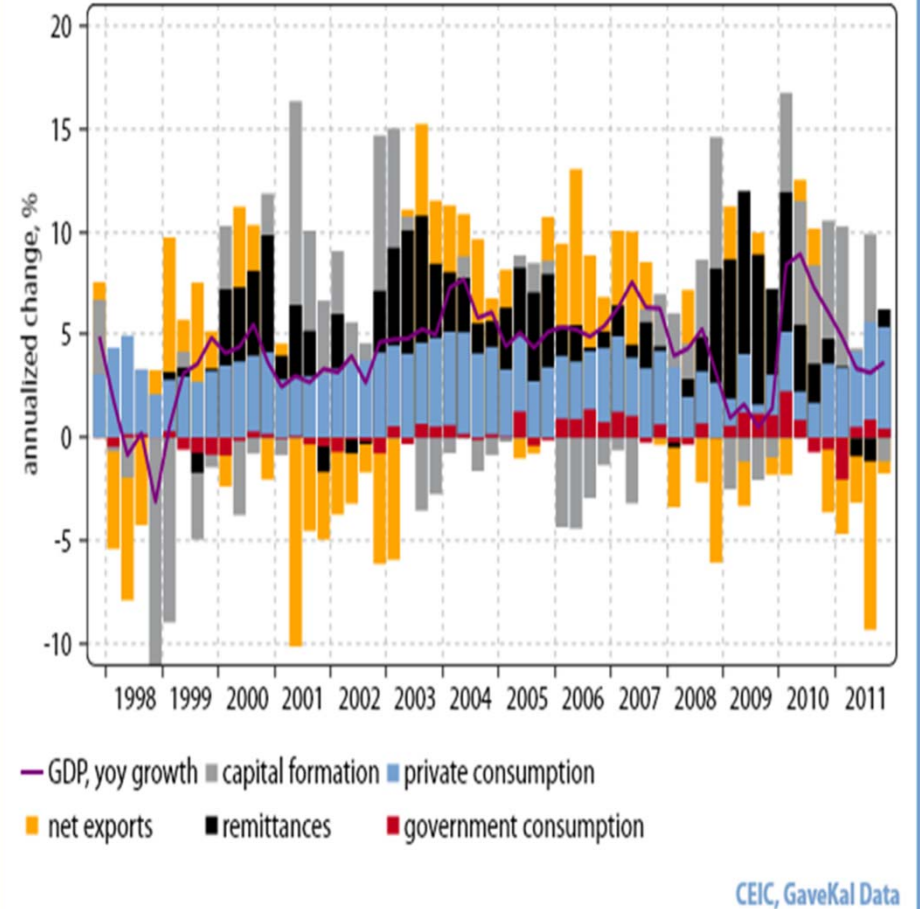


Phils are enjoying a peace dividend

Philippines bank NPL ratio vs. external debt to GDP

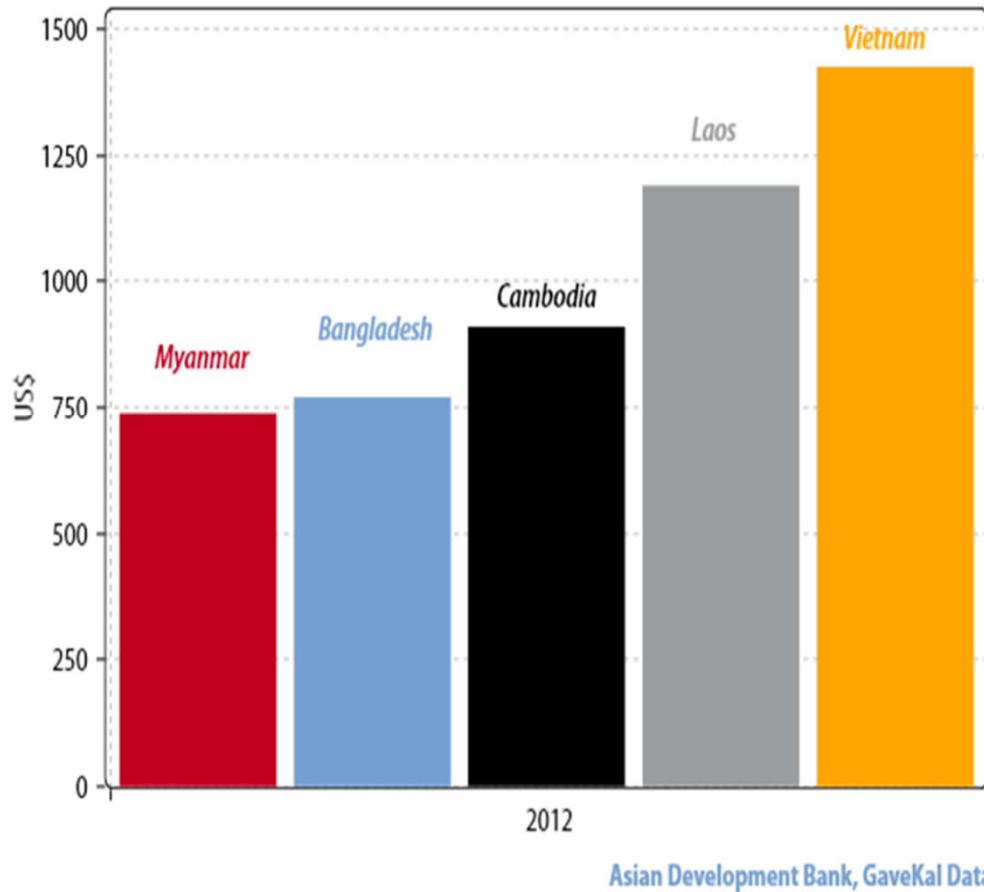


Philippines real contribution to GDP growth

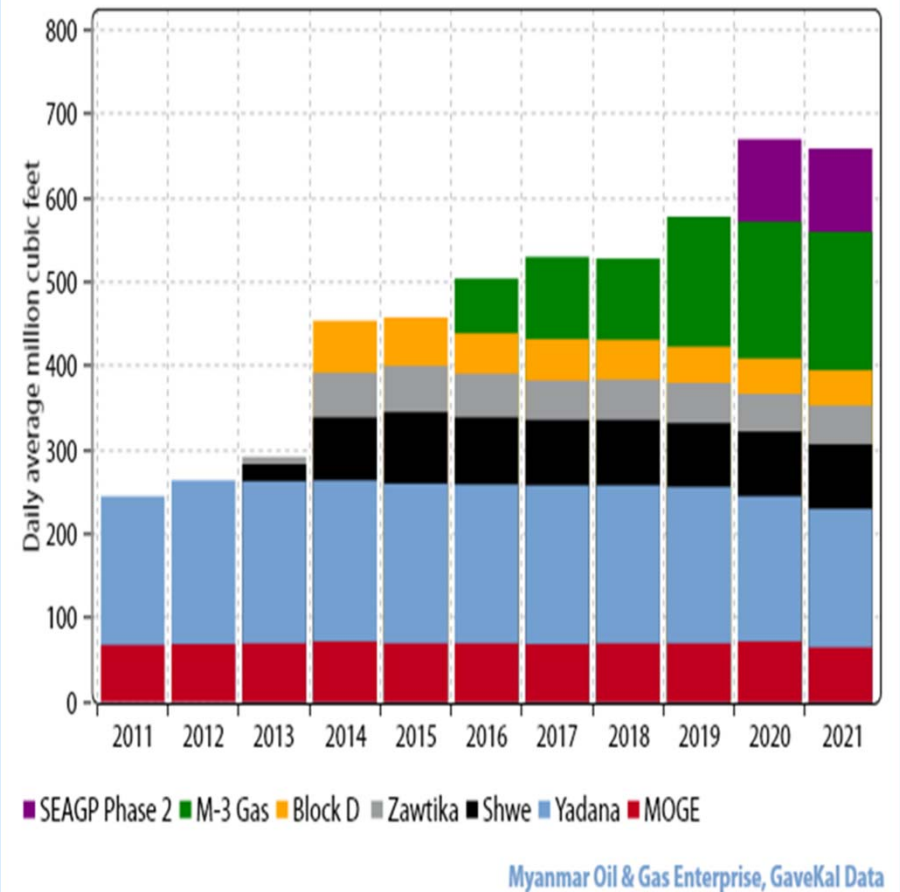


The most important political development in the region may be Burma

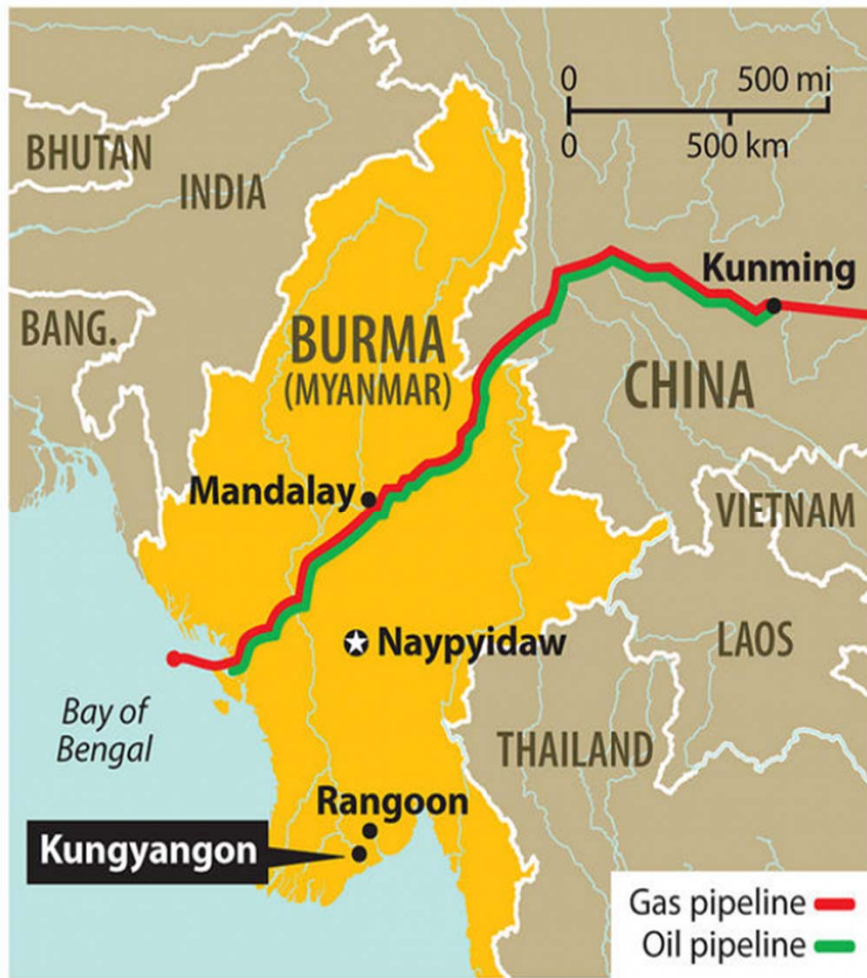
US\$ per capita income in late-developing Asian countries



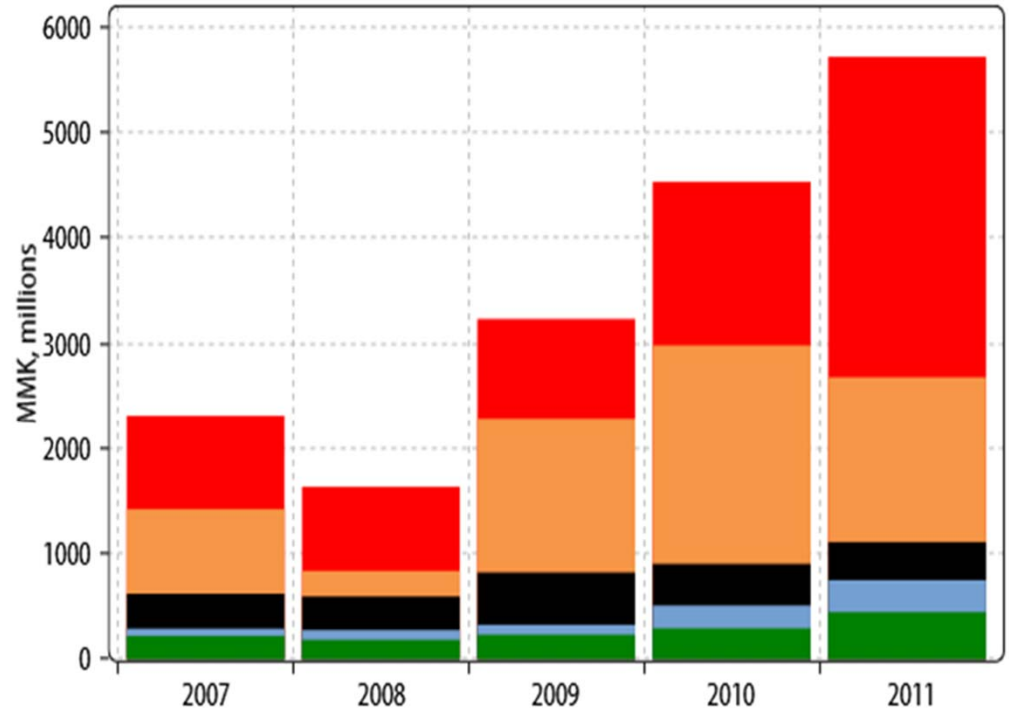
Myanmar future gas supply scenario by block



Myanmar sits at a strategic geographical position



Myanmar formal trade (exports + Imports) with regional counterparts



■ Myanmar trade with China
 ■ Myanmar trade with India
 ■ Myanmar trade with Japan
■ Myanmar trade with Thailand
 ■ Myanmar trade with Korea

CEIC, GaveKal Data

Thailand is first beneficiary of Burma's opening

Thailand, Equity Indices, SET, Index, Close, THB



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Investment conclusions

Assets that may be dangerous to own

- **French OATs:** with France heading into recession, the budget deficit may well blow out. Of course, the SNB remains a marginal buyer for as long as the Euro /CHF remains decently overvalued. But if France's recession disturbs the quiet status-quo, will the Euro be able to maintain its current perch?
- **Oil:** the two largest oil importers in the world are the US and China. But what if these countries manage to move towards energy independence thanks to the shale gas revolution?
- **CHF bonds:** why buy ten year bonds yielding 0.5% and pegged to the Euro?
- **Australian banks:** As a group, Aussie banks are now the third largest in the world (after US and China) and their combined market caps is bigger than that of EMU banks. This does not pass the smell test.
- **Yen:** with the coming change of leadership at the BoJ and with a far more activist likely PM in the form of Shinzo Abe, the Yen should be heading much lower.

Potentially mispriced assets

- **Chinese equities:** bearishness on China is now so thick. But with relative valuations at record lows, with sequential earnings growth becoming easier, with the economy bouncing back, with the RMB once again appreciating... the value just seems rather compelling.
- **North-Asian small-caps:** as liquidity tightened in recent years, this space has had its share of bankruptcies, scandals etc... and thus the consequent de-rating. But with liquidity now improving (especially if BoJ joins easing ranks), valuations should improve.
- **RMB bonds:** where else can one get 5-10% annual returns with a volatility of 2%?
- **Italian bonds:** Having endured four recessions in 12 years, there is little excess fat in the Italian economy. What the economy now needs is for the Euro to fall and Italy may once again thrive. At the very least, Italy's long-term outlook seems more promising than France's.
- **German real estate:** German real estate is where Chinese real estate was in 2003: undervalued, pegged to a central bank that is easing more than what the local economy requires, and a local economy still delivering terrific productivity gains.
- **Singapore real estate:** Singapore is still trading at a significant discount to HK. This discount should close.

More potentially mispriced assets

- **Gold mines:** gold miners have struggled in recent years because of rising costs and a flat-lining gold price. Meanwhile, they remain a hedge against further QE or Janet Yellen replacing Ben Bernanke at the Fed?.
- **Knowledge:** A long standing GaveKal theme. Knowledge is the most undervalued asset out there because it is simply not properly measured on the balance sheets of most companies.
- **Indian banks:** India remains one of the few natural 'growth' markets for a commercial bank.
- **HK and Singapore banks:** As the dim sum bond market grows, and as China embraces financial liberalization, and as trade in RMB grows, HK and Singapore based banks should clean up.
- **Thai equities:** the SET has already re-rated aggressively. But the opportunities unfolding in Burma, and across Indochina, can best be approached through Thai corporates. This bull market should have legs.

Contact & Disclaimer

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