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Mid-January 2012 - European Debt Crisis & China Slower Growth Update

Europe 1/12/12 Bond auctions in Spain & Italy had yields down sharply and demand was robust reflecting more positive investor sentiment even with the expected S&P rating downgrades.

MarketWatch 12/31/11 - The big picture will be crucial for investors in Europe, given the amount of uncertainty and the magnitude of the debt crisis. Decisions taken by politicians and the ECB could define the shape of things to come.

The stakes are huge also because more than 1.2 trillion euros of government debt will need to be refinanced in 2012 — Italy alone accounts for over 25% of that amount. High bond yields demanded by private investors could spell serious trouble.

It's going to be difficult, but euro zone leaders are making slow progress in ensuring the survival of the euro zone. Stock valuations in the region are "cheap for a reason," due to uncertainties.

Morningstar 12/27/11 - U.S. exports to Europe represent just 3% of U.S. GDP, and a lot of that is for basic necessities that can't be bought elsewhere.

However, European banks lend to sovereign governments, and those governments lend the money back to the undercapitalized banks. The failure of any one link could bring down a healthy chunk of the European banking system and the crisis could deepen.

In December the fifth European Summit was more productive than previous ones. But there is still lots to be done to get needed agreement on the details of the broad package proposed. Many agreements reiterate the same ideas as when the euro was first debated in 1998, with the stability and growth pacts and some of the sanctions that were never fully implemented.

More immediate actions came from the European Central Bank (ECB) which cut interest rates and assured that banks would be funded for whatever they needed for up to 3 years. The U.S. Fed opened up swap lines to assure the availability of \$US to European banks.

This gave confidence to markets, that there is little risk of a Lehman-like liquidity crisis that almost

crashed global financial markets — before U.S. Fed action prevented a potential global crisis becoming much worse.

While a bank liquidity crisis has probably been avoided, a European sovereign debt crisis is still not fully resolved.

The ECB remains wary of taking bold action that might take pressure off the government leaders to truly solve the underlying problems, leaving the ECB with all the risk. The ECB last summer stepped up purchases of Italian bonds, only to see Italian President Berlusconi try to backslide on his reform promises as market pressure eased.

Markets need to know that someone has both the money and the will to fund Italy or Spain if private markets become too scared to do so. The agreement to infuse money into the IMF is positive, but not enough to solve a situation of Greece plus Italy or Spain defaulting.

The Eurozone needs to be strengthened so that governments, not the central bank, can provide the funds a troubled member state might need. In return, there need to be assurances that countries will run their budgets responsibly. The summit made real progress in both of these regards.

Leaders agreed to create the European Stability Mechanism, (ESM), in mid-2012. The ESM €500 billion fund is the "bazooka" that is much better than the current European Financial Stability Facility to provide funding for troubled countries.

The ESM needs treaty amendments that are opposed by some countries. Tighter fiscal rules were proposed by German Chancellor Angela Merkel, who demanded treaty-level barriers against runaway debt and deficits.

Leaders hope to have a treaty prepared soon and signed by early March. The treaty will take effect once ratified by nine of the 17 euro-zone countries with a July 2012 target date. EU states outside the euro will join as they ratify. So far, only the U.K. has refused to sign up.

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China

The Hang Seng Index was down 20% in 2011 - its biggest annual loss since the 2008 financial crisis due to mounting fears about tight monetary policy in China, concerns about bad loans and corporate governance issues.

The Hang Seng Index closed 2011 at about 9.2 times forward 12-month earnings forecasts, representing a 25 percent contraction in valuations to near historic lows. Earnings expectations have come off sharply with analysts, on average, still forecasting 12.5 percent growth in 2012 earnings.

China is trying to be less dependent on exports going to Europe and concentrate on domestic spending. "Steady household income growth of about 10-15% in 2012 should continue to underpin consumption growth." Christina Chung, head of China team at RCM, manager of the RCM China fund 12/31/11.

Douglas Turnbull, manager of Neptune China and Greater China Income fund (UK funds), expects slower economic growth, but maintains: "Slower growth will also be better growth. Sentiment towards China is currently depressed, as expressed by near record-low multiples. We believe that government policy is no longer going to be a drag on performance, that notwithstanding crises in Europe, China's economy will continue to deliver."

Morningstar 12/27/11 – "China Slowing Is an Issue for Some, but Potentially Good News for the U.S." article says "China certainly remains an issue, as growth there slows modestly and the construction industry pulls back from its break-neck pace.

Slowing there is bad news for Europe, Australia, and perhaps Brazil, which are major exporters to China. It is also bad news for a lot of high-profile capital goods manufacturers in the U.S. But overall, China is an even smaller part of U.S. GDP than Europe.

Furthermore, slowing growth in China could mean significantly lower commodity prices, especially in the U.S.--which would be good news for low-end U.S. consumers, who were particularly crippled by rising commodity prices in 2011."

MarketWatch 12/31/11 - A number of analysts are upbeat about the prospects for Asian markets after a poor 2011. Thanks to lower commodity prices and easing growth, inflationary pressures are also rapidly declining. That is increasingly giving central banks more space to spur growth via interest rate cuts, or in China's case, a reduction in the reserve requirement ratios at banks.

Credit Suisse expects a "reflation rally" to provide a 10% to 15% upside in 2012 for Asian stocks,

excluding Japan. Citigroup estimates regional stock markets carry an "upside risk" of 25% to 30%.

The key question for investors is the pace of China's growth amid a recession in Europe, since the European Union is the mainland's largest trading partner. Capital Economics says China's fourth-quarter output growth may have dropped below 7% on a quarter-on-quarter, annualized basis. But it expects full year 2012 growth to be a more respectable 8.5%, assuming Beijing provides a policy stimulus.

China's growth is important for its Asian trading partners, as well as for commodity exporters in Australia and South America. The rate of expansion is also crucial for the country to overcome a possible increase in bad loans at banks, or to avert a bubble in the property market.

Recommendations

While nothing is assured, the investment potential seems especially strong in the U.S., with good fundamentals and near-historic low valuations and interest rates.

Europe has the most downside risk but also compelling values as long as austerity measures - which cut jobs and growth - don't result in more than a mild recession and a debt crisis is avoided.

I recommend managers with track records of long-term outperformance (Alpha) vs. Risk (Beta) as the best way for equity recommendations based on sector allocations given individual investment objectives.

CHART & FT ARTICLE "US immune from eurozone contagion so far" NEXT PAGE

DISCLOSURES

Past performance does not assure future results. Investors cannot directly invest in indices

Additional risks are associated with international investing (especially in developing countries), such as currency fluctuations, political and economic stability, and differences in accounting standards. There is no assurance that objectives will be met.

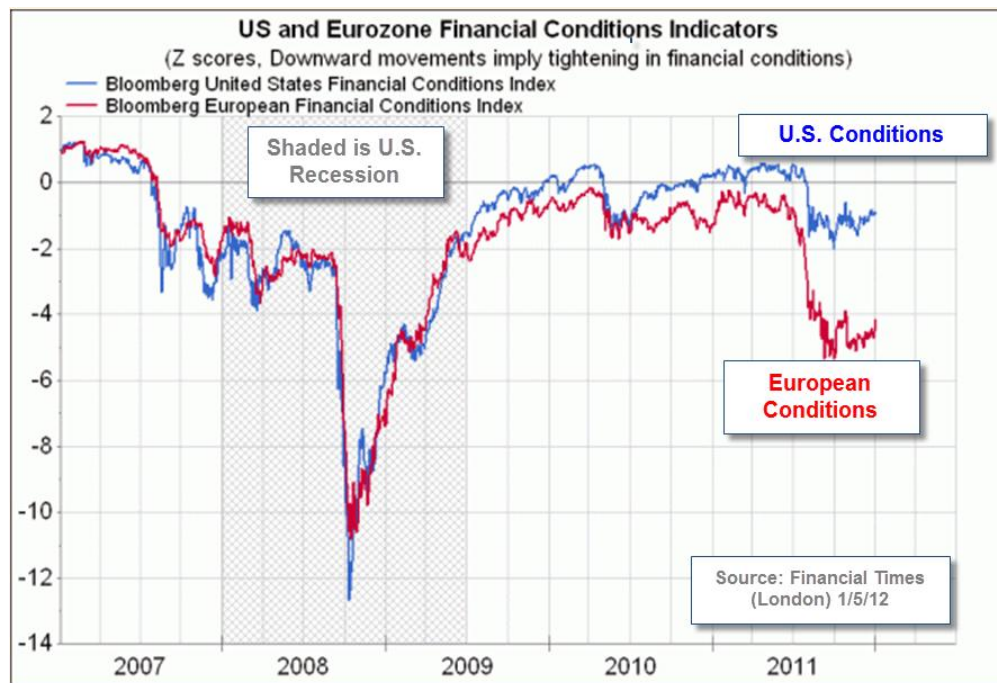
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The Financial Times of London 1/5/2012 article **"US immune from eurozone contagion so far"** highlights:

Leading indicators bottomed in July/August (2011), shortly after oil prices peaked. Global activity improved slightly in September and October, but at that stage only the US proved robust to the increasingly grim economic data emerging from Europe and China. There seemed to be a significant risk that the eurozone crisis would cause a renewed recession not just in Europe, but in the world as a whole. But the economic data which have so far appeared do not seem to have justified these fears.

The eurozone is, of course, already in a shallow recession, and this will inevitably worsen markedly in the peripheral economies as fiscal policy tightens this year and banks continue to delever.

But the large demand shock which is under way in the crisis economies of the eurozone will, on its own, reduce global GDP by no more than 0.2 per cent this year. Even assuming that the eurozone shock drags the core economies like France and Germany into recession, which is likely but not certain, the impact on global GDP would be only about 0.4 per cent. This is manageable, given the 3.3 per cent growth rate which the US economy seems to have recorded in 2011 Q4.



Consider the graph which shows financial conditions indicators (FCI) in the US and the eurozone, calculated by Michael Rosenberg at Bloomberg

The decline in the eurozone FCI has now been about half as severe as that which hit the European economy at the end of 2008. That is enough to cause a recession, but it would have been far worse if the ECB had not taken enormous steps to support the financial system, and the integrity of the euro. In the process, they have come much closer to full-scale quantitative easing, along

with bailing out of eurozone governments, than they have been willing to acknowledge in their rhetoric.

Meanwhile, the Fed's continuing preference for extremely easy monetary policy in the U.S. has prevented the financial tightening from crossing the Atlantic. The absence of any tightening in financial conditions in the U.S. during the recent crisis stands in sharp contrast to what happened in 2008.

Many economists are beginning to feel very uneasy about the ability of central bank balance sheets to absorb these shocks in an unlimited manner. This has never been tried before in anything like comparable circumstances. But no one seems to have a viable alternative to what the central banks are being forced to do.

A reader's blog entry points out:

MB194 | January 5 7:14am

I am not sure why economists seem to be finding this subject so difficult. The northern part of the Euro area has not diverged from the US that much, a slight slowdown in activity at the end of Q3 and through Q4. Northern Europe is now recovering reasonably well. The EMU should not be referred to as one economy. Asia has followed a similar story.

It is southern Europe, specifically Spain and Italy, that are in serious trouble. Both contracted sharply in Q4 and there is no sign of any recovery according to the latest PMI surveys. Once the [budget] cuts kick in without devaluation these economies will probably go the way of Greece, into a deflationary spiral. Both will default eventually unless the EMU is restructured to allow them to grow. Depressingly, any solution to this problem is not even at the discussion stage yet.