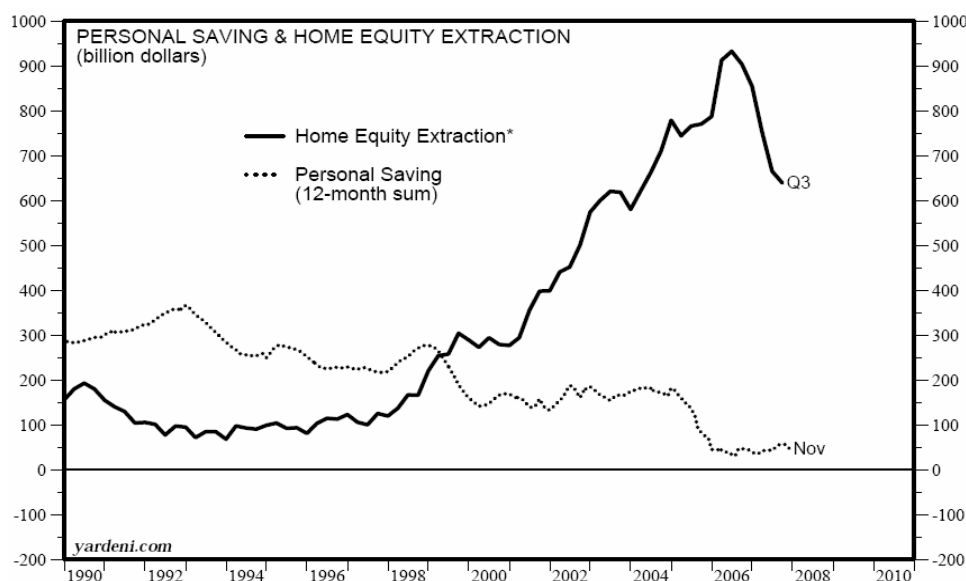


INFLATING A NEW BUBBLE?

BIG PICTURE – I have a suspicion that last month’s insane market volatility would have caused some sleepless nights throughout the investment world. There can be no doubt that the current year did not commence well with widespread declines in the capital markets, resulting in the selling nadir which forced the Federal Reserve to announce an emergency 0.75bps rate cut. A few days later, in an effort to boost the ailing American economy, the extremely intelligent US establishment announced its own bailout package worth US\$150billion. These measures helped to stabilise the situation and the markets recovered towards the month-end.

Now, I am aware that there are many skeptics who are not impressed by the monetary easing. These folks believe that the central banks are only compounding the current problems by adding more fuel to the already raging inflationary fire. According to them, the ongoing monetary and fiscal stimulus will not work as the US consumer is already stretched to the limit and cannot possibly spend any more. For sure, the skeptics have a point. It is worth noting that since the beginning of this decade, Americans financed their consumption binge by using their homes (which were appreciating in value) as ATMs. In

Figure 1: A problem for the US economy?



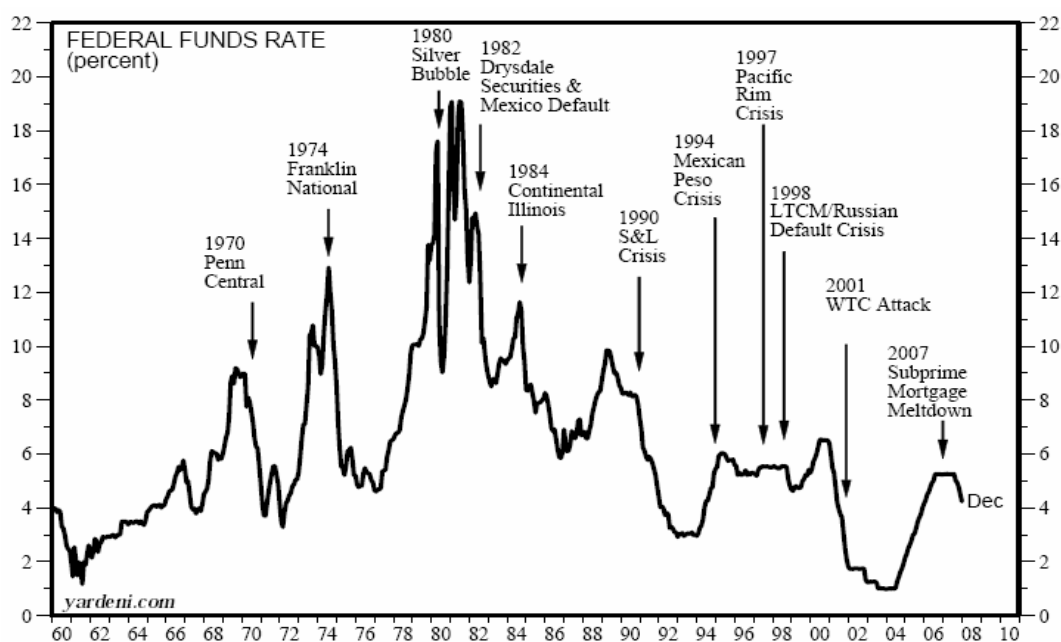
other words, home equity extraction became a major source of financing for households in the US. Unfortunately, the housing boom ended abruptly in 2006. Consequently, home equity extraction has contracted ever since whilst the personal savings rate seems to have bottomed out (Figure 1).

Source: www.yardeni.com

Surely, the above development is not a healthy sign for the US economy given the fact that consumer spending accounts for roughly 70% of GDP. In my view, the ongoing housing recession will continue for several months and this should act as a headwind for economic growth in the US. However, where I differ in my assessment from the dire forecasts of the bears is that I expect the latest bout of monetary and fiscal easing to work (like it always has), thereby inflating stock-markets worldwide. Over the past several months, central banks and various Sovereign Wealth Funds have pumped billions of Dollars into the financial system and I expect this infusion of “money” to ultimately support the stock market in the US and elsewhere. Remember, this is an election year in the US and the American establishment will tolerate either a deflating housing market or a declining stock market but not both. So, you can bet your farm that everything will be done to inflate the stock-market so that Americans are feeling happy and “wealthy” before they go and vote!

It is interesting to note that ever since gold was removed from the monetary system in the early 1970’s, regular financial crises have been the norm rather than the exception. And the response of the central banks following each crisis has always entailed creating additional inflation via lower interest-rates (Figure 2). Let it be known that it is these bouts of monetary easing which have provided the fuel necessary for the next bubble or mania in the capital markets.

Figure 2: Financial Crisis = Monetary easing



Source: www.yardeni.com

You may remember that 1987 brought with it the infamous “Black Monday” when the Dow plummeted in a single day. Back then, the Federal Reserve responded to the crash by pumping liquidity into the system, thus setting the stage for a massive bubble in Japanese assets. Unfortunately for investors, the Japanese mania ended in tears in 1990, resulting in widespread wealth destruction. A few years later, the financial world got jolted again by the Asian Crisis (1997) and Long-Term Capital Management Crisis (1998) and

again the Federal Reserve responded by slashing interest-rates and injecting more liquidity into the system. Over the next couple of years, this particular round of monetary easing spawned and fueled the biggest asset-bubble of all-time – the technology bubble which popped in early 2000. The bursting of the NASDAQ bubble at the beginning of this century caused serious pain to the business world (with the exception of the CEO's at Silicon Valley who made fortunes at the expense of the investing public) and threw the economy into a recession. Once again, the Federal Reserve (under the glorious leadership of Mr. Greenspan) decided to tackle the bear by dropping interest-rates to a miniscule 1% - a multi-decade low. Even though the US recession was relatively mild at that time and ended in November 2001, the Federal Reserve left interest-rates unchanged for several months, thereby creating a massive housing bubble in the US. Like all previous credit-induced booms however, the housing bubble burst in 2006; creating the ongoing sub-prime and credit crises. Now, if history is any guide, over the months ahead, I suspect the Federal Reserve will wage an all-out inflationary war which will create a massive bubble in the emerging-markets of Asia and Latin America. At this stage, it is impossible to forecast when the emerging-markets bubble will end but if I had to guess, I would say that the day of reckoning will probably arrive in 2010.

Turning back to the current situation in the US, opinion is divided as to whether the US will slip into recession, thereby triggering a global bear-market. It is my view that when adjusted for true inflation, the world's largest economy is already in recession. However, I doubt very much if the official statisticians working in Washington will ever admit to a recession in this election year. So, I would have to conclude that at least in the eyes of the mainstream media, the US will avoid a recession not least due to all the help being provided by the officials.

It is interesting to note that during previous recessions in American history, government-sponsored stimulus packages arrived around the time when the business cycle was bottoming out and a recovery was already underway. Here are the dates when anti-recession packages were announced followed by the dates when the recessions ended:

- October 1949 – *recession ended in October 1949*
- April and July 1958 – *recession ended in April 1958*
- May 1961 and September 1962 – *recession ended in February 1961*
- August 1971 – *recession ended in November 1970*
- March 1975 – *recession ended in March 1975*
- January and March 1983 – *recession ended in November 1982*
- December 1991 and April 1993 – *recession ended in March 1991*
- June 2001 – *recession ended in November 2001*

So, given the fact that Mr. Bush has already unveiled his stimulus package and the Federal Reserve is busy recapitalising the banking system via a steep yield-curve, I am willing to bet that after some more weeks of choppy trading and base formation, the global stock markets should trend higher. If this is the case, my preferred investment themes (natural resources, BRIC economies, Asian infrastructure and the US technology sector) should continue to outperform the other sectors and markets.

Although I am positive about the long-term prospects of the above themes, the global economy faces a huge risk (derivatives time-bomb) which is worth mentioning. The notional amount of the over-the-counter derivatives outstanding as at 30 June 2007 stood at a gigantic US\$516 trillion, representing a 400% increase in the past 5 years! This insane number equates to 10 times the size of the world's economy and 5 times the total market value of all stocks and bonds in the world today. Nobody knows if and when this mountain of obligations will implode, but if it does, the financial world will feel the tremors. Clearly, this is a huge risk but the question is where one can find a safe haven to park capital?

Over the past few weeks, investors have been liquidating assets en masse and finding "safety" in cash. However, given the precarious health of the banking system, I would argue that cash is probably the most risky asset to own! In a world where derivatives are growing to the heavens and the solvency of entire banks is in question, how "safe" is cash? Personally, I would rather continue to keep the majority of my hard-earned money invested in tangible assets (precious metals, commodities and stocks of solid companies). This may result in some further near-term pain, but at least I can be sure that I will not be separated from my cash in case the bank closes its door!

ASIA – There can be no doubting the fact that the world's most populated continent is powering ahead as its 3 billion plus people gradually improve their standard of living. I first started investing in China and India in 2002 when these markets were relatively undervalued. Since then, both nations have progressed extremely well and I suspect that they will continue to provide massive opportunities over the coming decades. Over the near-term however, the Asian markets may continue to churn and consolidate due to turmoil in the West.

Over the past few weeks, Asian stock-markets declined significantly, causing some to question the “decoupling theory”. Figure 3 shows that the MSCI Pacific Index fell by as much as 25% from its peak recorded in October last year.

Figure 3: Asian markets – correction over?



Source: www.stockcharts.com

Despite the recent sell-off in the East, I still maintain my view that these markets are in a long-term secular bull-market. After all, Asia’s economy is booming thanks to strong domestic consumption and soaring regional trade. Moreover, investors should remember that some of the Asian indices had appreciated considerably in the past year so a commensurate correction was always a possibility.

It is my belief that once the current problems in the West subside, the Asian markets will resume their long-term bull-markets. The reason why I am confident about this forecast is due to the fact that up until now, economic data coming out of Asia has been impressive.

It is interesting to note that despite China’s dependence on the ailing US, its economy continues to charge ahead. Recently, it was announced that China’s real GDP grew by a fantastic 11.2% in 2007. There is no doubt that China’s economy is booming and in 2007, its trade-surplus doubled when compared to a year earlier. Moreover, retail sales in China have been growing at 14% per annum for many years and in the past 12 months, total sales reached almost US\$1 trillion. Interestingly, the number of US Dollar billionaires in China jumped almost 10-fold in the past year from 14 to 106 individuals. All of the above leads me to conclude that the Chinese consumer will be an extremely influential factor in the years ahead.

Elsewhere in the region, India's economy is also growing rapidly with real GDP growth clocking in at roughly 9%. Its industrial production has slowed down somewhat in the recent past but production of capital goods continues to soar.

As far as the Asian region's dependence on the US market is concerned, Singapore, Hong Kong and Malaysia are the most exposed to the American consumer. Their exports to the US are equal to roughly 20% of their GDPs, compared with only 8% in China and a miniscule 2% in India.

Due to the slowdown in the West, exports to the US from Singapore and Malaysia have declined by roughly 15% from their peaks. Yet, it is worth noting that both these nations' total exports have still managed to grow by 6% due to surging exports to Europe and the other emerging nations. This data suggests to me that we are slowly but surely moving away from a US-centric world.

Skeptics of the bullish Asian story should take note of the fact that the cash-rich region intends to spend a mind-boggling US\$1 trillion on infrastructure projects over the coming year alone! This development will create additional employment in the rural areas and lift hundreds of thousands out of poverty.

Furthermore, given the great economic prospects of Asia, I find it absurd that the region's market-capitalisation (excluding Japan) accounts for less than 10% of the money invested in equities worldwide. Conversely, I find it equally strange that America's share of the pie comes in at roughly 50%! Call me biased but I believe that in the future, a significant amount of capital will flow out of the US stock-market and head towards Asia.

In my view, the current weakness in prices is a terrific opportunity to add to your positions in Asia. At this stage, my favourite market is India followed by China. If I were looking to invest fresh capital today, I would avoid Asian exporters and instead focus on buying resource-related or infrastructure companies in the region.

Since the commencement of the recent correction, the Hang Seng Index has fallen sharply and some of the top-quality Chinese "H-shares" listed in Hong Kong have lost anywhere between 50-60%! Not many people realise that (due to capital controls and the inability of the mainland Chinese to invest overseas) the same companies also trade in Shanghai as "A-shares" at twice the "H-shares" valuations! In the future, when the Chinese government allows the mainland Chinese to invest in "H-shares" in Hong Kong, I expect them to catch quite a bid as the gap between the two classes of shares disappears. In other words, unless I am missing something, I see this as a great time to load up on your favourite Chinese companies listed in Hong Kong. Once the correction is over and sentiment improves, I expect the Hong Kong-listed Chinese shares to soar.

ENERGY – The price of energy continues to defy all odds by staying stubbornly high. Despite all the talk about the impending doom in the US, crude is still trading above US\$90 per barrel. Figure 4 shows crude oil’s incredible rally in the past year. Clearly, black gold is overbought from a technical perspective but so far, we haven’t got much of a correction despite the ongoing drama in the markets. Rather than declining rapidly, crude is simply absorbing its recent gains by consolidating. This should not come as a surprise to my readers as I have long been an advocate of “Peak Oil” and have urged you on numerous occasions to load up on energy.

Figure 4: Not much weakness in crude oil!



Source: www.stockcharts.com

So, why is the price of oil not falling hard despite a slowing Western economy? The answer to this question lies in the petrol tanks of the Arabs and the Asians. According to the International Energy Agency (Paris-based energy watchdog), world consumption is expected to rise to a record-high 87.8 million barrels per day this year, representing a gain of 2.1 million barrels per day over last year. Furthermore, I would like to add that demand from China alone will increase 5.7% to 8 million barrels per day. More importantly, China is becoming increasingly dependent on foreign oil and this year it will import roughly half the oil it consumes.

Another bullish development in the energy market which seems to have been missed by most people is the arrival of Tata Motor’s ultra-cheap (US\$2,500) car – Nano. The Indian carmaker recently unveiled its new (very affordable) car which will make car-ownership a reality for millions of

middle-class Indian households. India, with its clogged streets and crazy traffic needs new cars like you need a bullet in your head, but I am sure that this tiny detail will not prevent the aspiring Indians from buying this little beast. The car will reach full-scale commercial production in the second half of this year and it looks as though it will further increase the demand for oil.

On the supply side, oil producers are struggling to increase production. Last month, Saudi Arabia announced that its Khursaniyah Oil-Field (500,000 barrel a day output) missed its December start-date. Over in North America, Petroleos Mexicanos (Mexico's state oil monopoly) declared that output at its massive Cantarell field has declined by roughly 40% in the past 3 years. So, it is becoming clear to me that some of the world's important oil-provinces are peaking and may not be able to meet our future energy needs. Furthermore, I anticipate that new supply will take a long time to hit the market. Kazakhstan's Kashagan Oil Field has still not produced a single drop of oil and Brazil's recent discovery - Tupi Oil-Field (second-largest find in the past two decades) will not produce any oil for at least another 5 years.

Compounding the problem of "Peak Oil" is the fact that only 7% of the world's estimated oil reserves are in nations which allow the major independent oil companies to invest and develop their fields. On the other hand, a staggering 65% of the world's oil reserves are owned by countries which have thrown out the technologically-superior foreign oil majors, thereby slowing down the development of such fields and in effect removing additional supply from the market.

As oil prices have surged over the past few years, producing countries have made a small fortune. Global oil revenues for all producing countries have risen 400% from roughly US\$500 billion in 2002 to US\$2 trillion last year! And not surprisingly, the governments of some of the oil-producing countries have been subsidizing the domestic price of petrol, thereby further boosting demand and keeping prices high. It is worth noting that oil consumption in the five biggest oil-exporters (Saudi Arabia, Russia, Norway, Iran and the UAE) grew by almost 6% in 2006 whereas their exports declined by roughly 3%.

Bearing in mind the above supply and demand factors, all I can say is that unless there is a global recession, the price of oil is going much, much higher. And the current weakness in the market is an ideal opportunity to load up on energy companies.

A few months ago, I made a bullish case for coal and urged you to invest in coal-producing companies. Back then, I explained why I felt that coal was likely to become much more expensive. I even cited China's new status as a net-importer of coal as a major factor. Well, it turns out that my assessment was correct. In the recent past, not only have we seen a record-high price of coal but the bull-market is also getting a lot of help from infrastructure bottlenecks in Australia – a key exporter. As it turns out, the Australian coal-miners are not being able to maximise sales and fully profit from the boom due to huge queues of ships at Australian ports. This to me is a sign that the boom in coal will not be short-lived and it is still not too late to invest your money in this "red hot" sector.

Finally, in the energy complex, both uranium and natural gas stocks are looking attractive at these levels and I would suggest that long-term investors consider this exciting opportunity. I have no doubt in my mind that over the years ahead, both uranium and natural gas will come back into vogue, thereby benefiting the producing companies.

METALS & CURRENCIES – The king of metals is flying high! After 28 years, gold recently broke out to an all-time high in nominal terms and the yellow metal is heading towards the skies (Figure 5).

Figure 5: “Barberic relic” back in fashion?



Source: www.decisionpoint.com

This should not be shocking news to my readers as I have been recommending precious metals for many years. Gold commenced its bull-market in 2001 and I suspect the ongoing boom will be a whopper. Make no mistake, nations all over the world are printing money like there is no tomorrow and debasing their currencies. In a competitive world, no nation wants a strong currency and this is not lost on gold – the anchor amidst the monetary madness. Apart from benefiting from monetary inflation, the yellow metal is also surging due to rising demand from India, its biggest consumer. For centuries, Asians have been fond of gold as a store of value and a rapidly developing India is a factor investors should keep in mind. As the billion plus Indians become wealthier in the years ahead, a lot more of the shiny metal will be sucked up in the form of jewellery which is loved in that nation.

On the supply side of the equation, it is fascinating to note that China has now surpassed South Africa to become the world's largest producer of gold. This should not come as a surprise either because I have a feeling that the Chinese government is encouraging its people to own gold. A few years ago, the Chinese set-up the Shanghai Gold Exchange and made it legal for the mainland Chinese to own gold. Recently, however, they also started futures trading in gold which should have a positive impact on prices. As I mentioned previously, Asians love gold and the Chinese will only be too willing to swap their cash for eternal wealth which is not anybody else's debt.

So, I am as certain as you can be in this business that the price of gold is likely to rise significantly in the years ahead. As far as the current rally is concerned, I suspect we have further to run over the coming weeks. If historical seasonal patterns hold intact, gold is likely to peak either in the first or the second quarter and afterwards, we will see a correction over the summer months. Silver looks even more undervalued when compared to gold and will have to rise to US\$50 per ounce just to get back to where it was (in nominal terms) 28 years ago! Now, I am not saying that this has to happen but chances are that silver will rise a great deal in the future.

Finally, in the currency markets, the US Dollar has come under renewed pressure of late due to the recent interest-rate cut by the Federal Reserve. My view remains that the world's reserve currency is in a long-term bear market and will lose a lot of ground against the Asian and commodity currencies in the years ahead. I am not so optimistic about the prospects of the European currencies due to the economic problems in that part of the world. For instance, Britain is running a huge current account deficit (roughly 6% of GDP), its household mortgage debt has ballooned to 126% of GDP, its housing market is deflating and it will become a net importer of oil by the end of this decade. Not a pretty picture and certainly not a country where I would want to hold my money! Apart from Britain, the situation is also poor in other European nations such as Italy, Spain and France. Accordingly, I feel that the Euro is overvalued and should be avoided.

DISCLAIMER: Please note that Puru Saxena Limited's publications and recommendations may involve significant risks. The value of an investment may fall as well as rise and investors may not get back the amount invested. Changes in rates of foreign exchange alone may cause the value of investments to go up or down. The past is not necessarily a guide to future performance. Puru Saxena Limited disclaims any liability for investment decisions based solely on information contained in this publication. Any investments should only be made after consulting your financial adviser and studying the corresponding prospectus thoroughly.

Author and Publisher	PURU SAXENA
Subscriptions and Enquiries	PURU SAXENA LTD. Suite 1301, Tower One, Lippo Centre, 89 Queensway, Hong Kong Tel: (852) 3589 6789 • Email: contact@purusaxena.com • www.purusaxena.com
Design	ADWRIGHT DESIGN CONSULTANTS Tel: (65) 6227 7227 • Email: enquiry@adwright.com • www.adwright.com
Layout & Production	X-IT MANAGEMENT LTD. Tel: (852) 3596 7575 • Fax: (852) 3585 5118 • Email: office@xit.com.hk