OPALESQUE
ALTERNATIVE MARKET BRIEFING

Opalesque : Investors should do more research on China investments and size opportunities in Japan.

By Benedicte Gravrand, Opalesque Geneva. April 6th 2011

Asia is not without its challenges, and the speakers at Tuesday's Jetfin conference in Zurich gave the audience a good round-up of those as well as of the many benefits this region can offer for investors. Here are a few of the many interesting observations focusing on geopolitics, China and Japan.

Investors invest without regards for current geopolitical risks According to Christian Takushi, fund manager and economist at Swisscanto Asset Management in Zurich, most investors are still investing the same way as they have done in the past decades, with little regard or understanding of the political and social changes taking place in the world. Money is folowing into emerging markets, especially Asia with little awareness of the multiple risks there.

He listed ten geopolitical risks for this decade, namely; 1. Shift in balance of power; 2. Arms race; 3. Radicalization of Islam; 4. Middle East conflict; 5. Massive money printing; 6. Climate change; 7. Energy shortages; 8. Food and water shortages; 9. Seismic activity intensifying; 10. Capital and production shifted to undemocratic nations.

North East Asia is the world's engine of growth but as such it is most vulnerable to crises and disruptions, to shocks in the supply chain and logistics, and its growth much depends on peace, security and stability. However, Takushi said, Asia is a "boiling pot," as no other continent has as many looming regional tensions and patched-up conflicts.

As geopolitical risks converge, investors should adjust their investment processes to include geopolitical trends and recurring and compounding crises; prepare for an increased pace of government intervention, for rising concentration of political power and for shifts towards a common global currency. Investors should also avoid running big shorts or bets against safe haven currencies (CHF, USD, Yen, Norwegian Krone), and they should run strategic and tactical positions in gold, silver, oil, LNG, coal, and the food chain.

China is the economic winne.r

China's GDP has risen about $3.5tn over the last decade while the US's GDP rose $4.7tn, said Mark Konyn, CEO of RCM Asia Pacific in Hong Kong. In other words, China has added about 75% of what the US did to the world's GDP even though it started the decade at about a 1/9th the size.

Today, China as an asset class is 3% of market cap. "Our view," he said, "is that if the growth of China's equity market continues, in ten years, it will represent between 10 and 15% of the World Index." Konyn also expects that Shanghai will be an international financial market by 2020, and that the country's currency will be fully convertible by then.

Institutions are starting to think of China as a separate asset class. They usually invest in big listings done in the last ten years (that everybody owns); they don't go much beyond those because of the coverage is limited. He believes that this won't be a problem any more.

His company, which runs $14.5bn worldwide, bases its investment methodology on grassroots research. Indeed, China investors' biggest mistake is to focus on management and on business plans, which can be very seducing. And there's hardly any general market research in China anyway. So RCM's researchers collect data by talking to suppliers, distributors, staff, etc. to see if sales projections are actually reasonable. Then the data is presented to management, which is then challenged, and their reaction is taken into account in the final investment decision.

"Our two biggest concerns," he explained, "are (1) corruption and (2) governance" – referring to what happened to Siemens' intellectual property as an example. According to the New York Times, in 2005, the China National Railway Signal and Communication Corporation invited Germany's Siemens to join in building trains for the Beijing-Tianjin high-speed railway. Most of the technology came from Siemens, which trained 1,000 C.N.R. technicians in Germany. But most of the trains were built in China.

For the next project — the Beijing-Shanghai high-speed rail C.N.R. bumped Siemens out. CSR Corporation, another Chinese train builder, did the same with Kawasaki Heavy Industries of Japan.

Whereas China's share of the world GDP was 5% in 1950 – up to 1973 – it went up to 8% in 2010, and it is expected by Goldman Sachs and Morgan Stanley to become 20% by 2030. Although the exchange rate is missing from this projection, noted Gustav Rhenman, portfolio manager at East Capital in Stockholm. People ask if China's growth is sustainable, but the real question should be: how is the West going to cope with China's growing dominance in industry. Indeed, he said, China will go from being an importer of things they cannot make now, to being able to produce these things themselves.

The top fears about China are: a possible property bubble; NPL problem in the banking system inflation; overspending for infrastructure; social stability and income gaps; environment and pollution; and political risks (the Jasmine revolution as an example, when an internet campaign tried to provoke a revolution earlier this year - although the call for mass participation in the demonstrations went largely ignored Source).Rhenma believes that most are indeed concerns, but they are also mostly exaggerated in the investment community.

Japan: an undervalued and overlooked market.

Symphony Financial Partners' Japan focused fund was slightly up this month, because of small investments in companies that supply products vital for the rebuilding of Japan, said David Baran, co-CEO of Symphony Financial Partners in Singapore. He mused at how much investors had ignored the importance of Japan in the global supply chain in the last years; now the realisation of how vital the country really is has hit home, as some manufacturing parts, only made in Japan, have become unavailable. Indeed, Boeing is facing new delays in the delivery of the Dreamliner; GM is slowing or shutting down production in U.S. factories due to a shortage of parts; and Toyota is expected to lose $73m for every day its factories are shuttered, according to Forbes.

Baran expects the reconstruction will be "a bit of a shock to the system, like cardiac arrest." Q2 will be a "disaster" but Q3 less so. Japanese people will do what they do best, that is, they will rally around the cause. The country will surprise investors on the upside. And G7 may have made a strong stance (by selling off billions of dollars worth of yen to drive the yen down against the dollar, after it reached Y76 per dollar), he noted, but he had shorted some yen himself.

When asked about the repatriation problem, he said he had not seen any done. But Yashwant Bajaj, Principal at Juggernaut Capital Management in Singapore, said that corporate liquidity is a real concern, and that Japan should stay in yen assets.

The 1995 Kobe earthquake, he said, had a negative effect on the market; however today, the East Japan earthquake's effect was three times as bad – but it recovered. Valuations were cheaper and earnings were going down, he said. The differences between then and now are that the financial system is stronger, earnings are rising, although the total cost is larger and current policy options are limited.

"Japan was cheap even before the earthquake," he said, "it had been outperforming running up to March 2011. And governance had been improving in terms of shareholder payouts since the 2008 pick-up."

There are opportunities for investors to make profitable investments, he concluded, because the incumbent is not in a position to argue. Furthermore, Japan is increasingly correlated to the rest of the Asian market.

Juggernaut is launching an Asia Fund in June 2011. It will invest primarily in Japan with some Asian Equities, and the return target is 20% p.a. Its opportunistic flexible strategy will comprise fundamental L/S equity, event driven /tactical short term trading, capital markets strategy."