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Asia
brief



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**Commentary and Review by portfolio manager
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The last few weeks have seen a series of extraordinary events. Natural disasters in Japan in the form of earthquake and resulting tsunami are turning into a man made nuclear crisis as people struggle to bring the nuclear reactors at Fukushima under control. At the same time, social upheaval in the Middle East and North Africa has thrown into question the government and social order of the region. High oil prices are putting a strain on developed and emerging economies alike, while nuclear power, seen as perhaps the most viable short term alternative to fossil fuel electricity generation, is now viewed with fear and outright hostility. The Human Progress story is going through another challenging period.

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Highlights**Japanese earthquake, nuclear crisis and implications for alternative energy**

The recent earthquake in Japan covered a very broad, predominantly rural area, in contrast to that which hit the city of Kobe in 1995. Although the quake was enormous, most of the damage was done by the following tidal wave. What the quake did damage was a number of nuclear powered electricity generating facilities, namely the four nuclear reactors at Fukushima. In the midst of this crisis it is not possible to gauge the full extent of the damage. The nuclear crisis, at the time of writing, has yet to be brought under control and the number of dead is unknown.

The future of nuclear power as a significant alternative to fossil fuels has been thrown into doubt in developed world democracies. At the beginning of March 2011, the US had 104 nuclear reactors operating with 101 gigawatts of installed capacity, one reactor under construction with a further 9 reactors planned or on order and proposals for 23 more. Events in Japan have, however, increased popular resistance to this technology. Germany has already moved swiftly, with regional elections looming, to quell public disquiet by closing down nuclear reactors built before 1980. This marks a major reversal of policy; only last year the German government had decided to extend the life of these plants to 2022.

China, by contrast, had 13 reactors with electricity capacity of 10 gigawatts; there are 27 reactors under construction with a further 160 reactors planned or proposed that would add a further 196 gigawatts of capacity. India has plans and proposals to add 58 new reactors to the 20 it already has. The high growth of these two economies puts immense pressure to generate sufficient electricity, and the polluting nature of coal fired plants is well understood. Regardless of the system of government, it looks likely that both will proceed with their nuclear plans, albeit with some delay.

Japan's nuclear crisis also provides extra impetus for demand for renewable energy solutions, we believe. China has recognized the potential for developing an alternative energy industry that could reduce its needs for imported fossil fuels and has encouraged the expansion of the solar industry in China. The Chinese manufacturers were playing catch up in terms of module quality, but their approach was to firmly focus on reducing manufacturing costs. These Chinese companies listed their shares in the US and used the proceeds to rapidly build out their manufacturing capacity, invest in research and development and start to develop sales channels into the key European markets.

Since 2008 annual global installations of solar modules have more than doubled and solar modules have become a commoditized product with cost being the key differentiator, which is itself an indication of the increasing maturity of this industry. The Chinese companies have been so effective at lowering their manufacturing costs that today they make up the majority of global module manufacturing capacity, and the best companies can sell a solar module at less than half the price they did in 2008 while still maintaining a decent margin. The Chinese modules are now as good, and in some cases better quality than German modules, and the German manufacturers are struggling to compete with them.

Politics and Oil in Asia

The uprisings in the Middle East and North Africa have led some to question whether China ought to be worried about its stability given the well-known social pressures that exist and the authoritarian character of the government. We do not believe that China's situation is comparable to those nations in upheaval. The populations of the Middle East and North Africa are predominantly young, and as we have discussed, their economic prospects are limited. Hopes for a rising standard of living are poor under the present regimes and policies.

However, for the past thirty years Chinese economic policy has been wholly directed toward investment and a mass-industrial model designed to increase wealth and improve the standards of living for as many people as possible in the shortest possible time. The reasons for this are not wholly altruistic of course; the Chinese ruling party have long been aware that to continue in power means improving the lot of the people - hundreds of millions of whom were living in poverty back in 1978.

The effectiveness of these efforts is beyond question. Life expectancy has risen from 41 years in 1950 to 73 years today. The population that was one of the most static in the world in 1980 is now one of the most mobile. Wages in both urban and rural areas have risen significantly and a growing consumer market is evident. In 2010, for the first time more cars were sold in China (13.5 million of them) than were sold in the United States.

This is not to say that China's population is universally satisfied. Pressures do exist and the government is highly sensitive to them. The prices of electricity, gasoline, diesel, staple foods and even the rate of interest paid on bank deposits are all tightly regulated in acknowledgement of the fact that there are huge divergences across China and within cities between income groups. The recent increases in minimum wages mandated by government serve two purposes: they address complaints from workers about exploitation, but they also raise disposable income to the benefit of the broader economy.

China and Asia look most vulnerable to an oil shock, as it has a high dependency on oil imports, especially from the Middle East, and the economies are more manufacturing rather than services based. Oil consumption in Asia ranged from 4% of GDP in China up to around 6% in Korea and Taiwan in 2010. Each \$10 increase is estimated to increase that proportion by 0.4% to 0.7% of GDP.

Inflation in the region has been a growing concern for some time as a result of food prices. Food accounts for 20%-25% of the inflation basket (the basket of goods by which consumer price inflation is measured) in developed Asia, but in developing Asia it is much higher at 33% in China and over 45% in India. Therefore, higher energy prices are compounding Asia's inflationary problems, and the concern is that this may result in more aggressive monetary tightening than is currently forecast by the market.

The long term growth story in China and Asia remains unchanged, in our opinion. Economic reform and liberalization accompanied by investment and rising wages are creating consumer markets in the world's most populous region. Higher oil prices inevitably hurt a region that is based so heavily on manufacturing and has a high dependency on imported oil, but we believe that this will not result in sustained damage to the economic model.

Market Performance Ending February 28th, 2011

	Feb 2011	2010	2009	2008	2007	2006
Australia	4.44%	14.69%	73.87%	-49.47%	29.38%	32.28%
China	-1.83%	4.59%	62.06%	-50.43%	66.01%	82.91%
Hong Kong	-3.32%	23.28%	60.48%	-50.46%	42.46%	30.67%
Indonesia	6.15%	35.47%	136.12%	-57.87%	55.34%	74.71%
Korea	-6.47%	25.84%	74.44%	-56.36%	32.14%	11.17%
Malaysia	-1.92%	37.67%	51.26%	-41.15%	46.56%	37.01%
New Zealand	-0.88%	8.73%	49.89%	-53.54%	8.95%	16.28%
Philippines	-1.34%	35.24%	67.34%	-52.02%	41.60%	59.48%
Singapore	-4.73%	22.03%	73.18%	-47.21%	28.52%	47.02%
Taiwan	-8.94%	23.14%	80.23%	-46.04%	9.15%	20.73%
Thailand	5.48%	56.67%	76.59%	-48.21%	46.29%	11.87%
MSCI AC Far East Free ex Japan	-4.18%	19.41%	68.56%	-50.34%	36.82%	31.73%
MSCI AC Pacific ex Japan *	-1.73%	17.95%	71.51%	-50.00%	34.96	32.54%

*MSCI AC Pacific includes Australia & New Zealand

(MSCI Indices were used for regional & individual market performance)

Market Review

This was a mixed month for Asian equities with weakness in the export-led markets, such as Korea and Taiwan, and the outward-looking hubs, such as Singapore and Hong Kong, balanced with strength in the resources-led markets of Australia and Indonesia.

The weakest sectors in the MSCI All Country Far East Free ex Japan Index in February were Industrials and Information Technology, while Energy and Healthcare were only slightly down on the month.

Korea and Taiwan were led down by Information Technology stocks, although much of the selling was domestic-led, given the Korean Won and Taiwan Dollar remained relatively firm during the month. The social unrest in the Middle East spilled over to Korea, as there was some weakness in the Korean industrial stocks on fears that planned petrochemical projects may be delayed. Many of the Korean industrial construction firms have projects in their order books in Libya and in the Middle East, and they often procure equipment and components domestically in Korea.

Thailand was strong this month, partly due to better investor sentiment as the political situation improved, given the Prime Minister indicated that elections are likely in June of this year. Fresh elections were a key demand of the 'red shirt' protesters in 2010, and holding elections in an orderly fashion should help to improve Thailand's political credibility. There was also good news on the border dispute between Thailand and Cambodia, as the Association of Southeast Asian Nations (ASEAN) negotiated an unofficial ceasefire. This is a significant step for ASEAN, as it has previously been a trade-led association with a policy of non-intervention in the internal affairs of its members. The ceasefire will be policed by unarmed Indonesian observers.

Monetary policy has continued to be tightened across the region, and both Thailand and South Korea raised interest rates in February. In Korea, February's increase in the consumer price index was 4.5% from a year earlier, which breached the central bank's target of 4%. The Chinese central bank also increased the banks' reserve requirement ratio again by 50 basis points during the month, despite a slight deceleration in the consumer price index data for January.

Market Outlook

Inflation remains the central challenge to economic growth in Asia ex Japan, and the increase in commodity prices globally is exacerbating the situation. China announced a wider-than-expected trade deficit for February, which was the highest in seven years. There was some slowdown in exports, but the main driver of the trade deficit was an acceleration in imports, mainly driven by increased prices for commodities such as iron ore, coal, cotton and soya.

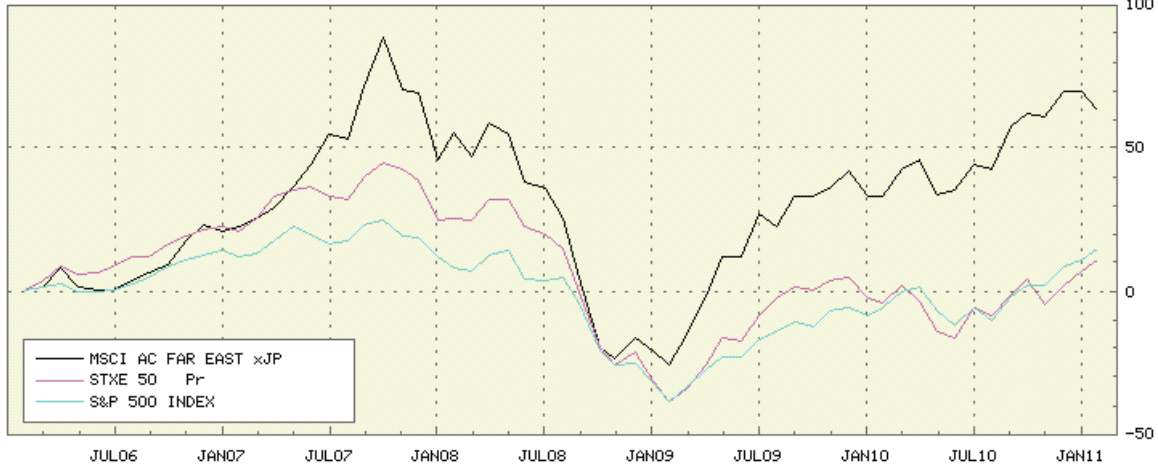
There has been an increase in energy prices in recent weeks, partly as a result of the social disruption in the Middle East and North Africa and the potential impact on crude oil production. However, the authorities in Saudi Arabia have already stated that they have sufficient spare capacity to make up a shortfall if Libyan production is offline. The concern for investors is that the disruption may spread to other countries and that production facilities could be damaged. An extended period of higher energy prices would be a negative for Asia and is likely to lead to higher inflation and demand destruction. Although interest rates are being increased to cope with inflation, it is difficult to see the efficacy of higher rates domestically against higher prices in imported goods.

There was some positive news for Taiwan in February, as the first meeting of the Taiwan Strait Economic Co-operation Committee was held. This body was set up between Taiwan and China as a result of the Economic Co-operation Framework agreement in 2010. This meeting signals a maturing in relations between Taiwan and China, which may pay tangible benefits for both sides in terms of future economic growth. One initial area to watch is the possibility of cross-investment by financial services firms from either side of the strait. Chinese banks could help to consolidate what is a relatively inefficient banking system in Taiwan, and the more efficient of the Taiwanese banks and brokers could find opportunities in the much larger market of China. Although deals agreed by the new committee have to be confirmed by the Taiwanese parliament, the Legislative Yuan, we would anticipate that there could be interesting developments in the financial sector later this year.

COMPARATIVE RETURNS

Securities	Range	Crcny	Prc Appr	Period	Monthly Total Ret	60 Mo. Difference	Period Annual Eq
1 MXFEJ Index	2/28/06 - 2/28/11	USD	43.11 %	M	63.07 %	52.18 %	10.27 %
2 SX5P Index		USD	-9.53 %		10.89 %		2.09 %
3 SPX Index		USD	3.64 %		15.22 %	4.33 %	2.87 %

(* = No dividends or coupons)

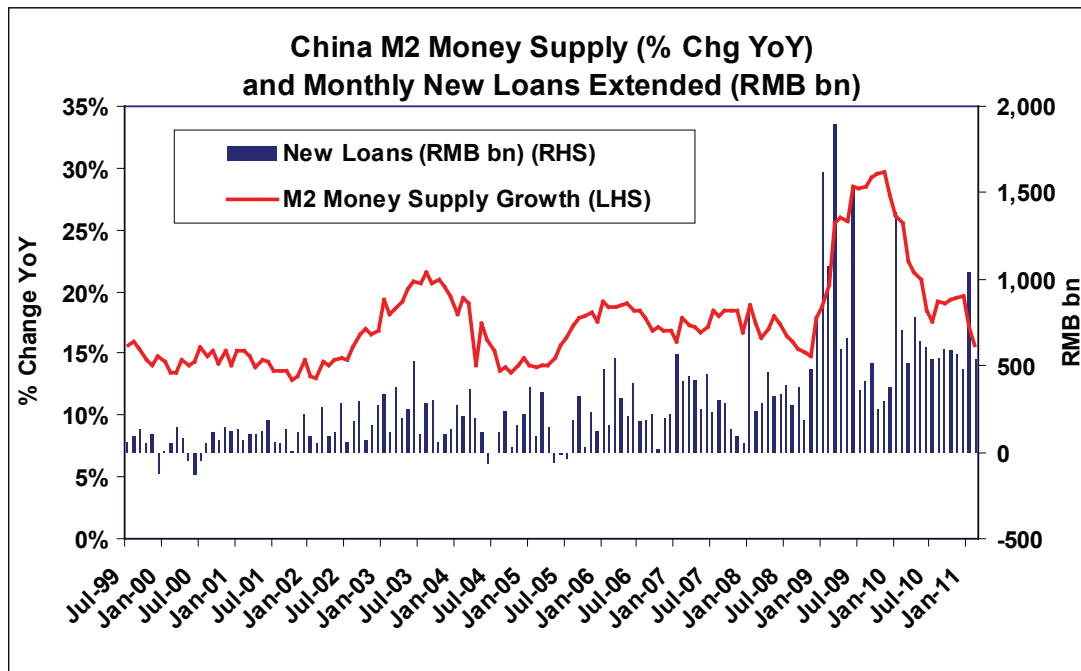


Source: Bloomberg

China Economic Monitor

The data for February suggest that the steps taken by the Chinese authorities to tighten monetary policy are having an impact on economic activity. Although this may be considered a negative for economic growth, it could be viewed positively by some equity investors, as it suggests the monetary tightening cycle may be close to an end.

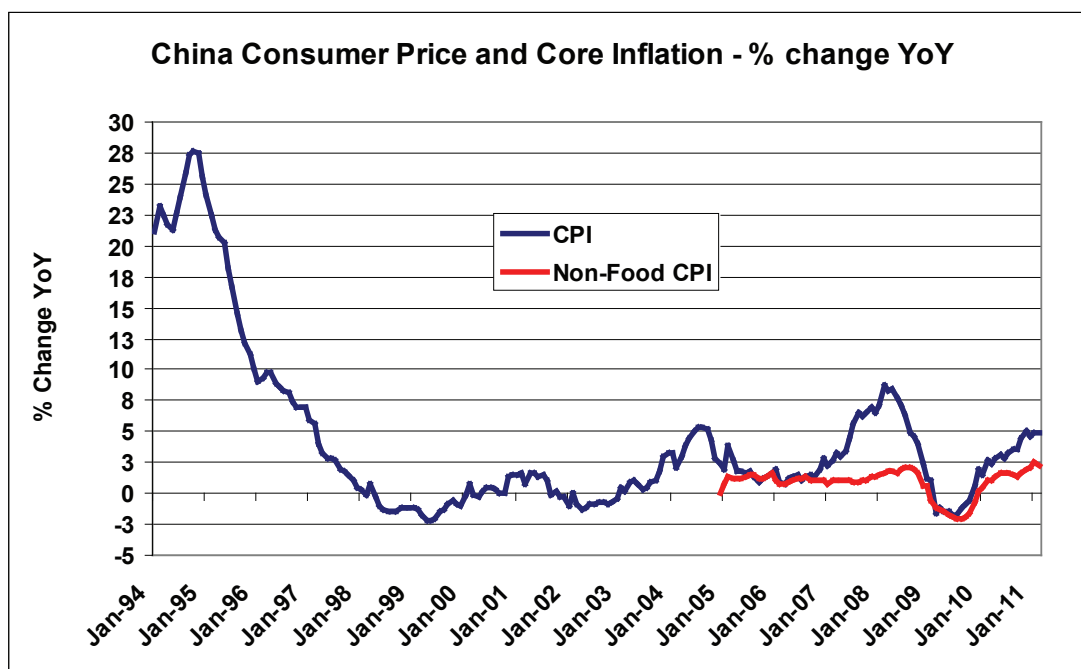
Money supply growth slowed again in February and is now back down around rates seen before the exceptional policy loosening as response to the financial crisis of 2008. This is also reflected in lower new loans advanced in February, compared to January 2011. This pattern is somewhat unusual, given the first quarter of the year has often been the strongest for new loan advances in China.



Source: The People's Bank of China

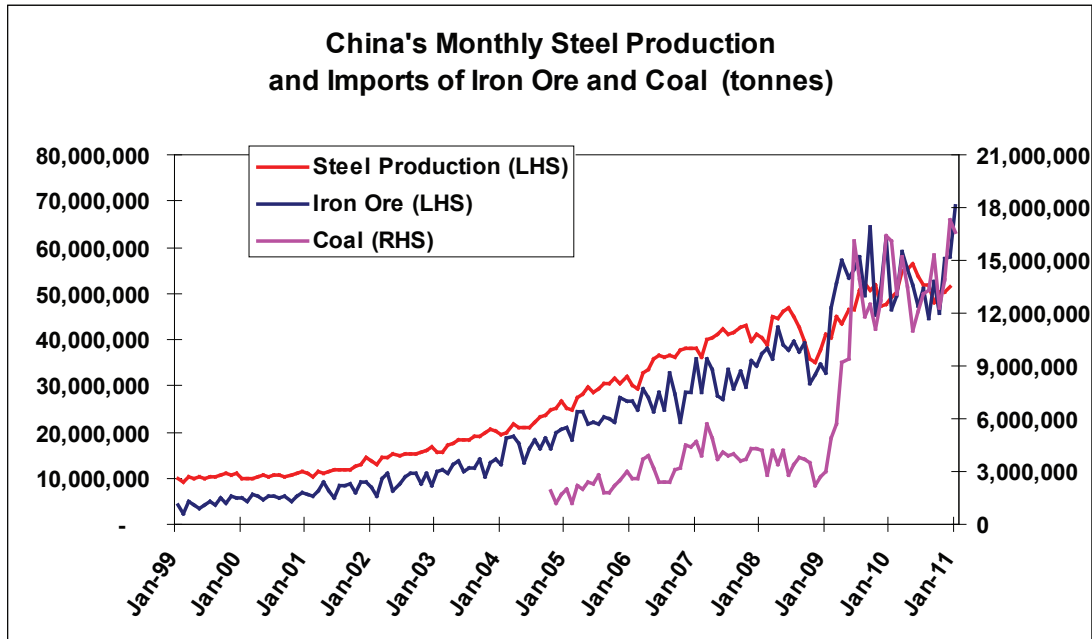
There was a slowdown in both broad consumer price inflation and in non-food consumer price inflation, also suggesting that policy is beginning to have an impact. This is despite continued upward price pressure from certain foodstuffs, with the price increases of meat & poultry and fresh vegetables still accelerating in February compared to the previous month. The clothing element of the consumer price index also accelerated slightly in February, and this may well be due to increases in cotton prices. Cotton prices have been rising for around a year, mainly as a result of international supply disruption, and this has begun to affect the fabric and garment manufacturers in China.

There has been so far little outstanding news on wage increases in China, although these had been widely feared by investors. The period after Chinese New Year in February is the traditional time for wage settlements in China, but the settlements reported so far have not been far beyond those in recent years.



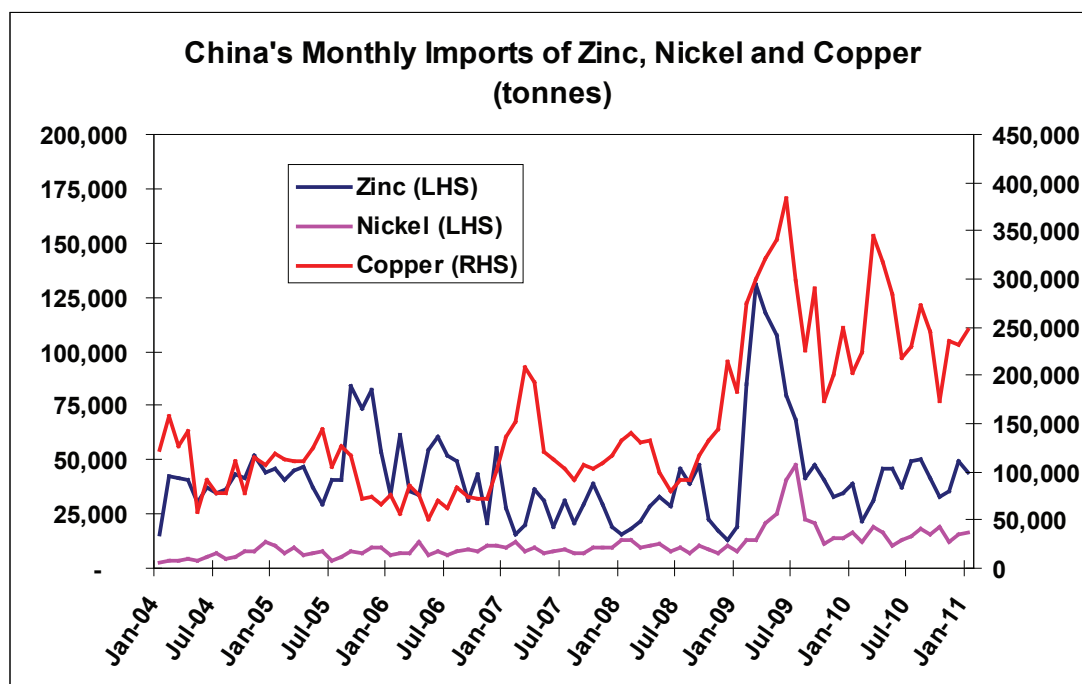
Source: Bloomberg, China Economic Information Net.

Iron ore imports continued to accelerate in February, reaching an historic high of 68.91 million tons. Coal imports also remained strong, at 16.55 million tons, although, this was down slightly from 17.33 million tons in January. These figures suggest that the demand for basic materials in China remains good, given the fact that the export tax structure was reformed in 2010 to discourage exports of energy-intensive goods such as steel. This may well be a result of an increase in demand for steel for affordable housing, as the Chinese government continues to address the supply-side of the property market, as well as dealing with excess demand through tighter monetary policy.



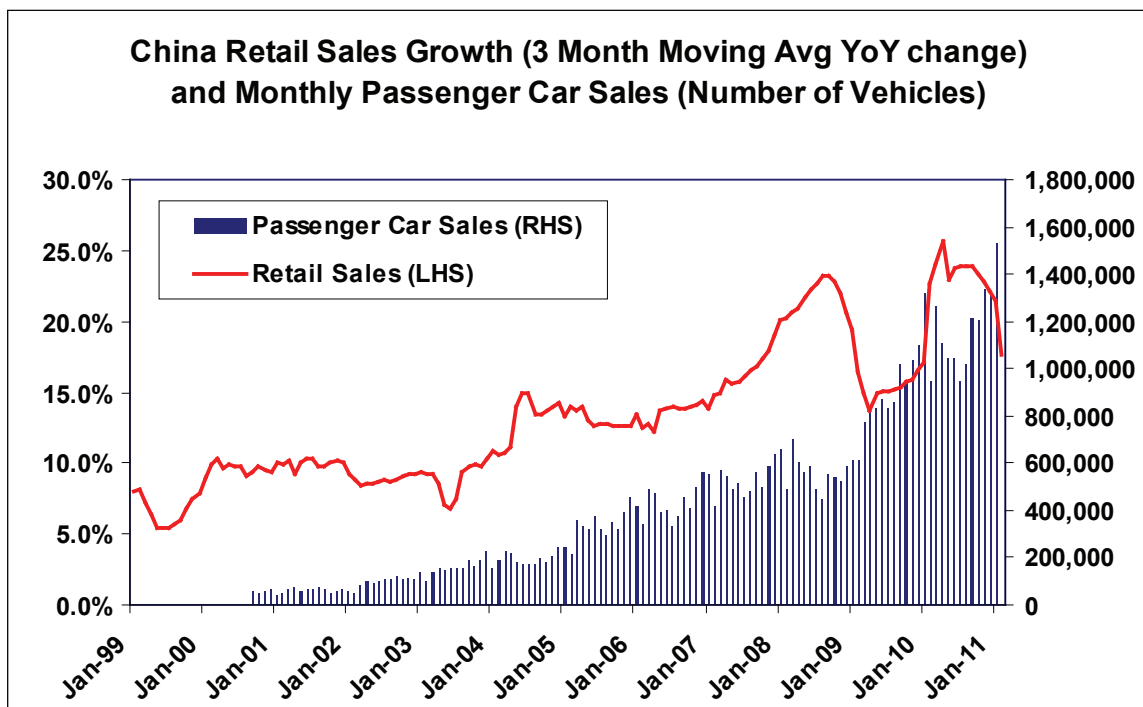
Sources: National Bureau of Statistics, China Customs General Administration

There was some re-acceleration in copper imports in February, although it is too early to suggest that this is an established trend. Nickel imports increased slightly, which tallies with the increased imports of iron ore and coal in February. However, zinc imports fell slightly in February compared to January 2011.



Source: China Customs General Administration

The impact of the monetary tightening measures is evident in weak retail sales growth in January and February, compared to the same period of 2010. This is despite this period being the usual peak season for consumption in China, ahead of and during the Chinese New Year holiday period. Considering the figures in historical context, the retail sales growth remains well ahead of growth rates from before 2008. Indeed, in our view, retail sales growth is still reasonable for an economy of China's size. Conversely, this result suggests that monetary policy is having a tangible impact on spending patterns, and this is a healthy sign as it may convince the authorities to end monetary tightening sooner rather than later.



Sources: China National Bureau of Statistics, China Automotive Information Network

Commentary for our views on Alternative Energy and Energy markets is available on our website. Please [click here](#) to view.

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The MSCI All Country Pacific Free ex-Japan Index (MSCI AC Pacific Index) is a free float-adjusted, capitalization-weighted index that is designed to measure equity market performance in the Pacific region. The Index is made up of the stock markets of Australia, China, Hong Kong, Indonesia, Korea, Malaysia, New Zealand, Philippines, Singapore, Taiwan and Thailand.

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