



ISSUE FOUR SOVEREIGN RISK

WHEN EMPIRES EXPIRE, WHO WINS AND WHO LOSES?

THINKING OUTSIDE THE SQUARE

FIVE THEMES TO HELP YOU CREATE A BETTER FUTURE

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THINKING OUTSIDE THE SQUARE
FIVE THEMES TO HELP YOU CREATE A BETTER FUTURE

GLOBALISATION



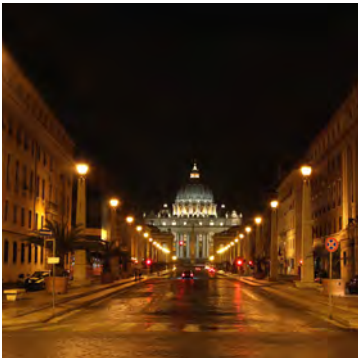
NEW INVESTMENTS
& INVESTMENT
STRATEGIES



GLOBAL
FINANCIAL CRISIS



SOVEREIGN RISK
AND DEBT



CHANGE



WE BELIEVE THAT ALL ROADS LEAD TO INCOME!

At the end of the day, regardless of gender, age, relative financial security, employment or retirement, we all seek the same thing as the product of our investment strategy: income.

Put more simply the reason we invest is so that we can have sufficient income to live and hopefully live well at the time when we choose, or someone else chooses that we no longer will receive income from employment.

Balmain Funds over the period ahead will make available a series of “thought pieces” designed to provoke new thinking on why we invest the way we do, challenge investment orthodoxy, such as “modern portfolio theory”, posit and in some cases guess at future risks and opportunities. The overall aim however is to help you create a better future for you and the ones you love.

We have identified five themes that we believe will impact your ability to achieve the income you want. These are:

1. The Global Financial Crisis
2. Sovereign Risk(s)
3. Change
4. Globalisation, and
5. New Investments and investment strategies

We will over time populate these themes with “thought pieces” that are designed to inform you, challenge and provoke your investment thinking and from that hopefully assist you in making better investment decisions.

ABOUT BALMAIN

Using our staff of 140 located in 8 offices in Australia and New Zealand we arrange and deliver financing solutions to Australian and New Zealand commercial property developers and investors. Balmain originates between \$2b and \$4b p.a in transactions ranging from senior debt to mezzanine and preferred equity.

Over the years Balmain has arranged commercial loans to over 140 lenders, banks, institutions, managed investment schemes and high net worth individuals / family offices. It currently manages over \$8b of ongoing loan relationships with over 100 of these organisations.

Balmain is Australia’s 5th largest commercial mortgage fund manager, who on behalf of over 8000 Australian investors, we manage over \$800m in commercial mortgage loans.

Balmain in its own name and via AMAL (in which Balmain has a substantial shareholding) provides special servicing skills to loan portfolio owners covering both residential and commercial loans.

WHEN EMPIRES EXPIRE, WHO WINS AND WHO LOSES? THE NEW MAD?

The generally accepted wisdom is that 'Empire USA' is on the way down and 'Empire China' is on the rise. But how far and how fast will this change occur? And how will it impact Australian investors?

In this article, Balmain gives a big-picture twist on what is currently being reported in the media.

History will likely record the 2008/2009 global financial crisis that started in the US and hit it the hardest as the 'tipping point' between the rise of China and the fall of the US.

While US wealth, military might, cultural dominance and intellectual/technological power still reigns supreme and will likely continue for some time, the GFC's inability to significantly hurt China has elevated this emerging superpower onto a higher level.

China's GDP is currently one third of the US. (see table below). Should China's GDP growth continue at 10% per year (as it has for more than a decade), its economy will double in seven years. At 7% growth per year, it will double in 10 years.

Table 1

Austrade, International Data Comparisons, /IMF

| | Australia | China | USA |
|----------------------------------|-----------|-------|--------|
| GDP US\$ billion | 1,193 | 5,365 | 14,800 |
| GDP per head US\$ | 53,862 | 3,999 | 47,702 |
| GDP growth 1998-2011F average pa | 3.3 | 9.7 | 2.5 |
| GDP growth 2009 | 1.3 | 9.1 | -2.4 |
| GDP growth 2010F | 3.0 | 10.5 | 3.3 |

In comparison, US GDP fell 2.4% in 2009, a year which marks the widest gap between the growth rates of the two countries. On present trends, China will be the world's largest economy in 15 to 20 years.

'On present trends.' That is a key phrase. There are 'big picture' developments taking place that make 'present trends' likely to change and it is these you need to understand and maintain a watching eye on.

Technology and globalisation spurs faster change.

Think bio-tech, high-speed trains, wireless communications, nuclear power stations, Internet businesses, electric cars, solar batteries. New advances in technology are enabling emerging nations such as China to 'leap-frog' to advanced status very rapidly.

In fact, China already surpasses the US in areas of infrastructure such as high-speed trains. While the US has the bulk of intellectual capital, (inventions, patents, and particularly military technology), China's army of researchers (926,000 vs 1.3 million in the US) and the nation's ability to rapidly copy commercialised products (iPad clones) is likely to close the gap and do so rapidly. (as another example, Chinese and Indian engineers already represent a significant proportion of engineers working in Silicon Valley.)

The benefits of centralised control.

China's one-party state and centralised control (in an IT age allowing faster information gathering and feedback) has (so far) been able to successfully manage the nation's economy. Decision makers are able to usurp individual interests for the 'national good' and can make decisions faster without a democratic process to slow it down. (Memo to local villagers - a nuclear power station will be built in your backyard. Thank you.)

Central party bosses can give instructions to state-run industries (Memo to Tangshan steel mills - cut your production by 1/3 to 2/3 for rest of this year) and long-term planning can take place without the worry of getting re-elected every three or four years.

Money – and plenty of it.

China has the financial resources to keep spending on domestic infrastructure, (transport, energy, dams, housing, etc) whereas the US is now constrained by budget deficits and massive debt. (See comments by Niall Ferguson, a British historian). China's ability to keep spending will give the country more options on how it grows its economy.

Demographics.

China's one-child policy is social engineering on a massive scale. The oldest of these are now entering their 30s, meaning a new generation of 'little emperors' (and fewer little empresses) have arrived in the labour market. The labour pool will progressively shrink as older workers retire and are replaced by fewer one-child generation employees. This 'sudden' (demographically speaking) drop in the number of working-age people, who will share the same amount of resources, will mean higher prosperity.

But what of the future massive number of retirees versus workers? What about health/aged care? China's future aged-care policy will also likely be social engineering on a massive scale. Retirees over the coming 20 years are likely (and are used to) 'eating bitter,' a Chinese phrase for enduring hardship. This is unlike the high expectations of Western baby boomers for government funded health care, aged care and pensions. Unlike the US, aged care in China won't be as big a problem, at least in the near future. (But see 'the downside' below)

You ain't seen nothing yet.

So far, China's rapid economic development has been focused on coastal areas. The vast hinterland (58% of the population is considered rural) including regional cities is now increasingly being developed.

What is the country's potential? A simplistic but useful exercise is to compare the US GDP per head (US\$47,702) with China's (US\$3,999). If China were to reach US levels of 'wealth' (measured by GDP per head), the nation's GDP would grow by a factor of 12, meaning its current GDP of US\$5,365 billion would grow to US\$64,380 billion in today's dollars. (In comparison, the US GDP is currently US\$14,800 as Table 1 above shows).

How will these developments impact on the Australian investor?

When the US sneezes, Australia catches a cold. We increasingly need to replace 'US' with 'China' in this statement as the correlation study in table 2 below demonstrates.

Table 2

Source https://mm.jpmorgan.com/stp/t/c.do?i=DBF2-2E0&u=a_p*d_471367.pdf#h_1mfr7d8v

| Real GDP growth | 1990-1999 | Currently |
|---------------------|-----------|-----------|
| Australia and US | 0.92 | 0.65 |
| Australia and China | 0.25 | 0.98 |

This table shows that the correlation coefficient between the Australian and US GDP growth rate was a close 0.92 during the 1990s but has since dropped to 0.65. Meanwhile the correlation between Australia's and China's GDP growth rate has become much closer at 0.98.

The Reserve Bank of Australia also made note of this closer Australia/China correlation in a presentation on September 16, 2010. "A decade or so ago, we spent a lot of time puzzling over why quarterly movements in Australian GDP were so highly correlated with quarterly movements in US GDP. We don't puzzle over this anymore – not because we solved the puzzle, but because the correlation has fallen. At the same time, the correlation between quarterly movements in Australian and Chinese GDP has steadily increased. Clearly what happens in the Australian economy is now more dependent upon what happens in China than has been the case at any time in our past."

We all know China is by far Australia's biggest export market. Our booming China-driven resource sector (and increasingly agri-business sector) is driving a two-speed economy in Australia and also a two State economy, WA and Queensland versus the other States.

As China's prosperity rises, so too will demand for luxuries. (Less 'eating bitter,' and more... please send us your beef, lamb, wool, seafood, wheat, sugar...) Chinese demand for tourism, education, and financial services will also represent opportunities, although Australia is not unique in its ability to supply these services.

(Note the expanding services recently provided by Chinese airlines into Australia to meet the growing demand from Chinese tourists.)

With China so important to Australia, we need to know more about the country, its history, and its culture, so when news about China takes place, we can put it into context and respond accordingly.

The downside.

'Getting news about China' is another key phrase to be attuned to. With Chinese press controlled by government, and official government statistics being 'open to interpretation,' news about China is not always accurate or complete.

Other downsides include:

Human nature is human nature, even if it has Chinese characteristics. Greed and fear drives much of Chinese investments too. Take the overheated residential Chinese property market. It happened, even with central government pulling at the levers, although it seems the levers have recently eased 'bubble' talk. It will be interesting to see which management system (central control vs. democracy) will be better at managing a large modern economy.

Little emperors become big emperors. A generation of spoilt kids (a generalisation perhaps but still relevant) becomes a generation of spoilt adults, with high expectations. The rich/poor gap, coastal/hinterland gap, freedom of expressions gap and gender imbalance gap needs to be managed, as internal harmony is critical

to a single-party state. (the people have no-one else to elect to vent their frustrations).

The US will not merely stand still and watch China take over. Threats of protectionism and trade wars would generate market volatility (we are already seeing this with the US's increasingly strident demands to see the Chinese currency re-valued up). China is still an exporting nation (for now) and needs the US and Europe as major clients (thus it benefits from a weak currency relative to its trading partners). However, China can counter with its holding of US Treasuries, the mass selling of which will cause chaos – a financial rather than nuclear 'Mutually Assured Destruction' (MAD).

US government decision making (in the long term) is a result of many different democratic viewpoints. Chinese government decision making comes from a narrower set of decision makers – for better or worse.

Conclusion and action.

As prosperity increases in China, more exports from a wider range of Australian industries will mean more income, but this also has a risk as Australia ends up with a concentrated buyer model with both attendant risks and benefits. (that is, Australia has 'all its eggs in one basket', that basket being China)

Australia's relationship with China (and to a lesser degree India and Japan) has also created the two speed economy we currently experience.

Have a look at the chart below on the Australian stock market without resources and you get some insight as to what risks exist to Australia. The chart shows the disparity between the booming resource sector and the rest of the market.

We expect to see a huge growth in demand from China for agricultural products in the period ahead as well. As our trade grows with China, look for significant Chinese interest in purchasing businesses and real-estate (remember Japanese interests buying tourism properties in Queensland in the 1980's). In particular, China's search for food security will likely result in more Chinese interest to buy large-scale Australian farms and this may not be palatable to those that question whether this serves our National Interest.

So what are things to look out for in the period ahead as Empire US declines and Empire China rises?

Declining value of the US dollar, stocks and bonds as pressures on the US economy becomes better recognised. Persistently high US unemployment will likely force US politicians to boost US exports and import replacement industries, and to 'get tough' on China.

There will be more US pressure on China to revalue its currency, which China will likely resist as it will potentially harm its export industries. There could even be a re-emergence of tariff wars and other trade restrictions. When combined with China's large holdings of US Treasuries, and the risk of mass selling as part of political negotiations, this is likely to set financial markets on edge should US/China tensions escalate.

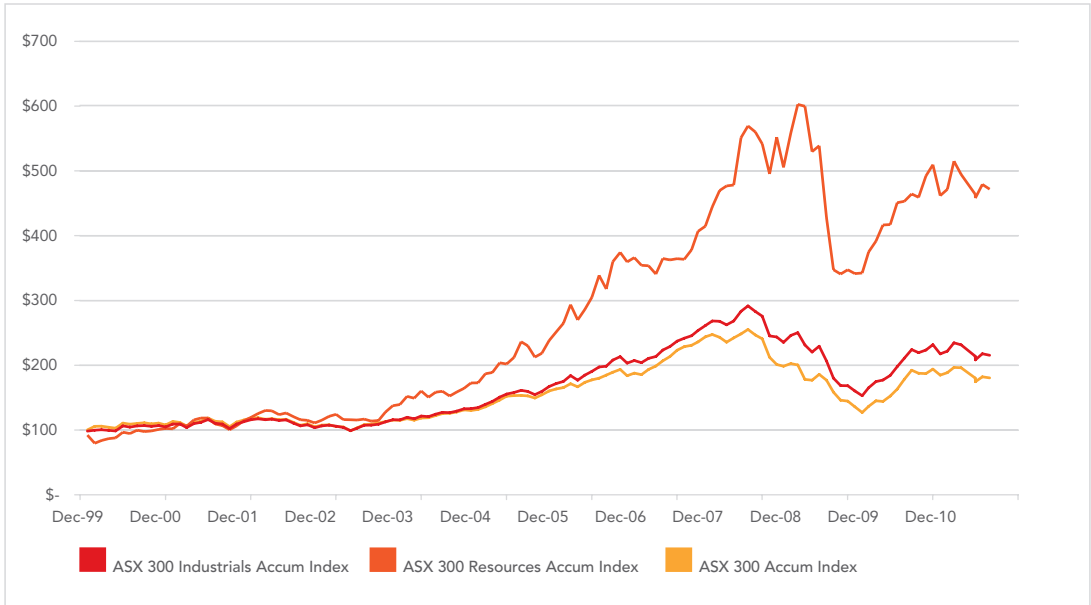
However, the reality is that China will continue to grow and the US will struggle to do so. As they say in Africa "when elephants fight – the grass gets crushed", so Australian investors need to look to understand these issues, inform themselves and be prepared to make the changes necessary to profit from what will be a momentous change.

This change will likely see Australian/China trade and investment increase, and perhaps there will be a new MAD – Mutually Assured Development – between the two countries.

At Balmain, we believe that all roads lead to income. From Australia's national perspective, we need to know where our national income is coming from and the risks related to this. And this means to know China... at least as much as we know the current superpower, the US. Do we?

ASX AUSTRALIAN SHARE INDICES 2000 - 2010

VALUE OF \$100



A brief overview of three modern empires in decline.

Soviet Union –an abrupt end in 1991 but which began in the 1980s when despite its military ‘strength’ that made it a super-power, its economy was progressively getting weaker.
See [http://en.wikipedia.org/wiki/History_of_the_Soviet_Union_\(1985%E2%80%931991\)](http://en.wikipedia.org/wiki/History_of_the_Soviet_Union_(1985%E2%80%931991))

British Empire –loss of its colonies (and the revenues generated) after WW11, led to the empire being eclipsed by the US. No collapse, just a slow decline relative to the US

Japanese ‘Empire’. While only an ‘empire’ in an economic sense during the late 80s, (when Tokyo property was reportedly worth more than all of the State of California, and when its stock-market was booming as a result of its successful export industries), the country has since faced a gradual economic decline –its ‘lost decade’ now entering its 3rd ten year period!

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