



# Johnston Asset Management

GLOBAL INVESTMENTS

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## *As We See It....*

Unfortunately the cautious tone we struck in our April letter proved to be warranted. The Greek sovereign debt crisis carried over to neighboring countries, and forced Europe to devise a rescue package that further constrained struggling economies. The recovery in employment in the United States has hit a soft patch and is affecting consumer and business confidence. Also in the US, uncertainty over what financial regulatory reform will look like is thought to have limited lending to businesses. Finally, BP's disastrous oil rig accident in the Gulf of Mexico has badly damaged the recovery in a vital economic region and industry. It is no wonder that global equity markets contracted over 10% for the quarter.

These problems and others do not have easy fixes, but actions are being taken. The Europeans are tightening their belts. Asia is focusing more on domestic consumption as exports wane. Regulatory clarity in banking is coming, and ingenious problem solvers appear to be close to capping the Macondo well's horrendous spewing.

There are some bright spots. The US housing market is on the mend, European manufacturers are strengthening, and employment is picking up in pockets around the world. Private markets are functioning. In our opinion, the reversal of all the stimulus policies enacted by national and regional governments over the last few years presents the biggest risk to the global recovery and will require tremendous skill and exquisite timing.

We have made few changes to the portfolio during the quarter, after an eighteen month period in which we were able to pick up some world leading franchises at attractive prices. Equity valuations are reasonable, but no longer as mouth-wateringly cheap as they were. Growth prospects are good in the long term, but muted near term. Interest rates are low, and we believe equities offer better risk adjusted returns, but markets have been volatile in the face of ever-changing economic news.

We remain confident that the portfolio is made up of companies that are leaders, with an edge in technology, skill, and market position over their competitors. We are also confident that the companies can grow at rates superior to their peers as well as other sectors, and that they can create value through growth. Companies that can grow in weak economies are scarce; we believe the portfolio represents tremendous value, and potentially contains some of the next decade's great investments.

## *Chinese Stocks...attractive now?*

Having stimulated significantly following the global financial crisis, Chinese policymakers began trying to slow the country's economy during the fourth quarter of 2009. Thus began a correction in Chinese share prices, well ahead of most other world stock markets. Now, fears that the government could overdo it and ruin one of the rare pockets of global growth seem to be abating, with Chinese stocks rebounding since mid-April. Have policymakers finished the job of slowing the economy?

There are some positive signs. Second quarter 2010 growth was 10.3% vs. 11.9% for the first quarter. Inflation eased, falling back below the central bank's official target of 3%. Residential property prices remain unaffordable in major cities; however, transaction volume has declined. China's banking regulator has reiterated orders for banks to step up scrutiny of lending to local government financing vehicles and to curb credit to new government-sponsored investment projects. Some banks must also adhere to restrictions on lending to property developers and mortgage loans to individuals. We don't expect to see policies aimed at restraining property prices relaxed any time soon. While the economy is slowing, helping to contain inflation, premature easing could easily fuel inflationary expectations and lead to a quick rebound in property prices.

Nonetheless other measures are being implemented to help balance the economy and to stimulate domestic consumption. Despite the fanfare, the de-pegging of the Yuan is not going to make much of a difference. Since the fixed exchange rate was relaxed on June 19<sup>th</sup>, the Yuan has gained all of 0.7% and markets expect China's central bank to slow the pace of appreciation as the global economy slowly strengthens.

China's seemingly inexhaustible supply of cheap workers is now demanding higher wages in the coastal manufacturing cities. In April, Shanghai raised minimum wages 17% US\$ 165 per month. Guangdong, China's largest export base, raised minimum wages in five areas by an average of 21%. As a result businesses on the coast now face margin pressure. Workers will enjoy a large increase in purchasing power though, which may help reshape the structure of the domestic economy.

It remains a mixed picture. From a bottom-up perspective, the sell-off has resulted in more Chinese stocks making it into the top quartile of our stock ranking system, primarily financials. We will be investigating the new top-quartile constituents to see if there are any that meet our qualitative investment criteria. We remain quite comfortable with the fundamentals of our existing holdings, China Life and Mindray. We don't know if the tightening phase is over yet, but China is still one of the growthiest economies and that characteristic makes it fertile ground for finding investment opportunities in companies with the attributes we seek: high growth, attractive valuation, business dominance and quality.