

Alison Adams, PhD

617-388-9817

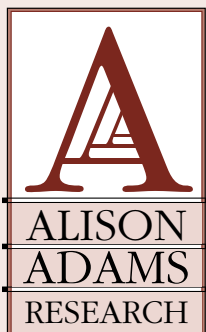
research@alisonadamsllc.com

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Brazil considers more currency and derivative interventions! Turkey will drag its feet on measures to encourage currency appreciation and South Korea continues its failing battle to reduce household debt. Russia lets inflation run high and interest rates low. Thailand will favor competitive currency over fighting inflation. *The currency wars are far from over!*

In Brazil, I think that there will be further action to cool bank cross-border borrowing from developed market banks.

As I wrote in April, Brazil will keep on the offensive regarding its currency. I would not be at all surprised to see more targeted actions on wholesale bank borrowing and shadow bank activities. The currency wars are far from over and the Fed has indicated that its policy stance means that EMs will be fighting asset appreciation and credit bubbles for the foreseeable future. MoF Guido Mantega is by far my favorite politician in all of EMs at the moment. (Yes I do have favorites. . . .) Most of the financial world is focused on the troubles in the U.S. and the EU, but Mantega rightly points out that bad policy in the developed world is hurting EMs. Moreover, it has made some EM countries favor unorthodox approaches that have yet to be proven. S. Korea and Turkey are perhaps the most striking examples of ad hoc monetary policy. In Turkey, banks will have higher reserve requirements. In S. Korea, lending rules attempt to curtail private borrowing for consumption.



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Portugal's downgrade to junk: It turns out that Europe is full of Argentina the ratings

agencies only just figured this out! But unlike the real Argentina, there is no good news for

the PIIGS in export competitiveness from a weak currency, and “internal” capital flight to

strong EU member states remains underestimated. *Won't good money flee these rescued*

states? Where will their growth come from? Austerity and structural change will not bring back

investment, bank lending, or the competitive advantages of a weaker currency. Austerity in

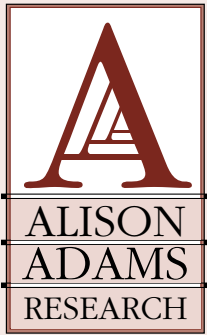
Greece won't bring more tourists. Austerity in Portugal won't boost exports. Austerity in Ireland

won't boost competitiveness. Trapped euros will go to France and German banks and stay there.

(If Greece and Portugal leave the euro, it could become stronger.)

In 1931, British merchant banks nearly crippled the banking system with their massive holdings of German corporate debt (equal to over half of the BoE's gold reserves). If Britain had remained on the gold standard, the flight of gold from the UK would have made that country look like the Weimar Republic. How will money stay in the PIIGS? It's becoming increasingly clear that all this drama related to the Greek deal (and soon the Portuguese deal) will not bring about the advantages of restructuring or default experienced by the likes of Argentina. Argentina's commitment to the pegged currency eventually brought down 2, or maybe 3, governments and brought the neo-Peronist Nestor Kirchner to power.

The logic of a haircut and bondholders taking some pain is that in the long run growth will return in sufficient quality and quantity to support banks and government finances. But without the



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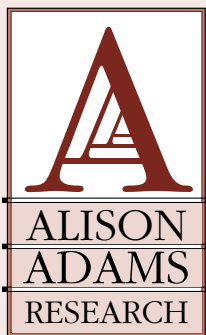
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currency mechanism of adjustment, where will the growth come from? Even before the Greek crisis reached its current height, the IMF and the ECB both argued that there was not enough emphasis on growth. Why would a German tourist go to Greece, when his euros will go further in Turkey?

Whatever Argentina's troubles with the Paris Club and the defaults that have kept it from accessing international markets, its weak currency has been a particular boon for its exports and local industries. Imports are expensive for Argentines. Argentine exports are cheap for Brazilians, and trade frictions between the two countries have been quite heated since Argentina's default. The country's wine exports are enjoying a considerable advantage in global markets because the peso is attractive. Argentine soy—even with the massive export tax that is propping up national finances—enjoys a considerable currency advantage over Brazilian soy exports.

China's rate hike—fight inflation at all costs. *Even as the markets are discovering that not all Chinese companies are honest, and there are new concerns about local government debt, the PBoC has hiked rates another 25bps. The latest PMI has fallen again to 50.9%; in 2009 that reading would have signaled a beacon of hope, but it is the lowest reading in 28 months. China will absolutely kill inflation before worrying about growth.*



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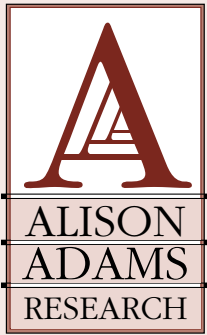
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I am keeping my call that China will risk a hard landing in 2011 so that it can foster an upswing in 2012. The difference between a hard and a soft land is very subjective. The difference is also derived from monetary policy operations in sophisticated and deep capital markets like the U.S. and the E.U. In China, the only real tool is money supply. The PBoC is clearly interested in cleaning up excess liquidity that is still in the system. With so much liquidity and so many off-balance sheet loans, SIVs, and “hot money” flows, more tightening might be possible.

Are Chinese banks significantly worse than say a French bank (BNP Paribus, perhaps) that has massive exposures to the PIIGS? Or Bank of America, which inherited a good deal of its bad loans through “speed-dating” arranged by the Federal Reserve? Chinese banks are certainly not immune from the fallout of the global financial crisis, where many banking systems have been caught with bad debts on their books. Just look at Europe. What about the U.S. banks—they have troubles themselves. (I have no evidence of this, but some the most egregious refinancing practices with delays and mismanagement are in effect—a tacit policy of creating a special category loan). In China after the last banking crisis, special category loans were NPLs with special features. In the U.S., many loans and mortgages could certainly fall into this basket.

I’m sure that in China there are as many opportunists as anywhere else in the world. But in 2008 and 2009, Beijing gave very direct orders to local governments to spend and borrow if necessary. A good portion of the local debts that have ended up on bank balance sheets are the result of national policy implementation. There are rumors that the local governments of Shanghai and



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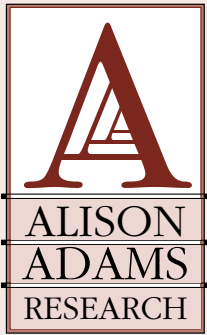
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Yunan might default on their debt or the debts related to their SIVs. But there are many types of local government loans on bank balance sheets; indeed, if they are on the banks' official books they are most likely guaranteed and preapproved by the NDRC. The off-balance sheet loans could be a very different story! And these loans are very likely to be highly speculative and possibly illegal.

Banks and local officials certainly took advantage of the policies to feather their own nests, but many of these loans must (by bank lending standards) bear the seal of the NDRC for approval. Even if the local government cannot pay back the loan, the NDRC seal carries a tacit national government guarantee. In the past, Beijing has absorbed these types of loans into the special category loan or into its own SIV, which bought up bad debts from banks after 2004. I believe that if any of these NDRC-approved local government loans become delinquent, the PBoC and Beijing will protect banks from the losses.

The big push for low-income housing over the next few years has encouraged miners that the near-term risks for demand are transitory. Chatter from the iron-ore middlemen in China reveals that there is only weak interest in buying up ore, even though stocks are low and prices attractive. It could be that bank credit is not as readily available and steel pricing is vulnerable and does not justify buying more ore. Falling sales in white goods and autos are part of the dilemma for steel producers in China. Iron ore prices might be attractive, but credit is scarce and demand is soft. In early January, commodity middlemen and steel producers loaded up on



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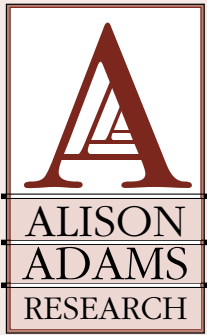
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commodity inventories—now they are hanging back. They have seen this game before, they will wait out the PBoC and look for the all-clear signal.

CFTC and day trading volatility: *Less than 20% of trading volume is from (physical) traders changing their net long or short positions. The rest of the volume is done by day trading or calendar spreads (ETFs?). It's possible that as the CFTC pursues its mandate of transparency, we will learn a great deal regarding market activity in the future's space for all commodities. The CFTC has already proposed limits on (financial) investments in commodities (as an asset class).*

The flash crash last May in the oil space promoted the CFTC to produce a new data set that captures the actions of large traders who change their net long and net short positions. The theory was that the flash crash must have been related to one or two very large position changes. The findings support complaints by physical traders that the role of financial investors in the futures markets has thoroughly distorted price discovery. Paper traders who play momentum and spreads are actually driving the oil price, not physical producers and end users. This is an abuse of a vital function for futures. The CFTC's recommendation that limits be placed on "investment in commodities" is sound and a fulfillment of their regulatory responsibility.

Thailand: Nothing changes so much as change. Thaksin's gang back is in power and so are its companies. *When Thaksin was pushed from office, the companies associated with his*



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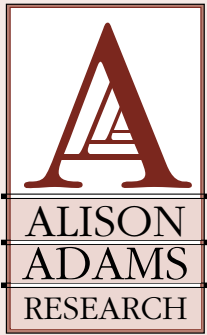
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entourage sold off in the stock market. Now that his sister has won, those stocks are back in favor and the companies associated with the Democrat Party have been sold off. National politics in Thailand are still about business interests. Elite cronyism remains the most powerful force in the country.

Will the minimum wage be increased by 40%? PM Thaksin's ambitious rural benefit scheme made him enormously popular before he was forced from office. Better wages for the poor garnered support for him with the urban working class. The Democrats had their chance to win that support. But they failed miserably. The King—whose health has been failing for years—is still hanging on. And the army, after its “defense” of democracy against Thaksin, has a new constitution and the power to intervene. After months of civil unrest between Red and Yellow shirts, a soft coup, a hurried rewriting of the constitution, and the installation of a minority government led by urbane business elites, Thais are back where they started.

It is, by definition, nearly impossible to predict the likelihood of another military coup. The new constitution allows them to defend the monarchy, which could be subject to loose interpretation. Too many coups would ultimately undermine the reputation of the armed forces. As in Pakistan, the military may decide that political intervention is not worth the trouble. The military in Thailand has learned that the Democrats, for all their fine talk, cannot wield or hold power on their own. I believe that the military would rather sit out the coming political intrigues regarding a return or pardon of former PM Thaksin.



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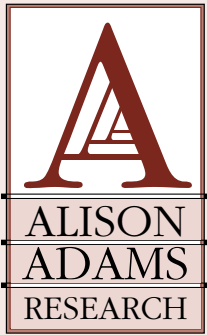
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Mexico: The PRI makes a strong showing ahead of critical 2012 presidential elections and wins control of key state governments. *The PRI, thought to be on its way to extinction in 2006, has fought its way back to power.*

Last December, in my emerging market election outlook, I wrote that the PRI would make a very strong showing in the local elections. I did not foresee that they would beat the opposition by at least 40% in the local elections for governor. The good news for investors is that the very far left in Mexico is increasingly handicapped by infighting and rivalries. AMLO, whose supporters managed to close Mexico City for a couple of months in 2006, has been playing dirty politics, which might have cost the PRD the strategically important State of Mexico (EdoMex). AMLO will do his best to run in 2012 and he will attract the most radical of the leftist voters. But he will not come close to winning.

The former governor of EdoMex, Enrique Peña Nieto, is the PRI's rising star and is preparing for a run at the presidency in 2012. His candidacy for the PRI is nearly a foregone conclusion, but there are powerful challengers like Manlio Fabio Beltones who might challenge him for the party leadership. The PRI has a deep bench of political and technical talent and the party has worked hard to promote its young stars to the top. The PRI used to be called the Party of the Dinosaurs because very old politicians held all the power in their claws. After 12 years out of Los Pinos, the PRI is set for a comeback.



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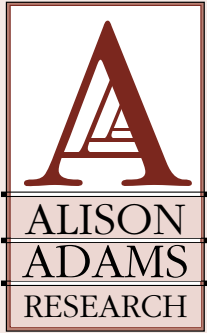
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Chavez is back and reshuffling his cabinet for the next phase! (Whatever that means.) *No*

reason for investor optimism in an ailing Chavez.

Kremlinologists learned that death at the top can take a very, very long time. Chavez has returned from Cuba, ready for his next phase! His brush with mortality probably only increased his sense of self-importance and revolutionary fervor. He could not possibly die before his revolution is complete. And so, I am sure we will see new rounds of expropriation, spending, and revolutionary passion.

Chavez might believe that he is the revolution incarnate, but his cadres are powerful and have serious economic interests in the current status quo. If Chavez were to die, the Chavista network would persist in defending its interests, in spite of polls that show that Chavez's personal popularity is waning. The new PDVSA (post-strike) management and contracts would stay in place. The armed militias living in nearly every community would need to be demobilized and paid off. The parallel Chavista cooperatives and local governments would need to be dismantled. The central bank has been gutted. The stock market, such as it is, is moribund. The black markets for dollars and imports are probably more important than legal channels. Expropriated land will be contested. The financial system is completely dysfunctional and banks are burdened with massive bad debts. There are so many new ministries that their functions may not be clear if the revolution officially dies. Domestic spies and informants have been earning a good living. What will happen to them? *If Chavez dies, there will be years of work ahead.*



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research@alisonadamsllc.com

Alison Adams Research

Mobile: 617-388-9817

Office: 617-475-5295

Email: research@alisonadamsllc.com

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