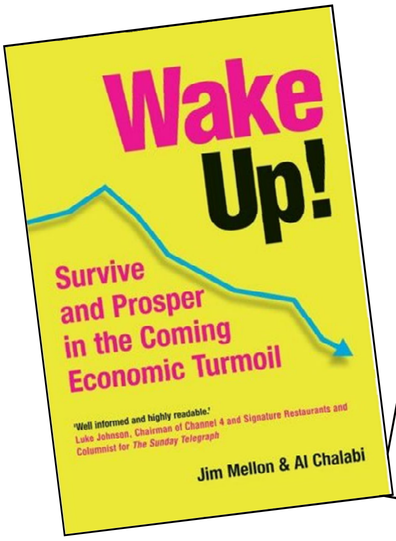


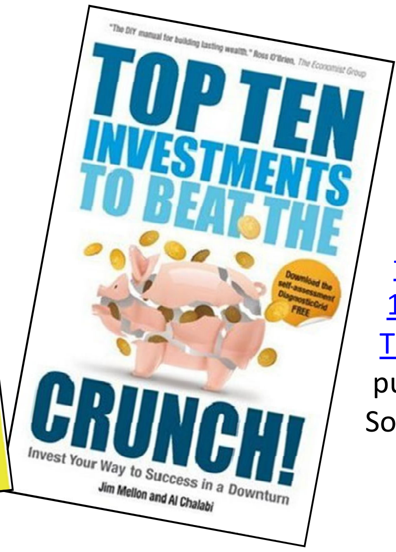


# NEWSLETTER

**Fourth Quarter 2011 Edition**

This newsletter is brought to you by the authors of "Wake Up! Survive and Prosper in the Coming Economic Turmoil", and "The Top 10 Investments for the Next 10 Years" / "The Top 10 Investments to Beat the Crunch", all published by Capstone, part of John Wiley & Sons.

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We apologise to our regular readers for the prolonged radio silence; we have been working hard on wrapping up our new book and we are proud to announce that it is now complete. We spent most of our summer researching and writing, but it has been worth it and we are very pleased with the result. We hope our readers will both enjoy it and profit from it. The main title we have chosen is "*Cracking the Code*" and our publishers tell us that it will be in bookshops by February 2012.

Given that it has been a while since we last gave an update, this is a good opportunity to take a tour of the major economies around the world. First stop Europe…

## Eurozone Crisis Still Centre Stage

Everyone is aware that Europe is on the brink of some sort of massive crisis, but as yet the euro currency itself remains relatively strong. Pockets of demonstrations around the Eurozone have not yet blown into full scale insurrections and economic indicators, while pretty unimpressive, are not yet signalling anything other than a mild recession. Don't be fooled readers; this is a phoney war and the real fireworks are going to be felt pretty soon.

What we are seeing is a conflict between democracy and eurocracy, i.e. the imposition of Germany's interests (and to a certain extent, France's) on reluctant Club Med countries, mainly Greece in recent months but no doubt others to come. It is baffling why all of the Club Med economies - Portugal, Italy, Greece and Spain - with critical debt levels and uncompetitive workforces don't just jump ship and hang the consequences. Trying to desperately hang in there is only going to lead to prolonged pain and austerity while Germany beggars them all with its awesome relative productivity. If these indebted countries are to stand a chance in the longer term, they need to leave the Eurozone straightjacket with its overvalued currency and a cheese paring central bank. All of them desperately need devaluation and they need it quick, or they are going to go bust later anyway in a more spectacular fashion. These countries should learn from Argentina's default in 2002. Life today in Buenos Aires isn't so bad and those pesky creditors can be bought off with ultra-long dated paper and soothing noises. Will Club Med follow suit? Yes, in our opinion, and we really don't know what the end result will be.

Italian bond yields softened slightly after Berlobufooni announced that he would step down, freeing him up for more of his bunga bunga parties. Despite this side show, Italy's bond yields remain at untenable levels and it is only a matter of time before Italy turns to the IMF. We think Italy is too big to be allowed to leave the Eurozone (and if that's the case, Italian bonds would be a buy at this level for the braver investor), but boy is it going to be difficult to balance its books, even if the population has its mattresses stuffed full of high denomination notes. However, because Italy is such a fiasco, we think it very likely that Greece, followed by Portugal and possibly Spain will exit the euro, and as that fateful day approaches, watch for a test of 1.20 to the dollar on the euro. Sure, the euro is volatile, but it is trending down and remains an excellent short play.

## China Softening

Meanwhile, the news out of China is increasingly bad, as credit conditions become near desperate for Small & Medium-sized Enterprises (SMEs), and property difficulties permeate every major urban centre. Only well-connected state-related organisations have access to credit, leaving the SMEs to resort to the so-called shadow banking system, where interest rates charged are reported to be as high as 6% PER MONTH, which when annualised is around 100%!

At the individual level, China's artificially low interest rate on deposits continues to punish savers, where the best deposit rate available is around 3.5%, while the latest official Consumer Price Inflation is running at 5.5%. However, the real inflation figure is almost certainly one to two percentage points higher than the officially reported one. Setting deposit rates at well below interest rates erodes wealth, which is why savers have until recently been trying to hedge against inflation by pouring their savings into property, but unfortunately the recent cooling measures to curb property prices have once again punished savers. China is struggling to maintain growth and fight inflation and it can only do one at the expense of the other.

The real longer term challenge for China's economy is how to stimulate consumer spending. Domestic consumption only accounts for around 35% of GDP (compare that to the US which is around 70%), leaving the 65% export dependent and therefore exposed to the health of external economies; its big trading partners, Europe and the US, are not in the best of shape.

At best, China is likely to experience a significant slowdown for 2012, with growth falling to around 6%. The worst case scenario is the hard landing that some economists are predicting, which will probably be triggered by a banking crisis, forcing Beijing to step in and bail out the banks. Unlike western governments though, China's can afford to do this without trashing its own balance sheet. Even so, such a scenario would send shockwaves throughout the economy.

Under any scenario, a slowdown from today's growth rate is on the cards, and commodity prices are very exposed. So we would be wary of many commodities now – coal, steel, rare earths, tin and lead are among the most vulnerable to a slowdown.

## The US: A Tale of Two Economies

The United States is in a two tier recovery/recession. The private sector is doing quite well, and companies are stuffed with cash, but the property and government sectors are still in massive deleveraging mode and this is set to continue for some time. US treasury bonds are signalling a "bump along the bottom" economy for some time to come and that is the real picture – undistorted by the Fed's latest attempt to create inflation with its operation "twist".

Something to watch out for as we approach 2012 is the expiring allowance in the US that permits companies to depreciate 100% of any capital expenditure installed in 2011. The impact of this is to create a temporary boost to the economy in Q4 as companies scramble to take advantage of this expiring perk by bringing forward investment plans from 2012. The downside is a likely slump in Q1 2012 once the allowance expires. There are some faint mumblings of extending this allowance beyond the end of 2011 but so far we haven't seen anything to indicate that this is likely to happen.

## Japan – The Only Safe Place to Take Refuge?

The one market that we think could outperform (apart from pharma stocks, which we still like) is Japan. Jim has just returned from a trip to Japan, which he feels is likely to outperform most markets in the coming two or three years. This is because on a price to book value basis, on a dividend yield basis and on most other measurements, the place has never been cheaper. And whereas western markets have been in a bear phase for about 10 years, Japan has been in a massive bear market for more than 20 years. The authorities in Japan have recently intervened very heavily in the FX markets to weaken the yen, and while this has been done before, this time we really think they mean business. The last intervention took the yen from around 75 to 79 against the US dollar and cost US$94 billion. It caught everyone unawares and we think they could do this again. Intervening in a so-called unsterilized way will significantly boost the money supply in the country, which in any case, is now growing nicely. The intervention to weaken the yen is to help the export sector which is hurting badly, as well as to end the deflationary cycle which has marked Japan for so long.

Yes, Japan is a highly indebted country at the government level, but the funding for this comes from inside the country's private sector and, as a result, Japan is not going bust. Companies have deleveraged significantly and many hold huge cash balances. Corporate governance may just get better post the Olympus scandal, and dividend yields on good stocks are over 4%. Compare that to bond yields at the long end of less than 1%, and you can see why Mr and Mrs Watanabe might just buy shares again, especially as the yen starts to weaken.

Price-earnings ratios are low and profit growth could be high if the yen weakens as we expect. So we think buying equities in Japan could be a smart move, but hedge against the yen weakening. Our picks are **Canon** (7751), **Fast Retailing** (9983), **Astellas** (4503) and **Hoya** (7741). Selling Japanese government bonds and buying the US dollar against the yen could also be a nice trade. (Thanks to Paul Kirkby for these ideas.)

## Investment Suggestions

From a stock market point of view, we seem range bound in the US, overoptimistic in European markets (particularly in financials, which if our scenario comes to pass are going to be wiped to the floor - and that includes life insurers), and blah in the emerging markets.

For general positioning of assets, we recommend buying the US dollar with a short hedge in the S&P500 and key Nikkei longs, and selling gold, silver and the euro.

We hope some of you bought **Medivation**, a company we mentioned in our last newsletter, which has more than doubled after its drug MDV3100 proved hugely successful in Phase 3 trials (the last phase before getting that elusive FDA approval.) We still think it has upside, but readers interested in our drugs (not the Ibiza kind) might now want to look at **Plethora Solutions** (ticker symbol PLE on AIM in London), although we'd rather not discuss what it does in a family newsletter (you can visit their website at http://www.plethorasolutions.co.uk/)

Another company we like is **Arrowhead Research** (ticker symbol ARWR on NASQAQ) which has acquired all of Roche's siRNA (short interfering RNA for the technically minded), and looks fantastic. On 11 November, the company's shares soared by 40% after one of its subsidiaries, Ablaris Therapeutics, released data on a weight loss drug candidate, *Adipotide*. The results showed that obese rhesus monkeys treated with *Adipotide* lost an average of 11% of their body weight after only four weeks of treatment.

In our new book, we explain what siRNA and why it will be key to many of the medical breakthroughs in the future.

As with all our suggestions, investors should find a suitable entry point in these volatile markets, or even adopt a phased entry to a particular stock, buying a smaller amount every couple of weeks or every month to smooth out the entry price.

We'd like to leave you on a cautious note with a quote from Thomas Jefferson, America's third President[1]:

*"And I sincerely believe, with you, that banking establishments are more dangerous than standing armies; and that the principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale."*

[1] The quote is taken from a letter that Jefferson wrote in 1816 to John Taylor (of Caroline), who was a lawyer, writer, politician and friend of Jefferson.

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