

December 22, 2011

Dear clients and colleagues,

China's stock market is down 21% this year and is now close to its bottom of 2009. There is a lot of negative commentary that the country is on the verge of a massive property and banking crash. We disagree with these dark predictions. The stock market in China is highly correlated to liquidity in the system. Since the middle of 2010, China has reduced liquidity by hiking rates, raising the bank reserve ratio and also implementing property sector restrictions. The effects have been to slow down property price appreciation and cool down inflation, the intended objectives. Economic data out of China still indicates growth. Retail sales were up over 17% in October, again, in line with China's objective to encourage domestic consumption. China's annual central economic work conference was held between December 12-14. The statement issued after the conference highlights that the authorities will focus on maintaining stable economic growth as the key policy initiative for 2012. In our view, China has the tools to slowly relax its policy and encourage growth. We certainly hope they will succeed as the Chinese economy is now part of the growth strategy for most companies around the world.

News that caught our attention this week are the latest forecasts given by Exxon (XOM US), the world's largest energy company and the stock with the largest market capitalization in the World.

Here are some excerpts:

- "Advanced hybrid cars will make up half of those on the road by 2040, up from about 1% today"
- "Global energy demand is slated to increase 30% from 2010 with a large portion of the demand coming from China, Africa, and India and emerging economies"
- "Electricity demand to rise by 80% through 2040 as standards of living and economies improve and more people choose cleaner forms of energy"
- "That 30% of the world's electricity will come from natural gas and that coal will go through its first long-term decline in modern history after hitting a peak. Though oil will still be the most used fuel, natural gas will overtake coal for the second highest spot"

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This year we have been puzzled at the relationship between natural gas and oil prices in the US. We are well aware of the temporary imbalance in supply and demand caused by the huge growth in gas supply coming from shale. In the short term, additional demand caused by a recovering US economy and fuel switching has not been sufficient to support natural gas prices. However, additional future demand coming from electricity generation (a record number of new plants being developed), transportation (truck fleet as well as automobile), and exports (LNG) will act as a floor on prices. Currently, gas prices in Japan and China are around \$15 per mcf as compared to \$3.10 in the US.

We are extremely optimistic on natural gas.

Other news that caught our attention this week. *Call of Duty: Modern Warfare 3*, the latest Activision hit war-game franchise, has realized \$1B worth of sales in 16 days, outpacing blockbuster movies including Avatar and Harry Potter. We have often discussed the importance of the video game industry, which is larger than the movie and music industries combined.

This is our last comment for this year, we wish you and your family happy holidays and all the best for 2012.

The Global Alpha Team

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