Major Themes

Our macro views getting down and semi-dirty in global markets

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Don’t be satisfied with stories, how things have gone with others. Unfold your own myth.

Rumi

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Introduction

The investment environment is changing at a rate that's representative of global economic imbalances, fund flows, and geopolitical risks. We believe this decade will witness greatly increased volatility and instability in the economy and financial system. Very few past models are still valid. Such a situation has contributed to the extreme uncertainty that currently prevails. **Our guiding principle is to help investors understand and navigate through all the complexities of an unstable, inflation-prone world.**

At TGSF, we are constantly searching for a new paradigm and look to identify major themes. Erudition drives our process. **Fundamental to our approach to investing is a core understanding of history, politics, economics and psychology.** We are always seeking more knowledge. We believe an eclectic approach that is based on common sense, strong logic, and objective data, balanced by right-brain intuition and lots of curiosity is what works best.

Our asset allocation framework divides the world into three buckets: the tactical outlook, the cyclical view and the strategic or thematic drivers. The tactical or short-term view has a horizon of up to three months. The main inputs are technical and focus on such indicators as sentiment, momentum and extremes in market positioning. The main thrust of the cyclical outlook is our 6 to 12 month view on the world. **The following themes should be key drivers of financial market performance over the next 1 to 5 years.**

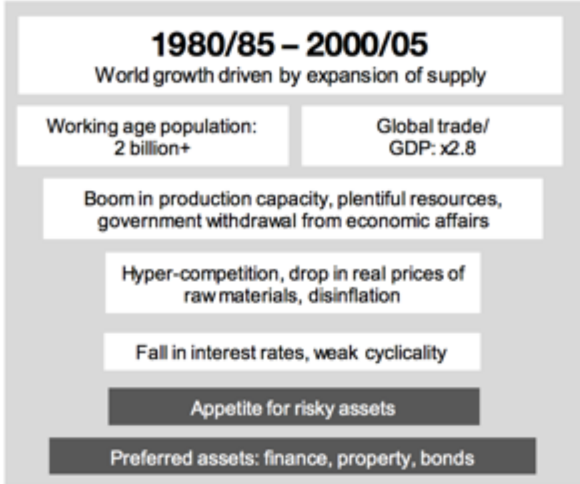
THEME 1

THE LONG WAVE DECLINE

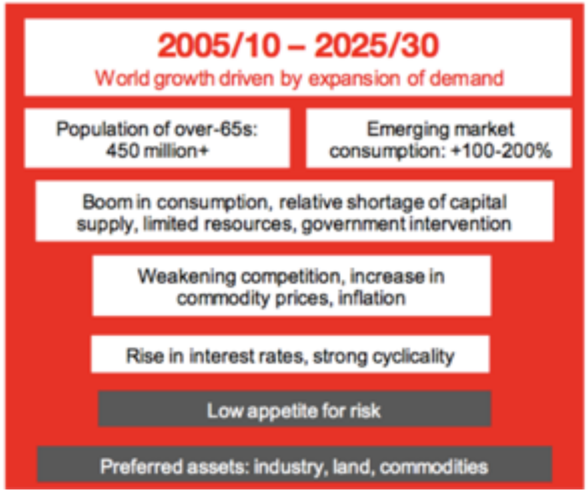
WINTER OF OUR DISCONTENT

THE SHIFTING MACRO LANDSCAPE

The last long cycle (from 1980 to 2000-05) was shaped by exceptional growth in supply on a global level. Strong growth in the working-age population across Asia and the opening-up of world trade led to considerable expansion in global production capacities. These factors created a highly competitive and disinflationary environment of plentiful supply, which was characterized by low interest rates, a credit boom and, in the financial markets, exuberant appetite for risky assets.



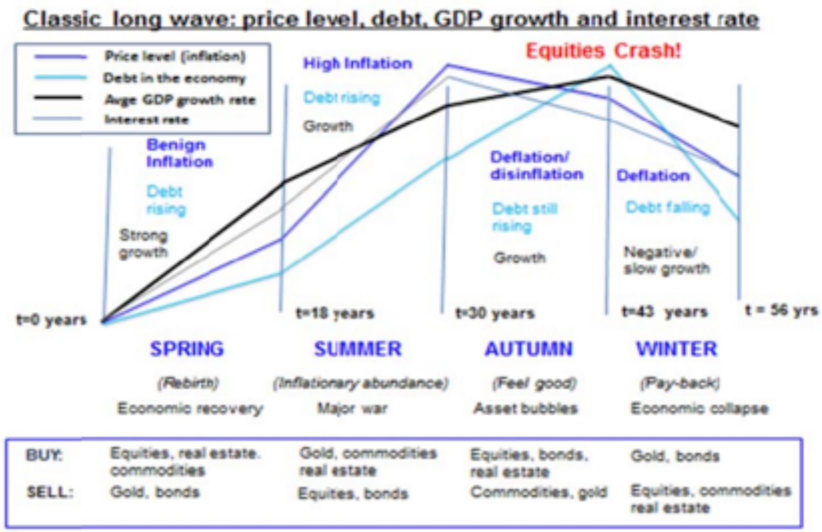
As the demographic cycle progresses, we are seeing the emergence of an aging population, which is less favorable to productive investment. Additionally, the developed world is facing a serious debt overhang and a long period of slow nominal growth. Meanwhile the rise in living standards among the emerging population heralds an unprecedented level of growth in demand. **Taken together, the world supply/demand balance is dramatically changing against a backdrop of resource shortages which are likely to favor shorter cycles, increased government intervention in economic affairs and inflation.**



Source: SG

The Kondratieff Cycle

The Kondratieff cycle is an inflationary/deflationary cycle. During spring, inflation is benign. In summer, consumer price inflation increases in line with the monetary expansion which finances the summer war. Price inflation reaches its peak at the end of summer. During autumn the rate of increase in inflation falls. This is disinflation. Conversely, in autumn, asset prices (stocks, bonds and real estate) are inflated to extreme levels on the back of a massive expansion of credit. This speculative excess reaches its peak at the end of autumn. In winter, prices for stocks, bonds, real estate and debt plummet. The fall in asset prices and the massive contraction in credit lead to a frightening deflationary depression (see Fisher's Debt Deflation).



Source: Seymour Pierce

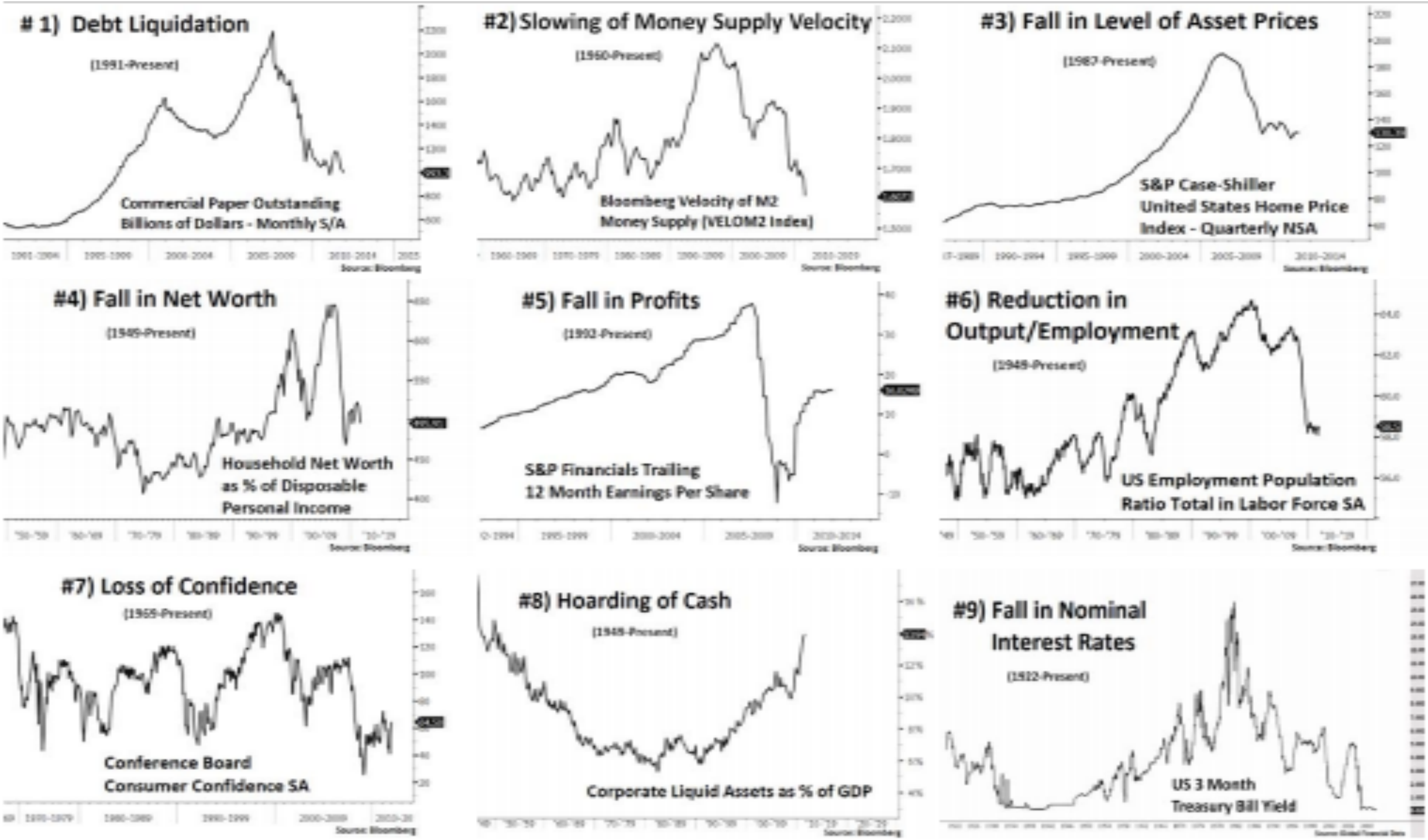
According to Seymour Pierce, key characteristics of the Winter phase are as follows:

- The economy is finally overwhelmed by excessive debt and speculation
- Prices, employment, output and investment all fall sharply as the economy goes into depression
- Poor management and bad financial decisions which remained undetected during the boom in asset prices are exposed
- Credit markets seize up and there are widespread bank failures
- Debt is reduced, usually through a mixture of bankruptcies and deleveraging

We have had three major cycles in this process since 1788 and are currently in the late stages of the fourth. The current long wave will likely play out just as it did in earlier cycles (1837, 1873 and 1929). **Historically, it's not been until excess debt, misallocated capital and speculative bubbles have been sufficiently purged from the system that a new long wave cycle begins.**

The transition towards the new regime can be nothing but chaotic. However, this time policy makers can create unlimited amounts of money in contrast to previous long waves. This suggests debt reduction will be targeted through extreme policy activism and inflation.

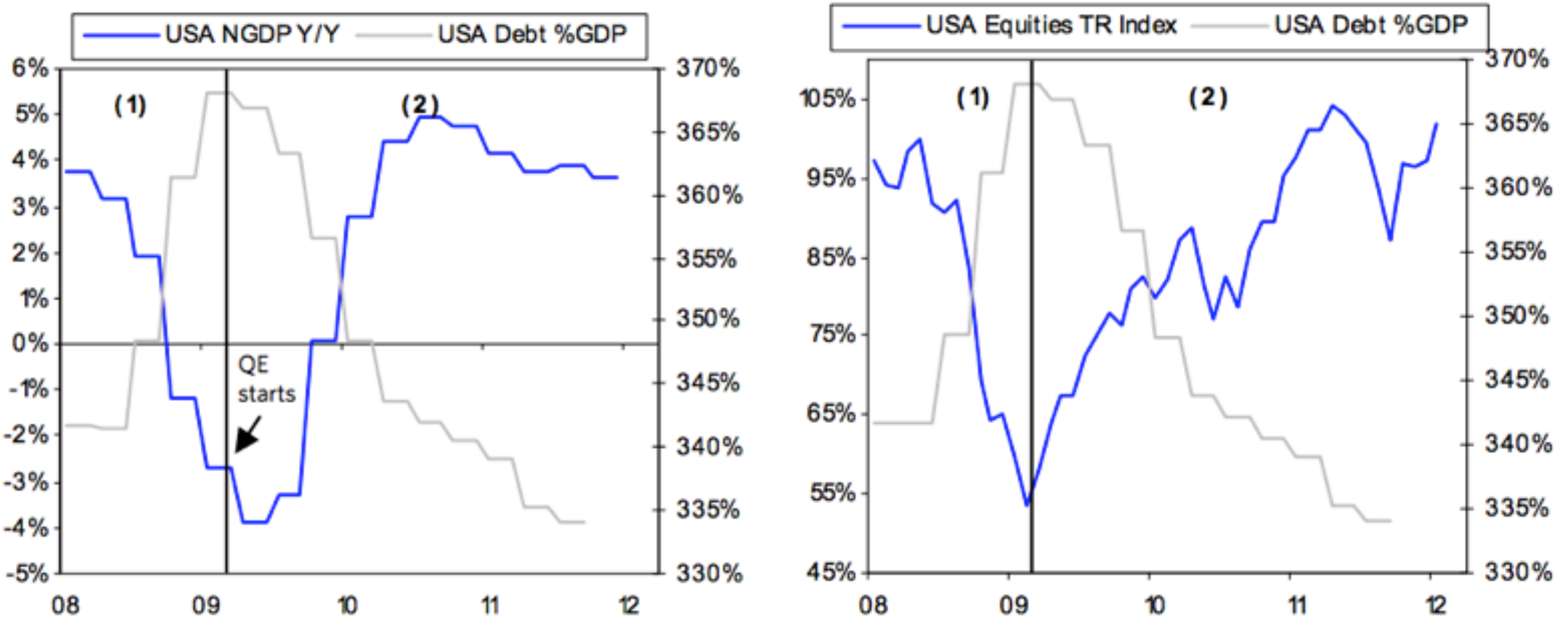
Fisher's Debt Deflation (2008 version)



Source: Nautilus Research

The Great Levitation

The Fed and its peers have manufactured trillions of dollars to prop up economies and financial markets.



Source: Bridgewater Associates

As shown in the charts above, unlike both the U.S. in the 1930s and Japan since 1990, the U.S. quickly entered a reflation and ended the "ugly deflationary deleveraging" phase of the process (which lasted from September 2008, when Lehman fell, to March 2009, when the Fed instituted its aggressive program of quantitative easing to monetize the debts). The key going forward will be for policy makers to maintain balance so that the debt/income ratio keeps declining in an orderly way.

UNFINISHED BUSINESS

The environment of the last decade fits well within the general form of a secular bear market (as experienced in the prior four instances highlighted on the next page).

- Pattern: generally lasted 15 years with highly cyclical oscillations (1-3 year up and down moves)
- Valuation: periods begin with extreme overvaluation and end only after achieving rock bottom undervaluation. The average dividend yield at the end of these periods was 7.8%, substantially higher than the 3.6% reached at the market's nadir in 2009 and current level of 2.1%
- Crises Aftermath: the defining financial, economic and geopolitical crises have occurred in the middle, not the end

With the unprecedented level of overvaluation achieved at the 2000 top, the pattern of negative returns since, and historic financial crisis in 2008, we believe the next 3 to 5 years will play out like the latter portions of the previous 4 secular bear periods. Such a projection would entail a few more cyclical corrections after the current uptrend is over; with a projected end around 2016 with a lower valuation to match those other secular lows.

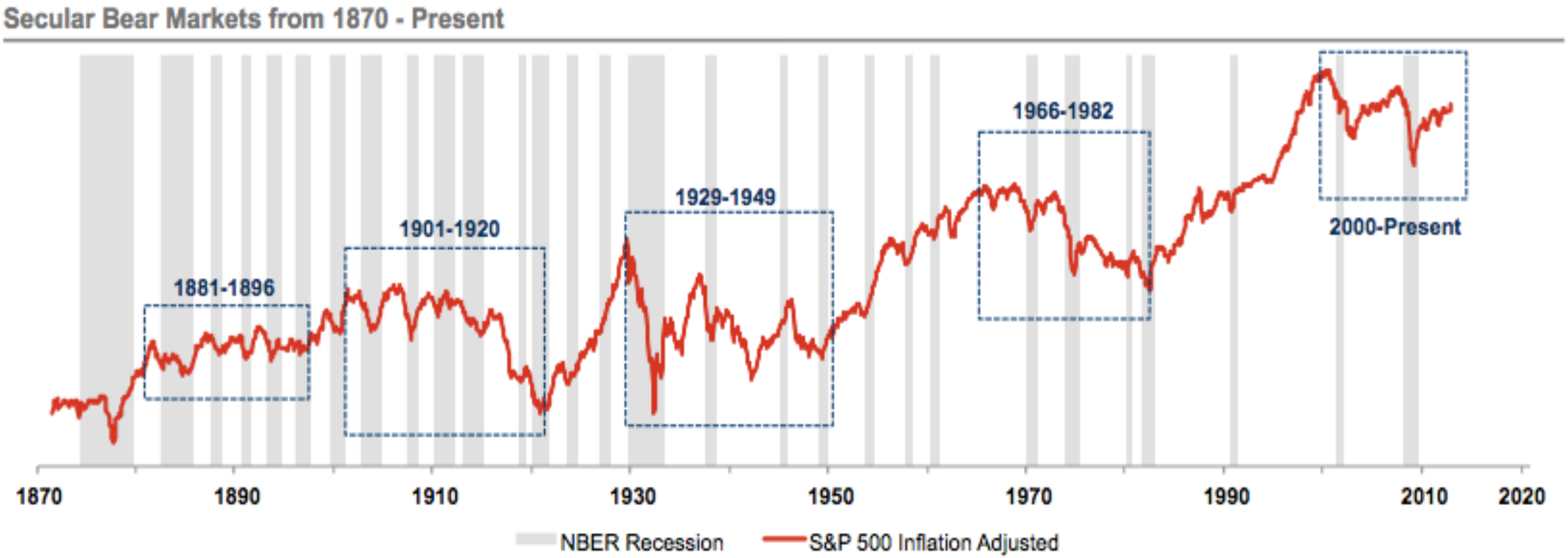
The current secular bear market has not yet finished correcting the imbalances of 2000 and 2007. **The aftershocks from the 2008 bursting of the real estate bubble, along with the banking crisis and global recession it engendered, will eventually roil the sovereign debt market, the only remaining asset class yet unscathed by the volatility of the past decade.**

We do not think the secular bear market for stocks can truly end until the havoc wreaked by an impending sovereign credit crisis is fully confronted and digested (see Theme 2).

Source: Streettalklive.com

CURRENT BEAR MARKET IN CONTEXT

Today's bear market has yet to match the extremes of previous secular trends.



Anatomy of the Bear							
Metric	**1881-1896**	**1901-1920**	**1929-1949**	**1966-1982**	**Mean**	**Median**	**2000-Present**
Peak-Trough Decline	-36%	-70%	-81%	-63%	-62%	-66%	-59%
Bear Market Duration (Months)	183	235	238	200	214	218	146
Economic Recessions (NBER)	5	6	4	4	4.8	4.5	2
P/E Low	12.4x	5.3x	5.8x	6.8x	7.6x	6.3x	13.5x
Shiller P/E Low	12.9x	4.8x	5.6x	6.6x	7.5x	6.1x	13.3x
Peak Dividend Yield	7.2%	10.2%	13.8%	6.2%	9.4%	8.7%	3.6%

Source: Federal Reserve, Robert Shiller

Source: Cliff Gehrett

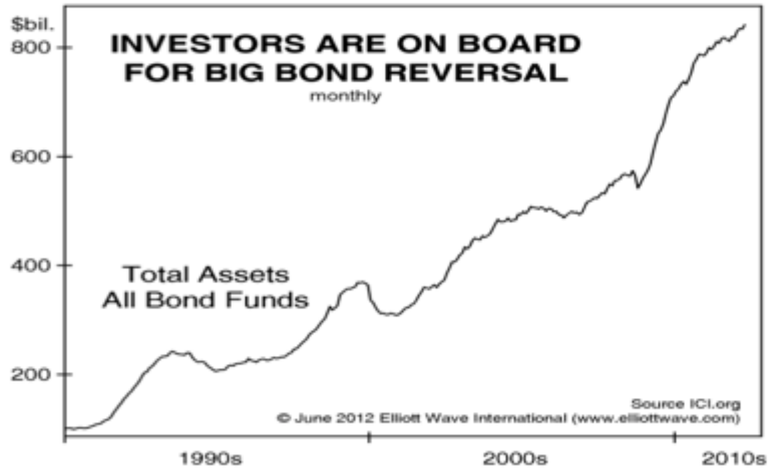
Theme 2

US BOND MARKET TOP

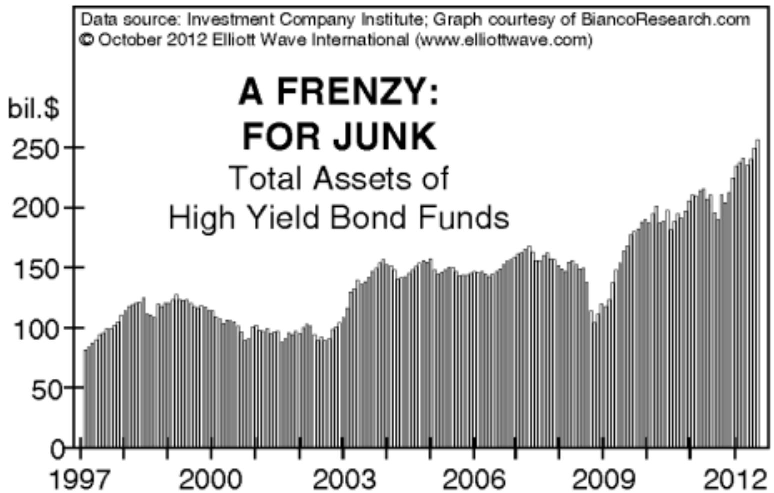
BUBBLE IN SAFETY

A GENERATION OF BOND BULLS

The bond bull-market began in 1981. The decline in yields from the peak to the present is a stunning 91%. For three decades, the trend in bond prices has almost been straight up, producing an entire generation of real money investors conditioned to buy any dip (in search for yield) and remain invested for the long term. There has been an 8-fold rise in total bond fund assets over the past 22 years.



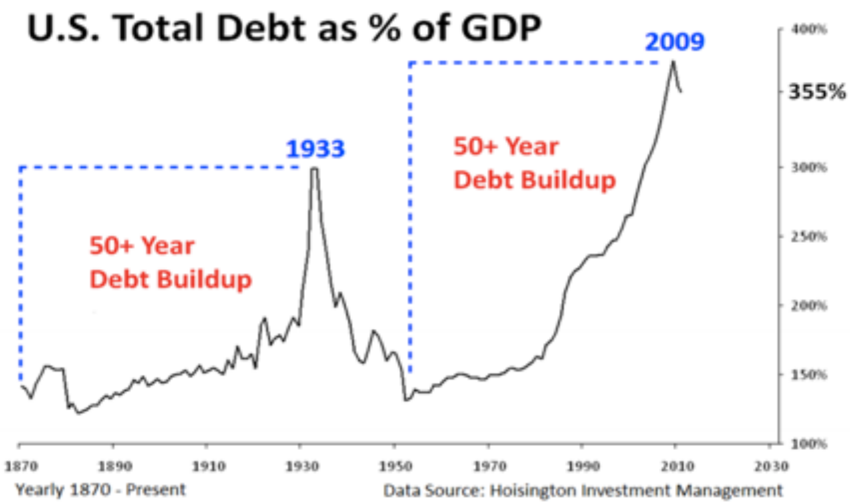
There are no guarantees in life or investing, but we are pretty sure that buying an extended market after three decades of rise is not a good idea, regardless of whether our monetary and economic expectations turn out right. Spending more than you make, let alone more than you will ever make, always leads to ruin. The only difference is that if you operate in the key currency it takes longer for the whistle to blow.



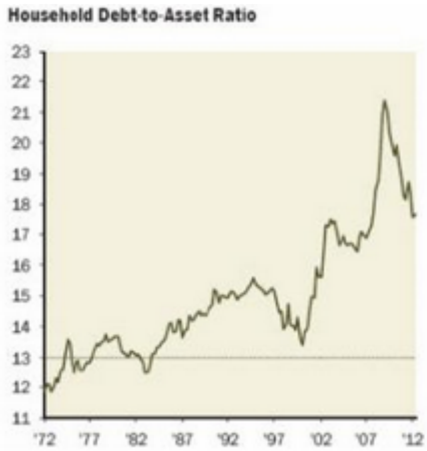
U.S. Treasury bonds have enjoyed their longest and biggest bull market on record and evidence is rapidly mounting that the trend in interest rates is poised to reverse.

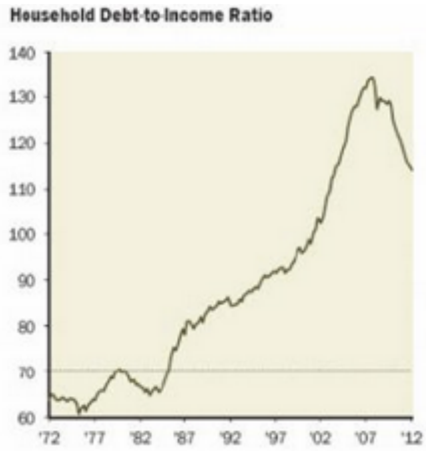
The Debt Supercycle

The Debt Supercycle is a description of the long-term decline in U.S. balance sheet liquidity and rise in indebtedness during the post-WWII period. Money and debt around the world exploded since the 1960s. Debt levels – especially in the household sector – rose far beyond what could reasonably have been predicted. According to BCA Research, below are just a few of the reasons why the debt ratio rose steadily:



- There was huge pent-up demand for housing and consumer durables after the war ended
- The decline in interest rates from the extremely high levels of the early 1980s meant that borrowers could afford to carry more debt
- Financial deregulation beginning in the 1980s, and innovations such as securitization, resulted in a general easing of credit conditions with banks becoming much more willing to lend
- The Fed was tolerant of rapid credit growth and chose not to lean against the growing housing and credit bubble





Source: Haver Analytics, Gluskin Sheff

The above tailwinds behind credit growth have largely ended. **The Debt Supercycle reached an important inflection point during the 2008 crisis, with the authorities reaching the limit of their ability to get consumers to take on more leverage.** The trend in the ratio of consumer debt to income is likely to be flat or even downward sloping in the years ahead, thus suggesting that deleveraging has a long way to go.

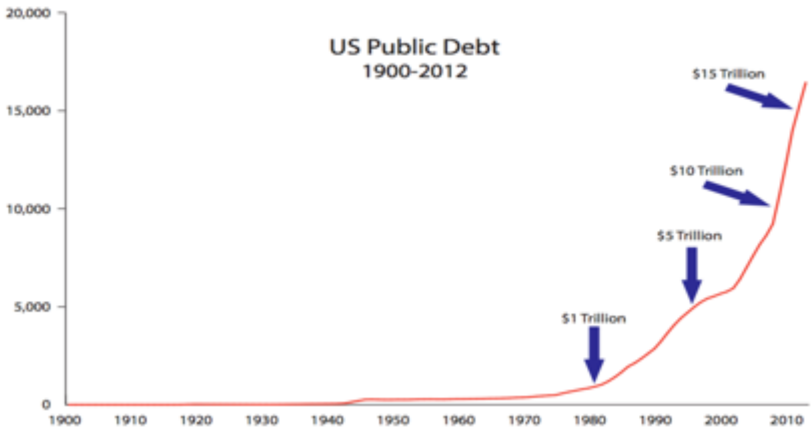
Pushing against the limit

With consumers no longer prepared to borrow and spend with wild abandon, the government was forced to leverage itself up instead. In doing so, the credit risk has shifted from the private to the public sector. **The Debt Supercycle has moved into its final inning, with government debt soaring dramatically in the past few years.**

It took the U.S. almost 200 years to accumulate a public debt of $1 trillion (from 1789 to 1981) but subsequently, just 30 years for the debt to explode to more than $16 trillion. Since 1981, the U.S. increased its sovereign debt by 1,560% while its population increased by only 35%.

The highest U.S. debt to GDP was in World War II at 127%. In the space of just five years, the US may possibly exceed that and accumulate more federal debt than during the previous entire history of the nation. In the 1980s, it took $4 of new credit to generate $1 of real GDP. Over the last decade, it has taken $10, and since 2006, $20 to produce the same result.

In our view, public debt will be pushed to the limit in a few more years. The massive government borrowing to fund the outsized deficits is only delaying the needed corrections. In the short term, U.S. is able to monetize rapidly expanding debt. Ultimately, this can only lead to inflation, which is a slow-motion default, and politically, the easiest way out.



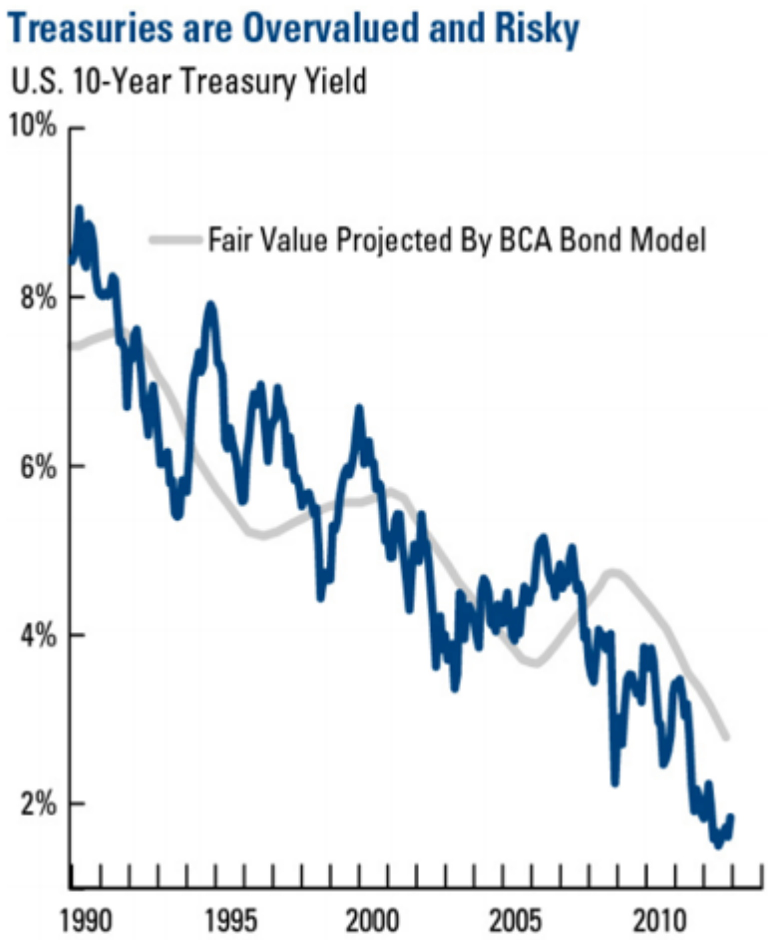
Source: TTMYGH

The return of risk premium

At this point, the immediate risk for the U.S. economy is not a rise in interest rates; it is the emergence of a risk premium on U.S. government debt. Such a risk premium is now very likely to appear if the U.S. government does not legislate a massive decrease in government spending.

As Grant Williams points out, if nothing is done and debt ratios continue to rise, there may come a day when the buyers of this debt come to understand that the rising debt-to-GDP levels have gotten to unacceptable levels and decide that they own enough or more than enough – particularly given the price risk at the end of a 31-year secular bull market, with the lowest yields in the history of capitalism. **And it seems this rollover in the U.S. Treasury market is already under way: foreign central bank purchases of U.S. Treasury bonds have been in decline since 2009.**

During the Great Depression, interest rates on lower-grade bonds trended lower until 1930, and those on high-grade bonds continued lower until 1931. Then they soared, on fears of default. Looking at current fiscal trends, we believe default fears will soon start to rise and investors will begin to demand higher rates to compensate for the perceived increase in risk, which will foreshadow an actual increase in risk. **Make no mistake – U.S. government bonds are no longer a risk-free asset.**



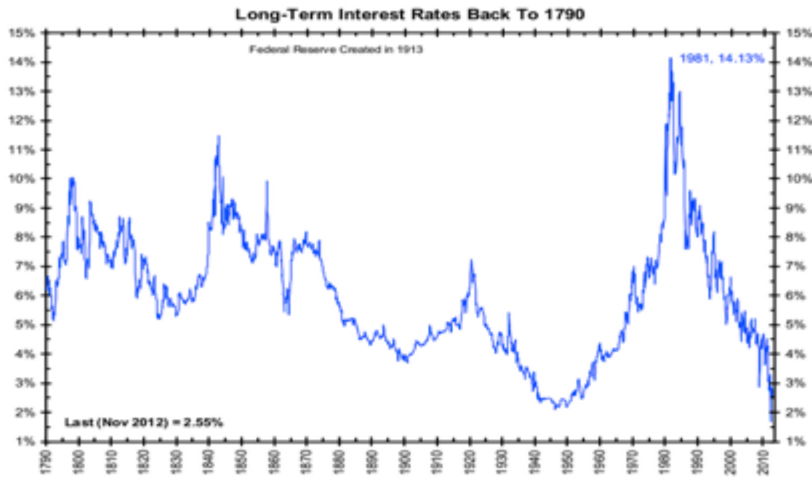
Source: BCA Research

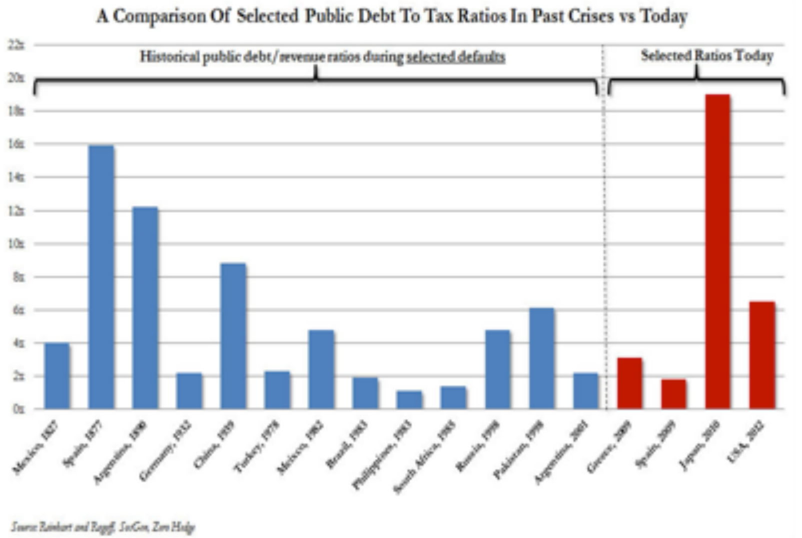
A FALSE SENSE OF SECURITY

America is running a chronic deficit and going deeper and deeper into debt. The U.S. government currently has monthly revenues of $200 billion and expenditures of $300 billion. That leads to a deficit of $1.2 trillion every year. **Once fiscal policy is pushed to the limits of sustainability, the Debt Supercycle could come to a violent end.**

The record low levels of Treasury yields and the resilient dollar show that markets are currently unconcerned with the U.S. fiscal trends. But, this will not always be true. The long-run fiscal trend is grim, largely reflecting demographic pressures on healthcare and, to a lesser extent, Social Security. **In the next several years, we believe the markets will likely force a major retrenchment in U.S. fiscal policy.** The current low interest rates in America are only creating a false sense of security. The initial rise in rates may be very muted, or may even be delayed, but will likely accelerate in time and lead, towards the end of this decade, to much higher rates than now seem imaginable.

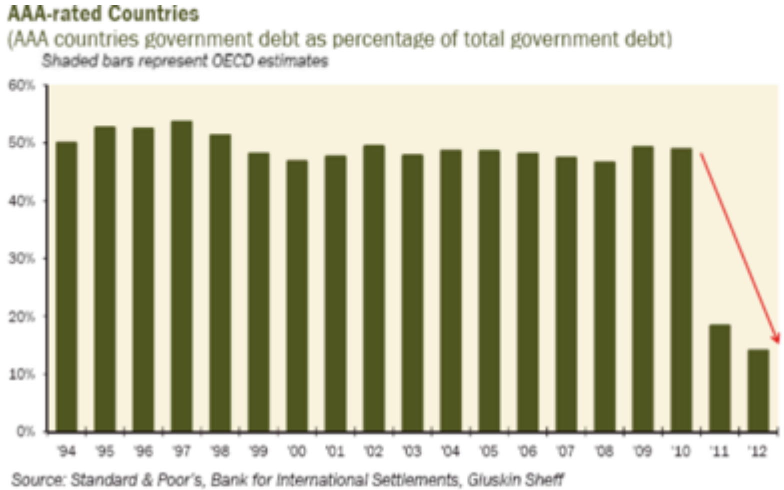
Since 1790, the average interest rate on U.S. long-term Treasuries has been 5%. If the interest to be paid on the U.S. government's debt jumped to 7% in the coming decade, not an unreasonable level given the nation's shaky finances, at that rate, the amount of the budget dedicated to debt service each year would soar from $454 billion today to $2 trillion – an amount equivalent to 80% of total tax revenues.





BUBBLE IN SAFETY

A strong market bid for bonds has been supported by a shortage of prime collateral in the global banking system. **Before the financial crisis, more than half of OECD government debt was rated AAA. Now, only 10% is.** Currently, there are only 11 countries ranked AAA by all three major ratings agencies; and of those, three are currently on negative watch by two of the three — which leaves only seven supposedly pristine sovereign credits in the world, none of which is big enough to absorb major inflows. **Solvency II and Basel III regulations in effect are forcing most long-term institutional investors to pile into sovereign bonds at the worst possible time.** This has created a huge bubble in the perceived safety of sovereign bonds.



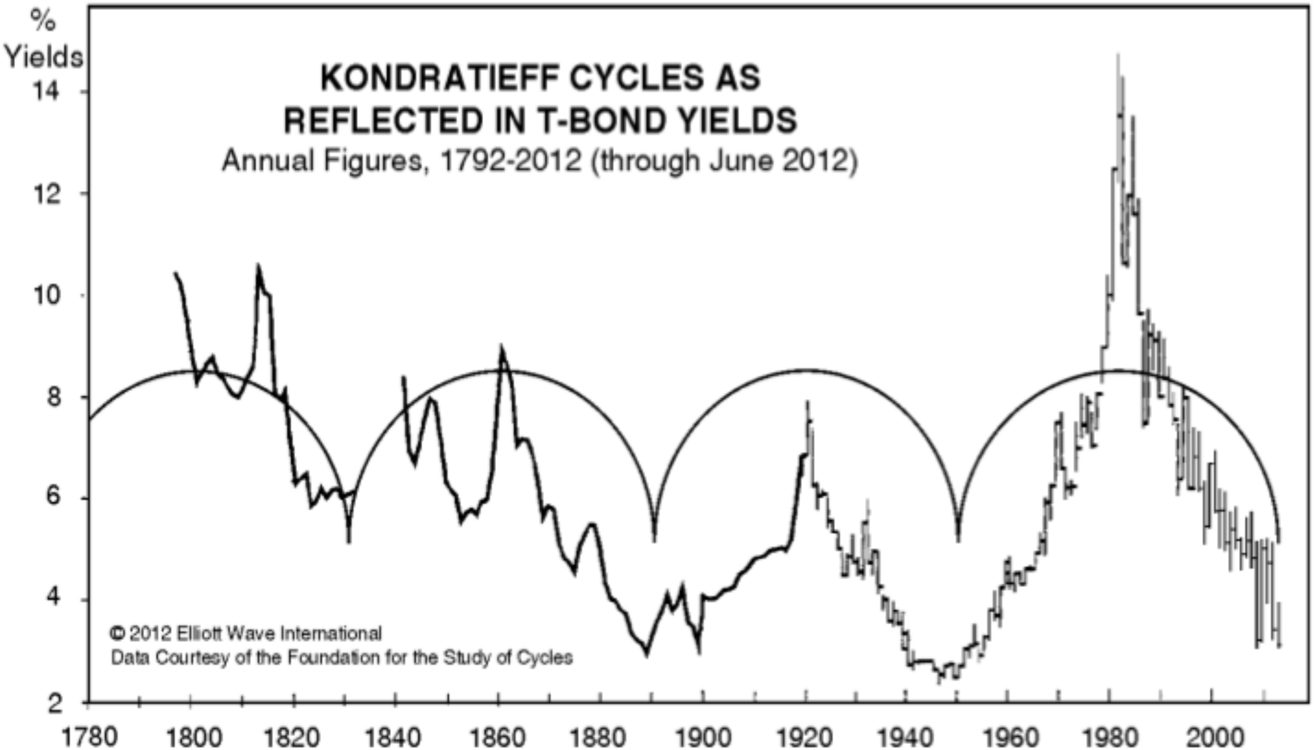
One might think that the U.S. government is the strongest sovereign debtor. It isn't. Eight other governments pay lower rates on their 10-year notes: The U.S. 10-year yield hit a low of 1.438% on June 1st, its lowest level ever. But the yields on comparable bonds elsewhere at that point were even lower: Singapore 1.37%, Taiwan and Germany 1.17%, Sweden 1.11%, Denmark 0.93%, Hong Kong 0.88%, Japan 0.80% and Switzerland 0.47%.

Country	Negative Watch
Australia	
Canada	
Denmark	
Finland	
Germany	Moody's, S&P
Luxembourg	Moody's, S&P
Netherlands	Moody's, S&P
Norway	
Singapore	
Sweden	
Switzerland	
United Kingdom	Fitch, Moody's

Source: TTMYGH

60-YEAR CYCLE IN INTEREST RATES

Interest rates are dominated by a 60-year Kondratieff cycle. Looking back through history, there have been important bottoms for interest rates which can be seen near the decadal marks of 1770, 1830, 1890, and 1950. Each of these bottoms arrives approximately 60 years after the prior one. The next major bottom for interest rates is ideally due about now. With U.S. yields close to 220 year lows, we are approaching the natural end of a 31 year period of declining interest rates.



When the Levee Breaks

Once the interest rate cycle turns, there will be a global rush for the exits. It may have already begun as the U.S. 10-year yield hit a low of 1.438% on June 1st, 2012 – its lowest level ever. We believe U.S. Treasuries could easily repeat their 83% price decline of 1946-1981.

Consider what would happen to bond prices if interest rates moved suddenly and sharply higher. A 300 basis point increase in yields would, on average, result in a 22% loss in 10-year bond prices. In 30-year bonds, the same increase in yields would lead to a loss of 40%.

10 Year	Current Yield	+50bps	+100bps	+150bps	+200bps	+300bps
US	1.606	-4.4%	-8.6%	-12.6%	-16.4%	-23.5%
UK	1.696	-4.0%	-7.9%	-11.5%	-15.0%	-21.5%
German	1.533	-4.5%	-8.7%	-12.7%	-16.5%	-23.6%
Japanese	0.812	-4.4%	-8.5%	-12.2%	-15.6%	-21.7%
Average	x	-4.3%	-8.4%	-12.3%	-15.9%	-22.6%
30 Year	**Current Yield**	**+50bps**	**+100bps**	**+150bps**	**+200bps**	**+300bps**
US	2.674	-9.4%	-17.7%	-25.0%	-31.4%	-42.2%
UK	3.009	-8.6%	-16.2%	-23.0%	-28.9%	-39.0%
German	2.177	-10.4%	-19.4%	-27.3%	-34.2%	-45.5%
Japanese	1.867	-8.7%	-16.1%	-22.3%	-27.7%	-36.5%
Average	x	-9.3%	-17.3%	-24.4%	-30.6%	-40.8%

Source: Bloomberg

THEME 3

THE COMING LOSS OF CENTRAL BANK INDEPENDENCE

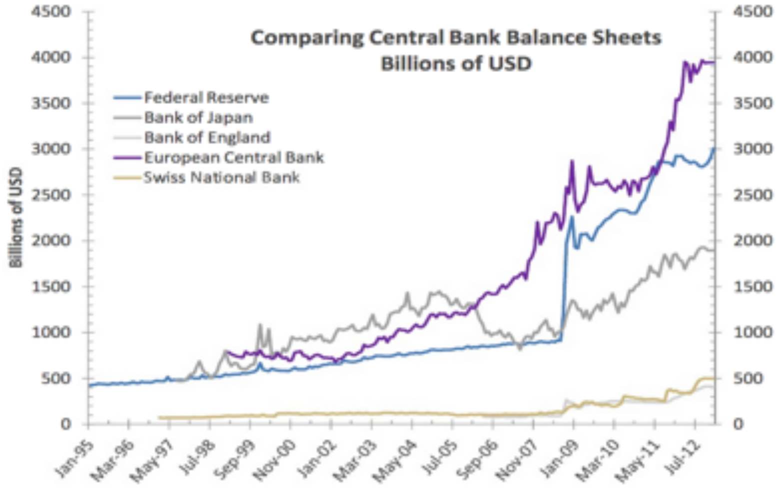
LORDS OF FINANCE

A FEW GOOD MEN

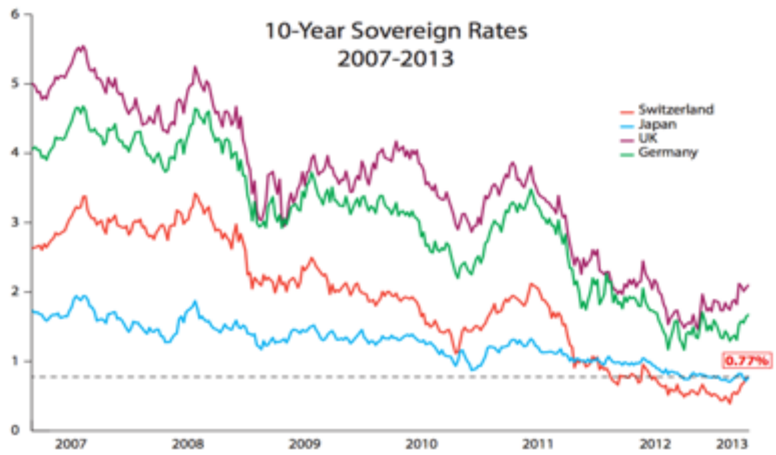
For four years rich-world central bankers have done their best to rejuvenate economies with conventional and unconventional monetary policy without great success. Policy rates in the U.S., U.K., Europe, and Japan are near zero while bond-buying programs are meant to drive down long-term interest rates to spur spending and investment and to flood the financial system with money.

The central banks' balance sheets are the new policy tool against a deflationary depression. **As interest rates embarked on a multi-year decline from the 1980s on, central bank balance sheets are now set to embark on a multi-year climb.**

Over the past year, central banks in the advanced economies have continued or even expanded their purchases of government bonds and their support of liquidity in the banking system. **At $18 trillion and counting, the aggregate assets of all central banks now stand at roughly 30% of global GDP, double the ratio of a decade ago.**



Source: Bloomberg



Source: Bloomberg

A BRAVE NEW WORLD OF CENTRAL BANKING

The era when monetary policy was simply about controlling inflation is over. Globally, central banks are now edging down monetary policy paths that can be viewed as increasingly backstopping budget deficits as lawmakers of respective governments continue to fail to make progress toward fiscal consolidation. **A progression down this road could lead to a series of unintended consequences.**

We believe this process is well underway and will accelerate as social unrest, the worst demographics in 500 years, and massive unfunded liabilities push governments to instruct central banks to directly fund deficits. The first country to openly acknowledge this step is the Bank of Japan, which is under enormous pressure to reflate aggressively. Governments are elected, central bankers are not. In the end when the pressure takes hold, central bankers have to do what they are told, in this case – ultra and unlimited monetary ease. It they don't comply, they will be replaced.

The primary issuance of government debt will remain elevated for the foreseeable future and that the burden of absorption of government debt by the domestic financial sector – including the central bank – will remain onerous. In turn, this development bears a direct threat to the independence of these central banks. To the extent that the central bank is driven to accumulate government securities at artificially inflated prices (and repressed yields), either such purchases must be i) held to maturity (implies that the central bank will not have the freedom to contract its balance sheet in a timely manner in order to tighten quantitative monetary policy) or ii) the government must be prepared to underwrite the capital losses realized from the sales of such securities in a normalized yield environment.

A central bank that is beholden to government in this way has lost its independence. Its objective has been subtly realigned to the preservation of the creditworthiness of the sovereign.

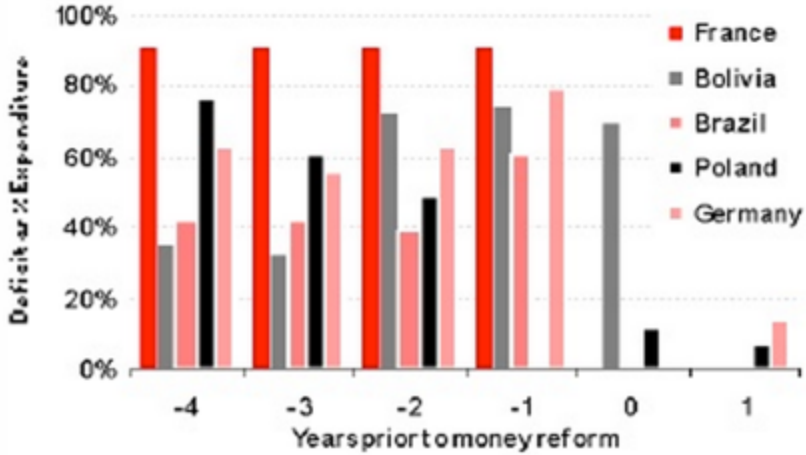
INFLATION: THE NEXT FINANCIAL TRAGEDY

As central bank balance sheets are essentially co-opted in the financing of perpetual fiscal deficits, central banks lose their ability to fulfill an inflation mandate. Fiscally-profligate, advanced economies, including U.S., Japan, U.K., France, Italy and Spain, are playing with inflationary fire as they consider alternatives to a disciplined programme of deficit reduction.

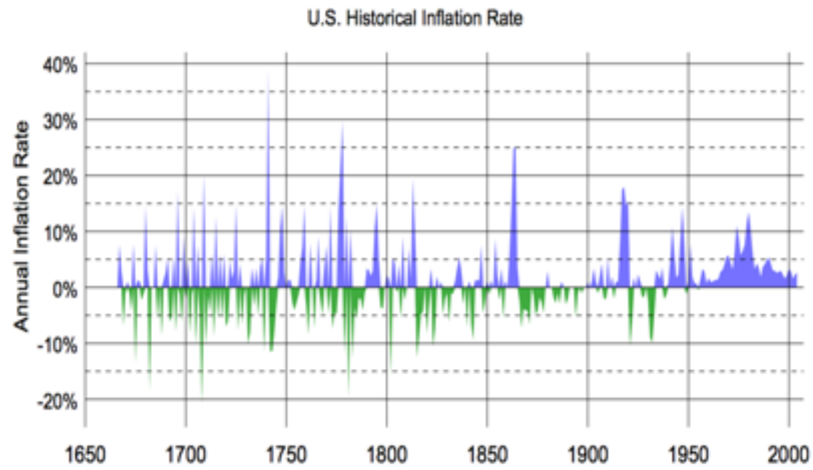
According to Dylan Grice, if we look back through time at inflationary crises – from ancient Rome, to Ming China, to revolutionary France and America or to Weimar Germany – uncontrolled inflations are primarily caused by overleveraged governments which resorted to money printing as the easiest way to avoid explicit default. We believe inflation will ultimately prove to be the path of least political resistance. It is merely a question of time before the global inflationary movement gets underway.

Today our central bankers are as confident in their ability to control inflation as they were in the soundness of the financial system in 2006. Hubris has played the lead role in all great financial tragedies. The stage is set for the return of inflation.

Budget deficits before five hyperinflations



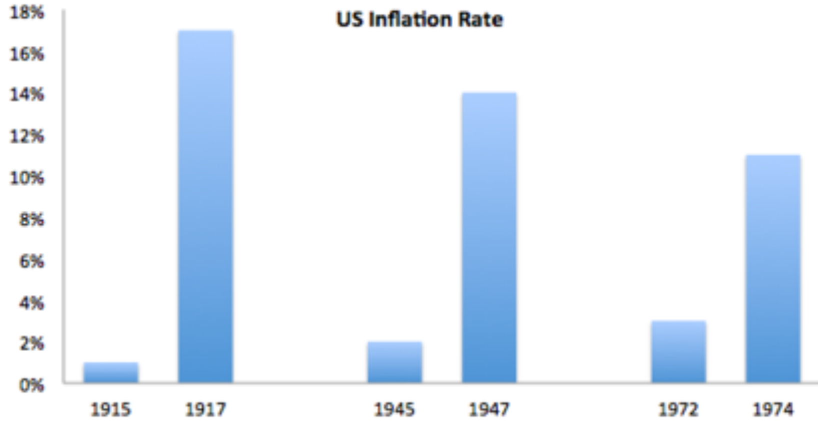
Source: SG, Bernholz



Source: US Treasury

The past suggests problems ahead

There are plenty of examples in history showing that once inflation takes hold, it can quickly spiral out of control. According to Amity Shlaes, a senior fellow of economic history at CFR, U.S. inflation was 1% in 1915. Over just two years, it hit 17%. As she states, it happened because the Treasury "spent like crazy on the war, creating money to pay for it." In another case, from 1942 to 1951, the Fed agreed to support massive government borrowing to fund the war effort by purchasing sufficient amounts of Treasury debt to keep interest rates pegged at artificially low levels. The post-War economic expansion ultimately kindled strong inflationary pressures and monetary policy makers were incapable of a response. After much acrimony, the 1951 Accord was agreed to, stipulating a division between fiscal policy and monetary policy in order to safeguard the economy from inflationary pressures.



Source: CFR

In the longer run, the dramatic increase in central bank asset purchases will have to be reversed. It will be a delicate act to sell those assets back into the market when the economy improves and unemployment drops back to levels deemed acceptable. Inflation may well be ratcheting up then and to sell trillions of dollars of assets into the market at that time without causing a sharp spike in interest rates may not be possible. **At that point, the big dilemma for central banks will be whether to let inflation run even higher or risk another asset bust, credit crisis and economic downturn.**

THEME 4

EUROPE (BREAK-UP)
SUPER SAD TRUE LOVE STORY

Eurozone's loveless marriage

The European Union was created for political reasons. Economic considerations were a means to an end, and that end was to stop the wars that had torn Europe apart in the first half of the 20th century. The key was linking Germany and France in an unbreakable alliance based on the promise of economic prosperity. Anyone who doesn't understand the political origins of the European Union and focuses only on its economic intent fails to understand how it works and can be taken by surprise by the actions of its politicians.

Germany was the main champion of the euro, a single currency controlled by a single bank over which Germany had influence in proportion to its importance. The single currency, with its focus on avoiding inflation, protected German creditors against European countries inflating their way out of debt. The debt was denominated in euros, the European Central Bank controlled the value of the euro, and European countries inside and outside the Eurozone were trapped in this monetary policy.

So long as there was prosperity, the underlying problems of the system were hidden. But the 2008 crisis revealed the problems. First, most European countries had significant negative balances of trade with Germany. Second, European monetary policy focused on protecting the interests of Germany and, to a lesser extent, France. The regulatory regime created systemic rigidity, which protected existing large corporations. The unequal distribution of the cost, both nationally and socially, is the threat facing the European Union.

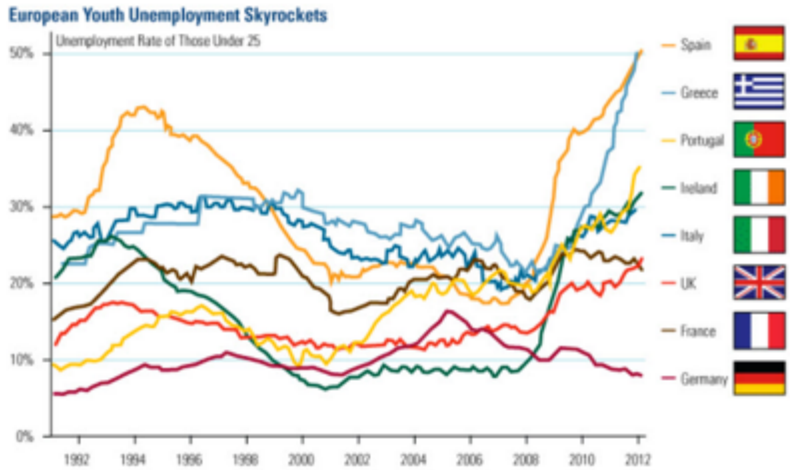
Stratfor believes what started out four years ago as a sovereign debt crisis, morphed into a currency crisis and led to the fall of several European governments, has now triggered a full blown crisis of public confidence: in the economy, in the future, in the benefits of European economic integration, in the euro and in the free market system. **The public is very worried about joblessness, inflation and public debt, and those fears are fueling much of the uncertainty and negativity.**

The young and the restless

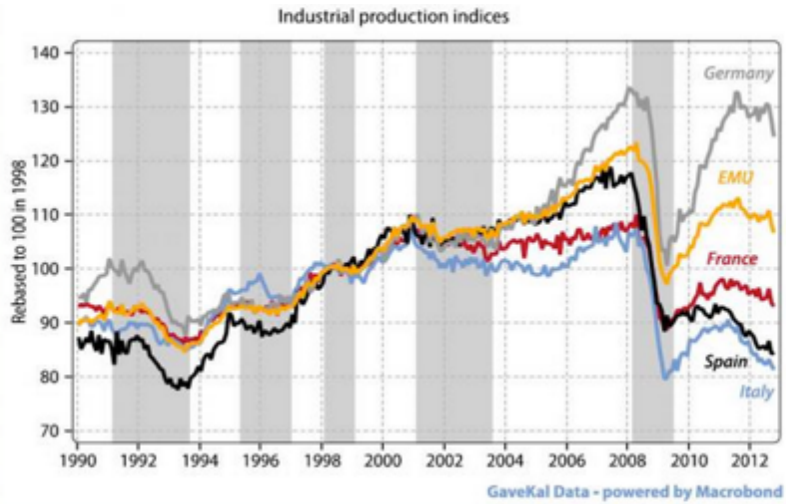
Dramatically higher unemployment has been one of the main social consequences of the European crisis. Average unemployment in the European Union has reached 10.7 percent of the labor force, a significant increase from the 7.2 percent unemployment recorded in the third quarter of 2007, before the crisis began. All told, more than 26 million people are out of work in the European Union.

Overall joblessness is spread unevenly across the Continent. The countries in the Eurozone's periphery have the highest unemployment rates in Europe, with Spain, Greece and Portugal at the top of the list. By contrast, central and northern European countries (Germany, Austria and the Netherlands) have the lowest unemployment rates. This unequal distribution of unemployment affects the way the different countries view the crisis and the strategies each government wants to use to overcome it.

Instead of leading to convergence in Eurozone economies, the union has led to massive divergences, with the strong getting stronger and the weak getting weaker.



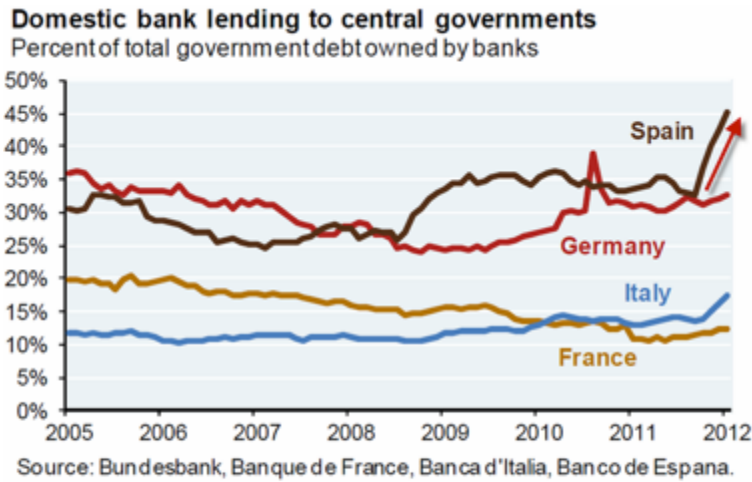
Source: Bloomberg



The inevitability of default

Gloom and doom surround the future of Europe. Troubled countries are facing an increasingly clear choice: i) they can stay in the Eurozone, and face years of endless recession, ii) they can abandon the euro, perhaps bringing immediate catastrophe but giving them the freedom to devalue their new currencies, or iii) they can accept the German offer to surrender sovereignty and accept German leadership and domination of a unified Europe in return for a financial rescue.

We believe bailouts that do not allow recipient countries to grow are doomed to failure and merely buy time. **Ultimately, there will be no choice but to allow countries to default.** This will necessitate a recapitalization of the European banking system.



If Europe is in crisis, the world's largest economy is in crisis, political as well as financial. And that matters to the world perhaps more than anything else. Soon, a new wave of defaults is set to begin.

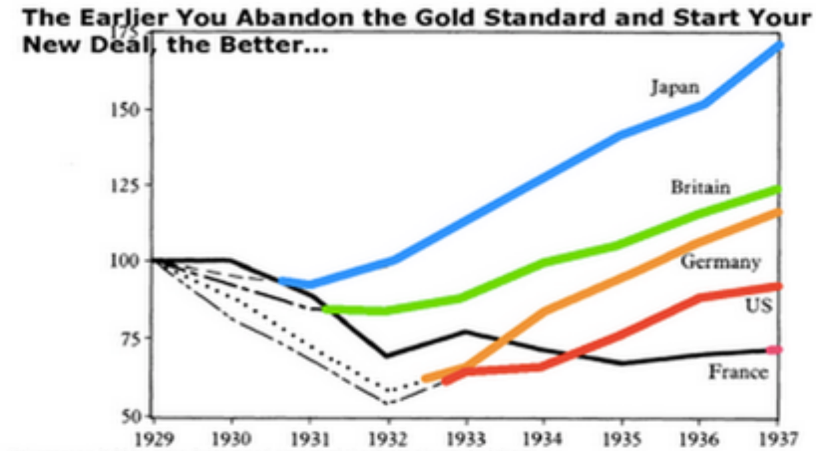
HISTORICAL PERSPECTIVE ON DEBT TRAPS

Debt traps have caused sovereign defaults to soar four times since 1800. The first three episodes began in the secondary depressions after wars – 1837, 1873, and 1933. The fourth was in the early 1980s. During the Great Depression, roughly 50% of the world's countries either defaulted on or restructured their sovereign debt. As part of the solution, every major currency left the gold standard.

Greece has defaulted or rescheduled its debt five times since gaining independence in 1829. In fact, since its independence, Greece has spent 50% of those years in default or rescheduling. Greece left the gold standard on April 26, 1932 and declared a moratorium on all interest payments – the only European country to do so at the time. Greece adopted protectionist policies such as import quotas, and coupled with a weak drachma, stifled imports, allowing Greek industry to expand during the Great Depression. By 1939, Greek industrial output was 179% that of 1928. Problem solved.

We expect a similar outcome ahead for troubled European nations as they decide to leave the single currency union.

Sources: Standard & Poor's; Kenneth Rogoff, Harvard; Carmen Reinhart, U. Maryland.



Eichengreen (1992), "The Origins and Nature of the Great Slump Revisited"

Figure 5. *Indices of industrial production, 1929-1937* (1929 = 100)

Source: League of Nations, *World production and prices*, 1937/8, p. 44.

Breaking up with Bunds

In our view, the next big movement in Europe is for convergence and not more divergence. If the euro breaks up, the Bundesbank will be left carrying the can for its credit position in Target 2 and the German banking system for possibly as much as €1trn. In other words, Germany, and its bond market, will be bust. The other scenario is that Germany or the ECB promises to underwrite a huge program of bank guarantees, in which case, southern European long rates will collapse, while bund yields rise. In other words, once an EMU break-up is on the cards, we are going to get more convergence in European yields one way or the other. The only question is whether that happens within a single currency and a resulting rise in German bond yields, or with different currencies and a resulting collapse of Southern European bond yields.

We favor selling bunds before Germany loses its triple-A rating and before the ECB attempts to override the Bundesbank.

Source: Bloomberg

THEME 5

JAPAN
MRS. WATANABE

The most ugly case of deleveraging

Japan has been stuck in what can only be called an "ugly deflationary deleveraging" for over 20 years. In 1989, the private sector debt bubble burst and the government sector debt and fiscal expansion began. However, there was never adequate "money printing/ monetization" to cause nominal growth to be above nominal interest rates and to have the currency devalue. While Japan has eased somewhat, nominal income growth has been stagnant, with persistent deflation eroding moderate gains in real growth.

Money creation has been limited at 0.7% of GDP per year, and the yen has appreciated 2.9% per year against the dollar. As a result, since 1990 real growth has averaged 1.1% with persistent deflation (averaging -0.5%). This has left nominal growth 2% below nominal interest rates which cumulatively has led to a large increase in the debt/income ratio from about 400% of GDP at the end of 1989 to 500% today.

The BoJ has "printed/monetized" very little in duration-adjusted terms throughout the deleveraging process, with most of the printing that it has done going to short term cash-like assets of little duration. As result, it has failed to reflate sufficiently and the government is building a terrible debt burden. Although, it seems that policymakers are finally grasping the situation.

	Japan: 1990-Present	
Overall Economy		
Nominal GDP Growth, Avg. Y/Y	0.6%	Deflation and weak growth
Of Which:		
GDP Deflator	-0.5%	
Real	1.1%	
Productivity Growth	1.0%	
Employment Growth	0.0%	
Of Which:		
Domestic	0.2%	
Foreign	0.4%	
Monetary Policy		
Nominal GDP Growth - Gov't Bond Yield	-2.0%	Nominal growth below nominal rates
Nominal GDP Growth	0.6%	
Gov't Bond Yield, Avg.	2.6%	
M0 Growth % GDP, Avg. Ann.	0.7%	
Central Bank Asset Purchases & Lending, 10yr Dur., Ann.	0.1%	Limited money creation, mostly i cash like assets
FX v. Price of Gold (+ means rally v. gold), Ann	-3.5%	
FX v. USD (TWI for USA), Ann	2.9%	Currency appreciation

Attribution of Change in Nominal Debt %NGDP		
Total Debt level as % GDP: Starting Point	403%	Debt burden has increased
Total Debt level as % GDP: Ending Point	498%	
Change in Total Debt (% GDP)	95%	
Change in Total Debt (% GDP), Ann.	4%	
Of Which:		
Nominal GDP Growth	-1%	
Real Growth	-3%	
Inflation	2%	
Change in Nominal Debt	6%	
Net New Borrowing	8%	
New Borrow. Above Int. Payments	0%	
Interest Payments	8%	
Defaults	-2%	
Of Which:		
Government Sector	8%	
Private Sector	-4%	

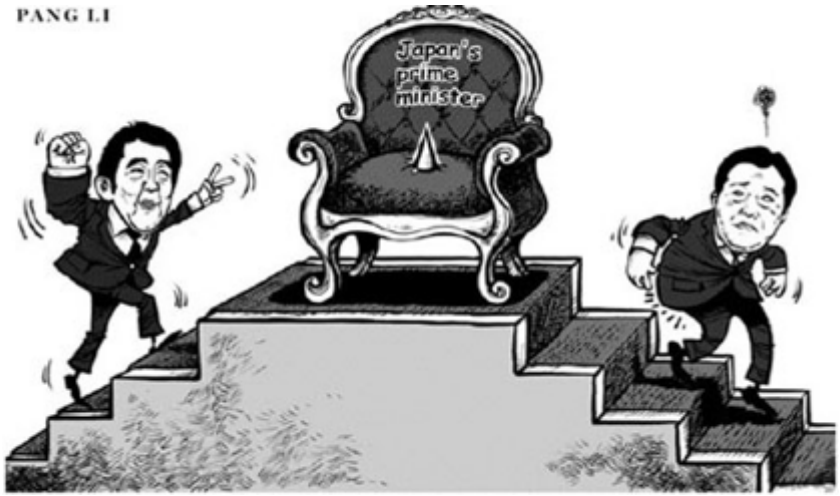
Source: Bridgewater Associates

This time is different (promise)

The BoJ Act was revised in April 1998 to ensure that Japan's central bank would maintain its independence from the government. However, given that the Japanese economy has contracted for the 4th year out of the last five, legislators are increasingly tempted to lean on monetary officials to provide further accommodation.

- On October 30, 2012 the BoJ and Ministry of Finance issued a joint statement entitled "Measures Aimed at Overcoming Deflation", setting the stage for "powerful easing", including an explicit attempt to weaken the yen
- On December 16, 2012 Shinzo Abe was elected Prime Minister with a mandate to end deflation
- On January 22, 2013 the BoJ agreed to a 2 percent inflation target and to make open-ended asset purchases from 2014
- On February 3, 2013 Finance Minister Taro Aso said the government is imitating his Depression-era predecessor, Korekiyo Takahashi, who told the BoJ to underwrite government debt to fund deficit spending

In addition to the actions of the government, there is ongoing discussion amongst politicians of the need to re-write the legislation that governs the BoJ to include a mechanism for the Diet to haul the BoJ Governor in front of a committee once per year to explain his success or lack thereof with regard to hitting the inflation target, and fire him if he fails.



BANK OF JAPAN

To-do list: a laundry list of problems

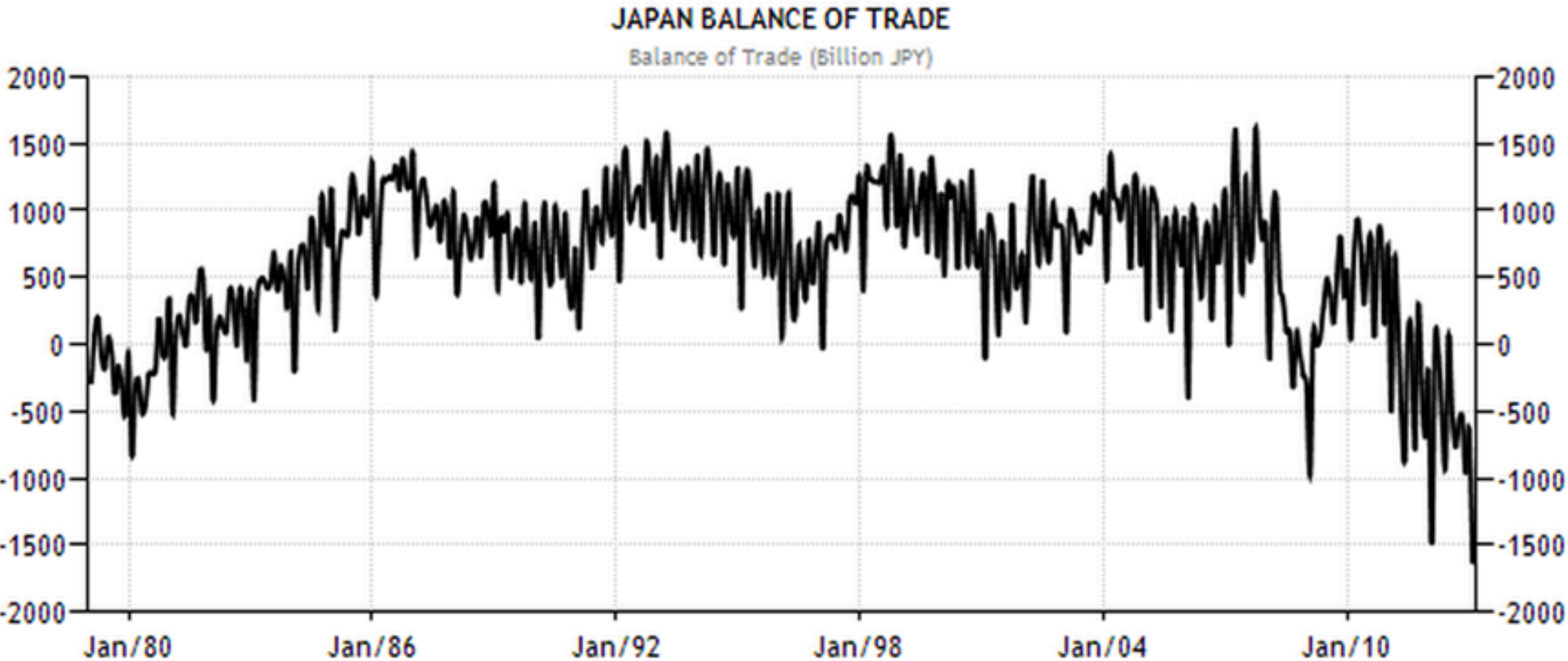
There are only two simple rules to remember when investing in Japan. The first is to never underestimate the amount of pain that the Japanese population can endure. The second is to never underestimate the Japanese policymakers' ability to test the first rule. Just consider the following:

- The country is in such disarray that the current Finance Minister is the 10th Japan has seen since 2006
- The government has run budget deficits for 19 consecutive years and new bond issuances have have outstripped tax revenues 4 years in a row
- The aging population has strangled tax revenues and is inflating expenditure on a growing basis
- Despite repeated interventions by the BoJ a strong currency persists and the the entire current account threatens to turn negative next year
- Energy costs have soared with abrupt closures of nearly all nuclear power plants, increasing reliance on high-cost LNG imports
- Flow of new domestic bond buyers is drying up so fast that the BoJ is now buying a majority of new issuance
- Diplomatic relations with Japan's three largest neighbors: China, South Korea and Taiwan have been thrown into chaos over disputed territories
- The stock market is still down 70% after 23 years

Source: Trading Economics

The big turnaround in trade

Since 1980, Japan consistently held a positive balance of trade – until 2011, when Japan had a trade deficit for the first time in over 30 years. The trend worsened in 2012 and January 2013 saw the trade deficit widen to a new record. The trade balance is facing a structural decline.



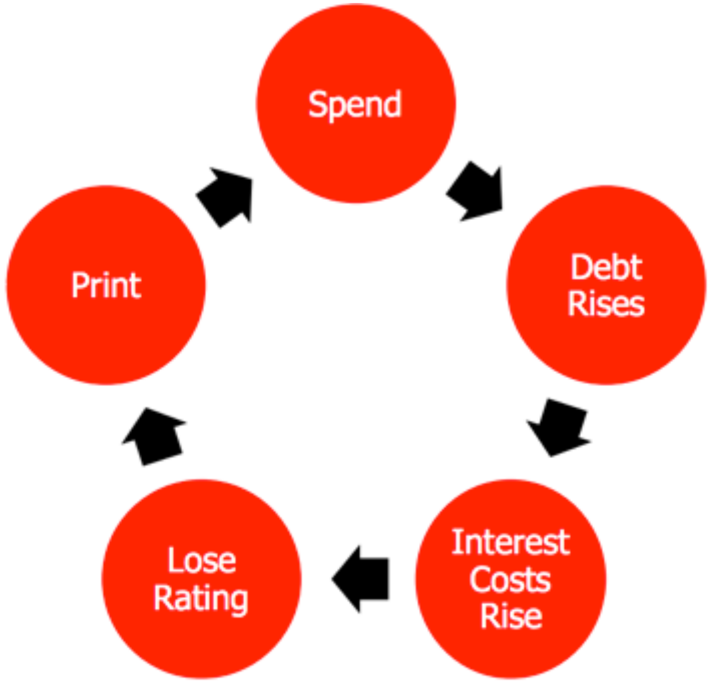
Source: Trading Economics

The Vicious Debt Cycle

Post-2008 crisis, the Japanese government's dependency on bond issuance to fund expenditures and generate revenue has become staggering. **Bond issuance is now responsible for the largest chunk of government revenues at 48 percent.** Poor demographics exacerbate the weak economy being held together by a mountain of debt. Substantial financing needs that cannot be covered entirely by national savings lead to ever increasing reliance on the bond market for expenditures and increasing import costs. The current low bond yields are no panacea, it only buys time for a structural adjustment to take place.

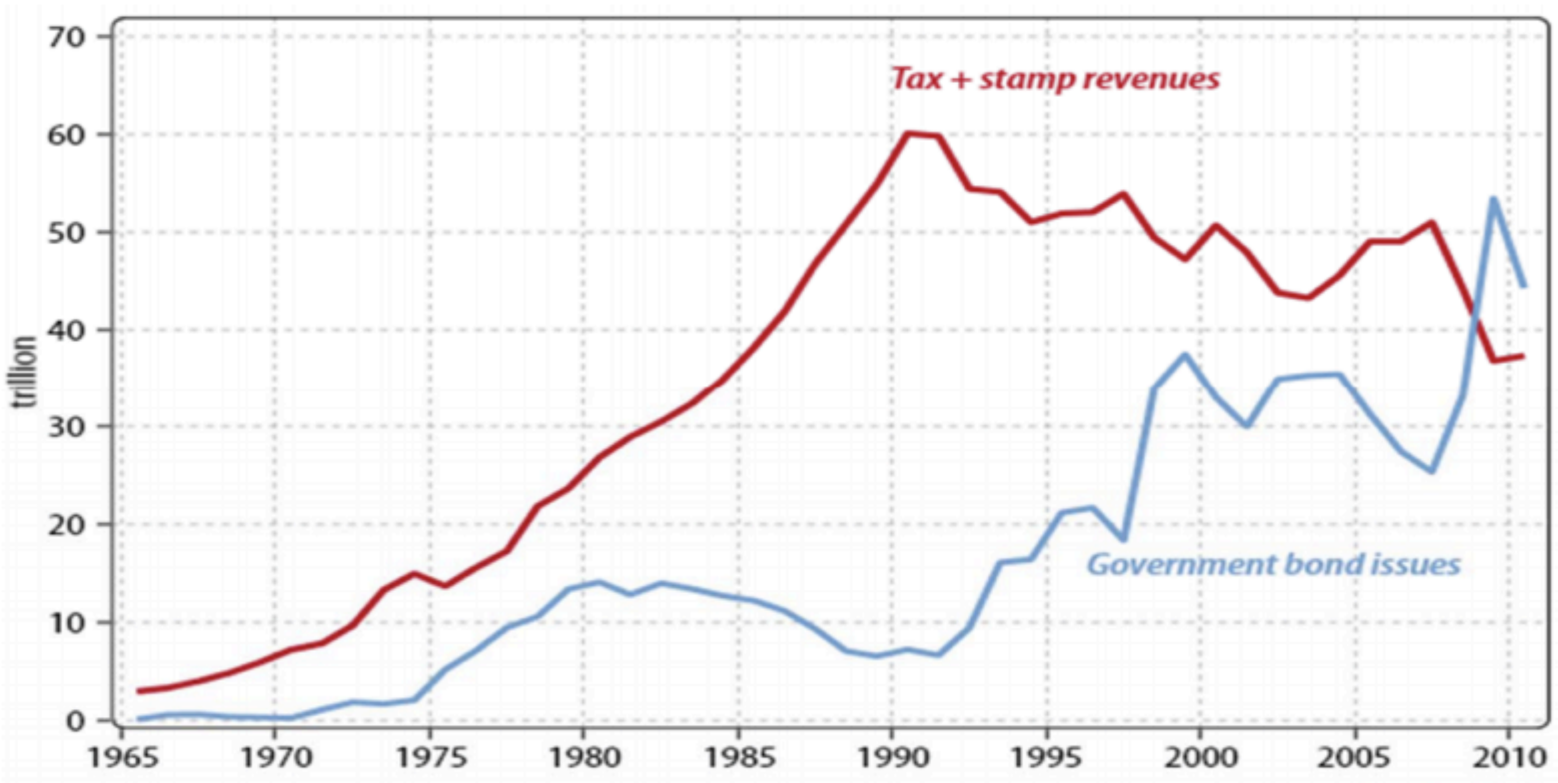
Based on analysis conducted by SG, with bond yields at around 0.8%, 'trend' nominal GDP slightly negative, and on-balance sheet debt to GDP at around 200%, Japan should be aiming for a primary surplus of 3.3% in order to stabilize its debt ratio. Should anything push bond yields higher, even by just a percentage point, the on-balance sheet debt situation will become explosive. The 8% contraction required to rein in Japan's current debt ratio is politically impossible. And note, the estimated 8% required contraction assumes the Japanese government can continue to fund itself at a near 1% JGB yield, which is clearly unrealistic.

Debt service is already 35% of government revenues at existing yields. **It would only take a 2.5% rise in interest rates, to an average of just over 3.5% for debt service costs, to consume 100 percent of government tax revenue. This is known as the "Keynesian end-point", when interest on debt alone would exceed revenue.**



Crossing the Rubicon

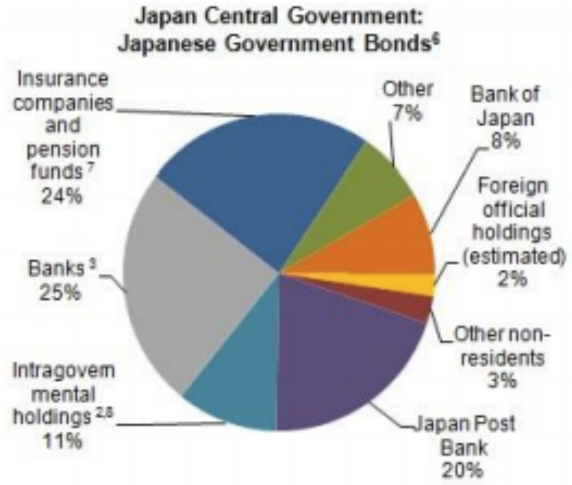
For the past few years, Japan has been issuing more debt than it collects in general revenues. This policy path is not sustainable over the long-run.



Source: GaveKal Research

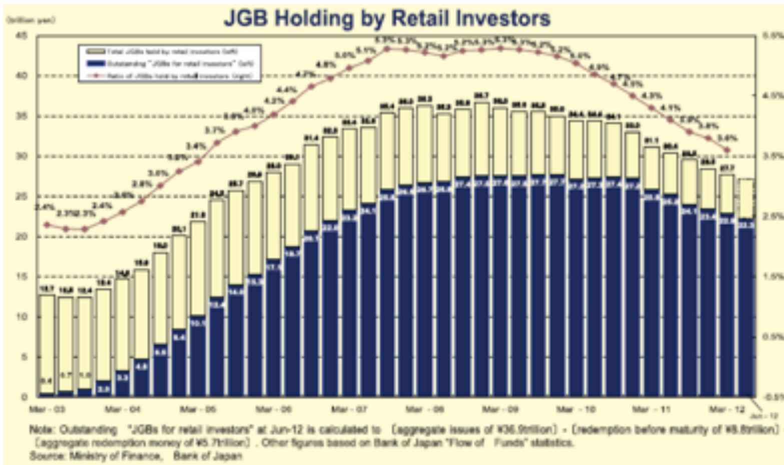
A slow unraveling of the JGB market

Historically, over 90% of Japanese government debt was bought by domestic investors, with the largest holders being Japanese institutions. But as the Japanese workforce nears retirement, it seems likely that many would switch from being net savers to net spenders, drawing down their bank and pension funds. **The Bank of Tokyo Mitsubishi projected that net household savings would become negative by 2014 or 2015.**



Source: IMF Fiscal Monitor

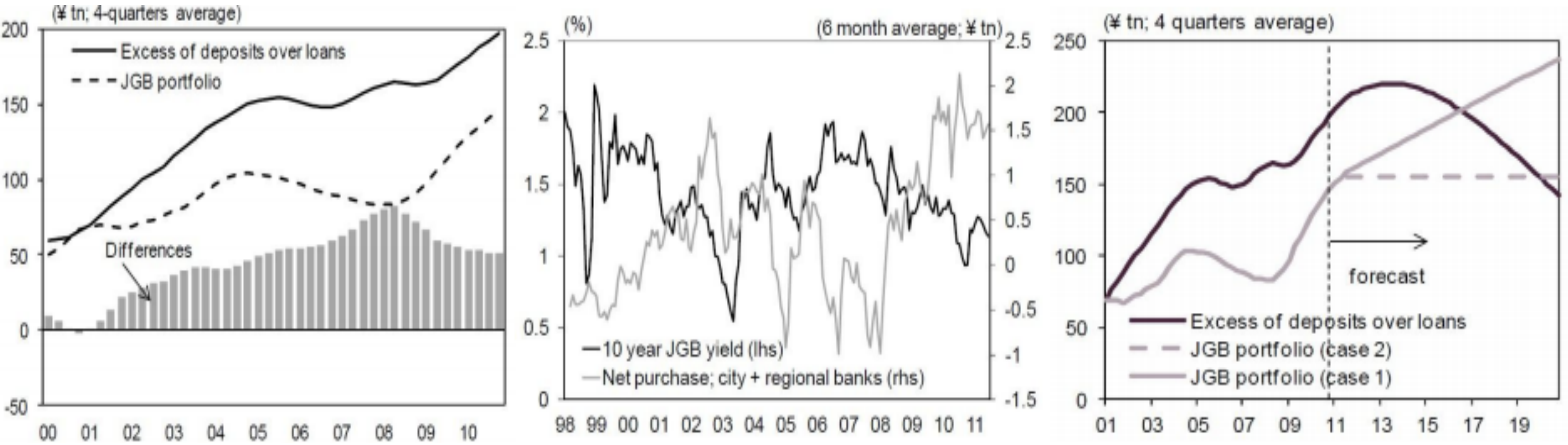
Takahiro Kawase, the head of Japan's $1.2 trillion Government Pension Investment Fund (GPIF) made an important statement in 2009, "The big change this year for us is that there is zero new money to invest, so we may need to be a seller in the market to meet the pension benefits. Our bond allocations are overweight, so we may need to reduce those a bit to raise cash." GPIF holds 67% of its total assets in domestic bonds, and 11% in Japanese stocks. **GPIF has only 10% of its assets in foreign bonds and 12% in foreign equities, and is now considering re-allocating a higher proportion of its assets to offshore markets.** In April 2010, Bloomberg reported that Japan Post Bank, the largest holder of JGBs on the planet, planned to cut their budget for government bonds by 30% going forward.



Japanese debt markets have been stable for such a long time that it's very difficult to imagine anything different, so we don't imagine anything different and predict that the future will look like the past. We believe that would be a big mistake.

The widow-maker

In our view, the key to understanding what will cause a shift to higher JGB yields is in the 3 images shown below: a) Excess deposits enter a drawdown period => b) Lower deposits cause banks to reduce JGB portfolios => c) JGB portfolio liquidation leads to higher yields, similar to what occurred in 1999, when JGB yields jumped from under 1% to over 2%. According to the IMF, the effect from a 1% decline in deposits results in a decline of 0.5% to 0.86% in banks' holdings of JGBs. This effect is found to have increased in recent years.



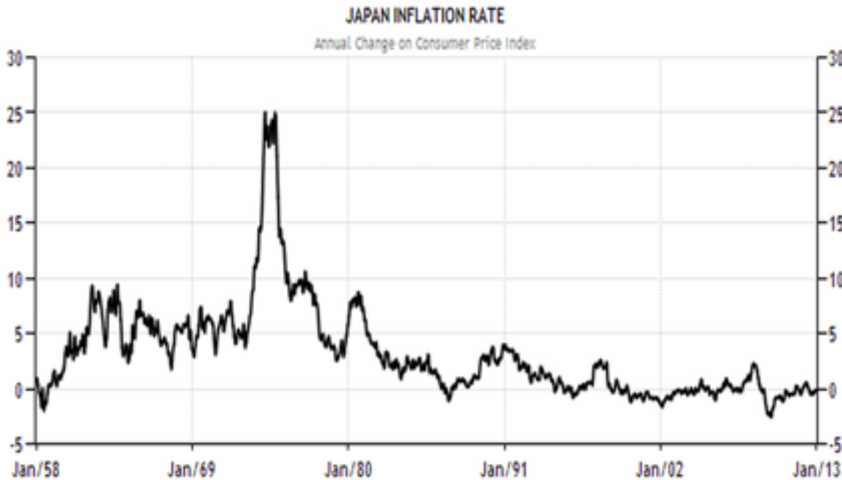
Source: GS, IMF, Yaser Anwar

Inflation: be careful what you wish for

Reinhart and Rogoff say that one of the telltale early signs that governments are struggling to maintain market confidence and risk inflation is when debt maturities decline. This is what is happening in Japan today. The average duration of Japanese government debt is now under 6 years. The vehicle of choice for the Japanese government has been shorter-term bills, not JGBs. **Once the BoJ is forced into monetization of government deficits, even if only with the initial intention of stabilizing government finances in the short-term, it will prove difficult to stop.** When it becomes the largest holder and most regular buyer of JGBs, Japan will be on its inflationary trajectory.

Peter Bernholz's study of hyperinflationary episodes over the centuries shows that deficits amounting to 40% or more of expenditures cannot be maintained and lead to high inflation or even hyperinflation. There's no one specific figure that indicates a blow up or not, it could be as low as 30% or as high as 80%. **The current ratios for Japan are well within that range as budget deficits have run above 30% for the last decade and currently stand at more than 40% of government expenditure.** Although bond vigilantes have not yet woken up, we believe that a global fiasco is brewing in Japan. The coming inflation is going to wreck the JGB market.

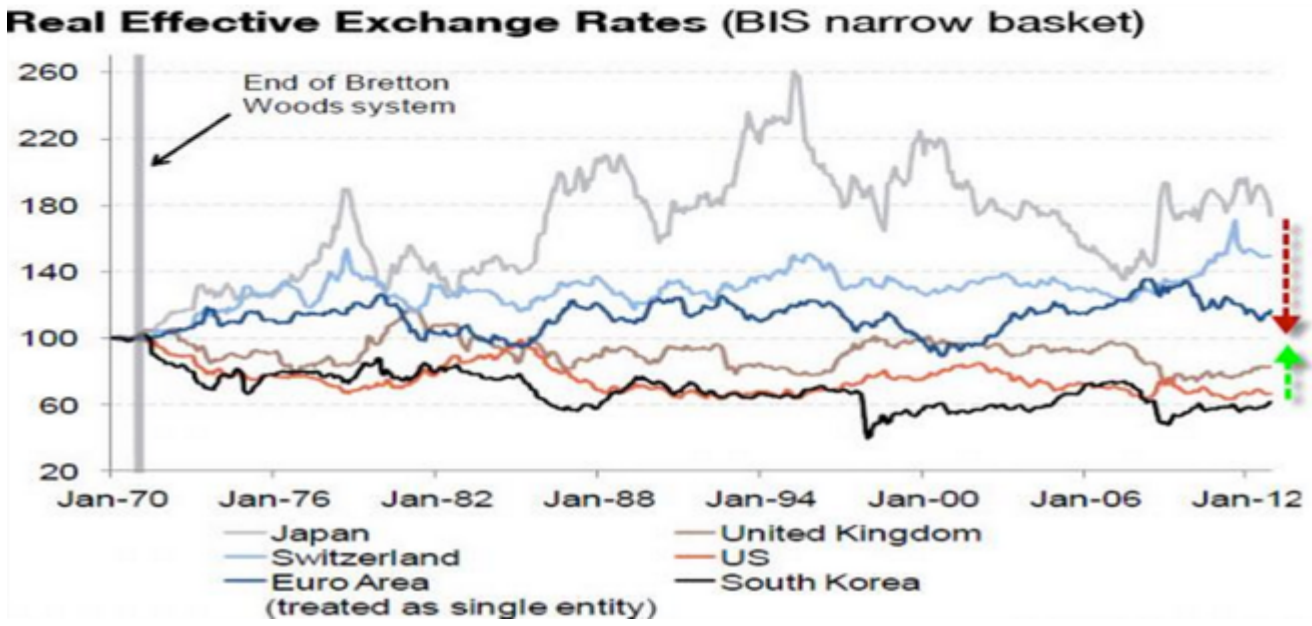
Japanese are simply unable to perceive the risk of inflation because they cannot imagine it. **But Japan's history has 3 distinct periods of high inflation (CPI >20%): i) 1917-1919, the WWI years , ii) 1945-49, immediately after the end of WWII; and iii) 1973-74, the first oil crisis and the only period with high inflation for reasons other than war.** Conventional wisdom argued that high oil prices were the primary culprit but the inflation rate already reached 10% several months before the Middle East crisis, which occurred in October 1973, and the primary cause was government interference in BoJ decision making to keep the yen undervalued and avoid restraining credit.



Source: Trading Economics

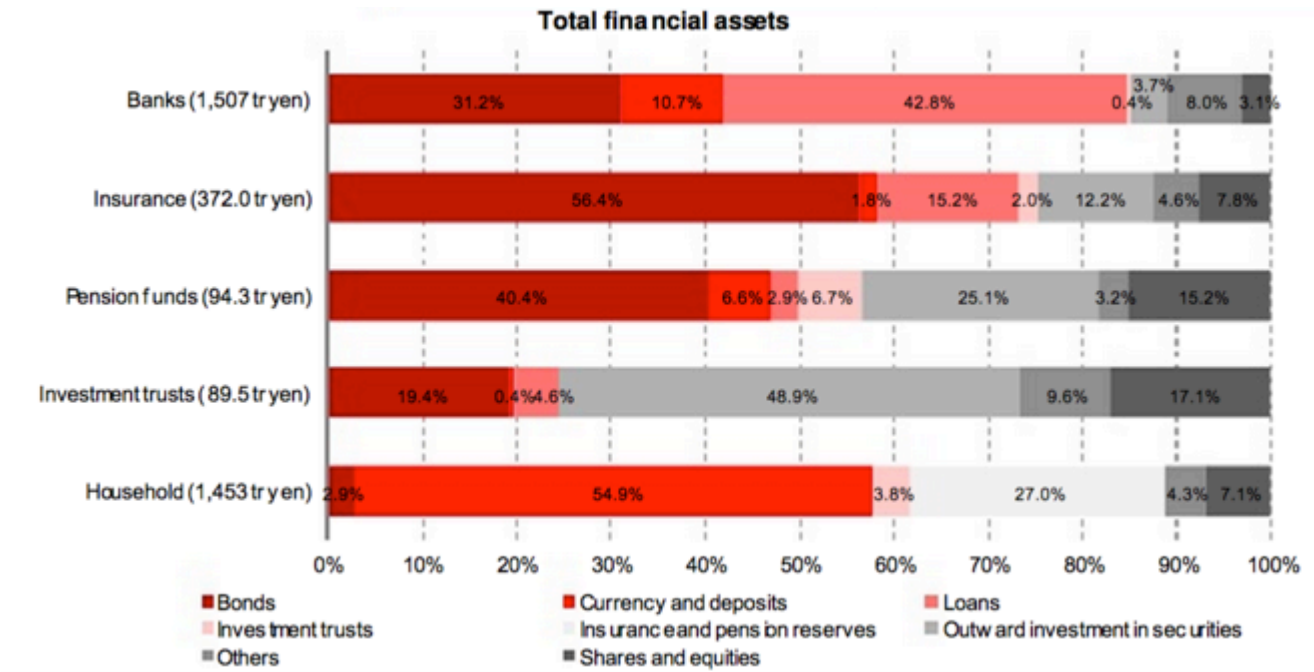
THE YEN WILL LOSE STRENGTH THIS DECADE

From a low in 1985 to the high in 1988, the Yen rose by 118%. Subsequently it corrected until 1990 by 25%. From the low in 1990, the Yen rose to a high in 1995 by 98%. Thereafter, it sold off again by 45% to a low in 1998. Following a trading range of between 145 and 100, the Yen rose yet again between 2007 and November 2011 by 67%. The bear-market in Yen has started now and could last for some time. Japan's currency is 80% stronger now than in 1971 while the U.S. and South Korea are about 40% weaker. There is plenty of room for the currency to devalue further. A self-fulfilling feed-back loop of Yen depreciation could be exacerbated as Japanese overseas subsidiaries delay their repatriation of foreign income and dividends if they anticipate further Yen weakness, which would cause further deterioration in Japan's current account.



THE SUN WILL SHINE ON JAPANESE STOCKS

The TOPIX 30 consists of the largest JPY companies whose sales primarily come from outside Japan, and indirectly are short significant USDJPY. So in a scenario where the BoJ is compelled to create inflation, equities would benefit, as per the case during periods of hyperinflation. Japan's financial system largely depends on JGB stability while Japanese equities are under-owned.



Source: SG, BoJ

Mrs. Watanabe corners the globe

Japan is going through a monumental change. The attitude of policymakers is changing and we expect to see that reflected in aggressive monetary actions and supportive fiscal measures which will result in a sharply weaker currency. The combination should also logically lead to a re-pricing of a number of assets around the world. **This is far from just a JGB market problem, which is a key source of liquidity for global pension funds, insurance companies, SWFs and reserve managers.** Japan is the fourth largest exporter in the world and second largest consumer of U.S. Treasuries.

Dylan Grice warns: as the Japanese situation gets out of control and/or Japan's retirees age and run down their wealth, Japan's policymakers will be forced to sell assets, including U.S. Treasuries currently worth $750 billion. **At nearly 10% of the outstanding U.S. Treasury stock, this might well precipitate other government funding crises** (bearing in mind that the Japanese model is the argument buttressing confidence in Western government bonds in the face of deteriorating fiscal conditions). At the very least we expect it to trigger an international bond market rout scary enough to spook all other asset classes.

THEME 6

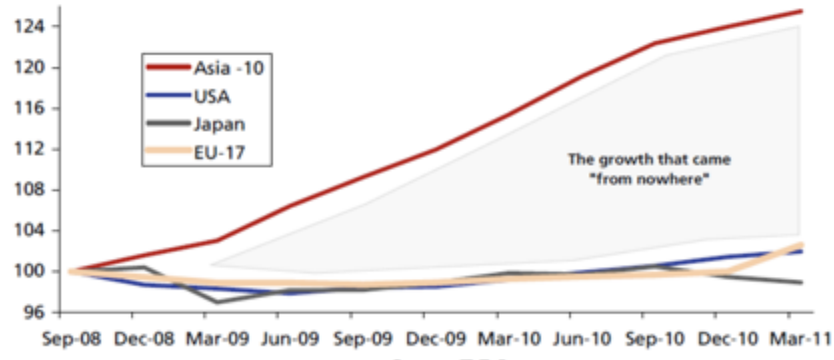
THE RISE OF THE ASIAN CONSUMER

RICHISTAN

The new emerging middle-class

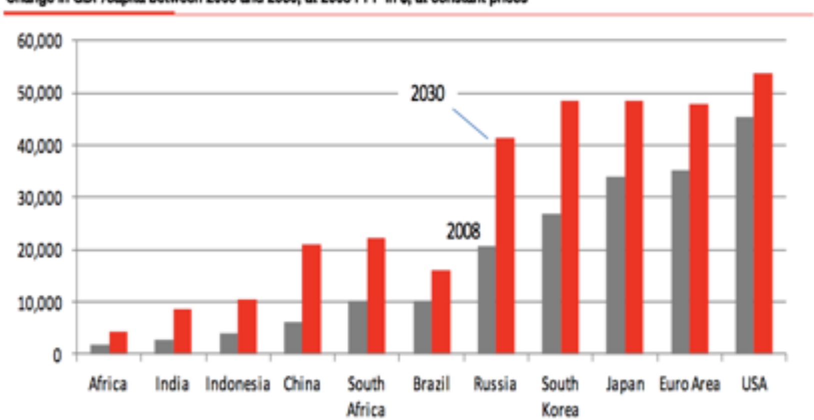
When poor people in poor countries get richer, the first thing that they do is to save. But at a certain level of wealth, people save less and consume more. **The "sweet spot" of consumption in emerging economies is between $3,000 to $10,000 per capita GDP**. So, while up until now less than one billion people have accounted for three-quarters of global consumption, over the course of the next two decades, the new Chinese, Indian, Indonesian, Latin American and African middle classes will bring an additional two billion consumers with similar needs and aspirations as today's North American, European and Japanese consumers. By 2020, Asia's middleclass population will more than triple from today's 525 million to 1.7 billion people, at which time Asia will comprise roughly half of the world's total middle-class population.

Real global consumption (3Q2008=100, seasonally adjusted)



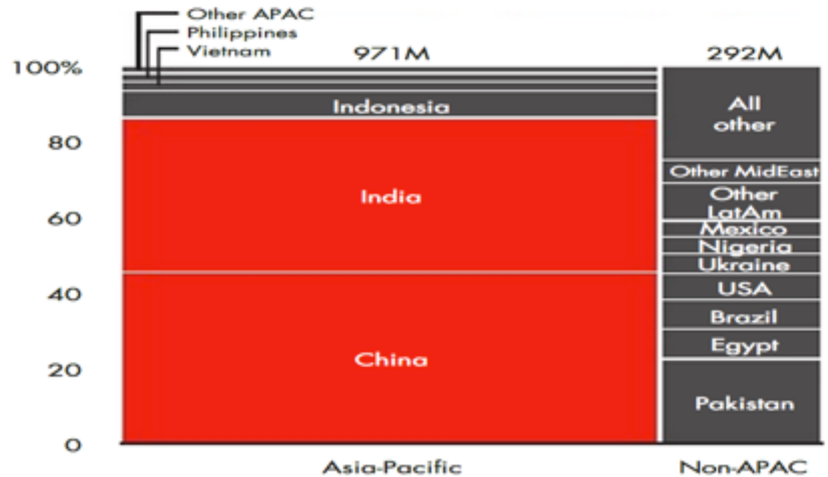
Source: DBS

Change in GDP/capita between 2008 and 2030, at 2008 PPP in $, at constant prices



Source: SG

Share of the 1.3B growth in global middle class between 2010–2020 (forecast)



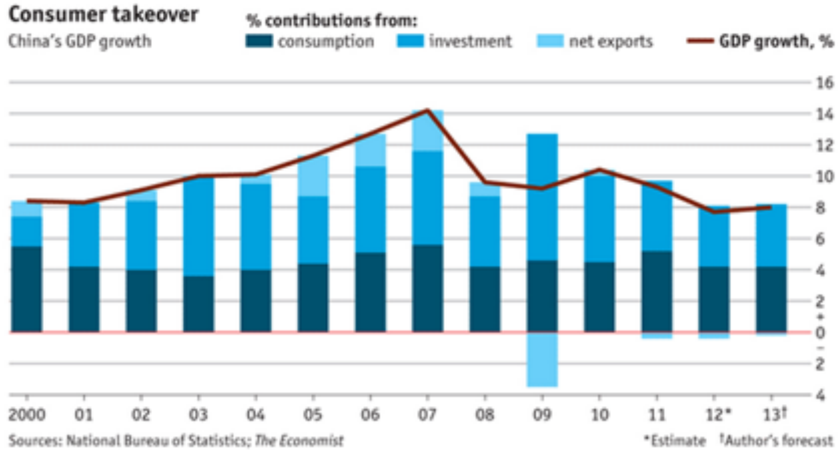
Source: Bain Consulting

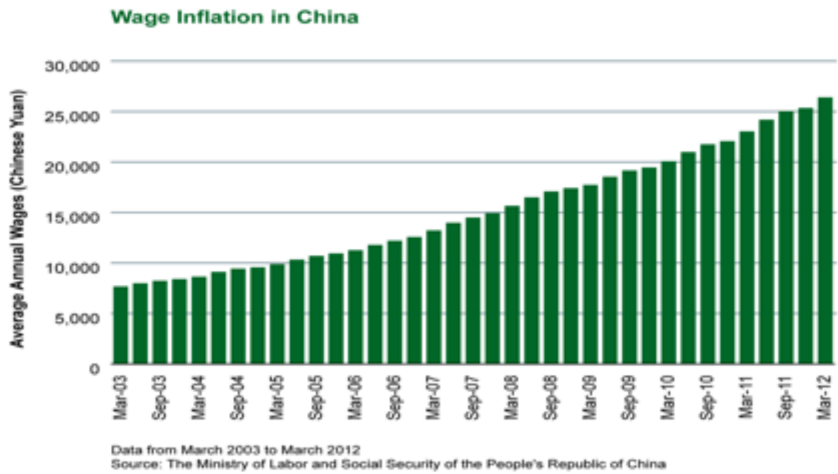
China's consumer fairy-tale

China is at a critical turning point. **With its export markets increasingly saturated, the country has no choice but to shift its growth model from investment and exports to domestic demand and consumption.** Over time, China's household saving rate will gradually decline. Rising disposable income, an aging population, the expansion of household credit, and an improving social safety net will all support domestic consumption.

Real private consumption growth has averaged 10.1% per annum over the last two decades, outpacing every other major country. China's monthly retail sales are approaching those of the U.S. in dollar terms. The potential for China's consumer story and the growth of its middle class is enormous. China is now the world's largest auto market and the second largest luxury goods market.

If one defines the middle class as those who earn between \$6,000 and \$30,000, China now has roughly 335 million people whose incomes fall in that range, compared to 50 million in the U.S., and by 2020 over 75% of Chinese income-earners will belong to this middle class, up from 25% today. To put this in some perspective, approximately 740 million Chinese people will join the middle class club over the next decade, more than Europe's entire current population.

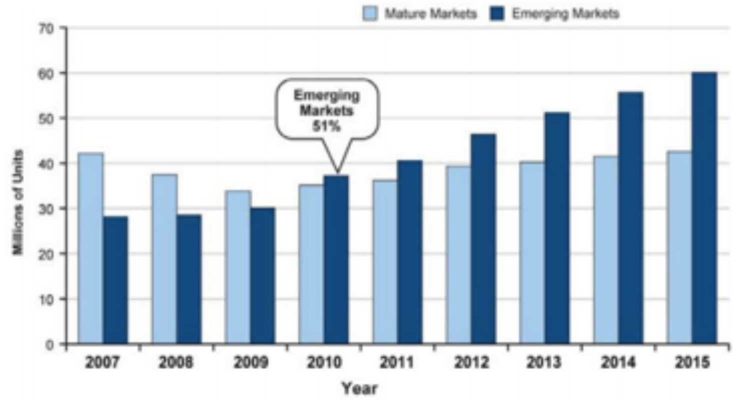




The Growing Auto Industry

China's new car market will grow by 15% annually to 2016. In addition to the new car market, China's passenger car fleet will grow from around 60 million in 2010 to more than 145 million by 2015, according to AlixPartners. By 2020, two out of every ten Chinese individuals could own an automobile. Total sales are expected to exceed 30 million units by 2020 in China, assuming an annual growth rate of 5.3% in the next decade. In Southeast Asia (Indonesia, Malaysia and Thailand), annual demand for motor vehicles is expected to expand at an even faster rate of 10.5% per year from 2.2 million units in 2010 to 5.9 million units in 2020.

Global Light Vehicle Sales, Mature & Emerging Market Proportions

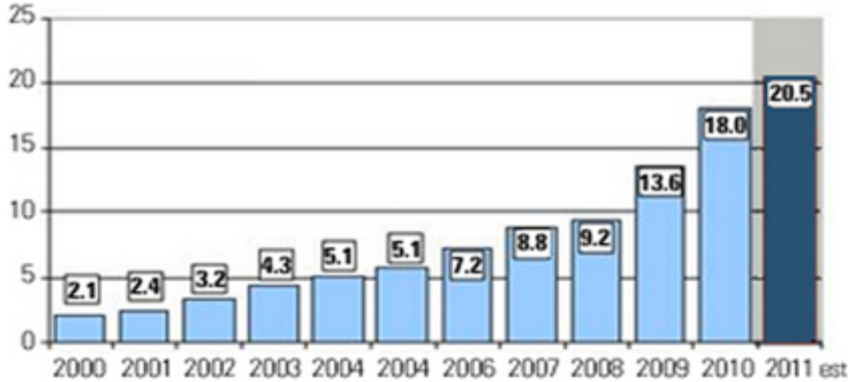


Source: J.D. Power & Associates

Despite rapid growth in automobile sales in recent years, the penetration rate is still below 100 cars per 1,000 inhabitants in China (compared to about 500 cars per 1,000 inhabitants in the developed world), implying huge upward sales potential in the future. Consider that Japan's ownership rate is over 300 cars per 1,000 inhabitants. If China grew to half of this level, it would imply a total number of 200 million cars, about 200% above current levels. Given this market potential, as well as its likely impact on other support industries, **the urgency of understanding China's auto industry has never been greater.**

China Total Vehicle Sales

Annual units sold in millions



In China, per capita GDP reached $1,000 in 2000. In 2010, when it reached $3,000 the growth of car sales grew exponentially, from 1 million to 18 million. In the next 5 years, when per capita GDP reaches $6,000, some 460 million people will be able to afford a car. How many people actually forecast that China's car sales would actually be 15 million or 17 million? Zero. And that's the point. The point is that non-linearity of demand is very difficult to forecast.

Living luxuriously

The luxury-goods market is booming. By 2015, China is expected to have four million wealthy households, defined as having annual household income exceeding 250,000 yuan ($38,000), making it the world's fourth-largest host of wealthy households after the U.S., Japan and the U.K. Although these wealthy households currently account for less than 1% of total urban Chinese households, they are growing quite rapidly, with the number projected to increase by 16% annually over the next five years.

According to McKinsey, sales of luxury items in China may more than double within five years to 180 billion yuan ($27 billion) in 2015. CLSA forecasts that demand for luxury goods and travel from Greater China will account for 44% of global sales by 2020, up from 15% currently.

The wealthy consumers in China are about twenty years younger than their counterparts in the U.S. and Japan, with 80% younger than 45 in China, compared to 30% in the U.S. and 19% in Japan. **In our view, multinational companies with the strongest global brands will enjoy the greatest opportunities in China.**

Buying into a local franchise

We find dominant consumer businesses to be excellent long-term compounders of capital: secular volume growth, pricing power and high margins due to strong 'moats', low capital intensity, scalability once distribution is in place and typically without much cyclicality or balance sheet risk in a downturn. The beauty of investing in a listed minority equity of global FMCG companies is highlighted by our friend Yaser Anwar:

- Proven business models in the world's fastest-growing markets
- Best-in-class management and governance in difficult markets protects against fraud
- Benefit from global brand portfolio, innovation, credibility with suppliers, scale in sourcing, and balance sheet strength of parent
- Strong alignment with parent who values local listing and can access cash only via dividends

Many of the best consumer companies have listings in emerging and frontier markets: Nestle, Unilever and Colgate-Palmolive are just a few examples.

Source: Bloomberg

Source: Bloomberg

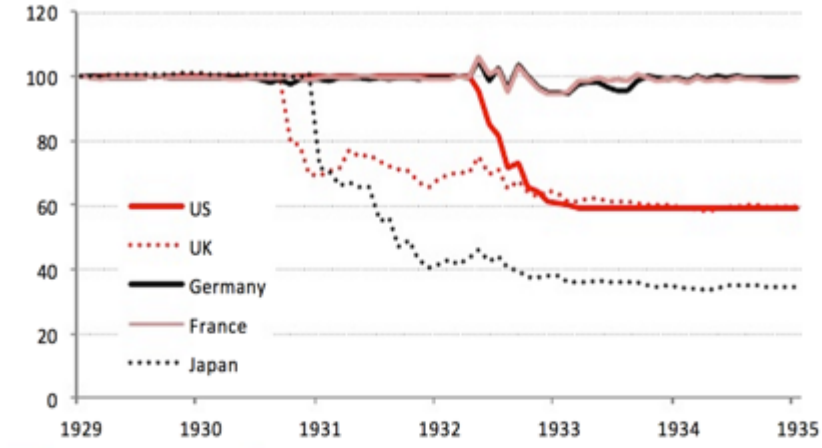
THEME 7

CURRENCY GAMES

DEVIL TAKE THE HINDMOST

LEARNING FROM THE GREAT DEPRESSION

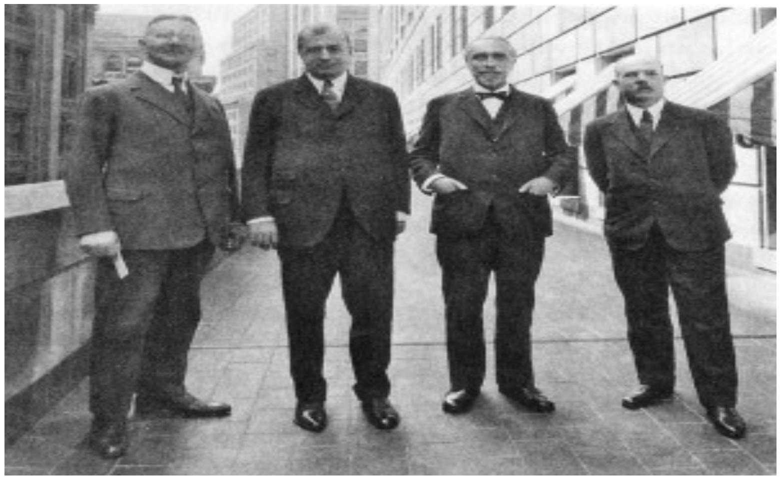
The most significant currency war began after the 1929 Wall Street Crash, when France lost faith in British Sterling as a source of value and began selling it heavily on the markets. France and the U.S. began building hoards of gold, which inevitably contributed to the Sterling crises of 1931; whereby Britain took the pound off the gold standard (see chart on right).



Source: SG, GFD

A "beggar thy neighbor" policy became entrenched as nations competed to export unemployment, via currency devaluation. The fluctuations in exchange rates were harmful for international traders. Global trade declined sharply as a result and was also disrupted by retaliatory tariffs.

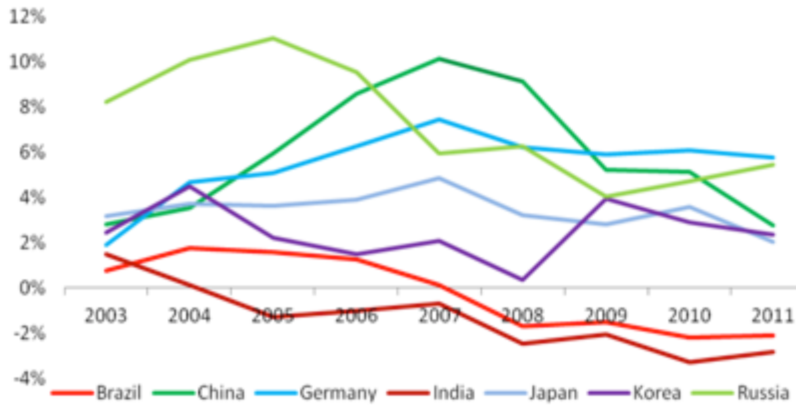
According to BCA Research, the rolling currency devaluations only ceased when France, Britain and U.S. created the Tripartite Agreement, which was informal and provisional, but nonetheless successfully stabilized exchange rates. World trade still did not recover until much later.



Bonfire of the Currencies

Over the past decade, current account surpluses relative to GDP have been shrinking in major countries around the world. If future growth appears to be more of a zero-sum game, with some countries and regions trying to gain advantage over others, then we should anticipate more competitive devaluations in the race to garner an increasing share of the export pie. **The combination of shrinking worldwide growth and "beggar-thy-neighbor" policies could get far enough out of control that war becomes the last resort.**

Current Account Balances-To-GDP Ratios, 2003 - 2011

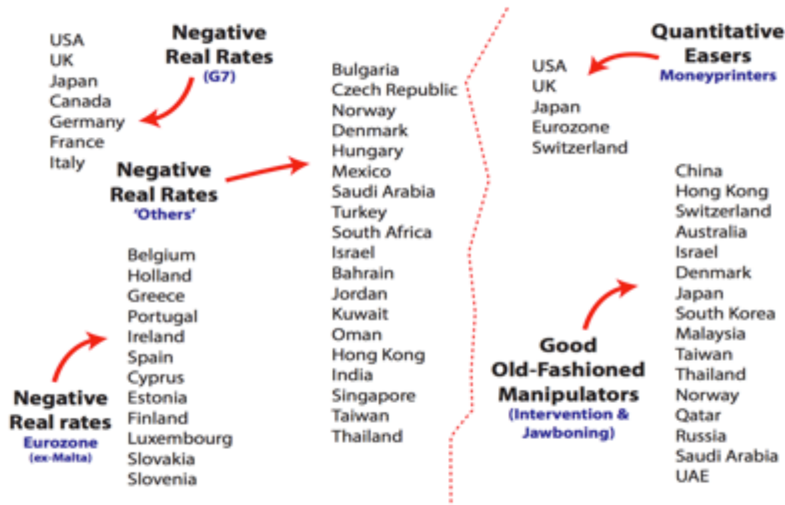


Source: IMF WEO Database, April 2012

RECORD OF CURRENCY CRISES

"Vesuvian Tremors", as with the volcanic eruptions of Mt Vesuvius on 24 Aug 79AD, are a forewarning of the "Coming Currency Crisis"

1994	Mexico
1996-97	Thailand, South Korea, Philippines, Indonesia
1998	Russia
1999-02	Argentina, Brazil, Turkey
2000	Ecuador, Zimbabwe
2001-08	USA
2004-07	Japanese Yen
2008-09	Australian Dollar, British Pound, New Zealand Dollar
2009	North Korea
2010	Greece, Latvia, Romania, Hungary, Portugal, Iceland
2011	Greece, Italy, Spain, Portugal, Ireland
2012	Iran Rial, Venezuelan Bolivar



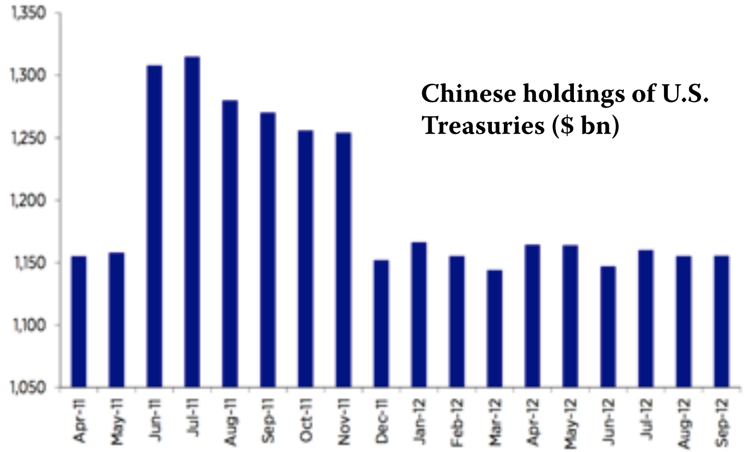
Source: Raoul Pal, Global Macro Investor

The death knell for the dollar

The peak and decline of current account surpluses around the world also suggest that the deficit countries that have traditionally benefited from surplus countries ultimately will be forced to rely on their own central banks to meet the capital-supply gap, which is what has occurred in the U.S. The Fed will be buying about 90% of the country's new issuance in treasuries and mortgage bonds in 2013.

According to Guggenheim Partners, central banks from Brussels to Beijing are once again over allocated to U.S. Treasuries. At some point, these institutions will seek greater portfolio diversification and the U.S. will lose its ability to foist debt on the rest of the world. **Following Bretton Woods' collapse, Japan reduced its Treasury holdings by over a third. Will China repeat this when Bretton Woods II collapses?**

China is showing a marked reluctance to continue funding U.S. deficits as its holdings of U.S. Treasuries have fallen by approximately $160 billion. S&P downgraded the U.S. AAA sovereign credit rating on 5 August 2011 and Chinese holdings of U.S. Treasury bonds peaked at $1.3 trillion in July 2011.



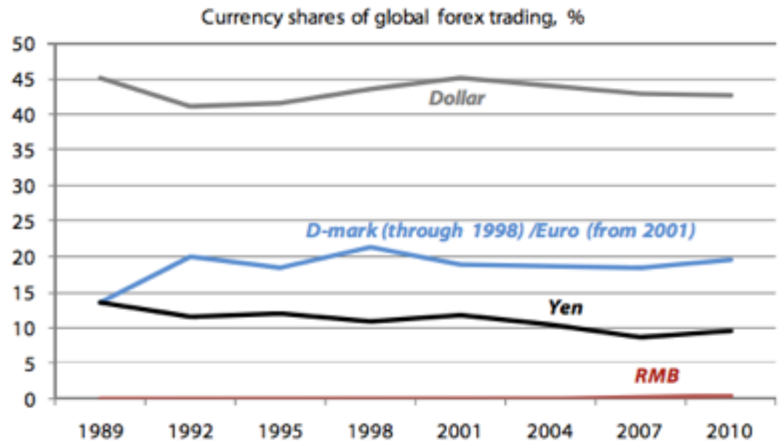
Source: US Treasury

RMB Internationalization

China is now the center of a growing percentage of both Asian, and emerging market trade. As a result, China is increasingly asking its EM trade partners why their mutual trade should be settled in U.S. dollars? After all, by trading in dollars, China and its EM trade partners are making themselves dependent on the willingness/ ability of Western banks to finance their trade. For China, the fact that Western banks are not reliable partners was the major lesson of 2008 and again of 2011.

China is taking the leading role and has either begun trading in local currencies or agreed currency swaps in order to permit this with a long list of trading partners including: Germany, Japan, Russia, Australia, Brazil, Turkey, UAE, Thailand, Indonesia, Malaysia and Kazakhstan. In July 2012, trade in Yuan accounted for 10% of China's trade compared with zero two years ago. Preparations to replace the dollar are advancing. China has a genuine opportunity to establish the RMB as the dominant trade currency for its region and the wider emerging markets, just as the deutsche mark did in the 1970s and 1980s.

The internationalization of the RMB and the birth of the RMB bond market is likely to be one of the most important developments of the decade.
Understanding this new market will prove essential to understanding the world of tomorrow.



Source: GaveKal Research

Theme 8

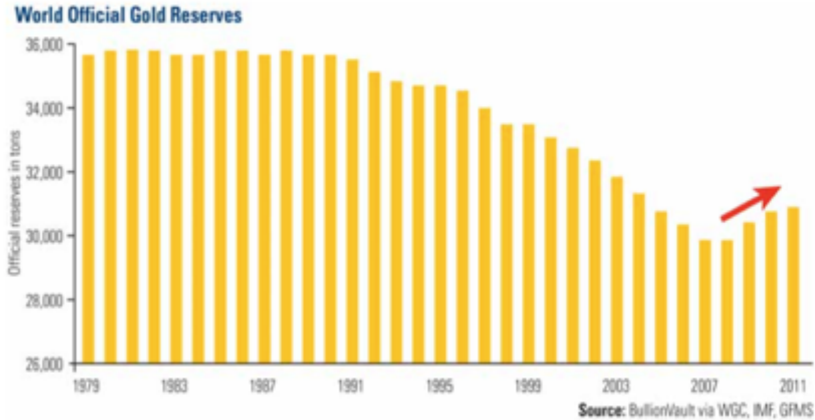
PRECIOUS METALS *SUPERMONEY*

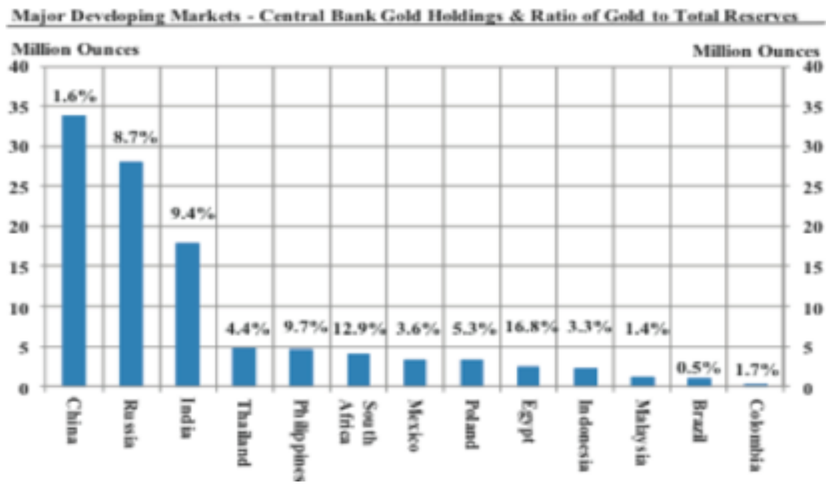
Central banks reverse role

The largest and most price-insensitive institutions in the world are now buyers of gold. **The reversal of the trend of central banks selling gold is one of the most important developments in recent history.** Central banks as a group are now buyers of gold for the first time since 1988. In 2012, central bank demand totaled 534 tons, a level not seen in nearly 50 years.

The proportion of bullion as a percentage of official reserves in the BRIC countries – Brazil, Russia, India and China – averages just 5%, compared with more than 70% in the US and Germany. Russia has doubled its gold since 2007, India has increased its gold reserves by more than 50% while China continues to buy aggressively. In our view, this trend will not reverse.

China holds roughly 1.7% of its $3.2 trillion reserves in gold. If the country was to increase the proportion of gold in its reserves to the world average of 10.7%, it would need to buy some 5,000 tons – that's equal to almost two times last year's global mine output.





Source: World Gold Council

CHINA'S LONG-TERM DEMAND OBJECTIVES

Back in December 2009, China Youth Daily quoted State Council advisor Ji Xiaonan as stating that a team of experts from Beijing and Shanghai had set up a task force to consider growing China's gold reserves. Most telling were his conclusions: "We suggested that China's gold reserves should reach 6,000 tons in the next 3-5 years and perhaps 10,000 tons in 8-10 years…if China wants to take its gold reserves to 10,000 tonnes in 10 years, the country needs to buy or acquire the yellow metal to the quantity of nearly 1,000 tonnes per year." In April 2011 PBoC Governor Zhou Xiaochuan said that USD reserves had to be urgently diversified, without going into specifics. Days later Xia Bin, a member of the PBoC monetary policy committee, said that USD reserves of $1 trillion would be sufficient, implying a $2 trillion cut in USD reserves.

- At today's spot price (~$1,700/oz), $2 trillion equates to ~33,000 tonnes of gold, or ~12 years worth of global mine supply

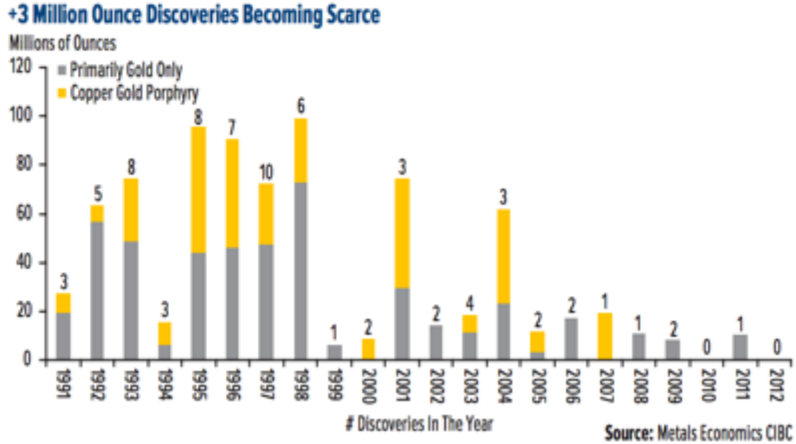
Even if only a fraction of the demand from China's reserve objectives flows into the spot market, it would put significant upward pressure on prices.

Despite China's highly publicized gold hoarding over the past several years, China has not updated the IMF on official gold holdings since April 2009 (reported at 1,054 tons). **Using China's imports from Hong Kong as a proxy for additions to current stockpiles, we can see that China has at least doubled its gold reserves. In 2012 alone, China imported more gold than all ECB holdings.**

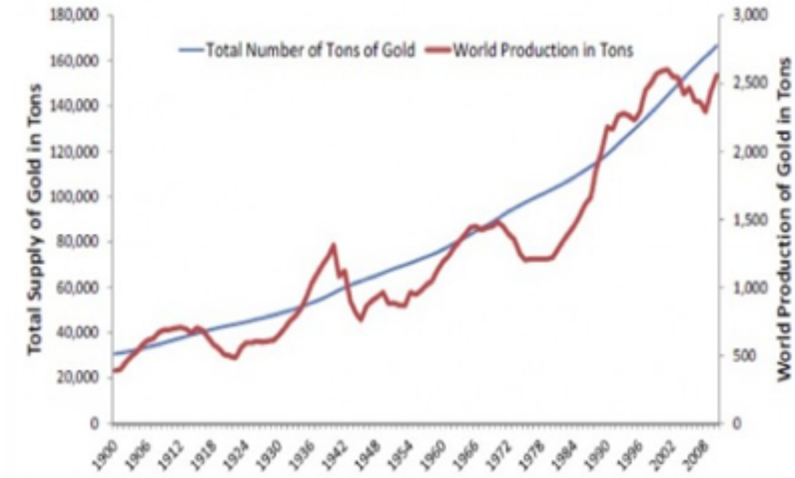
Source: Sharelynx

Peak gold?

There is simply not enough gold in the world that has been mined or will be mined in the next few decades to meet the demand for gold by central banks if they all decide to diversify their portfolios. If the BRIC countries decide to bring their gold-to-currency ratios up to the standard of the U.S. (a standard admittedly declining of late), they would need to find 78,000 tons, not quite half the gold ever mined. If they decided that Switzerland was the “gold standard” for central banks, they would need to buy more than twice the amount of gold ever mined. Neither is possible – and that is just the BRIC countries.



Annual gold mine production has averaged about 2,500 tons per year for the last few years. In 1900, about 30,000 metric tons of gold had already been mined. This means that over 80% of the current aboveground supply of gold has been mined since 1900 and that the aboveground stock of gold has increased by about 1.5% per annum. **If global production of gold continues at a rate of 2,500 metric tons a year, and if the USGS is correct in its estimate that there are only 51,000 metric tons of exploitable gold reserves, then gold production will be exhausted in about 20 years.**



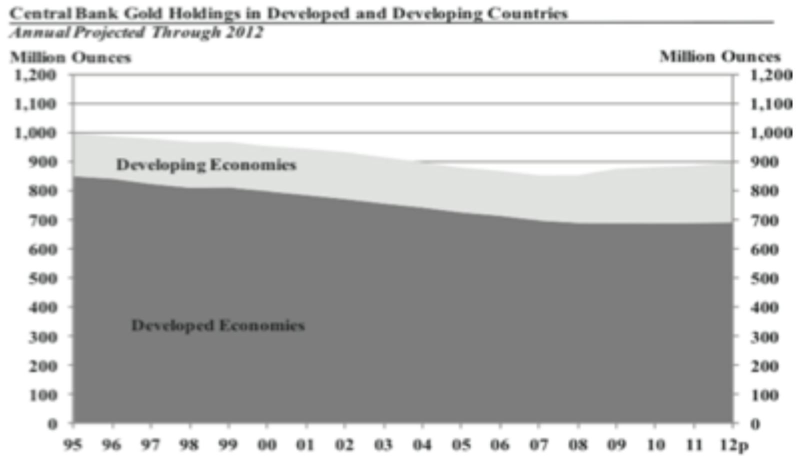
Source: World Gold Council

GOLD HELD AS OFFICIAL RESERVES

We are heading towards a central bank arms race to accumulate gold.

Top 15 Central Banks by Gold Holdings

Country	Gold Reserves Million Troy Ounces	Percent of Total Central Bank Gold Reserves
United States	261.45	29%
Germany	109.19	12%
Italy	78.83	9%
France	78.30	9%
China,P.R.: Mainland	33.89	4%
Switzerland	33.44	4%
Russia	28.09	3%
Japan	24.60	3%
Netherlands	19.69	2%
India	17.93	2%
European Central Bank	16.14	2%
Taiwan	14.97	2%
Portugal	12.30	1%
Venezuela, Rep. Bol.	11.99	1%
Saudi Arabia	10.38	1%
Total for all countries	901.57	83%



Source: World Gold Council

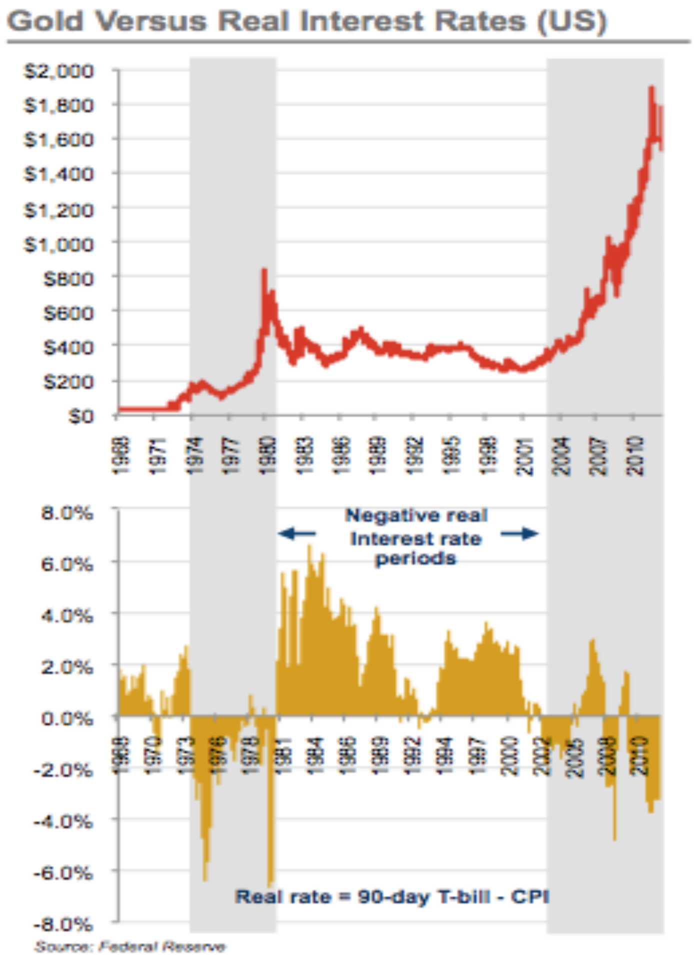
Real interest rate levels are important

Negative real interest rates have been a significant driver of the gold price in past years as shown in the chart on the right prepared by Cliff Gehrett:

- From December 1973 to November 1980, real interest rates averaged negative 1.7%, while the price of gold increased by ~500%
- Similarly, the negative real interest rate from October 2002 to the present have averaged 0.8% while the price of gold has risen by ~400%

We are currently in a ~2% negative real interest rate environment, solidly within the bullish sweet spot for gold price appreciation.

- Negative real interest environments force investors into risk assets, such as gold, to avoid a loss of purchasing power
- It is likely that this environment will continue as the Fed has pledged to keep the federal funds rate unchanged through at least 2015

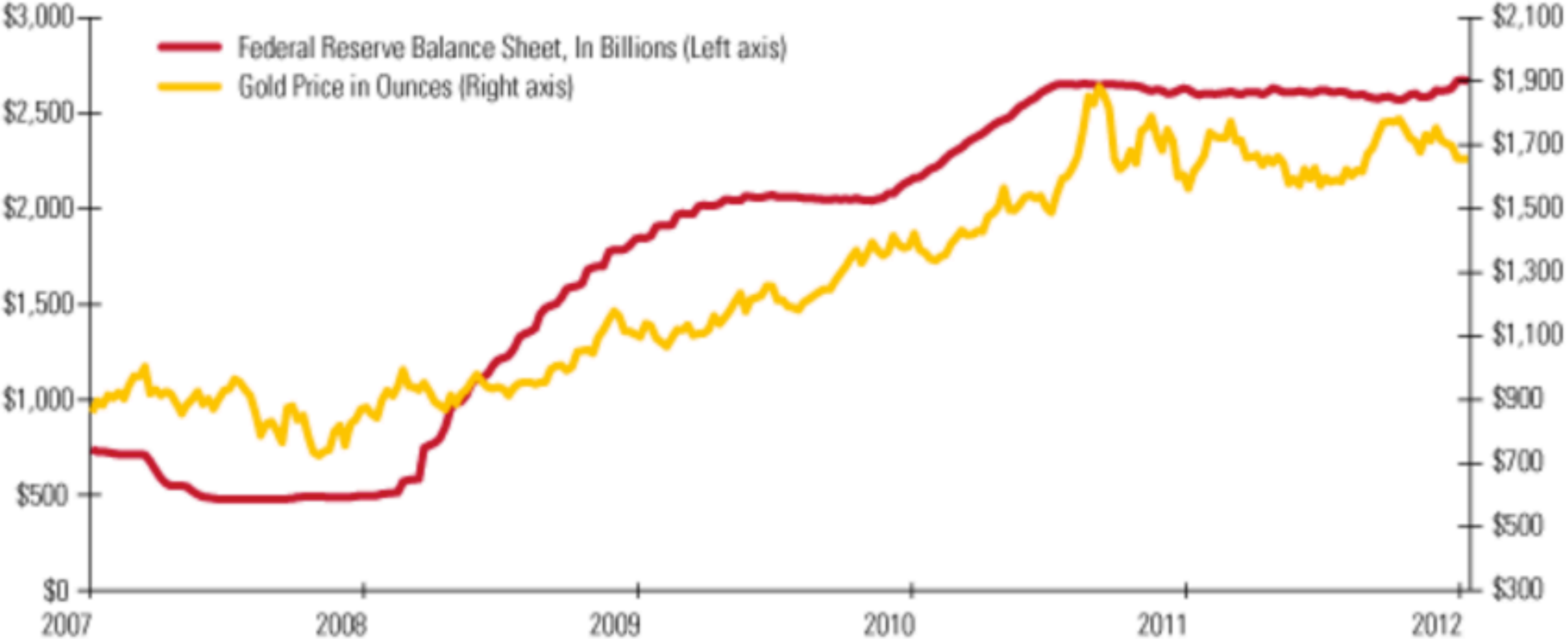


Source: Cliff Gehrett

Don't fight the Fed

The correlation between the Fed's balance sheet and the price of gold is very high at 0.93.

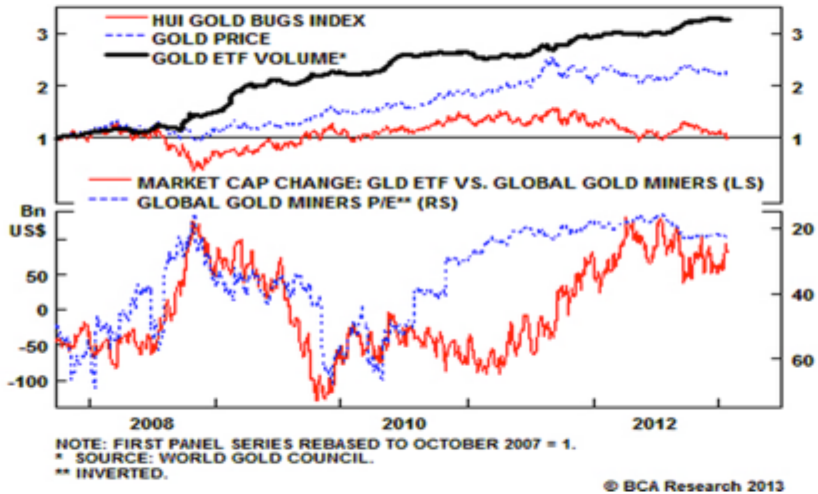
High Correlation Between Gold Price and Fed's Balance Sheet



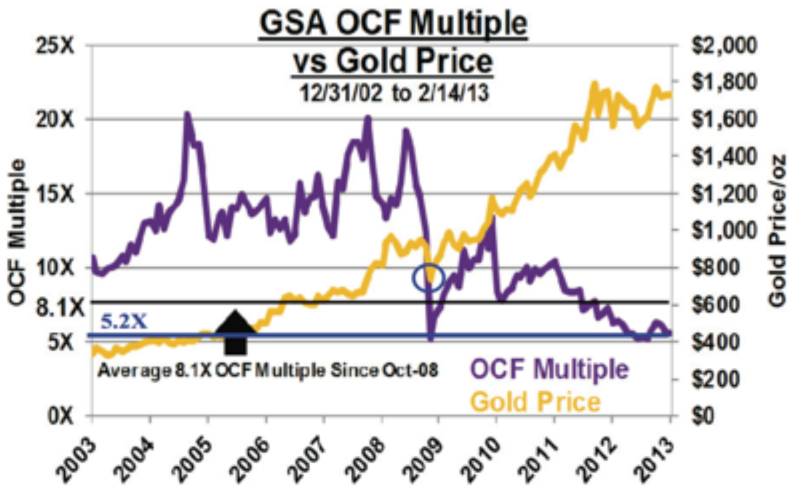
Source: Bloomberg, Federal Reserve, Macquarie Research

GOLD STOCKS ARE VALUABLE NOW

Gold stocks are now trading back near 2007 levels, despite a twofold increase in the price of gold. The underperformance of gold equities vis-à-vis the price of gold can be mostly explained by ETF flows. Gold stocks have been cannibalized by the surge in ETF volumes, with P/E multiples moving inversely with ETF flows. Part of the reason is that during times of extreme risk aversion and safe haven demand, investors prefer physical gold. Gold holdings in 22 ETFs amount to 2,450 tons – exceeding the bullion held by the Bank of France and just 2 tons below Italy's reserves.

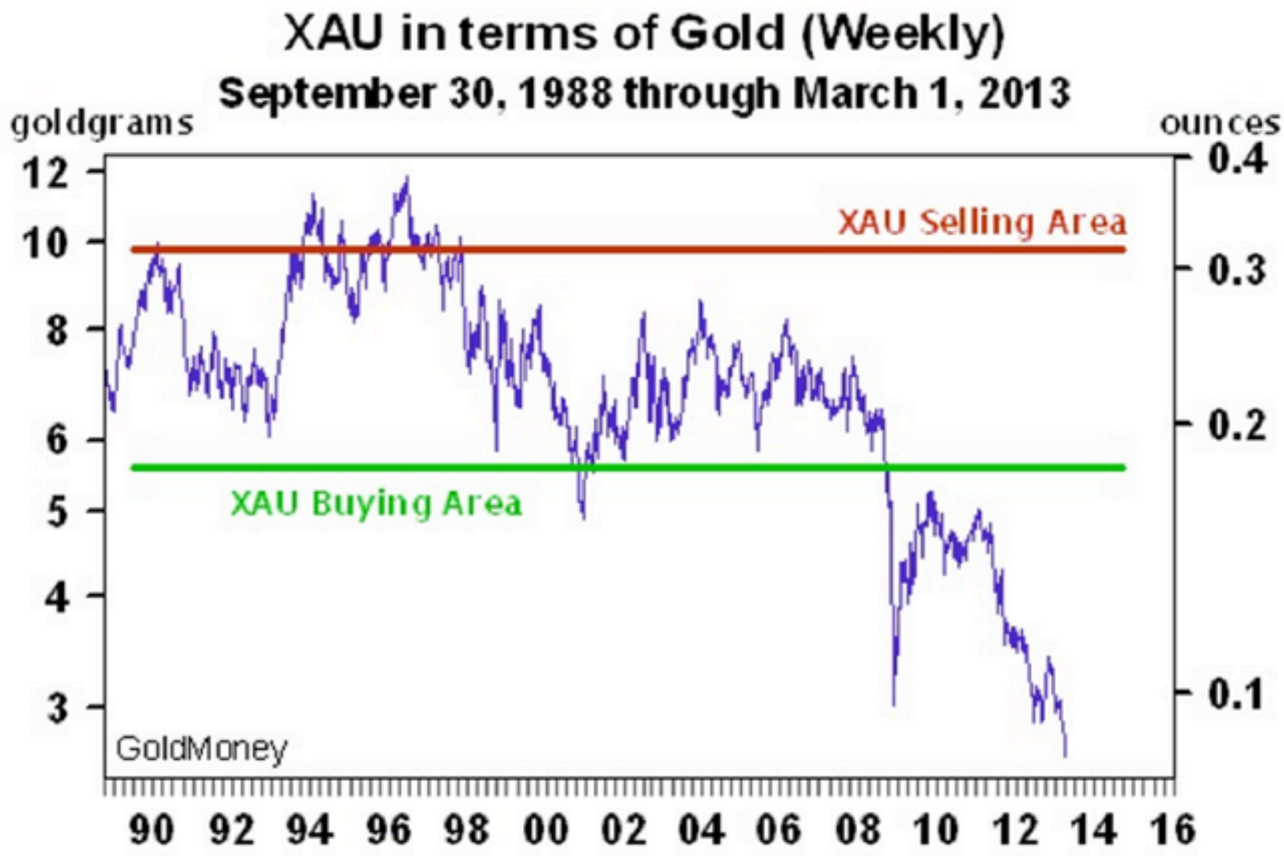


We believe the gold equity sell-off over the past 18 months represents a nadir in investor sentiment, typical of major bottoms. Investor disappointment over the past three years has left gold equities cheap, unloved and under owned. The final catalyst for gold shares may well be intense investor pressure to contain cost overruns and focus on efficiency. Six gold mining CEOs lost their jobs in 2012. Such shakeups usually herald a major shift in corporate strategy, and with current valuations, gold equities could do well, even if gold prices go nowhere.



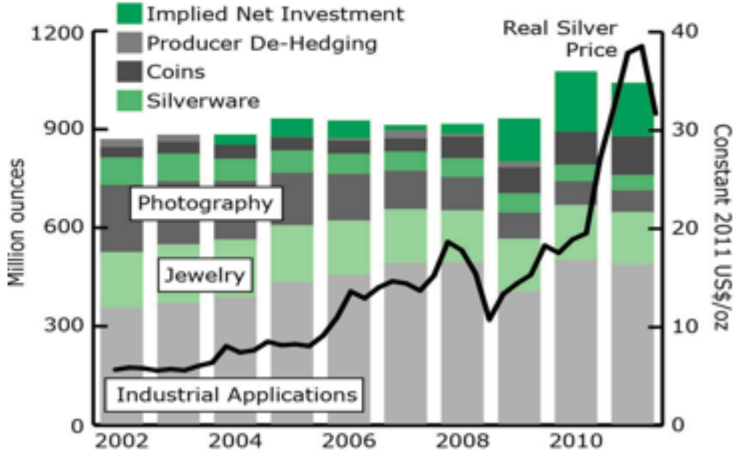
We're making history here

Despite rebounding after the 2008 collapse, mining shares, when priced in ounces of gold, have hit new and unprecedented lows.



Silver: even more attractive than gold

In 1950, there were 10 billion ounces of available silver above ground. By 1980, that number shrank to 3.5 billion. And today, no significant government stockpiles of silver exist anywhere in the world. The USGS actually lists the U.S. government's current stockpile of silver simply as: "None." **There are currently just over 1 billion ounces of silver left above ground in bullion form today.** That is a surprisingly small number in relation to the 46 billion ounces mined throughout history. For comparison, there are currently approximately 2 billion ounces of gold above ground in bullion form compared with the 5 billion ounces of gold mined throughout history. The reason is due to silver's consumption in industrial use and the fact that it is typically never recycled.



Source: Thomson Reuters GFMS

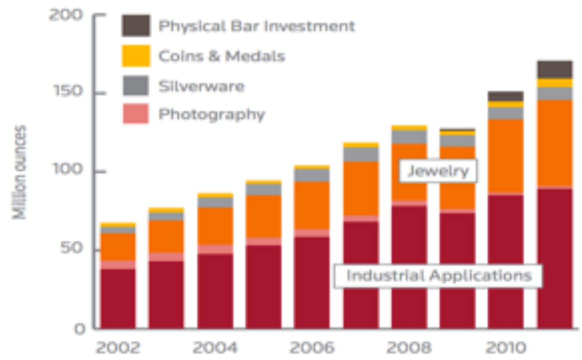
Annual silver demand (see chart on top right) from industry and other sources totals approx. 700mn oz which leaves only 300mn oz for investment purposes ($10 billion at today's price). That is a very small amount compared to potential investment demand and in relation to available gold supply for investment (~$230 billion). **This makes silver even more scarce than gold.**

Chinese entering the silver market

The last two decades have witnessed a number of significant changes in the Chinese silver market. Looking back to 1990, it is fair to say that the country was only a relatively small player in the global silver market. Last year, however, following a period of robust growth, China is now the world's second largest silver fabricator and is likely to become the second largest producer, with its share of global demand and supply now standing at 17% and 14% respectively.

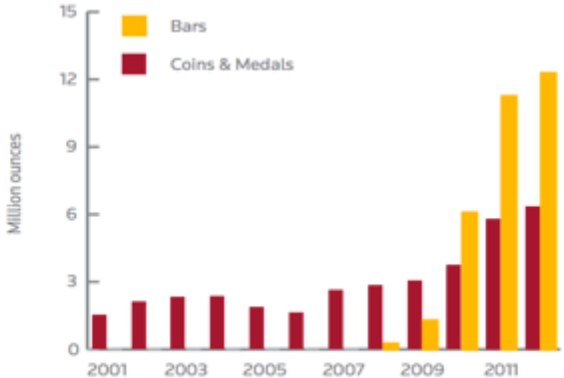
In China's first full year after liberalization of the investment market in July 2009, net demand for silver bars and coins more than doubled, totaling 9.8 Moz, equivalent to almost $200 million. By 2011, these had figures soared to 17.0 Moz and some $600 million respectively. To put this into a wider perspective, Chinese investors last year accounted for 8% of global net purchases of silver bars and coins. Moreover, expectations are that further growth is in the pipeline for the years to come as local savers put their trust in precious metals as a store of value and inflation hedge.

CHINESE SILVER DEMAND



Source: Thomson Reuters GFMS

RETAIL INVESTMENT IN CHINA



Source: Thomson Reuters GFMS

An Important Math Lesson

The data below is taken from Sprott and it shows the U.S. Mint gold and silver sales in ounces. **You just can't keep buying physical silver on a one to one ratio to gold and have the price differential be 54 to 1**. That's just mathematically impossible. We believe the gold to silver ratio (shown right) will move significantly lower to restore a fundamental balance between supply and demand. The ratio has varied widely through the years but has declined in the past to the range of 10 or 15 to 1 in extended precious metals bull-markets.

Source: CIBC WM

	SILVER	GOLD	SILVER: GOLD
2008	19,583,500	860,500	22.8x
2009	28,766,500	1,435,000	20x
2010	34,662,500	1,220,500	28x
2011	39,868,500	1,000,000	40x
YTD 2012	33,742,000	744,000	45x

Source: US Mint (www.usmint.gov)

PLAYING PLATINUM AND PALLADIUM

While gold and silver are a pure demand-side story, we are positive on platinum and palladium given the favorable supply-side situation. Supply problems out of South Africa (which produces close to 75% of the world's annual platinum supply and 37% of the world's palladium) will be the driving force behind platinum's price appreciation, while palladium will benefit from the depletion of Russian stockpiles and flat production from Norilsk (accounts for 42% of global supply).

Roger Baxter, senior executive at the Chamber of Mines of South Africa, recently stated that at least 50% of the country's platinum industry is marginal or in a loss-making position today. In addition, many of the mining operations are suffering from declining ore grades, further lowering mine output. The result has been a 25% decline in annual South African platinum production since 2006. The palladium supply is also at risk of further labor strikes and mine shutdowns.

On the demand-side, both metals are crucial to a number of important industrial applications where demand for them is relatively inelastic to price. The driving force is the autocatalyst market which benefits from growing global auto sales (the average automobile carries a mere $212 worth of PGMs per vehicle). The jewellery market is also key. China is expected to have consumed 1.92 million ounces of platinum in 2012, representing 70% of the overall global platinum jewellery consumption of 2.73 million ounces. **We prefer to build exposure through direct purchases of the metals themselves.**

PLATINUM SUPPLY AND DEMAND
'000 OZ

Supply	2010	2011	2012
South Africa	4,635	4,855	4,250
Russia	825	835	790
Others	590	790	800
Total Supply	**6,050**	**6,480**	**5,840**
Gross Demand			
Autocatalyst	3,075	3,105	3,070
Jewellery	2,420	2,480	2,725
Industrial	1,755	2,050	1,785
Investment	655	460	490
Total Gross Demand	**7,905**	**8,095**	**8,070**
Recycling	**(1,830)**	**(2,045)**	**(1,830)**
Total Net Demand	**6,075**	**6,050**	**6,240**
Movements in Stocks	**(25)**	**430**	**(400)**

Source: Johnson Matthey Platinum 2012 Interim Review

PALLADIUM SUPPLY AND DEMAND
'000 OZ

Supply	2010	2011	2012
South Africa	2,640	2,560	2,400
Russia	3,720	3,480	2,850
Others	995	1,320	1,320
Total Supply	**7,355**	**7,360**	**6,570**
Gross Demand			
Autocatalyst	5,580	6,030	6,480
Jewellery	595	505	450
Industrial	2,465	2,480	2,410
Investment	1,095	(565)	385
Total Gross Demand	**9,735**	**8,450**	**9,725**
Recycling	**(1,850)**	**(2,345)**	**(2,240)**
Total Net Demand	**7,885**	**6,105**	**7,485**
Movements in Stocks	**(530)**	**1,255**	**(915)**

Source: Johnson Matthey Platinum 2012 Interim Review

Theme 9

IRAQ

THE RICHEST MAN IN BABYLON

The story of Babylon

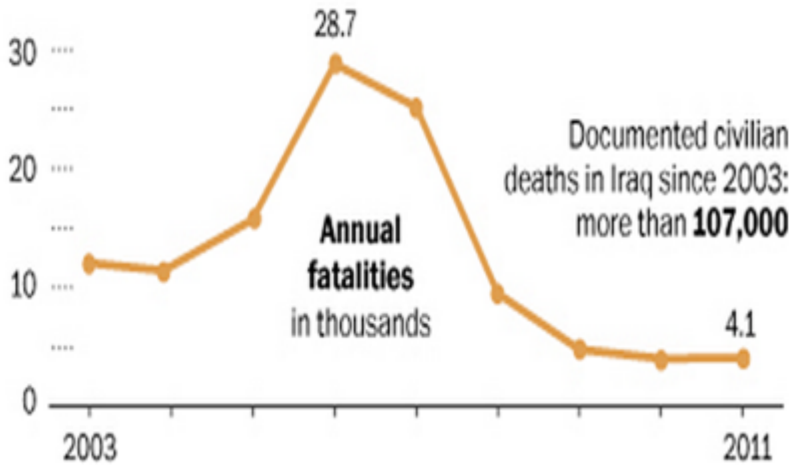
Iraq is the latest iteration of an old story. If the Third Baron de Rothschild articulated a theme – *"buy when there is blood on the streets"* – then Iraq is the latest variation on that theme. Heeding Rothschild's advice was immensely rewarding in earlier "frontier" markets, such as post-WWII Italy and South Korea; in time, the same might be said of Iraqi equities.

Few would think of Iraq as being a place worth investing in today given the continued outbreaks of violence, political uncertainty, the legacy of war damage and the persistence of fundamental ethnic divisions within the country. For almost a decade, perceptions of Iraq have been shaped by stories that tell only of the country's horrors and ignore what we believe is so crucial to understanding the potential of Iraqi equities to undergo a historic re-rating. We thank Euphrates Advisors for being the first to alert us of this long-term opportunity.

Iraqi GDP was $88 billion in 2007; the 2012 GDP was $179 billion – a doubling in five years. Iraq's oil exports are at an all-time high and the 13% GDP growth this year makes it one of the fastest growing economies in the world. Inflation is under control and the country sits on $47 billion of international reserves, an amount equivalent to 12 months import cover and one that provides the central bank with a great deal of power to defend the dinar should the need arise. The story could not be better. Yet Iraqi equities are given no credit for this objective economic improvement.

THE MAJOR PIVOT POINT

To appreciate how far Iraq has come since 2007, we look at what life was like for average Iraqis during the 20 years before 2007. **From 1990 to 1998, the Iraqi dinar lost -99.9983% against the U.S. dollar, the result of mismanaged finances and a crippling sanctions regime. Prices spiraled out of control, rising 45,000% and creating devastating economic conditions**, examples of which include: i) surgeons driving taxis to make ends meet; engineers and accountants selling fruit, ii) a "highly-paid" physician fortunate enough to practice medicine earning the equivalent of 30 eggs and 20 loaves of bread per month, and iii) individuals finding it more economical to stay at home rather than work since daily transportation costs exceeded monthly income.



Source: Brookings

According to Euphrates Advisors, the turning point came in 2007 for two reasons. First, the "Surge" eliminated 90% of the insurgency and put an effective end to the civil war. Second, the Central Bank of Iraq (CBI) achieved price stability, establishing its institutional credibility and thereby ending the 17-year hyperinflation. To regain control over inflation the CBI allowed the dinar to appreciate roughly 20% against the dollar. This action reduced import costs thus relieving the major source of inflationary pressure. **Taken together, both reasons imparted much needed macro stability to Iraq and set the stage for an economic revival.**

Source: Trading Economics

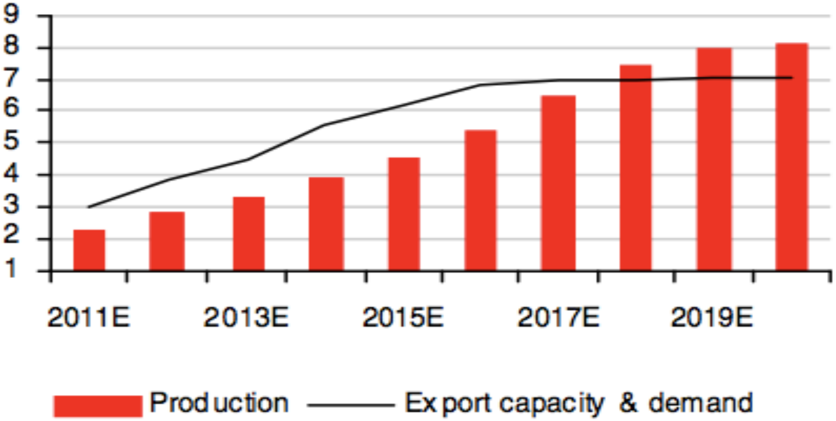
THE NEWEST OIL BARON OF THE WORLD

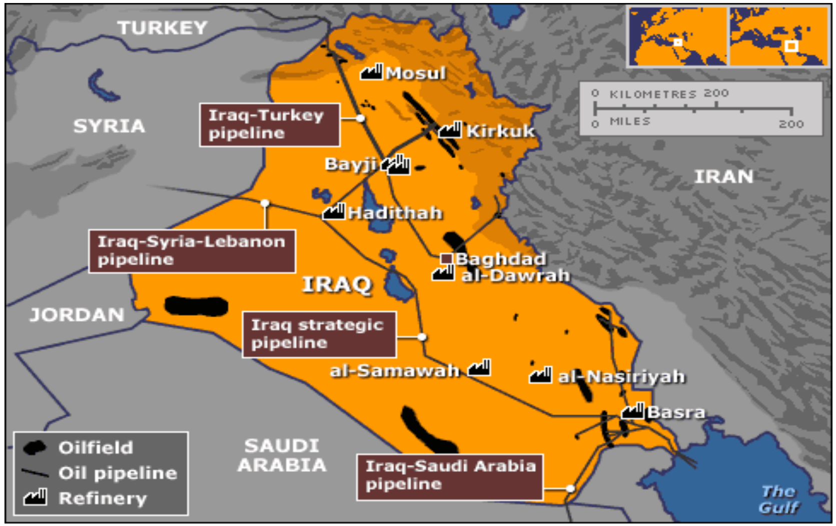
Iraq has the world's 4th largest proven oil reserves (after Saudi Arabia, Venezuela and Iran) and 10th largest proven gas reserves. Much of Iraq is unexplored and the range of possible upside is 45-100bn additional barrels with some of the world's lowest production costs. **Iraq's oil production, at 3 million barrels per day, is 13% higher than one year ago, 27% higher than two years ago, and double its 2005 level.**

According to BP, Iraq has proven recoverable oil reserves of 115bn bbl, equivalent to 8.3% of global reserves and 10.8% of OPEC's reserves. We expect the proved reserve base to rise further given the operational performance of the existing fields, which will benefit further from modern enhanced recovery techniques brought in by the foreign oil companies, as well as the recent giant discoveries, especially in Kurdistan.

BMI sees Iraq crossing the 6mn b/d oil production mark by 2015, with the largest contributions from the giant southern fields such as Rumaila, Zubair and West Qurna-I. The forecast assumes that oilfields being developed by foreign companies will only hit 50-60% of their intended plateau target. **The country could be producing as much as 8mn b/d by the end of the decade, representing the greatest potential for oil production growth in the Middle East region.**

Iraqi oil production and export capacity (mmbbl/day)



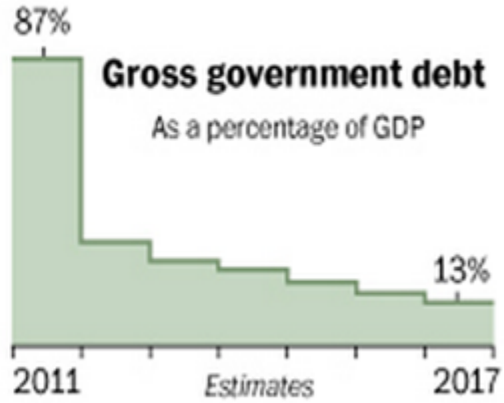


A TRULY RARE TALE OF ECONOMIC PROGRESS

The most important question (Yaser Anwar): How many post-war reconstruction growth stories with natural resource endowments has the world seen at the turn of the 20th century? Answer: Just one. Russia post-'92. Our comparison periods use an average, which for Russia commence post-crisis of '98 to '11 and Iraq's post-Great Recession and start of the transition period '09-'17E:

- Real GDP: For Russia, growth averaged 5.3% vs. Iraq's expected 9.2%
- GDP/capita: For Russia, GDP/capita increased from $1,345 to $13,235 vs. Iraq's starting at $2,000, is expected to reach $5,900 by 2017, and by the end of the decade to reach $8,000
- Inflation: For Russia, price stability remained elusive through the past decade at 18.5% vs. Iraq's expected 7.1%
- Twin surplus/deficit (sum of fiscal + C/A, % GDP): For Russia, the surplus came in at 10.9% vs. Iraq's expected 2.9%

Russia, with its vast natural resource endowments, and Iraq-esque political challenges post-communism, lacked one resource we believe gives Iraq an upper hand: its youthful demographics. However, Iraq's political challenges will create output volatility as it goes through its transition phase.



The coming credit boom

Iraq is slowly transitioning from a state-dominated financial model to one in which the private sector plays a substantial role. The country has long operated with essentially no financial leverage. **Iraq could be in a situation in which a new phenomenon – the private credit cycle – is superimposed on a petrodollar cycle.** Below are some of the key highlights:

- Population of 32 million in Iraq yet only 4.5 million people have bank accounts
- Debit and credit cards, ATMs, internet banking and auto loans are all new to the Iraqi financial system
- Iraqi banks have low loan/deposit ratios but that will change with improving confidence and robust economic fundamentals (some banks are now extending the duration of certain loans to 3 years; in 2006, most banks were only comfortable extending 1-month loans)
- Bank participation levels are rising with recent data from the Central Bank of Iraq showing a near 80% increase in the deposits component of M2 (primarily a result of the oil wind-fall)
- GDP/capita has been steadily rising from $1,200 to $3,500 ('05-'12) bolstering domestic demand, and given expected size of Iraqi economy over the next 10 to 15 years (around $500 billion), bank assets and deposits as a % of GDP in '10 of 3.2 & 2.3, respectively, will meaningfully expand
- Regulatory/central bank initiatives aimed towards improving flow of credit include lowering domestic reserve requirements to 15% vs. 20% in 2011, and raising minimum capital requirements by 5x to $213 million by 2013

Long-term opportunity: Iraq's GDP is approximately $170 billion. Suppose GDP is $240 billion by 2020. If Iraq's top five private banks assets equal 50% of GDP (the same rate for Saudi banks), then they will collectively have $120 billion in assets. If they equally split that figure, then each bank will have $24 billion in assets in 2020. Excluding Al Rajhi Bank, which trades at a steep premium relative to its peers, the average top five Saudi banks market cap is .2x total assets. If we apply that same ratio to Iraq, that implies a 2020 market cap of $5 billion for each of the top five private banks. These banks currently have market caps of approximately $250 million. Thus, in this admittedly rosy scenario each of the top five Iraqi banks will have market caps 20x higher at the end of this decade.

INVESTMENT OPPORTUNITY OF THE DECADE

We strongly believe Iraqi stocks are going to be the investment opportunity of the decade. **Iraq fits a well-defined, time-tested narrative about buying neglected, poorly understood and undervalued assets.**

- The ISX has 70 companies listed – 30 of which trade regularly
- Index turnover of $1 to $2 million per day is in line with many fledgling frontier markets
- Market composition: 1) 50% Telecom; 2) 42% Financials; 3) 7% Industrials; and 4) 1% Consumer Discretionary
- Stock market appreciated by 51% in 2011 and 20% in 2012 (USD priced RS ISX Index)
- Market capitalization more than doubled to $10.2 billion as of February 2013 following the listing of Qatar Telecom affiliate Asiacell
- Foreign investors make up less than 7% of the market

In our view, investors are unaware of the major turning point that occurred in 2007, the dire conditions that preceded it, and the steadily improving fundamentals which have followed it.

Source: Bloomberg

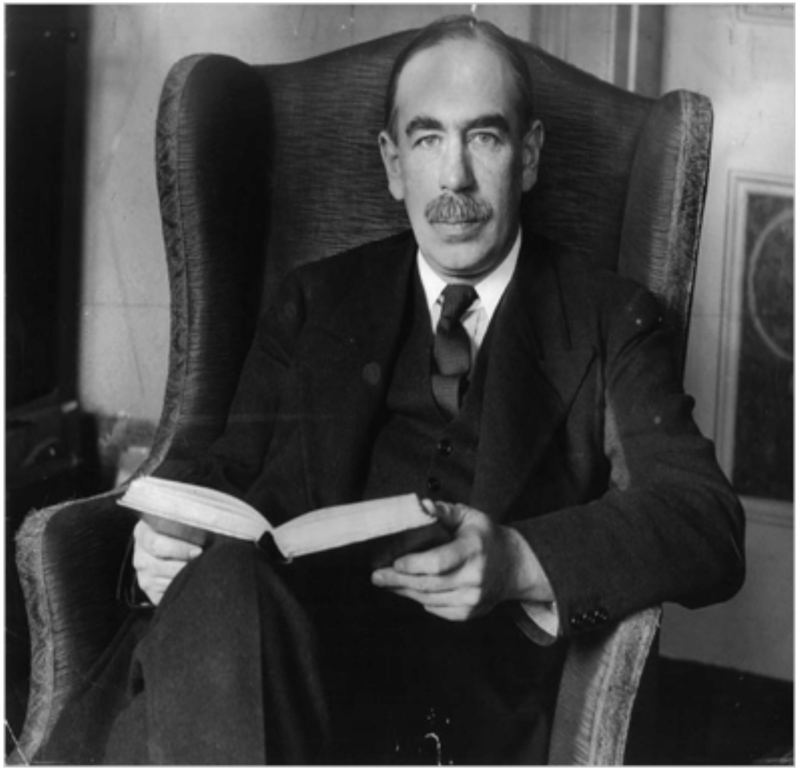
Theme 10

THE GREAT SOCIAL DISORDER

WHEN MONEY DIES

Words of wisdom

"By a continuing process of inflation, Governments can confiscate, ***secretly and unobserved,*** *an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate* ***arbitrarily****; and, while the process impoverishes many, it actually enriches some .... Those to whom the system brings windfalls .... become "profiteers" who are the object of the hatred ... the process of wealth-getting degenerates into a gamble and a lottery .. Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all* ***the hidden forces of economic law*** *on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."*



Lord Keynes (1921)

History is replete with disorders in which social cohesion has been undermined by currency debasements. The multi-decade credit inflation can now be seen to have had similarly corrosive effects. Yet central banks are determined to continue down the same route. **Further debasement of money will cause further debasement of society.** – Dylan Grice

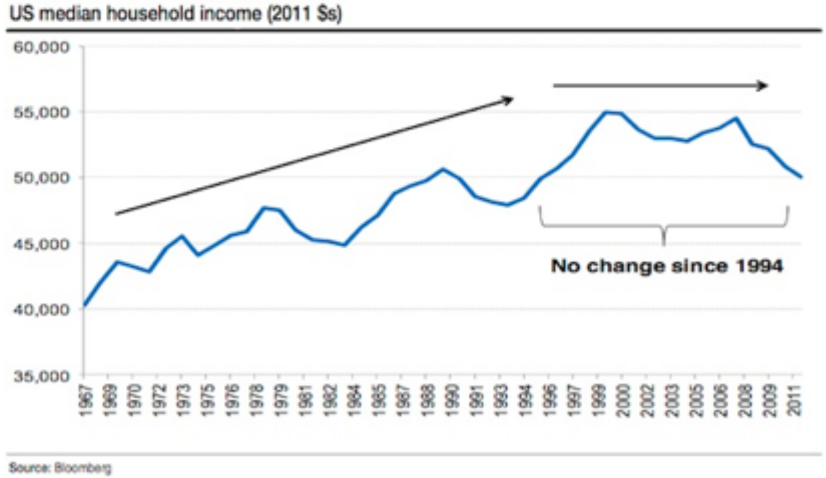
THE GREAT SOCIETY

The Gini coefficient (which is a measure of income inequality) is reaching its highest level since the early 1920s. Real wage growth has stagnated since 2000, while education and healthcare costs have soared. In the U.S., one in six people are on food stamps – that's 47 million people. 37% of young households hold zero or negative net worth. More than half of college graduates under the age of 25 are jobless or working in positions that didn't require a college education, the highest percentage in at least 11 years. Labor force participation is at a 31-year low (63.5%). The percentage of young people not in the labor force is the highest since 1955. These trends are unlikely to change anytime soon.

The American society is vulnerable. The family unit, that basic building block of all communities and civilizations from village to empire, is breaking down. Marriages are at an all-time low. As a whole, just 52% of adults above 18 are married, compared to 57% in 2000. The average age at marriage is pushing 30. Divorce is booming: 50% of first marriages, 67% of second, and 74% of third marriages end in divorce. That is dismaying. The social consequences of this are vast.

Income Gini ratio for US households

Source: US Department of Commerce (Census Bureau), Sprott

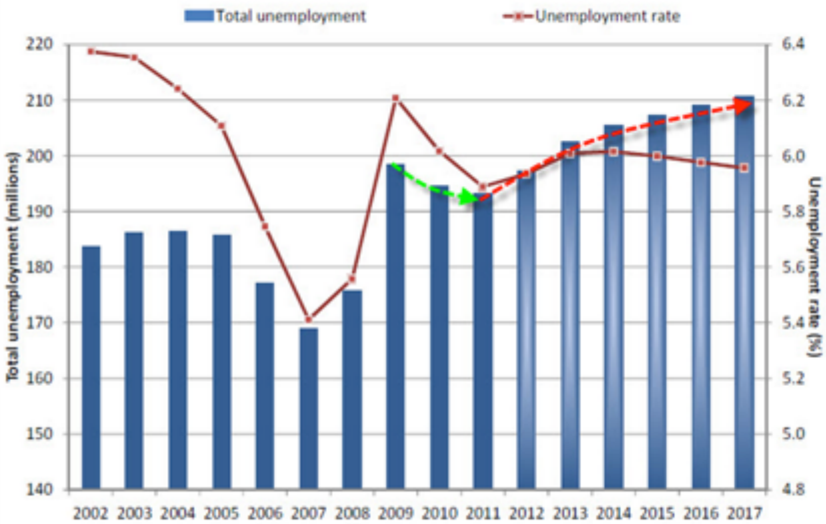


A GLOBAL ARMY OF THE UNEMPLOYED

Macro imbalances have been passed on to the labor market to a significant degree. According to ILO, 2013 is expected to top 200 million people unemployed with the epicenter in the advanced economies. The number of underemployed 15-to 24-year-olds in the OECD is higher than at any time since the organization began collecting data in 1976. **A paradigm shift is afoot and the great challenge facing the developed world is figuring out how to re-absorb the hundreds of millions of unemployable. Failure to do so will create unsustainable political, social, and economic strain.**

Consider someone unemployed in his 20s, perhaps with a university degree. The numbers mean that there is an excellent chance that he will never have the opportunity to pursue his chosen career and quite possibly will never get a job at the social level he anticipated. In Spain and Greece, the young – and the old as well – are facing personal catastrophe. In the others, the percentage facing personal catastrophe is lower, but still very real. Also remember that unemployment does not affect just one person. It affects the immediate family, parents and possibly other relatives. The effect is not only financial but also psychological. It creates a pall, a sense of failure and dread.

The deep lack of confidence in the financial and political system has left the public deeply divided and hostile. Globally, there are young people full of energy and anger. We are mindful that unemployment is a root of anti-state movements on the left and the right. The extended and hopelessly unemployed have little to lose and think they have something to gain by destabilizing the state. It is hard to quantify what level of unemployment breeds that sort of unrest, but there is no doubt that Spain and Greece are in that zone and that others might be as well.

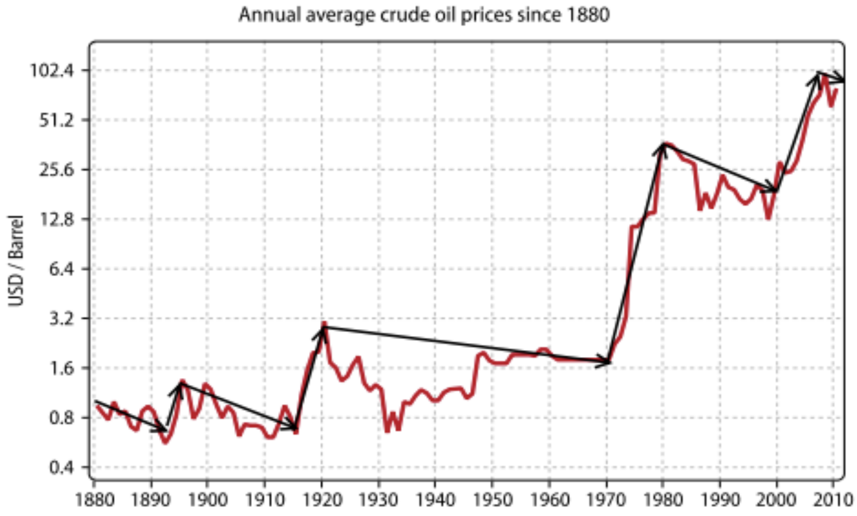


Source: International Labor Organization

Bull-market in international tensions

In the coming years, trillions of dollars of debts will be restructured and millions of financially prudent savers will lose large percentages of their real purchasing power at exactly the wrong time in their lives. Again, the world will not end, but the social fabric of the profligate nations will be stretched and in some cases torn. Sadly, looking back through economic history, all too often war is the manifestation of simple economic entropy played to its logical conclusion. **We believe that war is an inevitable consequence of the current global economic situation. – Kyle Bass**

High commodity prices also lead to a sharpening of the struggle for new supplies and increase the occasions for military conflicts. Simply put, when markets are glutted and over-supplied; no one is going to care to fight in order to satisfy its demand. Conversely, when markets are characterized by acute shortages, people will fight and go to war in order to secure their required supplies. This is particularly the case when shortages threaten to undermine economic survival or national security. This pattern can be observed throughout history. **Writing in 1968, Will Durant, in his The Lessons of History, said that "in the last 3,421 years of recorded history only 268 have seen no war."**

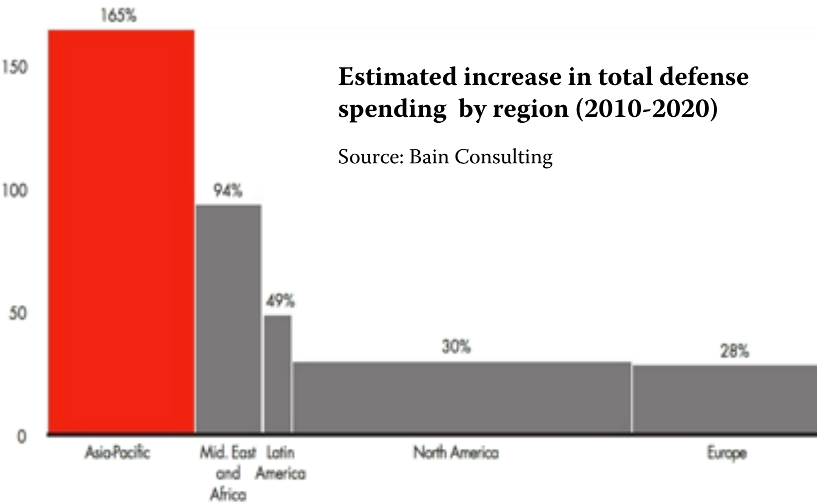


Source: GaveKal Research

Potential conflicts around the world

The world's major powers – the U.S., Russia and China – have made it clear that they are shifting their attention away from the developed world towards Asia. Relatively smaller countries in the region have no choice but to choose sides and follow the major powers in their geopolitical battles. **The geopolitical situation in Asia is becoming increasingly complicated**. Territorial disputes could easily turn into regional tensions, with further escalation possible due to the involvement of the major powers. Such has been the case with the ongoing disputes in the East China Sea and the South China Sea. **Militarization is set to increase.**

There are rising tensions across the Middle East as traditional ruling elites attempt to defuse the impact of the Arab Spring and its demands for democratic accountability. This has manifested itself in two ways: first, the stressing of religious allegiances which has led to increased discrimination against religious minorities and an active Sunni-versus-Shia rivalry; and second, the massive increases in government expenditures which imply that most producers now need prices of $75 to $100 per barrel or higher to balance their budgets. As a result, there is rising potential for conflict that will lead to a cutoff of some portion of the region's oil supply or the crimping of export capacity due to regional population demand – or some combination of the two.



APPENDIX

THE FUND

THE GOOD SOCIETY FUND

The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelope our future.

Lord Keynes

Our Philosophy

The investment environment is changing at a rate that's representative of global economic imbalances, fund flows, and geopolitical risks. We believe this decade will witness greatly increased volatility and instability in the economy and financial system. Our guiding principle is to help investors understand and navigate through all the complexities of an unstable, inflation-prone world.

Fundamental to our approach to investing is a core understanding of history, politics, economics and psychology. We are always seeking more knowledge. We believe an eclectic approach that is based on common sense, strong logic, and objective data, balanced by right-brain intuition and lots of curiosity is what works best.

The Good Society Fund (TGSF) is a discretionary global macro strategy hedge fund. The Fund seeks to combine fundamental investment research with technical analysis to exploit opportunities in global stocks, bonds, currencies, and commodities. Our primary objective is to achieve long-term capital appreciation by targeting 15% to 20% net annual returns.

World at a glance

In the investment world, anyone who foresees and understands the trends, who is open-minded, and who keeps emotions at bay, wins.

The structural backdrop for a global macro strategy

- Developed economy governments are insolvent
- The process of deleveraging and global rebalancing is underway
- Outsized dislocations from "non-economic" policy actions
- The loss of central bank independence with likely unintended consequences
- Ongoing battle between deflation and reflationary forces
- Shorter and more volatile economic cycles that are globally synchronized
- Drop of confidence in policymakers, institutions and the "system" at large
- Increased risk of geopolitical tensions and social conflict
- Market prices only reflect fair value by accident and in passing

Investment Strategy

Our investment strategy is grounded in a thorough understanding of the macro environment and key investment themes. We look to build a diversified portfolio of trades that each add incremental alpha. Our approach takes advantage of directional market movements that have a strong fundamental reasoning based upon our independent research. We have a deep focus on cyclical versus secular economic trends and their impact on various markets.

In our analysis of the macro environment, we look for markets where there is the potential for a paradigm shift. This is when the basic assessment of the outlook completely changes and the market slowly recognizes that there is another economic equilibrium which is very far from the current state. These shifts will commonly allow for great entry levels and the potential to grow into major long-term trends.

We pay particular attention to the embedded beliefs in financial markets and assess valuations and trends in this context. It is the changing views and behaviors of market participants that changes asset pricing, which is driven by both new information and a changing interpretation of existing information. In pursuing our target of superior risk-adjusted absolute returns, we use a strong alliance of trading disciplines and aim to maximize the balance of risk and reward at all times.

Thematic Approach

One or two big themes define most years

1997 The Asian Financial Crisis
1998 Yen / Asian FX rally / Russian Default
1999 Tech / Dotcom boom
2000 Tech / Dotcom bust
2001 Eurodollar surge / Gold upturn
2002 US dollar bear market
2003 Deflation scare / Emerging market bull-run
2004 Oil price break-out / US housing boom
2005 China bottom / GCC stock market bubble
2006 M&A boom / US housing top
2007 US housing bust / China bubble peak
2008 Credit crisis - Policy panic! / Commodity top
2009 Reflation QE I / Global risk rally
2010 Reflation QE II / EU Deleveraging I
2011 EU Deleveraging II / US housing bottom
2012 Bubble in safety / China bottom
2013 Abenomics / Gold stock lows

Fund Overview

Launch Date:	May 2013
Style:	Discretionary global macro
Typical Portfolio:	5 – 10 investment themes, 30 – 40 positions
Tradable Instruments:	Stocks, bonds, currencies and commodities
Geographic Focus:	Global, thematic approach
Investment Horizon:	6 to 18 months with shorter term tactical trading
Position Limits:	Max 15% on longs, Max 5% on shorts at cost
Volatility:	Target annualized volatility of 12%

Research Methodology

Macro Analysis - Imagine

- Assess broad capital market, demographic, economic and political environments
- Analysis of monetary, fiscal and regulatory policies
- Identify secular themes and look for trends that are against mainstream thinking

Fundamental Analysis - Research

- Top-down fundamental research across stocks, bonds, currencies and major commodities
- In-depth country, sector and company reviews
- Bottom-up valuation analysis

Technical Analysis - Execute

- Analysis of trends, market flows, sentiment, consensus views and investor positioning
- Identify entry and exit points, support and resistance levels and changes in trends
- Reduce the influence of emotions and ego on trading

Investment Process

Idea Generation

Thematic approach leads to selection of key countries and sectors based on detailed macro analysis

Particular interest in potential for paradigm shifts when consensus outlook completely changes

Evaluate risk-reward profile for range of trades that can be used to express a theme

Maintain flexibility towards shifts in data and economic expectations

Portfolio Construction

Build a diversified portfolio of themes to enable profitability in different market regimes

Optimize position sizing, define entry and exit points and implement trade only when the timing is right

Constantly evaluate changing asset correlations to ensure genuine independent themes rather than multiple expressions of the same idea

Risk Monitoring

Real-time portfolio monitoring seeks to ensure ongoing picture of aggregate risks

Stop-loss set pre-trade with strict risk limits for each position

Portfolio risk reduction levels at 5% and 10% to facilitate re-evaluation before rebuilding risk

Examine tail risks with scenario based stress testing

Risk Management Principles

Focus more intently on the downside than the upside. We believe if we protect the downside, the upside will take care of itself. Preservation of capital is our number one priority.

We believe in being open-minded and flexible when challenged by the market. The willingness to admit we could be wrong and take action to limit downside risk.

Use of macro analysis to avoid economic turbulence by managing the portfolio's risk exposure, and bottom-up analysis to maintain a value bias to the holdings within the portfolio.

Scenario based stress testing identifies the potential portfolio losses that can be ascribed to specific (sometimes very large) simultaneous changes in market prices and rates.

We practice patience and do not mind holding funds invested. We take risk only when we see an opportunity.

An objective assessment of behavioral risks inherent in our decision making to improve our investment process and philosophy.

Team

Jawad S. Mian

Founder and Chief Investment Officer

- 8 years of investment management experience
- Most recently Portfolio Manager at QInvest in Doha, Qatar where he managed $250mn in assets
- Previously, Portfolio Manager at Rasmala Investments in Dubai, UAE
- Started career at CIBC in Toronto, Canada in Retail Markets before moving to CIBC Mellon
- BA in Finance and Economics from The University of Western Ontario in Canada
- CFA and CMT charterholder

Summary of Terms

Domicile:	Bermuda
Minimum Investment:	USD 10,000
Liquidity:	Monthly
Fees:	2% management and 20% performance
High-Water Mark:	Yes
Prime Broker:	Interactive Brokers
Administrator:	Apex Fund Services
Auditor:	Deloitte

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The Good Society Fund