

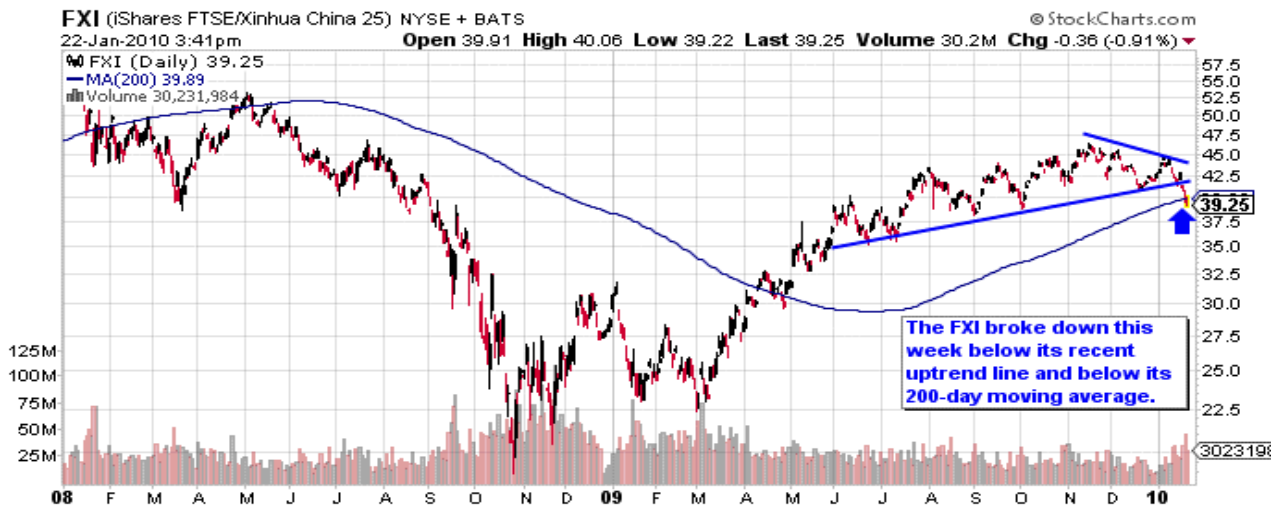


The Starboard Side Report

The week ending January 22, 2010

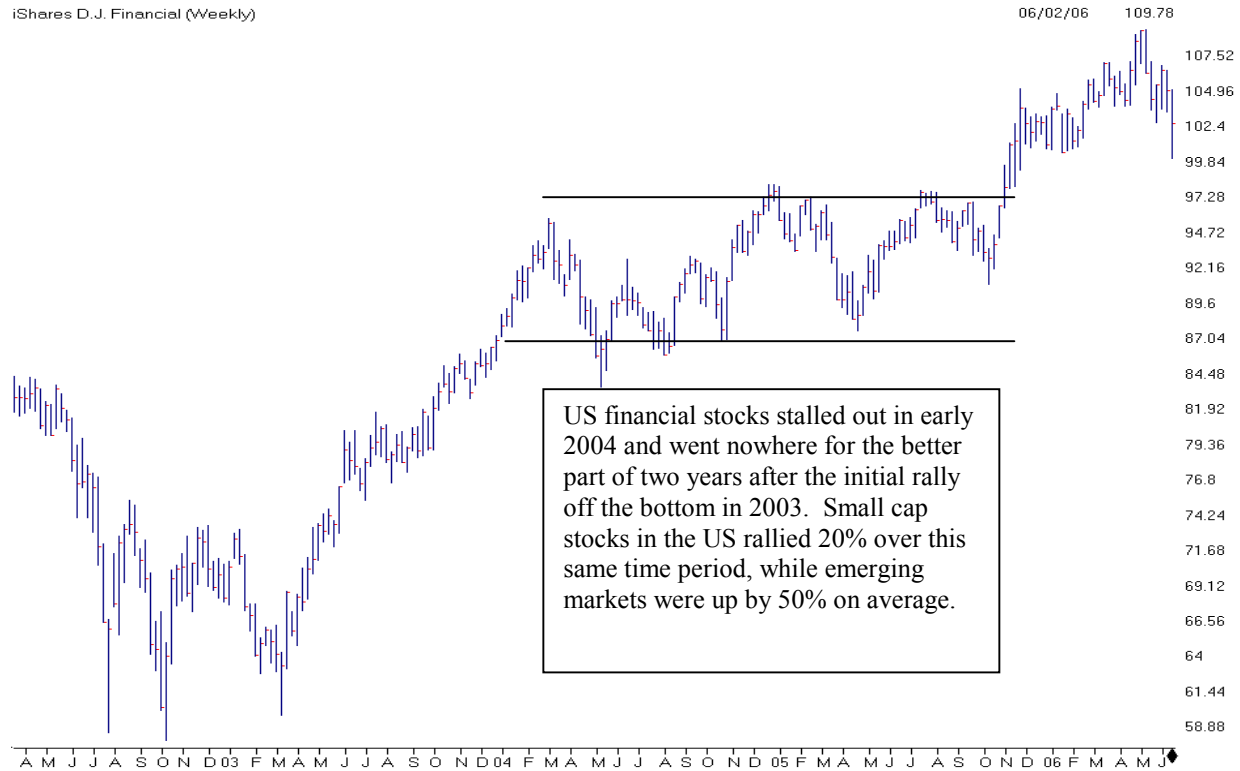
Two major developments hit the market this week and wiped out the majority of year-to-date gains. China has decided to start raising interest rates in an effort to cool down their economy and head-off inflationary pressures. Closer to home, a stunning defeat in the Massachusetts Senate race suddenly increased the political appeal of bashing rich and powerful special interests. This caused Washington's populist pitch forks to aim directly towards Wall Street investment banks and then Federal Reserve chairman Ben Bernanke. As of this writing, Bernanke's once locked-up reconfirmation is now up in the air. Nothing motivates a politician to act quite like the threat of getting voted out of office.

We do not want to dismiss these issues because they are creating the thing most despised by markets....uncertainty. Waning relative strength in Chinese stocks has been on our radar for a few weeks now. Their economy led the market from the depths of despair back in late 2008, so they are very vital to the big picture. It is important to note that what we are seeing is not broad based weakness across the entire Asian region or even all Chinese stocks for that matter. In fact, smaller capitalization Chinese stocks are holding up quite well on a relative strength basis. The weakness we are seeing is in the largest and most liquid H-shares that are freely traded in Hong Kong. The large cap FTSE/Xinhua China 25 Index (pictured below) is made up of almost 50% financial companies and it is these large banking stocks that are causing this underperformance.



It makes sense that interest rate increases will have a negative effect on financial stocks, so it is not a surprise that an index with 50% financials is going to lag the rest of the market. Below is a chart of the Dow Jones Financial Index in the US between 2002 and 2006. After leading the charge off the bottom in 2003, the sector stalled out in early 2004 and went nowhere for almost two years. Despite this underperformance, the housing and credit bubbles went full steam ahead. We believe that there are interesting parallels between the US credit bubble that developed after the easy money period in 2002-2003 and this easy money credit boom in China. Credit growth in China was over 30% last year. Once that type of momentum gets going in the credit markets it is hard to stop no matter how hard central bankers try to reign it in. There have been many articles written in the press recently that have warned of a bursting Chinese credit bubble. In theory, we agree that there are a lot of potential excesses building. However, we believe those calling for an imminent melt-down are very early with their call. If the recent move to raise interest rates have the effect of reigning in inflation, it should help

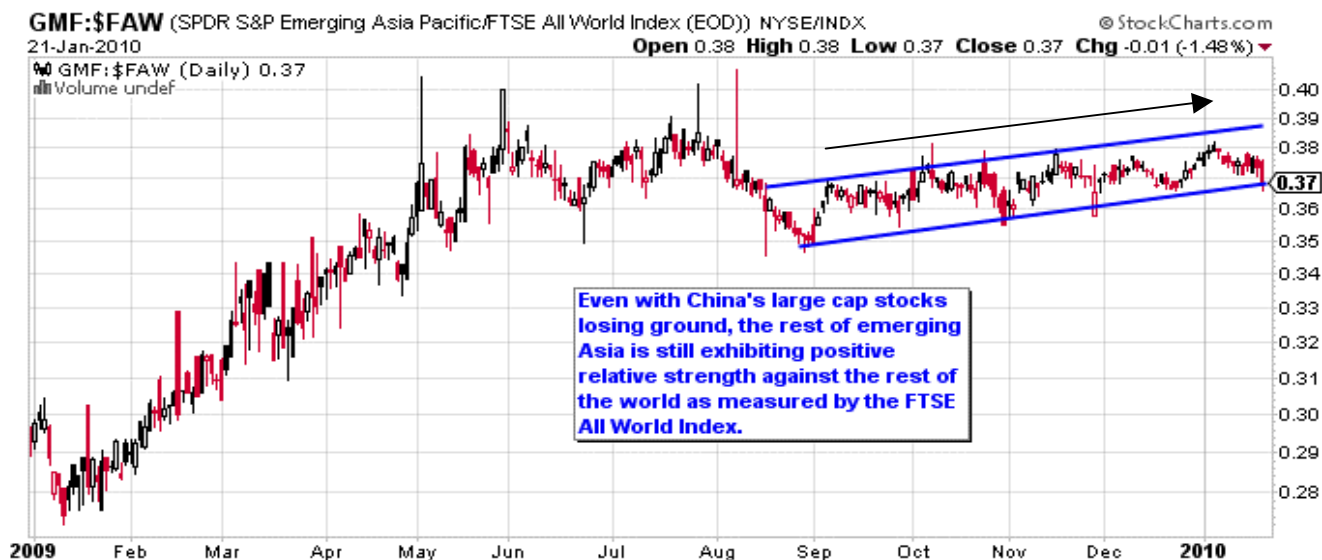
prolong this economic growth cycle in Asia, not snuff it out. A lengthy correction is certainly a possibility over the next few months as the market digests this move to higher rates. However, we do not think there is enough evidence to be concerned about a bust just yet.



The next chart below is a relative strength chart of the FTSE/Xinhua China 25 Index Fund (FXI) versus the S&P Emerging Asia Fund (GMF). Please note the recent falling relative strength we discussed above.



Yet, the rest of Emerging Asia is still holding up well versus the rest of the world's stock markets. This chart shows Emerging Asia versus the FTSE All World Fund.



Finally, Chinese small cap stocks are holding up even better than emerging Asia versus the rest of the world.



This is not a static analysis and it bears close watching in the weeks ahead. We want to make sure that this correction does not turn into something worse, so we will continue to monitor the situation in China and Asia.

The other major news story of the week was the assault by the Obama administration on the big Wall Street Commercial banks. It remains to be seen how successful they are taking on the Wall Street political lobbying machine. However, if they are able to reign in this outsized influence in the national debate, it could go a long way in getting relief to those that truly need it instead of the bankers.

The two charts below from Gary Tanashian of www.biiwii.com summarize the divergence going on at the moment in the banking sector. Regional banks (first chart) are gaining momentum as investment banks like Goldman Sachs (second chart) are starting to roll over. After the bank break-up plan was announced on Thursday, Goldman lost over 4% on huge volume while the KBW Regional Bank Index gained 3.3%. The volume spikes are circled on the charts. We believe this rotation is a good thing because healthy regional banks are better for the US economy than a healthy investment banking and hedge fund sector. The reason being that investment banks like Goldman have basically morphed into licensed casinos via their proprietary trading desks. On the other hand regional banks are still mostly involved in the bread and butter economic lending that can help spur economic growth.

