



FLASH REPORT

China's Market Correction

On Tuesday, February 27, the Shanghai Composite Index, which tracks shares listed on the larger of China's two stock exchanges, tumbled 8.8% on fears that the government would intervene to slow down the market. The decline ranks as its biggest single-day drop since 1997, after the death of reformist Communist Party elder Deng Xiaoping. The Index had hit a record high on Monday, rallying 13% in the previous 6 trading days. In 2006, it was the best performer among all major global indexes, rising a stunning 130%.

Global markets tumbled, with emerging markets and commodity related shares leading the declines. In the US, stocks plunged in their worst one-day performance since 2001, as a disappointing US durable goods report and a failed assassination attempt on Vice President Cheney in Afghanistan added fuel to the fire.

Today, Chinese shares rebounded 3.9%, after the Finance Ministry officially denied rumors of a potential capital gains tax on stock investments. Even after Tuesday's declines, the Chinese equity market is still higher than it was on February 1st. For over a year, the Chinese government has expressed concern that the greatest risk to the economy was overheating, and had taken a number of steps to curb excessive growth and potential inflation. These measures have included increased reserve requirements for banks, interest rate hikes and the tacit approval of Renminbi appreciation. We believe that these measures are appropriate and will continue to help China manage its economic growth and provide opportunities for long-term investors.

Although most other Asian markets were affected by the sharp decline in Chinese equities, we believe that the market over-reacted. There have been no significant changes to Chinese, Asian or global growth expectations over the

past 48 hours. The fact that most Asian markets fell in near lock-step with each other, regardless of their relative valuations or recent performance, seems indicative of a short-term trading reaction, not a thoughtful reevaluation of regional economic growth.

Commodity prices also experienced increased volatility. As with the impact on other regional Asian markets, we believe the one day linkage between the Chinese stock market and natural resource prices is overstated. Increased economic activity throughout Asia has spurred demand for a wide variety of natural resources. Short term volatility in equity markets should not impact this demand, nor should it impact the earnings of the companies in the natural resource sectors.

In short, we believe that Tuesday's decline in Chinese stocks was primarily a local event with local causes. Some, such as the rumors of a tax change, have already been addressed. These events had impact across global equity and commodity markets far in excess of what was warranted. The long-term growth trends in China, and in emerging markets generally, have not changed.

As we stated in our year-end newsletter, Newgate remains optimistic on global growth and believes that valuations are generally reasonable based on historical norms. However, we continue to believe that volatility in emerging markets will continue to rise back toward historical levels. During the past four years, we have seen market returns far in excess of historical norms. Moreover, this recent bull market has been accompanied by lower than average volatility. Both returns and volatility should move closer to their long-run averages. Market corrections are both common and normal in emerging markets. ♦