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Martin Spring's private newsletter on global strategy

May 10, 2014   No.175

China: Assessing the Risks

Increasingly, it seems, there are predictions of impending calamity facing China – in purchasing-power terms, about to overtake the US and become the world's biggest economy, and a most important driver of global growth.

The pessimists say there's a hidden "toxic debt" problem even worse than Europe's, with recent bond defaults as signs of much worse to come. They point to excess capacity in industries – in everything from steel to solar power equipment. There are bloated inventories of natural resources such as iron ore.

There's dangerous dependence for economic growth on property speculation, they say. Over-investment in physical infrastructure, including wasteful absurdities such as "bridges to nowhere." And now a new development -- weakness in the currency, the yuan.

However, others are optimistic. Standard Chartered Bank CEO Peter Sands, for example, says: "To jump to the conclusion that… a crash is inevitable, is wrong."

And there is no turbulence in the Chinese stock-market – which you would expect if things were about to go seriously wrong.

The three big issues for investors are:

► Is China's economic growth going to continue declining, as it has been recently, and if so, by how much?

► How serious is the risk of a crash?

► What are the investment opportunities, if any?

The first phase of China's extraordinary economic growth was driven by exports as global integration (the infotech explosion, free trade, capital flows), and the transition from communist regimentation to private enterprise, led to the creation of enormous manufacturing complexes.

The export stimulus evaporated with the onset of the global financial crisis. In four of the past five years, net exports haven't contributed anything to economic growth. The driving force it provided has been substituted by a surge in fixed capital investment powered by abundant credit, accounting for half all economic activity.

Now China has started to move into its next phase, revolutionary in its scale and nature. With the world's most populous nation set to create the world's largest middle class, living standards are to become the new priority.

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The emphasis is shifting from investment in physical capital such as buildings and infrastructure to investment in public services such as healthcare, welfare such as retirement pensions, better cheap housing for the masses, and a much-improved environment -- all with a continuing strong rise in personal incomes.

It will be a difficult transition. You can't just close steel plants and convert the human and physical resources into medical clinics. It's much more difficult to build the personal incomes of more than a billion people to American levels in an economy where growth is increasingly driven by private enterprise, than it is to force-feed a fixed-investment explosion through political direction of state-controlled banks, enterprises and public authorities.

Transforming China's economy from the developing model, fuelled by abundant cheap labour and low-tech industries, to the developed model of expensive but highly-skilled workers, leading-edge manufacturing and sophisticated services, implies substantial costs that will moderate economic growth.

China has already geared down from annual growth in double digits to around 7 per cent. For the immediate future, policymakers are unlikely to allow growth to fall below that, because that's the level needed to maintain job creation. However longer-term, growth is heading towards rates more like 4 or 5 per cent a year. That will still be far greater than can be expected in the mature economies of the US, Europe and Japan.

The worrying possibility is that stresses generated by the transformation from the developing to the developed model, and the inevitable accompanying loss of momentum, will trigger crises in major areas of the economy – finance, real estate, industry.

Worries about the "moral hazard" in finance

"Bad debts might amount to the equivalent of a quarter of the country's GDP," *The Economist* reported recently. Total debt – the figure that includes all public, consumer and corporate borrowing – has grown sharply since 2008 and has now reached 230 per cent of GDP.

The major concern is that so much borrowed capital has been invested in poor-quality assets that will never be commercially viable. There's a looming problem of non-performing loans, which are starting to show up in defaults.

It's still largely a hidden problem because banks and other lenders "extend and pretend" – refuse to recognize in their accounts the dodgy quality of much of their loans and take write-offs, instead refinancing maturing loans rather than insisting on repayment.

However, that's not a problem unique to China. It can be seen elsewhere, particularly in Europe.

China's debt-to-GDP ratio is in fact much lower than those of advanced economies, where total debts have averaged more than 300 per cent of GDP in recent years.

Foreign debt isn't a problem – it's only 10 per cent of GDP. Consumers aren't overborrowed. Neither are property speculators, who have relatively low levels of mortgage debt. And central government debt in GDP terms is only half the level of major nations', even Germany. Potentially toxic debt is limited to the local government and corporate sectors.

Carnegie Endowment researchers point out that the recent rise in China's debt was the result of a deliberate state-driven stimulus programme in response to the global financial crisis. That's in contrast to other crisis countries, where credit surges were due to "the culmination of a long-term deterioration… brought on by excessive external borrowings, rising current account deficits and overvalued exchange rates or excessively leveraged housing markets, exacerbated by chronic fiscal deficits."

Another analyst comments: "When you borrow to consume, as the US and Europe did before the crisis, you have little to show for it afterwards other than a slide in living standards when the party stops. When you borrow to invest, you may end up with some white elephants and overcapacity, but you also gain some superb infrastructure… and some world-class productive facilities."

Recent experience worldwide has shown that governments will not allow really big financial institutions to go bust because of toxic debt. We've seen that in America, the Eurozone and Britain. Rescue in a crisis is no less certain to come in China, whose government is in an even stronger position because it exercises tough centralized political control, has enormous financial resources, and largely owns the major banks.

Allowing greater scope for market forces

However, bad debt is not the only risk in China's financial system.

Around the world, savers have for several years suffered "financial repression" -- central banks have kept interest rates artificially low to stimulate borrowing to encourage economic growth. In China this has taken the form of caps on bank deposit rates.

With few alternatives to bank deposits available – most shares offer low dividends, property investments are designed to deliver capital gains rather than income, there are few bonds, and exchange control makes it difficult to invest outside the country – China's extraordinary thrifty citizens have searched desperately for acceptable yield on their massive savings.

To meet that need, the government and the central bank have started to permit (encourage?) market forces to operate that circumvent the restrictions on bank deposits.

They allowed the emergence of "shadow banking," where financial companies match lenders to borrowers, but are not subject to most of the restrictions and reporting requirements applied to banks.

It's become huge, is growing fast, and encompasses several different kinds of business.

Most important are the trust companies that provide "wealth management products" (WMPs) – investments housed in special vehicles offering interest rates, typically for a two-year period, higher than those allowed on conventional bank deposits – even as high as 12 per cent. The equivalent of about $1 trillion was raised by WMPs last year alone.

Much of this capital is loaned to higher-risk private-sector companies such as property developers and coal miners who find it hard to borrow from the banks.

More recently, the authorities have permitted the emergence of Internet savings vehicles which also circumvent liquidity, capital and rate controls, so they are also able to offer interest rates to lenders that are higher than the banks', such as 5 to 6 per cent.

Their growth has been explosive. Alibaba's Yu'e Bao fund alone has attracted some $87 billion in deposits since its launch less than a year ago.

Nearly all of this money is being lent to the banks, which struggle to raise enough through their conventional deposits.

Another important new development is "entrusted lending" -- company-to-company loans. Large firms with access to more bank credit than they need to expand their own operations divert the surplus cash to those starved of credit, especially in dodgy sectors such as steel, coal and energy supply.

There is much talk about the dangers of a financial calamity in this regulation-evading shadow and Internet banking. Certainly there are risks. But this misses the point that the authorities are clearly willing to tolerate these visible breaches of controls as steps towards modernization of the financial system, giving greater power to market forces and greater exposure of both lenders and borrowers to the financial penalties of bad decisions.

The technocrats are increasingly willing to accept the risks, confident of their power to contain financial crises.

China has few of the risk factors that are common to such crises. It doesn't run a deficit on its foreign trade. It has low foreign debt, enormous foreign exchange reserves (approaching $4 trillion), and a fairly valued (perhaps undervalued) currency. Exchange controls would make it relatively simple for Beijing to manage domestic financial shocks. With below-normal loan-to-deposit ratios of 70 per cent and minimal dependence on volatile wholesale funding, banks are highly liquid and not vulnerable to a US-style freeze of the interbank lending market.

China's government has proved to be one of the world's most competent at economic management, with Zhou Xiaochuan, central bank governor, and his regulatory and government counterparts, proving to be remarkably surefooted in their incremental reform of the financial system.

Although there are undoubtedly going to be financial shocks arising out of bad debt, and the growing pains of adjusting the system to be more responsive to market forces, the prospects of systemic, debt-ignited calamity in China are minimal.

A bubble in property

Linked to fears about safety in the financial system are those about the enormously important real estate sector. Construction, sale and outfitting of homes accounts for a quarter of China's annual economic activity.

The Chinese are big savers, but lack attractive places to invest their money. The stock-market hasn't been offering capital gains. Dividend and interest rates are low. Exchange control prevents investment abroad.

What the Chinese do like is property. Some 80 per cent live in homes they own. The family's spare cash often goes into second or third properties, held not to generate rental income, but as capital assets.

Pessimists like Edward Chancellor, an asset manager GMO, argue that the real estate market is "overbuilt and overpriced" … in a dangerous bubble similar to Japan's in 1990 that produced "two decades of economic stagnation."

Others are less gloomy. The *WSJ*, for example, says: "The problem is not so much high prices, since the average cost of an apartment has tracked rising urban incomes. Nor is it leverage, since regulations restrict mortgages and many buyers pay with cash." There are no high-risk "sub-prime"-type mortgages.

The problem is simply over-supply. Far too many apartments have been built, encouraged by local governments that depend on property developers for about 40 per cent of their revenue, spawning "ghost towns" of new but never-occupied apartment blocks and townships on the outskirts of many Chinese cities.

However, the *WSJ* argues, that will not necessarily lead to catastrophe. "When prices begin to fall, most owners will likely hold on and wait for a rebound." Instead of a collapse, we can expect "a long period of stagnation as the excess supply gradually comes on to the market."

Average property prices have risen 10 per cent over the past year in Beijing, 13 per cent in Shanghai and Guangzhou, but sales are falling sharply. Banks are tightening credit. First-time buyers have to give down-payments of 30 to 40 per cent of the price of homes to be financed, and meet mortgage-interest rates of 7.2 per cent.

The slowdown in property is largely a response to a policy squeeze. Beijing wants to discourage speculation in luxury units and focus development on basic housing, but achieve that without imposing too much constraint on economic growth.

Switching growth from investment to consumption

The unhealthy emphasis on static, often unproductive physical assets, is part of a broader problem of the need to re-shape the structure of the Chinese economy.

Last year China produced more than $9 trillion worth of goods and services. But half of that output consisted of new capital goods – infrastructure, housing, factories and machinery. This investment rate is among the highest ever recorded anywhere, but much of it has been wasteful – ghost towns, an extraordinary network of high-speed railways, steel plants and shipyards way beyond requirements.

Beijing knows that it must shift a lot of productive capacity into providing consumer goods and services for consumers – but it has barely made a start with turning good intentions into achievements.

The share of China's annual output taken by household consumption is among the world's lowest – just 36 per cent of GDP in 2012, compared to 69 per cent in the US.

Admittedly, the Chinese statistic may not reflect reality. Some experts reckon consumption is 10 to 12 percentage points higher because the official figures ignore the value of "imputed rent" (what owner-occupiers would need to pay if they were renting); a lot of private consumption that is claimed as corporate expenses (such as the value of private cars paid for by companies); and, most importantly, under-reported spending by high-income families.

Jonathan Garner of Morgan Stanley says the transition to economic growth driven by consumer demand has been under way for some time. Car sales, for example, are growing by 13 to 14 per cent a year; consumer-related stocks have long outperformed industrial ones. The annual consumption growth rate, 12.7 per cent in nominal terms, is among the world's highest, with spectacular growth in e-commerce.

Scrapping *hukou* to make universal the benefits of city life

The main priorities of the government's agenda for the economy as outlined last year are to improve the operating environment for the private sector, which now accounts for at least 90 per cent of new job creation, and to reform the *hukou* system to extend urban-living rights to 100 million migrant workers by the year 2020.

This household-registration system denies access to urban welfare such as healthcare, education for their children, jobs, sometimes even the right to buy a car or a home, to one-third of those living in cities.

If they gain *hukou* privileges, they will be under less pressure to save and more willing to spend, stimulating consumer demand.

Reform of *hukou* will not be easy. It cannot be scrapped without providing ways to pay for the schools, hospitals and other public services that will then have to be provided by local authorities. Plenty of opposition can be expected from state-owned enterprises (SOEs), recalcitrant bureaucrats, party ideologues, and citizens already benefiting from full urban residential rights who see reforms as a threat to their interests.

The government plans other reforms. Farmers will gain more rights (although sale of land except to those who cultivate it, and mortgaging of rural property, will continue to be prohibited). More private hospitals will be allowed. But there will be no large-scale privatizations that would further concentrate wealth in the hands of a politically-connected few.

There's to be further improvement in efficiency of the SOEs by, for example, introducing employee stock-ownership plans, increasing the scale of their private ownership, and increasing competition by opening up protected sectors such as finance and energy. The SOEs will be expected to more than double the share of their profits distributed as dividends to the state.

Private firms now account for a third of industrial profits, compared to just one-tenth a decade ago.

Americans and Europeans spend, Asians save

Unlike the US and Europe, China saves a lot – more than half its GDP. It has the highest national savings rate of any major economy. This year its gross national savings will be close to $5 trillion. The US's will be only $3 trillion. China's government has access to resources on a scale even America's can only wish for.

East Asia is a region whose peoples are naturally thrifty, with cultures based on family self-sufficiency. Welfare systems offer minimal benefits; people cannot look to the state for significant support, so they have to limit their spending, save and accumulate assets for themselves and their families.

One reason for China's astonishing economic growth is the way it mobilizes those savings through its banking system and channels the capital to industry.

Increasingly those savings are being invested in the vigorous private sector rather than bureaucratic state enterprises with their political priorities. Private firms now account for two-thirds of new bank lending, compared to 40 per cent a decade ago.

Plus points for the future

China suffers from neither inflation nor a foreign trade deficit, and is not living beyond its means. It has formidable resources that seem to guarantee strong economic growth in the years ahead. An industrious, mobile work-force. Dynamic entrepreneurs always on the lookout for new opportunities. Low taxes. A sound, modern infrastructure.

Millions of people every year continue to move from rural areas to the cities, and retail sales continue to grow every year at astonishing rates. Even though there is no more "low-hanging fruit" in manufacturing, where labour costs are rising fast, there is plenty of scope for generating growth and jobs in the service industries.

Christopher Wood of investment bank CLSA says that despite "the rising chorus of bearish sentiment" towards China, the track record since the reform programme began in 1978 suggests it would be wise to give its leadership the benefit of the doubt. "Most policymakers are fully aware of the issues" cited by the pessimists and "are certainly not in denial about them."

China has delivered an unprecedented economic transformation over the past decade, with the share of work-force in agriculture falling from a half to a third, the share of exports in economic output falling to a quarter, and the share of services in economic activity overtaking that of industry, all achieved with continuing high economic growth. Similar dramatic development seems probable.

Should you invest in that future?

The outlook for the stock-market

Generally speaking, Chinese shares have been a huge disappointment for international investors. The main reason is lack of interest from domestic investors, who prefer to deploy their enormous savings elsewhere, preferring property for long-term capital gain, bank products for income and liquidity.

The stock-market has a bad reputation as a place manipulated by politically well-connected insiders, rife with dodgy accounting, and always threatened by the possibility of over-supply through dumping of enormous holdings of state-owned equity. It's also been highly volatile – in 2007/8 shares lost more than two-thirds of their value.

However, if the property sector chokes on over-supply, and risks in financial investments become more apparent, domestic investors could start to switch some of their immense cash flows in the shares of best-managed Chinese companies.

The stock-market is largely closed to foreign investors, although it's slowly being opened up to institutional investors. The only avenues open to individuals are the shares of Chinese companies listed outside the country (mainly in Hong Kong), depositary receipts of such firms listed overseas, or foreign multinationals whose profits are geared to business with China.

The Shanghai A-share index bottomed at the end of 2012 and has ranged sideways since then. It looks to me as if the market has established a strong bottom – downside risk is negligible.

It doesn't yet show any sign of take-off. Nevertheless, the *FT* advised last month: "Be bold… buy China." Increasingly, it said, Chinese stocks are "a consensus contrarian bet."

The index of Hong Kong-listed shares of 40-odd mainland companies, most of them very large and important ones, "is trading on seven times forecast earnings, compared with 16 and 14 for the S&P 500 and the FTSE Eurofirst [indexes] respectively. Chinese stocks in general are at their biggest discount relative to those of the US and Europe for at least five years.

I don't expect any fireworks for a while as the market equivocates in the face of negative news such as a continuing moderate slowdown in economic growth, liquidity tightening, and a "stress test" for shadow banking as Beijing allows some bond defaults and bankruptcies to discourage unwise lending and speculation.

However, that process of controlled destruction won't be permitted to go too far. At some stage – perhaps soon, but more probably next year -- investors will awaken to the reality that it's part of the government's plan to produce a healthier financial system, that the defaults/bankruptcies are actually good news for the longer-term.

So this should be a good year to investigate investment opportunities in China, even do some buying. My list of some of the best-looking shares, all of them relative-strength leaders with attractive fundamentals, follows.

TEN CHINESE STOCKS TO CONSIDER

Baidu is one of the world's ten biggest internet service businesses, and was the first Chinese company to be included in the Nasdaq-100 index. It is China's dominant search engine, and is expanding aggressively in the mobile and now internet banking sectors. Its earnings have grown at an average annual rate of 74 per cent over the past five years. It currently trades in New York on a price-earnings ratio of about 33x.

Bank of China is the country's third largest, and is a great income play. Its Hong-Kong-listed stock is yielding a juicy 7.3 per cent, 3½ times covered by earnings. And the bank has outperformed its main rivals since switching its focus from international to domestic business. Earnings growth has averaged 17 per cent a year.

Biostime is a niche retailer of infant foodstuffs and other baby care products through specialty stores. It's the major domestic competitor to foreign companies in its sector, where annual growth has been averaging 19 per cent due to urbanization, expansion of the middle class and a rising proportion of working mothers. This Hong Kong-listed small-cap has been expanding its earnings at an average 77 per cent in recent years. It currently trades on a PE of about 31x.

China Medical makes and distributes pharmaceutical products and medical instruments to hospitals and wholesalers across China. This Hong Kong-listed small-cap has been achieving an average annual profits growth of 32 per cent. It now trades on a PE of about 29x.

Fosun is an interesting and dynamic conglomerate founded by four university graduates 22 years ago. It has operations in industry (steel, pharmaceuticals, mining), insurance and investment management, and has a varied portfolio of holdings (banking, media, tourism, fashion). Driven by earnings growth that's been averaging 33 per cent a year, this Hong Kong-listed mid-cap now trades on a very attractive PE of less than nine.

Galaxy is one of the six big casino groups operating in Macau, the world's largest gaming centre. The Chinese love to gamble and they're increasingly able to afford to do so, so Macau is experiencing explosive growth. Galaxy is spending a remarkable $7 billion on expansion of its principal casino. The Hong Kong-listed company has been delivering earnings growth averaging 69 per cent a year. It now trades on a PE around 26x.

Great Wall Motor is arguably the most successful of China's car companies. It specializes in SUVs and pick-ups, achieving operating margins even higher than those of ultra-luxury players such as Ferrari. It dominates its sector in China, exports to other countries, and is "trading up" from basic SUVs by introducing a bigger, high-end model. Earnings growth averaging 39 per cent a year has made founder-chairman Wei Jianjun China's fourth-richest man. Currently the Hong Kong-listed stock trades around 13 times earnings.

Haier Electronics is the world's biggest producer of major kitchen appliances such as refrigerators, washing machines and cookers, with almost 10 per cent of the global market and 27 per cent of China's. It recently tied up with the internet giant Alibaba in a joint venture to create a logistics and customer service network. Earnings growth have averaged an astonishing 62 per cent a year over the past five. The Hong Kong-listed stock is trading on a PE of around 20x.

Sinomedia is a small-cap that is a specialist in planning and placing CCTV advertising, and has been rated by *Forbes* as one of the 200 best companies in Asia with a market value below $1 billion. Annual earnings growth has averaged 21 per cent a year over the past five. Listed in Hong Kong, the share trades on an inexpensive ten times' earnings.

Tencent is another internet services giant. It's the dominant player in China's messaging market, with approaching 800 million monthly users of its WeChat mobile and older QQ desktop products. The *WSJ*'s analyst said recently that it looks "better positioned in mobile than any major Chinese internet player." Goldman Sachs reckons its mobile payments "will account for 12 per cent of all retail sales in China by 2017, or $683 billion, up from almost nothing today." 45 per cent of the stock – listed in the US, Germany and Hong Kong -- is owned by South Africa's Naspers media group. Earnings growth has averaged 41 per cent a year over the past five, so it's not surprising the shares are now trading on a PE around 48x.

Syrian Rebels Gas Civilians

Evidence is emerging that in Syria chemical weapons were not used by forces of the Assad government, but by rebel units seeking to trick the Americans into military strikes against the Assad regime, blaming it for breaching President Obama's so-called "red line" against use of such weapons.

According to a long and detailed report published in the *London Review of Books*, the nerve-gas attacks last year on civilian populations were carried out by anti-Assad forces sponsored and supported by the Turkish army.

► In March the first gas attack took place at Khan Al-Assal, a village near Aleppo. To United Nations' investigators "it was clear that the rebels" – not the army – "used the gas," but that "did not come out in public – because no one wanted to know."

► In May members of the al-Nusra Front, a jihadist faction, were arrested by police in Southern Turkey and found to have in their possession several kilograms of deadly Sarin. "The American and British intelligence communities had been aware since the spring of 2013 that some rebel units in Syria were developing chemical weapons."

► In August nerve gas was used to kill civilians in Ghouta, a Damascus suburb. British intelligence obtained a sample of the Sarin used in the attack. Analysis at the UK's Porton Down military research centre showed that it had not originated in the Syrian army's chemical weapons arsenal. The US was informed, making clear it was being "set up" by anti-Assad forces.

► The US joint chiefs of staff "knew that the Obama administration's public claims that only the Syrian army had access to Sarin were wrong." They opposed the planned military strike against Syria, telling the White House that it would be "an unjustified act of aggression."

That's why Obama made the extraordinary last-minute decision to ask Congress for approval for such a strike, knowing it would not be forthcoming; and why within days he was willing to agree to a deal with Russia about removing chemical weapons from Syria.

Share and Bond Markets

Earnings – the lack of them – remain the biggest threat to American equities, whose recent strong growth has been driven by optimism and buy-backs rather than underlying profits, while the latter have come from cost-cutting, not growth in sales.

"First-quarter earnings growth is running at minus 1.3 per cent, according to FactSet – well shy of Wall Street's sunny forecast of a 4.4 per cent gain back in January," Michael Mackenzie reports in the *FT*.

The earnings cycle is the weakest in 55 years, says Jeffrey KIeintop, a strategist at LPL Financial, with average earnings having risen only 20 per cent from their prior peak, compared to gains of 50 to 70 per cent in previous cycles.

Wall Street does expect a strong pick-up in profits ground in the second half of this year. However, Mackenzie says, if the "rosy earnings forecasts don't materialize in the coming quarters and the Fed ends QE [money ‘printing’], rougher water is the destination for equity bulls.”

Things are very different in Asia.

Investment bank CLSA says it expects earnings of the 851 companies in the universe of the Asia-Pacific excluding Japan that it covers, to grow by 8 per cent this year. It’s forecasting return-on-equity of 13.6 per cent this year.

Asia also offers defensive quality as its companies are paying higher dividends, two-and-a-half times covered by earnings.

Once again global bond markets have made fools of the perennial pessimists and rewarded the handful of optimists like myself.

20-year US Treasuries have delivered a total return of more than 12 per cent this year, the equivalent German Bunds an amazing 18 per cent.

Longdated government bonds has outperformed both equities and lower-rated company paper since the year began. Why?

Institutional money seems to have switched out of riskier assets after the sharp rise in their values last year in anticipation of some weakness in those values this year. The lowest-risk “sovereigns” look attractive investments in an environment where there is no sign of the inflation that is bonds’ greatest enemy.

However, two of the world’s most important markets in sovereign debt have parted company in over the past year. The *FT* reports: “Bund yields have fallen to their lowest level against their benchmark US counterpart in nearly eight years, as investors anticipate contrasting central bank policies in the coming months.”

The US Federal Reserve is “tapering” – slowly trimming back its extreme easy-money policy – while in Europe the central bank is expected to do the reverse, and switch to more aggressive stimulation.

Bond values move inversely to their yields, and lower yields indicate greater investor preference. The longdated German paper was recently trading around 2.37 per cent, the American equivalent at 3.51 per cent.

Tailpieces

Don’t credit easy-money: “Many investors have allowed themselves to be convinced that QE and other liquidity measures are the main driving forces behind the strong showing of equities in recent years,” but this “seems improbable,” says Jonathan Davis of *Independent Investor*.

Markets always overreact during large peaks and troughs, and would have rebounded anyway in due course following the Lehman Brothers collapse. The only net buyers of US equities in the last few years have been corporations buying back their own shares.

“Today the equity markets look expensive on many measures. The fact that there are few obvious alternatives [as investments] may explain, but cannot entirely justify, today’s lofty equity valuations.

“Could it be that the markets have simply got it wrong at the macro level once again, extrapolating from unrealistic assumptions about earnings?”

High fees aren't warranted: The cheapest equity funds in terms of their charges have outperformed their expensive competitors, the Vanguard group argues in a new attack on its rivals in the UK for overcharging clients. It says that over the past decade funds in the cheapest quartile returned an average of 12.3 per cent a year after charges, 3.1 percentage points higher than the average for those in the most-expensive quartile.

Over the period 1999 to 2013, after taking into account funds that closed or merged because of poor results, only one quarter of UK funds pursuing active management strategies outperformed their benchmark.

Global freezing: January was "the third coldest… on record" for the 48 contiguous US states and "broke more than 4,800 snowfall records, reports climatologist Evelyn Browning Garriss, with the Great Lakes experiencing their greatest ice cover since 1994. Last year the Arctic had "the coldest summer on record," with 60 per cent more sea ice than the previous year.

This extreme weather is being blamed on volcanic eruptions that put particles into the atmosphere that block sunlight. So it seems volcanic activity has a much bigger impact on climate than long-term changes in gas levels, whatever their cause.

Ukraine: One reason it's critically important to Russia, and could lead to a dangerous escalation in the crisis, is military dependence. According to the *FT*: "After the collapse of the USSR, about a third of the Soviet defence industry was left in Ukraine." Its Motor-Sich plant makes the engines for most Russian military helicopters. Ukrainian factories make missiles and a host of critical defence components for Russia – but all deliveries have been suspended since the outbreak of the Crimea crisis.

Cash pile: American multinationals continue to show lack of confidence in the economic outlook by accumulating cash rather than invest it in expanding their businesses. According to Bloomberg data, holdings of the 2,300 non-financial companies in the Russell 3000 index have topped $2 trillion, and have been increasing at an annual rate of 13 per cent.

Gold: Chinese demand, which soared to nearly 1,200 tons in 2013, is not likely to grow this year, but "at best" no more than maintain last year's level, predicts Albert Cheng of the World Gold Council.

Wise words: *Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria.* John Templeton.

Martin

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