



The Asian Miracle

April 18, 2006

A recent trip to Asia reinforced my belief about how remarkable this region's achievements over the last few years (Tom and I were last there in 2000) have been. Having spent nearly a month touring Asia, it is clear that, economically, the success of the four dragons – Hong Kong, Singapore, Taiwan and South Korea – has graduated into a cliché, they have grown so fast! Even the communist states of Vietnam and China have opened their markets and forsaken Marx; indeed only North Korea remains faithful to its Stalinist heritage. The economic achievements of these prosperous nations of Asia have been paralleled by a democratization of the political process. These developments support our Global Growth investment theme that we first wrote about in late 2004.

Global Growth: Every few decades, a seismic shift occurs in the world economy that has far-reaching implications across a wide range of markets. The rise of the U.S. economy in the late 20th century, the post-war rebuilding of Japan and Western Europe and the rise of the East Asian production network have all been events of this kind. The rise of the four largest emerging economies, the BRICs—Brazil, Russia, India and China—could be the same kind of transforming event over the next few decades. Of these four emerging economies, only those that maintain steady progress in strengthening the conditions for growth by fostering infrastructure development, providing new opportunities for capital investment, and emphasizing free market principles will come out ahead. Alongside liberalization, one of the most important developments is the private sector initiative.

Globally competitive firms are raising the bar for international products and strong corporate governance. As emerging economies grow and contribute to world growth, global financial markets will be impacted. Commodity markets are already the clearest pressure point for growth and the impact of this demand in these markets is likely to be at its peak in the next decade. The importance of the BRICs as consumer markets is likely to be the next growth phase as the number of people entering the middle class is forecast to double in the next three years alone. Additionally, the ability of information technology, and services more generally, to promote organizational efficiencies can give the growth process an extra kick—enhancing productivity across the economy. If there is successful inter-linkage between services, agriculture and manufacturing, there is greater scope for growth in services that have a beneficial impact on other parts of the global economy.

Having invested our personal assets in addition to our clients' assets in these emerging economies since the mid-1990s, we have witnessed a tremendous advancement in their respective investment climates. Over the years, our "favorite" country out of the four BRICs has been China. Virtually none of the development that we have witnessed in Asia, and in China in particular, was predicted by the "experts", which may be one reason references to "the Asian Miracle" have become so popular. The success that Asia enjoys is clearly the result of unremitting hard work, an unquenchable spirit of enterprise, and sound economic policies. The fruits that Asians now enjoy are available to anyone willing to walk down this path.

The Global Economy

President Bush's tax cuts in 2003 were exactly the right medicine following the stock market plunge, the Iraq war and the outbreak of corporate scandals earlier in the decade. The ability of both large and small businesses to rebuild their balance sheets and move to unprecedented profitability is directly traceable to higher after tax rewards for capital formation. Capital formation favors both business and consumers.

The U.S. economy has never been better. The most recent manufacturing and construction data correspond to a 4.5% real GDP growth rate. Stronger growth is being fueled by a 16% gain in private construction spending and a 21% surge in spending by the non-residential sector. Huge gains in the production of transportation equipment, primary metals and various technology components belie the usual "gloom and doom" reports suggesting that America doesn't manufacture anything.

Employment data remain strong with the economy adding an average of 174,000 jobs per month over the past year resulting in an unemployment rate of 4.7%! Moreover, people are earning more – earnings are growing at a 3.7% pace – the strongest rate since 2000. Lower tax rates on capital have not only caused a surge of economic growth since mid-2003, they have also led to a ballooning of individual Treasury tax receipts from higher employment, more rapid economic activity and a strong stock market. State tax coffers are now also in surplus, a big change from the deficits of only a couple of years ago. U.S. household net worth now stands at a record \$52.1 TRILLION while the federal budget deficit has declined to only 2.5% of GDP.

Corporate profits are also at record levels. The most accurate profits measure shows that both pre-tax and after-tax profits have climbed to \$1.5 trillion and \$1.1 trillion, respectively, after posting 21.3% and 14.6% increases. As a share of GDP, the pre-tax profits share is the highest since 1966 while the after-tax share is at a post-WWII high! In addition, corporations are sitting on at least \$700 billion in cash and liquid assets.

The global economy has also improved markedly over the past few months. Recoveries in key countries such as Japan and Germany -- two of the weak sisters in economic terms over the past several years – have taken hold and now appear more durable. This year may be the first since 2000 in which the United States, Japan and Europe all grow at or above their potential. The combination of more robust global growth including a pickup in global investment and the acceleration of monetary tightening in key regions such as Europe and Japan has contributed to the recent run-up in global interest rates. In late March, Ben Bernanke presided over his first meeting as the Chairman of the Federal Open Market Committee (FOMC), the Fed's decision-making group. As expected, the Fed raised its overnight lending rate by 25 basis points to 4.75%. This move marked the fifteenth consecutive rate hike since June 2004 and the Fed left the door open to further increases should the economic data warrant such moves. Despite an increase in interest rates, inflationary pressures remain well-contained. Official U.S. government inflation indexes – which tend to be more backward looking – generally remained under control during the first three months of 2006. Core rates of inflation, i.e., excluding food and energy prices, continue to register rates near 2% -- a level we don't see much changed by the end of the year. Global competition that keeps a lid on business pricing power isn't going away anytime soon and neither is the healthy productivity growth that has helped dampen inflation pressures since the 1990s. We expect the Fed to raise rates at least one more time, and perhaps twice, for the balance of 2006.

During the first quarter, the European Central Bank (ECB) raised short-term interest rates by 25 basis points to 2.50%. Shortly thereafter, the Bank of Japan (BOJ) announced its intention to end the policy of quantitative easing and to adopt interest rate targeting instead. Officials from both central banks have continued to stress upside risks to inflation, but we believe that inflation remains well contained. The ECB is likely to raise interest rates one more time this year. Despite the fact that the Bank of Japan ended its policy

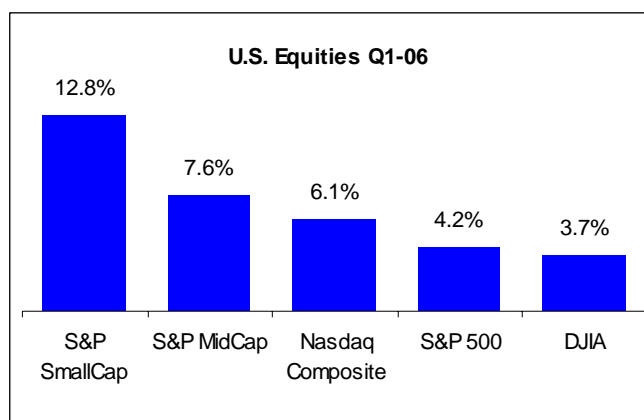
of quantitative easing, we expect inflation to decline in Japan over the next six months requiring only a modest increase in interest rates by the end of the year.

China's economy maintained excellent growth with first quarter GDP rising by 10.2%. The mainland's economy expanded by 9.9% in 2005 and the government has set a growth target of 8% for this year. The government has made it clear that it is committed to pursuing growth that focuses more on efficiency and quality of development. It is paying more attention to the transformation of the mode of growth, resource conservation, protection of the environment and, more importantly, the improvement in the lives of the people. Moreover, China announced last Friday that it will make it easier for the Chinese people to invest outside China through banks and overseas investment companies. Chinese firms will be able to increase their holdings of foreign exchange as well. These are further steps toward freeing up capital outflows and thus making the Chinese yuan fully convertible. When that is achieved, China will become a more normal country in trade and investment terms. President Bush's visit to China and the current visit by President Hu Jintao to the U.S. strengthens the expanding economic relationship between these two countries.

There are few signs that growth in China and the Asian dragon economies are slowing while emerging market economies continue to show solid growth. Robust global demand has boosted Asian exports and growth prospects generally – a phenomenon likely to continue. The recent improvements in the Japanese and European economies, plus the expectation that growth in both the United States and China will continue in the months ahead suggest that we are experiencing a synchronized global recovery -- a welcome condition for rewarding financial investing.

U.S. Financial Markets

U.S. equities finished their best first quarter since 1999, with the S&P 500 index in the black for a fourth straight quarter. The broad Standard & Poor's 500-stock index rose 4.2% -- slightly better than the 3.7% gain in the Dow Jones Industrial Average. The Nasdaq Composite index, whose volatile technology stocks have continued to endure sharp ups and downs, rose 6.1% in the first quarter -- their best quarterly start to a year since 2000. This year's strongest performers continue to be small and medium-size stocks that outpaced their larger brethren despite pundits' predictions that they were due for a rest. Small-cap stocks as measured by the S&P 600 rose 12.8% while mid-cap stocks gained 7.6%. Size was the theme for the first quarter as growth and value both benefited from increasing investor interest.



The stock market weathered additional debt downgrades and intensified solvency questions for embattled automaker General Motors, continued weakness in newspaper and traditional media stocks, such as New York Times and Time Warner, and even weakness in online search-engine Google, whose meteoric rise had previously been cited as the proximate cause of traditional media's recent swoon. As media stocks continued to suffer, energy stocks continued to surge, finishing up more than 7% for the quarter. However, commodity and natural gas prices took a breather. The Dow Jones-AIG Commodity index dropped nearly 7% for the first three months of this year.

U.S. bonds declined in price during the first quarter as the yield curve inverted for a period of time. The Lehman Brothers Aggregate Bond index was down 0.65% from the start of the year. Corporate bonds held

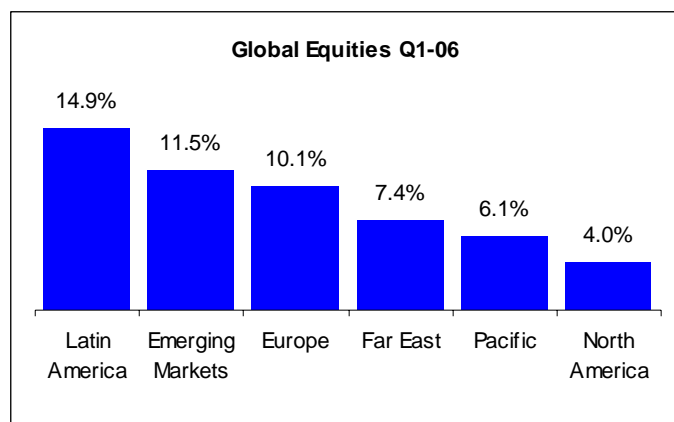
steady, their high prices and low yields reflecting robust corporate earnings as well as low default rates. High-yield bonds did well during the quarter, adding 2.6%. The spreads between the yields on lower-quality bonds and high-quality Treasuries has narrowed dramatically in recent years, but yield-hungry investors continue to take on the risk in exchange for the modestly higher yields. However, there was some turbulence in the high-yield sector as auto-parts maker Dana Corp. filed for bankruptcy-court protection and investors grappled with the possibility that General Motors Corp. would do the same. The thirty-year Treasury bond returned to the market in February and was embraced by pension funds and other institutional investors. At the end of the first quarter, the 30-year bond yielded 4.89% not far from the yield on the ten-year note -- or the 6-month Treasury bill for that matter.

Given an increase in ten-year treasury yields of nearly 100 basis points since last June, it is important to stress that the major factors that have kept long-term rates well behaved as the Fed tightened 375 basis points are intact. These include broad-based faith that the Fed has the mandate, capacity and willingness to do whatever is necessary to control inflation; strong productivity readings that are helping to keep inflation tame; a strong appetite for U.S. bonds; a global savings surplus; negligible U.S. corporate borrowing; and the ongoing global hunger for high quality fixed income securities.

Foreign Financial Markets

International stocks continued to climb in the first quarter, despite persistently higher energy prices and campaigns to raise interest rates by the central banks of the three largest economies.

Latin America continued its advance from last year and posted a gain of nearly 15% during the first three months of 2006. The natural-resource-rich region continues to benefit from higher commodity prices while Brazil and Mexico have benefited from an increase in energy demand thanks to positive macroeconomic and corporate conditions. Mexico's IPC stock index hit a record in late March, helped by solid retail sales that pushed up shares of Wal-Mart de Mexico while Brazilian shares rallied on strong export growth and a rise in the value of its currency (the real) that has strengthened by nearly 8% this year. Both stock markets saw renewed investor interest in these developing economies.



Emerging equity markets continued to outperform developed equity markets during the first quarter with Russian stocks gaining nearly 40% and emerging Asian stock markets advancing more than 20%. Stocks in Japan dipped in January and February following last year's 40% rise in the benchmark Nikkei Stock Average of 225 companies, but by the end of March, Japanese equities gained 6% in the first three months of this year. After 16 consecutive years in which corporate earnings surprised on the downside, upward profit revisions have been surfacing since the end of last year. In many cases, consensus earnings revisions for Japanese companies have been the strongest in fifteen years.

Chinese equities continued their strong performance during the quarter led by large cap H share companies in the financial sector. In early February, Hong Kong's HSI Services announced that H shares would be eligible this year for inclusion in the Hang Seng index for the first time, provided all of their shares can be traded on a stock market. Currently only Hong Kong-incorporated Chinese companies, known as "red chips", are qualified for inclusion in Hong Kong's benchmark. This latest development shows that China-

based companies are becoming more important to the local Hong Kong market, and Hong Kong's role as the investment gateway for the mainland is strengthening.

Indian equities gained more than 20% on the back of strength in the auto sector as investors focused on the opportunities within transportation and logistics arising from the improving road network in India. The fast moving consumer goods sector was lifted by better than expected results reported by a leading consumer staples company, and by some tax relief provided by the finance minister in the annual budget.

Conversely, South Korean equities rose only 4% as strong performance last year made investors wary. Moreover, concerns over slowing exports contributed to market consolidation over the last three months. The telecommunication services sector was an underperformer last year but has been gaining some traction this year due to relatively attractive valuation.

In Euroland, both German and French stocks advanced more than 13% -- seeing their best start to a new year since 1998. Ongoing strong exports and rising investment is contributing to GDP growth in Germany while gains in private consumer demand in France was a positive for investors. Spanish equities gained more than 12% on the back of robust job creation and strong consumer spending. Next year's planned tax cuts should remain supportive for Spanish equities. The Benelux stock markets gained more than 10% on increasing economic growth. London equities advanced at a slower pace of 7 % as investors feared rising inflation and related interest rate hikes by the Bank of England. During the first quarter, however, the Bank of England successfully managed to stomp out most of the speculation in the British housing market without derailing its economy. Despite less than double-digit returns for London stocks, the UK economy has continued its unbroken string of thirteen consecutive years of economic growth. The three pillars of our bullish case for European equities remain intact: stable economies, robust corporate profit growth and powerful de-equitization that will reduce equity supply.

Conclusions

Asian economies are booming. Capitalism is on the March as an economic model even though, in China, the political model remains Communism. While Japan and Korea are experiencing strong economic resurgence, it is the sheer weight of a Chinese expansion that is propelling these countries' economies. In our opinion, there is no greater factor on the horizon than a growing China to influence both our economic and political future.

The day after the conclusion of the National People's Congress (NPC) annual meeting in Beijing in March, we visited Tiananmen Square. Located at the center of Beijing City, Tiananmen Square comprises Tiananmen Tower, Monument to the People's Heroes, Great Hall of the People, and Mao Zedong Memorial Hall. It was within the walls of the Great Hall of the People that the NPC approved both the 11th Five-Year Plan and the macroeconomic policy framework for 2006.

The government also introduced new targets of a 20% improvement in energy efficiency and a 10% reduction in emissions over the coming five years. In addition, as part of the government's commitment to reviving rural growth, policy measures approved include ending agricultural taxes from the beginning of 2006, providing free education for nine years for all rural children at the age of 2, establishing rural healthcare cooperatives by 2008 and investing heavily in rural infrastructure.

Complementing these government initiatives, China's private sector now accounts for a good two-thirds of the nation's economy. Although this figure understates the influence of the country's biggest state-run companies, opportunism is fast opening China ever further to foreign investors. Sales of partial stakes in state banks is probably the biggest story so far and probably one of the most critical of all the economic

pieces. Foreign capital inflows to China that a decade ago might have gone into a factory are now being spread across many industries.

The key factor behind China's growth is private investment. The economy has excelled in encouraging both foreign and domestic private investment. Local private companies have been the most dynamic investors in China. Private-sector growth has transformed the economy in the course of less than two decades in which China transitioned from complete reliance on state-owned collectives to a mixed economy where the private sector plays a leading role. Moreover, the government's role is likewise being transformed. Local governments are withdrawing from direct ownership. More than 70% of state-owned enterprises have gone through partial or full privatization. Government regulation has become a substitute for government ownership and the government is enforcing uniform rules of market conduct so that Chinese business practices will gradually converge with international standards. Over time, it will become harder to distinguish China from other successful and mature market economies.

Thanks to synchronized globalization today, companies around the world have the opportunity to maximize stakeholder returns by participating in the vibrant growth opportunities offered in emerging economies like Brazil, Russia, India and China. China has demonstrated a pragmatic and de-centralized approach to growth-promotion that sets it a level above Brazil, Russia and India who have much reform ahead. As investors in emerging economies and proponents of global growth, we seek to purchase those companies that are taking advantage of international prospects to contribute to the bottom line.

As our regular readers know, the investment environment is not without ongoing risks. The very power of capitalism driving global growth is also putting pressure on commodities' prices. The recent rise in the price of gold above \$600 per ounce and the price of oil above \$70 per barrel are leading indicators of strong economic demand. The price rise in oil over the past three years from the mid \$20s to over \$70 may not trigger an economic downturn, but if that trend persists the global expansion might sputter. Moreover, the war in Iraq is another gnawing problem that should have been resolved some time ago. The threat of civil war and declining popularity of foreign troops lowers Americans' resolve to stay the course in Iraq. Not unlike Vietnam, lack of a clear victory in Iraq may very well force us to shun international responsibilities. The ebb and flow in Iraqi independence could cause volatility in financial markets.

As developed as China has become, some things still get lost in translation:



An Air China counter at Shanghai Airport.

Diane V. Nugent, *President*
Victoria Capital Management, Inc.
4101 Main Street, Suite C
Hilton Head Island, SC 29926

Tel: 843-342-3044
diane@victoriacapitalus.com