



## Investor Letter – March 2011

# Introduction

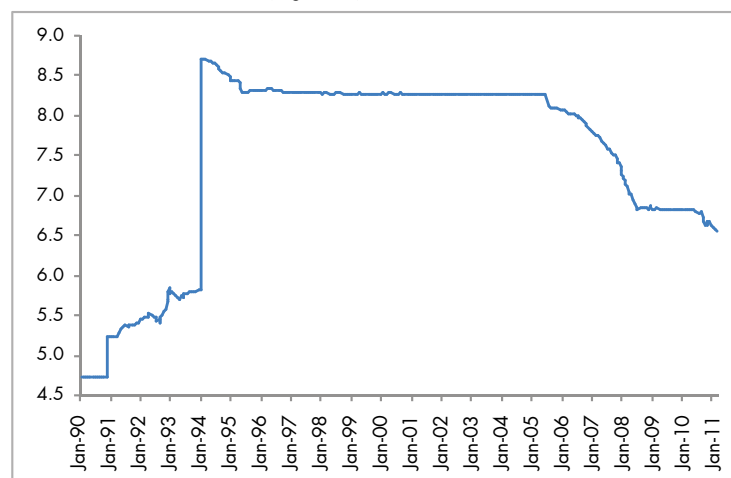
The prediction business is fundamentally difficult and requires constant vigilance to mitigate the inherent risk. This may seem surprising given our more thematic investment process, but risk management is the best elixir for the uncertainty in any predictions. For us, this means making well researched trades that are asymmetrically designed for us to succeed. While we don't ascribe to the theory that all predictions have equal value, the less our results depend on overly prescient viewpoints the better. Knowing that the markets can often create mispricing due to fear, greed and other heuristics, we strive to find unique and often mispriced assets that fit our return and risk objectives. We will stick to this approach while over-laying what we hope is a well thought out world view.

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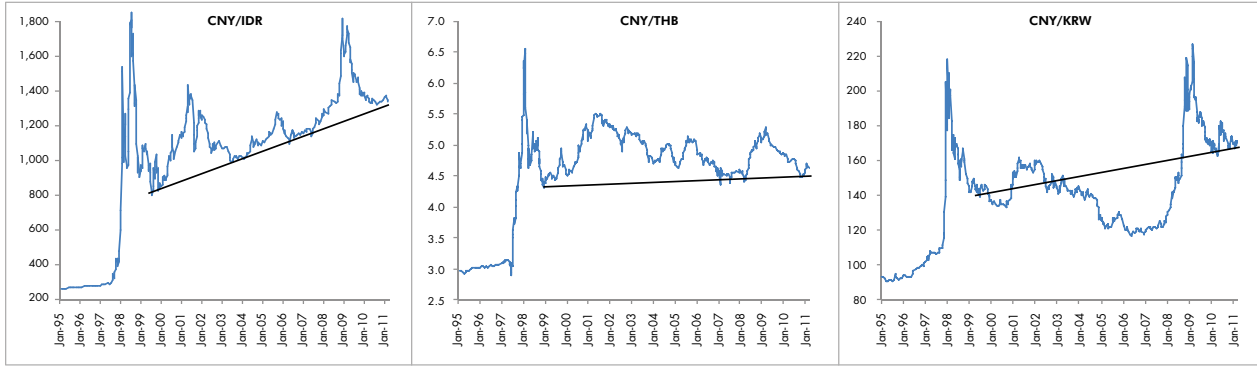
# Cause-Effect

In our view, the basic disease that has infected the world economy has not been cured. The imbalances created by the neo-mercantilist model of East Asia combined with the structural rise in energy oil prices (that is at least in part itself due to the East Asian growth model) persist. The success of Japan and the East Asian Tigers (Hong Kong, Singapore, Taiwan and South Korea) created a template for industrialization that proved irresistible to the Chinese. Beginning in 1980, with the opening of the special economic zones around Hong Kong, the Chinese have been charting a path of development by way of exports and domestic investment. This process has been wildly successful, but we think that the Tiananmen Square massacre (likely precipitated by increases in inflation in China) pushed the Chinese to seek greater control of their monetary base. This was done first by a major devaluation in 1993 and later by pegging their currency to the US Dollar. This policy choice created massive advantages relative to China's other East Asian export competitors like Indonesia, Thailand and South Korea that likely contributed to those countries (who had freely floating exchange rates) suffering a global margin call in 1998 (the Asian financial crises) (Figure 1). Hoping never to experience this humiliation again, these countries have been very attune to making sure that their currencies do not deviate too much from the Chinese RMB (Figure 2). These policies virtually assure massive reserve accumulation in East Asia (Figure 3). This currency manipulation also resulted in major competitive advantages for East Asia versus US manufacturing that resulted in a substantial decline of employment in tradable goods manufacturing in the US (Figure 4). The reserve accumulation coupled with the need to shift employment away from the tradable goods sector in the US meant two things: 1) The US would drive growth in the financial sector as the demand for dollar denominated assets due to reserve accumulation became extreme (Figure 5); and 2) Employment growth would occur in non-tradable goods (we saw this in the 2000's to an extreme) like government, housing and healthcare, areas of the economy that do not compete at all with foreign labor. Having such a large percentage of the economy NOT having to compete is clearly an advantage on some levels, but it has severe consequences in that the sectors that have been growing in employment and output have little or no contribution to overall productivity growth (Figure 6). Manufacturing has been a stellar productivity contributor but in effect this amazing productivity growth has been overwhelmed by the areas of the economy that do not produce much increases in overall labor productivity (Figure 7). This probably explains why US growth rates have been slowing and average wage growth has been relatively anemic. This second issue is a major problem that we will revisit below, as the consequences of this have been and will be felt for some time.

(Figure 1) Chinese RMB

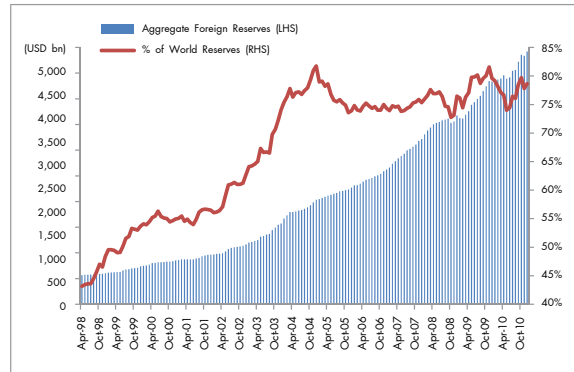


(Figure 2) Chinese RMB vs. Asian Currencies



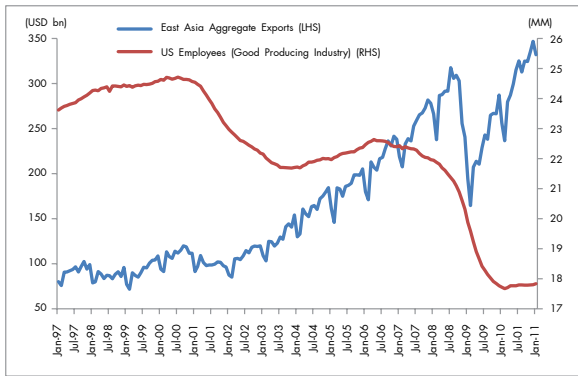
Source: CWOC, Bloomberg

(Figure 3) East Asia Aggregate Foreign Reserves\*



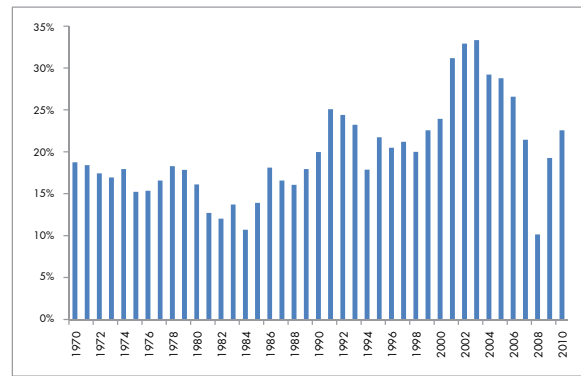
Source: CWOC, Bloomberg; \*Including Indonesia, S. Korea, China, Japan, Taiwan and Hong Kong

(Figure 4) East Asia Aggregate Exports vs. US Employees in Good Producing Industry\*



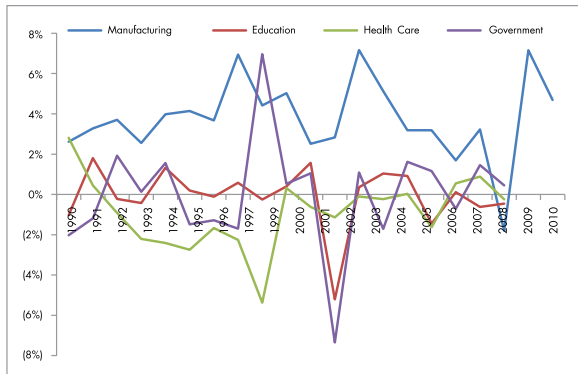
Source: CWOC, Bloomberg; \*Indonesia, S. Korea, China, Japan, Taiwan and Hong Kong

(Figure 5) Financial Institution Profits as % of Total Corporate Profits



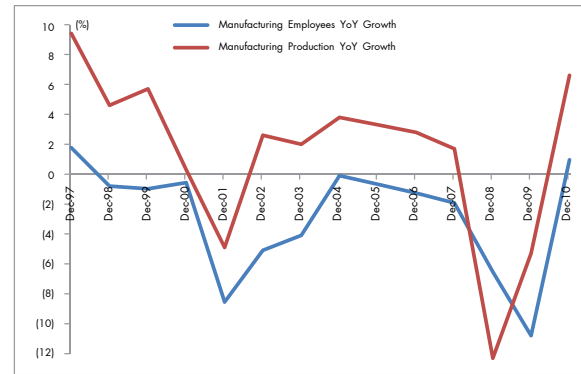
Source: CWOC, Bloomberg

(Figure 6) US Productivity Growth in Selective Sectors



Source: CWOC, Bureau of Labor Statistics, Bloomberg

(Figure 7) US Employment in Manufacturing vs. Production YoY Growth



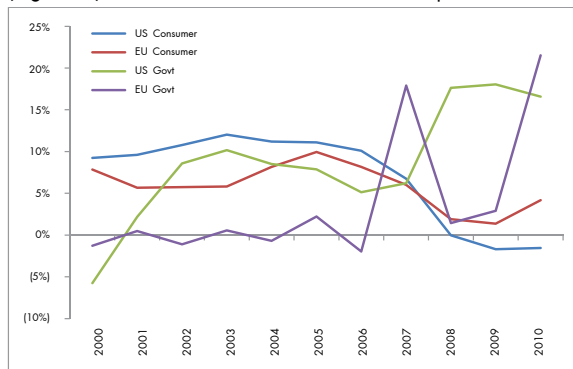
Source: CWOC, Bloomberg

# An Imbalanced World

The global imbalances that precipitated the events of 2008 remain in place. The “cure/drugs” that have been administered since the September 2008 global margin call have provided many market participants the opportunity to ride a wave of asset reflation, and as risk managers we are happy to have been one of them. That being said, the underlying disease we feel is even more of a problem as the policy makers have likely used all their ammunition fighting this last episode. The global monetary system of cheap money finding its way to the emerging markets and these markets led by China accumulating massive reserves to maintain “cheap” currency levels is now even more pronounced. Very few would have bet that the US and Europe would have such high levels of unemployment while still seeing oil over \$100 and other commodities exceeding their summer of 2008 highs. It is a testament to the power of monetary stimulus, low interest rates, high and rising government debt issuance in the west, and willing buyers in the east (who need to buy to maintain their cheap currencies) that has allowed such a perverse outcome to exist. The eastern world is energy and commodity intensive, so the stimulus ends up where the demand is sufficient (developed markets and their proxies) to absorb the liquidity. The obvious problem with this is that the perversion of the cost of money has created lots of unsustainable pricing. Let’s go through the list :

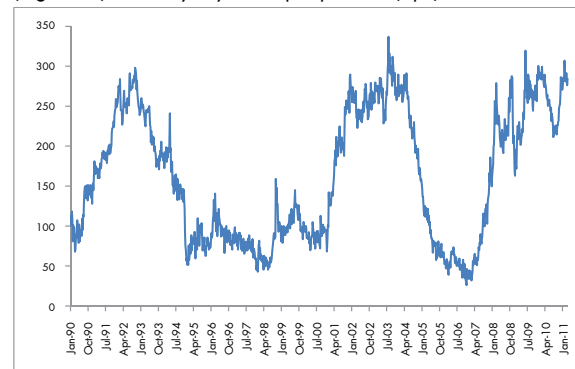
1. The cost to borrow money in the developed world is not sustainable. Governments who since 2008 have been the source of over 65%<sup>1</sup> of credit creation are borrowing at levels that do NOT reflect EITHER long term inflation levels or what is likely the increasing risk of default (Italy or Spain) or currency devaluation (US or Japan) (Figure 8).
2. Given that the cost to borrow for governments is not sustainable it’s safe to assume the cost to borrow for everyone else will need to go up as well, especially in the developed world. Maybe we have another “bust” before this happens but it’s unlikely that present interest rates and spreads can be maintained if both rate and underlying economic volatility reappears.

(Figure 8) Credit Growth YoY - US vs. Europe



Source: CWOC, Bloomberg

(Figure 9) US 10yr-2yr Swap Spreads (bps)

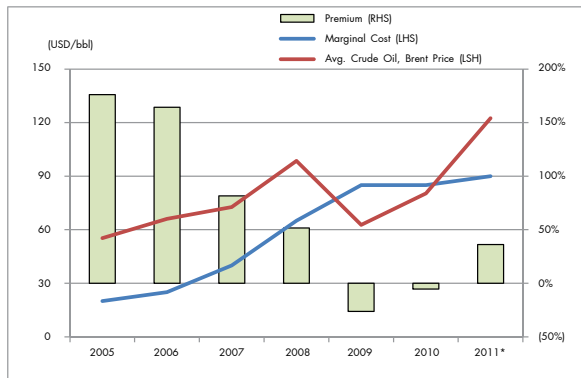


Source: CWOC, Bloomberg

3. Commodity prices are not sustainable longer term. For one, they are well in excess of economic cost (which needs to be arbitrated away over time) and secondly, the countries that have been driving their unending growth in the east will need to either slow down or change their growth mix towards consumption and away from investment (China is at present trying to do this with minimal success thus far) (Figure 10). This process may happen slowly, which is the preferred path for policy makers, or it might happen quickly if either prices go up enough to destroy demand (at least temporarily) or there is another policy error that causes a global shock.

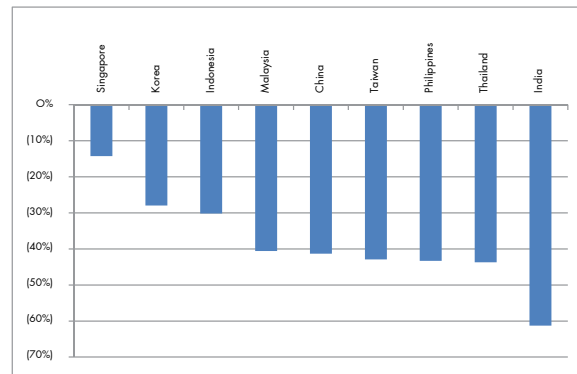
<sup>1</sup> Federal and state/local government combined debt outstanding increased by 68%, 151% and 101% in 2008, 2009 and 2010. Source:

(Figure 10) Crude Oil (Brent) Marginal Cost vs. Market Price



Source: CWOC, Goldman Sachs, Bloomberg  
\*Market price as of April 6, 2011

(Figure 11) Asian Currency Est. % of Undervaluation based on 2010 PPP



Source: CWOC, Bloomberg

On many metrics, most East Asian currencies remain severely undervalued (Figure 11). The global imbalances need to be unwound and their cause—the currency manipulation—needs to end. In all likelihood, the mispricing noted above would unwind (maybe violently) but the system would ultimately be more stable.

Stability is an interesting and widely misperceived concept. People often acknowledge instability only after experiencing its effects. For example, the offshore oil wells run by BP in the Gulf of Mexico were as unstable before the explosions as after, but people's perception of stability changed dramatically after the event. Note also, that perceptions can run wildly in the other direction, as when many were assuming that BP could not survive the spill as a going concern. This is an issue for another day but we are very illogical creatures when it comes to evaluating the improbable ex ante or ex post an event. We believe the costs of mitigating instability are likely far less if incurred before an extreme event. In the case of the global economy, for example, we would argue that the costs of rebalancing the system now and relieving the innate pressure are probably less than the consequences of deferring the inevitable reckoning. But this is ultimately a philosophical point that cannot be proven ex ante, and likely a moot one as well, since it's fair to say that given the nature of human beings both individually and collectively, particularly the tendency to procrastinate, we won't likely experience the cost of taking our medicine now. And bear in mind, there are many actors who don't want to see the types of changes, either expressly or implicitly, that addressing the global imbalances now would require. Since this camp includes exporters in East Asia, commodity producers and sovereign borrowers, we can just end the conversation there, as it is unlikely that these constituents could ever be "beaten" politically without a crisis.

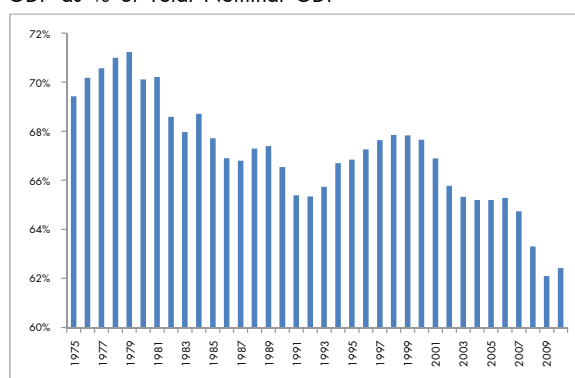
## What's Ahead?

The question then we need to ask is will there be a crisis or reckoning point (and, if so, why and when) and ultimately what will benefit from this outcome? Let's start with the first question. The "will" question is actually somewhat easy as far as we can tell. The growth rates in the developed world are NOT high enough for these countries (Japan, the US, and many European countries) to pay off their debts without either crippling high taxes or massive cuts that are both politically unlikely and also a threat at some level to growth. We have written in the past a lot about Greece and the periphery, and while these countries are in much worse shape (they can't print money), there are similarities. To us the big similarity is that, for all of these countries, including Greece, the currency needs to do some of the work. Like for Indonesia and South Korea in 1998, currency depreciation enabled each country to share the adjustment process with its

creditors and trade partners. In effect, the creditors took a haircut (literally if they owned local debt) and the trade partners transferred production and jobs INTO these countries when their currency adjustments made their export sectors more competitive and a bigger contributor to domestic growth. Reinhart and Rogoff<sup>2</sup> do a great job explaining how debt consolidations worked in the past, but the key takeaway is that growth, not fiscal austerity, was the key driver in debt reduction. Part of this growth came by way of currency revaluations and part through internal structural reforms. We would argue that the continued accumulation of reserves by the East Asian countries while maintaining their managed currency policies is somewhat akin to the Germans insistence on maintaining the rigidity of the Euro while the European Financial Stability Facility accumulated claims on peripheral countries. Certainly it's more extreme, but we think the distinction is less than US policy makers may perceive. We are skeptical that the latter can do all of the work and as such believe a currency adjustment is very necessary. The other option of course is for massive productivity gains to come to the fore. We believe that given the percentage of GDP now allocated to government and non-tradable good like healthcare and services, sectors where (other than retail) productivity gains are diminishing, this is unlikely (Figure 12). Worse still is that the retiree and aging issues just accentuate this problem. So if "will" is settled, then the key issue is "when"? Timing is always the most difficult problem to address, but on some levels that is precisely what we get paid for. How does one embed optionality, convexity and time into a portfolio to capture the inevitable impact, while also making money in the interim? We will discuss a few thoughts below.

First, we believe policy makers will persist in the old tools to try to solve these problems. As we saw last summer with the initiation of QE2, policy makers will move quickly to maintain both asset prices and economic activity. This "Greenspan put" created opportunities on a day-to-day basis that include being constructive in precious metals, as they benefit from the belief that policy makers will continue to print money if all else fails. Additionally, risk assets in the part of the world where monetary accommodation will remain (the US) should for the near term appear attractive. As an aside, we are cautious near term given the pending end of QE2. Other commodities should do well as Asian countries that are de facto importers of US monetary policy will be hard pressed to fight cheap US rates with their own rate increases so as to avoid further upward pressure on their currencies. They will be faced with either domestic inflation or a higher currency and at least in the near term we think they will choose the former.

(Figure 12) US Non-Financial/Health Care/Government GDP as % of Total Nominal GDP



Source: CWOC, Bloomberg

We do not believe that inflation in Asia will cause the Fed to move too quickly, and those in East Asia who are hoping for the Fed to relieve some of the stress will be disappointed. Therefore, we remain long many Asian currencies and are at the margin willing to "pay" rates in Asia. The events in Japan gave us the

<sup>2</sup> Carmen M. Reinhart and Kenneth Rogoff (2009) – *This Time Is Different Eight Centuries of Financial Folly*

opportunity to initiate new positions on some of the countries we were seeking to enter over the past few months. We also feel that credit spreads will become more volatile with the imminent end of QE2, and one of our favorite ideas is buying CDS on very tight names that have high beta.

Lastly, we think there is a real possibility that there will need to be a grand bargain struck on the issues raised in this letter, which would have to include a significant rise in FX in Asia against the dollar, yen and euro. We have a few trades that we feel can benefit greatly from this outcome where the downside is very small (if at all) and the upside is quite large.

As always, we encourage your thoughts, questions, and comments. We are always happy to share the details of our investment strategies with our investors and appreciate your continued support.