



SPECIAL CHINA

EDITORIAL

Stock markets have been hit by sharp declines in the last few days, with the S&P 500 down 11.52% from its April 29 peak. In addition to fears over the sovereign debt of European countries and the United States, the latest economic indicators have done nothing to soothe fears of a new recession.

On August 4, to contain an eventual spread of the debt crisis to Spain and Italy, the European Central Bank again purchased bonds with the aim of providing the banks with more liquidity. This news failed to reassure investors, who tightened their focus on debt problems and sent market indices tumbling.

Since late May, Blue Bridge has been forecasting a highly volatile summer, with stocks valued then on the basis of fairly optimistic scenarios. As such, we have significantly slowed or even halted the application of stock strategies. On the contrary, we have been far more aggressive in implementing worldwide bond strategies. This decision has been beneficial up to now in terms of capital preservation in our portfolios, which have outperformed the stock markets.

Despite clouds on the horizon, we continue to believe that the spectre of a new recession is premature. We still expect to see a slow or even stagnant world economic recovery, and we will adjust portfolios accordingly when markets seem to be lurching too far one way or the other. We are keeping a close eye on the market and will resume stock purchases gradually when we view the timing as opportune for bringing our clients the benefit of better market-entry points.

Alain E. Roch
President & CEO
BLUE BRIDGE

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by Rolf Spielmann

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FEATURE ARTICLE

Sovereign investment and wealth funds

Many a nation's abundance of foreign monetary reserves, the result of trade surpluses, needs to be channelled and used properly as not to create internal economic problems. It is not always desirable to channel excess liquidity into immediate consumption. Particularly China, which has been described as an über-realist power, is faced with the problem of protecting its reserves and investing them prudently for the long term.

Sovereign wealth funds are a relatively recent phenomenon, but their fast expansion in size and importance results in them having a potentially huge impact on a number of asset markets. Since they are run by governments, there is a lack of transparency which increases the overall risks to the global financial system. The IMF, recognizing these dangers, has implemented common standards in regards to governance, transparency and independence, but the fact remains that the asset size of those funds is growing and it makes them increasingly important and somewhat unpredictable players on the international scene.



As China uses its accumulated reserves to enhance its prospects for the long-run, it invariably creates conflicts with other nations, particularly the missionary-oriented United States. China, in its desire to guarantee itself secure long-term supplies, sees nothing wrong in doing business with authoritarian regimes. It is also fully aware that by securing its economic needs, it is shifting the global power balance. In this it is aided by its favourable geographic location. To quote from a recent article by Robert D. Kaplan, "China is a rising continental power, and, as Napoleon famously said, the policies of such states are inherent in their geography."

Such actions show that sovereign investment funds are strategically important not only for financial gain, but they can also be used for political gain. This raises national security concerns in those countries which are politically and economically strong enough to oppose actions by those funds. Increasingly we are seeing countries object to and even block certain proposed foreign acquisitions. This may be possible to do for rich western nations, but not, for example, for poor African nations.

The actions of sovereign wealth funds are therefore watched with a certain mistrust. It is true that they are changing the landscape. It is also true that all of us are financing them. Think of it next time you go to the gas pump or you buy an item Made in China!

Sovereign wealth funds have been created for strategic and economic reasons. A number of them serve as war chests for less favourable times. In the case of China, the money is prudently used to assure that internal growth can be maintained, and to do so China is building far reaching power relationships. Having been inward looking for a long time, China now reaches out to the world, and this in ways that some may find aggressive. The purpose is to secure access to the materials China needs for future growth.

Rolf Spielmann, CFA
Senior Vice President
& Chief Strategist





ECONOMY

An end to “Made in China” by 2015?

While China may boast today of being the world’s second-biggest economic power, behind only the United States, this has been due to its strong economic growth, felt worldwide, starting in the late 1980s. Its expansion has come from its manufacturing power and abundant low-cost labour, much in demand by foreign production chains. Since 1996, multinationals have been heading to China for their production.

However, China’s strong, rapid growth has led to high demand for raw materials, such as oil and basic foodstuffs. We are therefore seeing increased world demand, caused by a new type of consumption. In China, the resulting inflationary pressures have pushed up the cost of living, creating worker stress reflected in social scandals such as the suicides at Foxconn or the major strikes at Honda in 2008. Since that time, the government has decided to raise wages by 15% by 2015. However, attention must be paid to the vicious circle of inflation. With higher wages taking up a larger share of costs at various companies, the latter, in turn, are choosing to raise prices to avoid cutting too deeply into profits.



Inflation has reached record levels, with the consumer price index up 6.4%.* To this must be added a demographic shift in the near future, greatly reducing the number of

workers. This is caused by the single-child policy and by the migration of *mingongs* (workers who have moved from the rural west to the east) back to their homelands. Supply and demand have come into play, leading many foreign manufacturers to relocate. They are leaving China, either moving to other Asian countries with cheaper labour, such as Bangladesh or Vietnam, or even returning closer to their markets, to Eastern Europe or the United States. The latter phenomenon is due to high oil prices: multinationals prefer to reduce transportation costs and to rely on worker productivity to offset higher wages.

While China may not be going overboard to stop companies from relocating, this is because it wants to engage in an economic transition, moving gradually from a manufacturing economy to a knowledge economy. This is becoming necessary today as the country enters a demographic shift. China will have to allow for the rise of a true middle class.

If the country becomes more uniform and a middle class appears, it can look forward to pursuing growth through rising household consumption resulting from higher wages. This would also create a greater propensity to save. To achieve the title of world leader, China must cease being the world refuge of cheap labour and enhance its knowledge base so that it can rival developed countries.

Accordingly, China has chosen to use Germany as a model. German-based firms, with their technology, are setting up in China. The Chinese can then learn from the Germans and raise their technical prowess. Chinese Premier Wen Jiabao would like Germany to enable Chinese industry to modernize in due course and seeks its co-operation in engendering the economic structural adjustments needed for China to achieve leadership status. As such, China is now in the same position as Japan in the 1950s and 1960s. It wants to use German technology in the same way that Japan benefited from American technology and to undergo the “Japanese miracle” in its own way.

Specialists say that if China manages to advance technologically and to maintain growth of about 9.5%, it would become the world’s economic leader in 2015. However, China’s economic goals for the future are rather different. It would like to see more moderate growth, averaging around 7% or 8% annually, for the next 20 years.

This would give it more time to assimilate and master the knowledge it accumulates, and it could become the leader in 2030. A future can thus be envisaged that will not be Chinese in terms of mass production. China intends to move into new areas such as technology and services in order to go forward in its demographic and economic transition.

Clémentine Durieu Du Pradel
HEC Montréal





NEWS

China: out to conquer Western economies through the financing of public debt?

China has more than half of its foreign reserves denominated in dollars and euros. With the sovereign debt crisis in Europe and the United States, the authorities have plenty to worry about, many experts are suggesting.

As shown by the words Wei (dangerous) and Ji (opportunity), which combine to form the Mandarin term for crisis, the Chinese have often seen a crisis as an opportunity. But with the surge in public debt rattling both sides of the Atlantic, they may have forgotten that it is also a danger.

With their economic boom, the Chinese had bet on the United States. They viewed U.S. Treasury bills as safe and lucrative, and they soon became the largest foreign holders of these securities. China is by far the United States' largest creditor. In May 2011, it held \$1.16 trillion in U.S. Treasury bills, according to numbers from Washington. But the situation took on a whole new dimension in July 2011, as American and even Chinese rating agencies threatened to downgrade U.S. debt.

With more than one-third of their foreign reserves in dollars, a decline in the value of Treasury bills, with a risk that could extend to default, would be very bad news for the Chinese, various economists say. In mid-July, a Beijing spokesman called upon the United States to adopt measures guaranteeing interest payments to investors after Moody's rating agency announced it was placing U.S. debt under watch.

According to a report published June 20 by Standard Chartered Bank, China began a greater diversification of its holdings in January. The difference between Chinese foreign reserves in dollars and U.S. debt may have peaked at \$150 billion this year, with foreign reserves rising 76% during the same period. Economist Stephen Green says this shows clearly that China has begun to apply a policy of diversifying its foreign reserves.

If China stops investing in U.S. Treasury bills, what will it buy instead? Europe is the only region with a big enough debt market to absorb the new reserves

accumulated from January to April, Standard Chartered notes.

During his visit to Greece in October 2010, Chinese Premier Wen Jiabao agreed to support the assistance program created by the European Union and the International Monetary Fund, the official Chinese news agency Xinhua reported at the time. Beijing took up 10% to 15% of loan issues from the European Financial Stability Facility (EFSF), established in May 2010. The Chinese now hold the equivalent of \$700 billion in European debt.

But since then, the bond crisis has been threatening to contaminate the entire euro zone, and European leaders are having trouble devising a common response. The Chinese have much to be worried about, Mr. Green says. Did China make a mistake by investing so heavily in European and American bonds?

For the time being, the Chinese authorities are keeping mum and continuing business as usual. The last minute announcement of an agreement between President Barack Obama and the U.S. Congress to raise the country's debt ceiling was seen by Chinese state television as more hype than reality. "It's a political performance which has more pomp and ceremony than substance," China Central Television said in a rare editorial broadcast on its evening newscast.

Up to now the Chinese government has not reacted officially to the U.S. agreement, aimed at preventing a potential default that could be catastrophic for the world's largest economy.

Alain E. Roch
President & CEO
BLUE BRIDGE





MARKET WATCH

Selection of Financial & Economic Indicators

Index	DJ Ind	DJ Transp.	Nasdaq	S&P500	S&P/TSX	MSCI World
July 29th	12143,20	5184,05	2756,38	1292,28	12945,60	1306,05
Monthly var.	-2,18%	-4,58%	-0,62%	-2,15%	-2,67%	-1,89%
Year-to-date	4,89%	1,51%	3,90%	2,75%	-3,70%	2,03%
Year-over-year	16,03%	17,21%	22,25%	17,31%	10,52%	16,11%

Index	FTSE	DAX.	CAC40	SMI	NIKKEI	EURO50
July 29th	5823,01	7161,48	3679,39	5783,35	9833,03	2672,85
Monthly var.	-2,06%	-2,91%	-7,60%	-6,53%	0,17%	-6,17%
Year-to-date	-1,30%	3,58%	-3,30%	-10,14%	-3,87%	-4,30%
Year-over-year	10,75%	16,49%	1,00%	-6,73%	3,10%	-2,53%

Commodities	GOLD	COPPER	CRUDE	WHEAT	LUMBER	CRB
July 29th	1626,80	448,25	95,79	715,75	251,20	342,08
Monthly var.	8,33%	4,98%	0,83%	1,20%	-3,01%	1,14%
Year-to-date	14,59%	0,99%	4,80%	-9,88%	-21,50%	2,79%
Year-over-year	37,43%	35,34%	21,42%	8,20%	20,19%	24,69%

Currencies	\$CA	¥	€	£	\$AU
July 29th	0,9555	77,0000	1,4375	1,6415	1,0995
Monthly var.	0,93%	4,35%	-0,93%	2,24%	2,52%
Year-to-date	4,07%	5,17%	7,52%	5,22%	7,37%
Year-over-year	6,92%	10,93%	10,15%	4,55%	21,36%

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