

# The First Advisor

First Advisory's Monthly Newsletter: Issue 2

March 2009

The First Advisor is First Advisory (Indonesia)'s newsletter for the financial community. Our focus is our take on global stories over the past month, but we do not repeat bad news stories. We keep an eye on the positive things happening in global markets with the other eye still focused on reality.

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February's First Advisor began with a brief excerpt of information from Jon Authers (Financial Times commentator) Short View regarding signs of the recession potentially bottoming out. Many people are asking if we have reached the bottom, and there are some further statistical indicators out there to show that perhaps we are at least close to the trough, or leveled out.

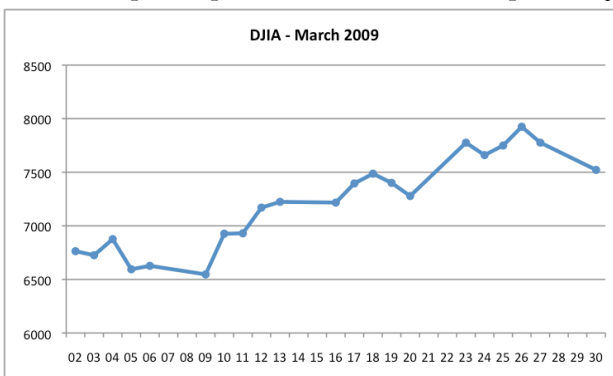
The Dow Jones Industrial Average had its biggest monthly gains since 1987 up to close of business on the penultimate Friday in March, but then came some bad news for US automakers with a get tough stance being adopted by the White House. There would be no easy money for Automakers, with GM and Chrysler under a tough time limit to get business development plans approved in order to secure fiscal help. This news, along with some play-safe strategies ahead of the G20 meeting, signaled a sell off on markets over the past few days in March which wiped out much of the earlier gains, and made March's gains seem more like the result of short trading buy-ins, rather than real signs of a recovery in equities.

Retail sales were better than expected in February and two major US banks reported healthier than expected balance books, surprisingly meeting profits targets (but don't forget the huge negative effect of the masses of toxic assets). The stock market usually hits bottom before the rest of the economy.

In this recession, a severe fall-off in demand has led to deflationary effects in some areas, and this means that businesses earn less but they still owe the same. Russell Napier, a consultant with Cr dit Lyonnais and author of "Anatomy of the Bear: Lessons From Wall Street's Four Great Bottoms" said he believed stocks would not rise until deflation ended and businesses could charge higher prices to pay off debts. Early indications suggest that this may be happening and that the stock market may be near the bottom, Mr. Napier said. He pointed to three indicators that

often signal that economic growth and inflation are on the way — the prices of copper, corporate bonds and inflation-protected U.S. Treasury securities. Prices for all three are higher now than they were in November. "All the indicators suggest you should be buying and not selling," he said. Still, Mr. Napier acknowledged that stocks, while cheap, could fall further. Measured by their 10-year P/E ratio, stocks were a lot less expensive in the early 1980s, when the ratio fell to less than seven, and in the 1930s, when it was below six.

Let's not forget though that last October,



Warren Buffet was highly in favour of buying equities because he believed the market had bottomed out at that point, but the next few months saw a further fall — off in stock prices of 20%.

Around the middle of the month, OPEC announced that they would not cut production, thereby keeping oil prices at their low levels. This of course has more of a positive effect than a negative effect in terms of aiding economic recovery.

On the 16<sup>th</sup> March, The US Federal Reserve Chairman, Mr Ben Bernanke told the CBS 60 Minutes TV program that "This decline will begin to moderate and we'll begin to see a leveling off". Mr Bernanke also mentioned that "a government fund of \$500bn was stabilising the mortgage market and business lending was picking up".

Many believe that house prices will continue to fall, and therefore exacerbate the bank's credit flow to customers, and more importantly, to each other to an

even larger degree. The amount owed by owners of toxic assets increases markedly with each percentile fall off in private real estate prices.

Also in this month's edition we discuss the likely reaction to the credit crunch from regulatory bodies such as the FSA. Is it sufficient to just say that trading in complex securities may go ahead as long as high street and investment banks have a certain percentage of capital on their books? Many IFAs are worried that whatever measures are imposed will be an overreaction and altogether kill trading of complex securities. In **The**

## Future of Financial Risk Management

we discuss these issues. The idea of assigning property rights to the environment as a way to protect has some history beyond the current environmental issues — in fact these ideas go back 100

years. Carbon trading makes you feel good, and has not been too adversely affected by the economic downturn, and we discuss these points in **The Greener The Fund, The Better?**

In **Currency Markets March Winner: Norwegian Krone**, we look at developments during for March for some major currencies and take a look at a potential new safe haven currency.

**Commodities** are of special interest to Indonesia and aside from the usual look at oil and gold, we look at copper this month.

## The Future of Financial Regulation

### UK: The FSA

The FSA brought its first criminal charges for insider trading in January 2008. Previous to 2008, insider trading was conducted with impunity, with many cases resulting from one-upmanship from market watchdogs, competing to prove they were the toughest of them all. However, in the past, the FSA would only bring civil charges (in the form of fines).

Furthermore, when the FSA audits, it tends to accept the word of management teams. That will apparently change according to Hector Sants (Chief Executive of FSA), now the “judgment of management teams will be under judgment”.

The cases of insider trading mounted through 2008. Hedge fund GLG Partners lost an appeal against the French market regulator for insider trading in Vivendi shares. Hong Kong saw its first criminal prosecution: An ex-BNP Paribas banker faces up to 10 years in jail – and a fine of up to \$1.3m – for tipping off friends and family about an upcoming buy-out.

### The US Response

In the United States, The White House wants Congress to make progress on regulatory reforms before Mr Obama attends the next meeting of the Group of 20 leading economies in London on April 2. The situation in the US (which by the way is where the credit crunch was born) is complicated in that there is more than one regulatory body. Tim Geithner's predecessor as Treasury Secretary, Henry Paulson, formulated some proposed changes to regulatory functions in March 2008 (both sides of the Atlantic smelt regulatory trouble ahead at approximately the same time):

- Market stability regulator (the Federal Reserve): Under the plan, the Fed would be given sweeping new powers and evolve into a "market stability regulator." In essence, the agency would become the police chief of the entire financial services industry and focus on ferreting out practices at all sorts of financial firms—from tiny banks to hedge funds—that threaten to derail the stability of the system.
- Prudential financial regulator: The plan also calls for a single regulatory body for banks, which are currently supervised by five separate federal agencies.
- Conduct of business regulator:



Paulson also proposes the establishment of an agency dedicated to protecting consumers and investors.

The blueprint issued by Paulson also mentions merging the SEC (Securities and Exchange Commission) and CFTC (Commodities Futures Trading Commission), creating a “mortgage origination commission (they would set standards for industry participants and rate each state's regulatory framework), and the option would be given to insurance companies to adopt a federal charter, similar to those used by banks.

More recently Barney Frank, chairman of the House Financial Services Committee has started work on legislation that would create an early warning system for systemic risks of the kind that caused the current financial crisis.

President Obama said at the end of February that there was a “growing consensus” over the need for stronger regulation and promised to work with Congress to push through reforms in “coming weeks and months”, also saying “We now know from painful experience that we can no longer sustain 21st century markets with 20th century regulations.”

### The Future?

So when will the new regulations be instated roughly? Opinion is divided on the urgency of financial regulatory reforms. Mr Paulson was in favour of leaving any major reworking until there was real evidence of a recovery (with the justification that adding further complexity could slow the recovery), whereas the Obama administration is showing more signs of urgency.

So what does the future hold? Given the

events of the past year, with a total failure of risk management and regulations, more regulation is a done deal. Getting regulation perfect is an impossible goal, but what banks and the authorities will want is a genuine improvement to the current system, so that, at the very least, the same failures do not happen again. Especially in the case of the US, there are many different fingers in the pie, so reform will not happen overnight.

The planned G20 meetings are intended to produce a coordinated, international response to regulatory failures, and both the UK and the US have shown willing in ensuring a global response, in an increasingly interdependent world. However, it's not thought likely that a truly effective plan can be arrived at without significant differences of opinion.

There is also a danger of overreaction. The FSA's Hector Sants has gone on record as saying that financial institutions need to be ‘scared’ of the FSA. Major players in the world of financial services have also raised concerns. John Tattersall, a partner at PwC in the UK mentioned that “Firms do need to take notice: there is a very real determination to be seen to be more aggressive, particularly for high-impact firms.” John Liver, a partner at Ernst & Young, said the regulator's “intense approach” would be “akin to living on permanent red alert.”

London and Manhattan are the two most influential and busy financial centers in the world. London in particular has been a major financial hub since the end of the Thatcher years. London benefits from overlapping working hours with both the US and Asian markets, and has attracted a vast wealth of financial expertise from many different countries. Over-regulation may well result in driving financial operations away from the US and UK, to be less regulated areas – which results in the same dangers existing in global markets.

Clearly a regulatory response is needed, and a detailed response at that. If we are saying that we are to continue trading complex, sliced-n-diced securities, then we can say that what was before an opaque situation, must now become transparent – and achieving that will be extremely difficult. We should probably be prepared for an over-reaction because this situation does not compare with any other situation since the start of the industrial revolution. Getting it right first time is unlikely in this case...

## The Greener The Fund, The Better?

The idea of protecting the environment by investing in it goes back more than 100 years. Alfred Marshall, a British economist, and Henry George, a US contemporary had the idea that assigning property rights to the environment was a good way to protect it.

Many, even non-“tree huggers”, are convinced about the inevitability of carbon trading and don't see it as a choice, rather a necessity. However business, industry and the community in general are largely uninformed about what carbon trading involves and its likely effects.

Many write-ups on this subject seem deliberately ambiguous (or the writers didn't understand the subject themselves), so a major part of this article is going to be an attempt to clean up the jargon and de-mystify the subject.

The idea of carbon trading can be strange because there isn't the usual economic concept of investing in something, which depreciates or gains in real monetary value. Why would one invest in a rain forest? What does it give me back in return? Well, the answer is of course, that the rain forest gives you back oxygen, and that of course is priceless. By investing in a carbon fund, the money could be allocated to buy up areas of rain forest, making the value of that land sufficiently high to protect it from local logging and clearing operations. An example of an operation such as this is the one by Rabobank which has bought up huge swathes of rain forest in French Guyana.

In heavy industries such as power production, carbon trading is the buying and selling of permits to emit greenhouse gases. A total target for pollution output is set then distributed throughout industry, allowing a capped level of emissions for each power plant, factory, etc.

The key to the concept is that it encourages companies to cut emissions, because they can sell leftover permits for profit and discourages over-polluting, as this means buying more permits.

At the end of a set period, say one year, companies must have the correct number of permits for their emissions or face penalties.

Only a certain number of permits are allocated in an industry, so overall emissions should remain on target no matter how the permits are traded.



One expected offshoot of carbon trading is that industry will develop new, greener technologies in an attempt to reduce outputs. Trading systems can also incorporate credits, whereby companies can create additional revenue by getting involved in projects that actively reduce emissions.

The global carbon market to late 2008 was worth \$100 bn, a 56% increase year on year from 2007.

ETF Securities, which has led the way in providing innovative exchange traded commodity products, has just launched a carbon ETC, providing easy access to the world's largest carbon trading market, the European Union Emissions Trading System. The ETS includes more than 80 per cent of the world's carbon credits, each of which represents the right to emit one tonne of carbon into the atmosphere. Each country in the EU has set a total limit on emissions and then allocated allowances to large carbon emitters, such as energy companies.

The companies are then free to trade these allowances (EUAs) with each other to allocate them as efficiently as possible. They can also use Certified Emission Reductions, credits brought into the system from outside based on projects cutting carbon emitted elsewhere. The CERs are approved by the United Nations under the Kyoto protocol, but at this point, they may only make up a small proportion of an EU company's emission allowance.

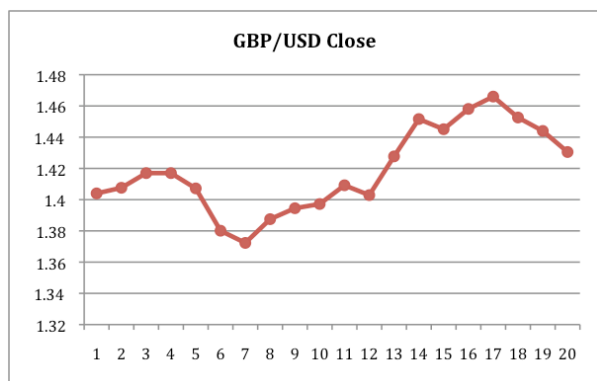
CERs are also created when companies engage in some environmentally beneficial project such as wind or solar

power farms.

Generally, economic downturns are not good for carbon trading because of the resulting reduction in industrial output, which in turn results in lower emissions. Also oil is cheaper than coal at the moment, so companies will move to using oil for energy wherever possible. Oil is also a cleaner fuel, so emissions will be less.

Carbon trading is still a very immature market and the funds' existence depends on the political will of governments to cut carbon emissions. The trading market is therefore the economic fund that is most closely dependent on politics.

## Currency Markets March Winner: Norwegian Krone



The overall trend since the fall off in US equities Q2 2008 was to move away from the US dollar. At that time the problems in economics were being felt most strongly in the United States and it was a US recession. As realization set in that the problems were global, there was a move back towards the greenback and the Yen as traditional safe havens in times of stress.

March saw some interesting developments. Into the 2<sup>nd</sup> half of the month, the gradual strengthening in the US dollar seemed to have halted somewhat, and the Japanese Yen had lost value as it became apparent during February and March as to the severity of the effects of the downturn on Japanese market fundamentals.

Around the middle of the month the US dollar weakened considerably but then clawed back some ground in the last week of the month, on the back of a poor last few days of trading in riskier assets – brought on by the news that car makers would not be in for an easy ride. The Japanese Yen also recovered some considerable ground despite even worse news from the jobs market and rapidly falling industrial production. Both the dollar and the yen were also helped by sell offs in the Euro and sterling as European economic data worsened.

The US dollar is likely to experience some forces (such as the filtering through

of large-scale US fiscal and monetary loosening policies), which could cause it to weaken during the year, but for the time being it holds its status of a safe haven currency.

There were some comments from Beijing regarding the dollar's status as the international reserve currency. China raised concerns about the dollar, and endorsed an idea from the central bank to use SDRs (Special Drawing Rights). Tim Geithner did not dismiss the idea and mentioned that SDRs are "evolutionary". This led to a brief weakening of the dollar on 25<sup>th</sup> March.

The other safe haven currency, which experienced turmoil in March, was the Swiss Franc. The SNB intervened in the currency market to erode trust in the franc. The SNB is also more vulnerable as it engages in unconventional policies; from swap lines for Eastern Europe to the issuance of US dollar-denominated Swiss Treasury bills.

The Korean Won followed the equities market tightly during March, but it was one of the bigger movers among the major world currencies, gaining 18% on the dollar during March, before falling back slightly over the past week.

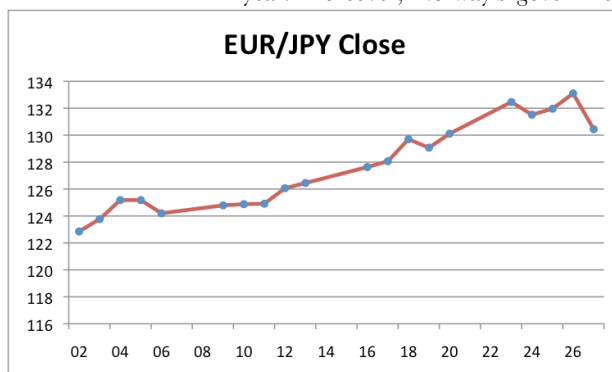
Another star performer during March was the Norwegian Krone, as the Swiss Franc, Dollar, and Yen were weakened during March. Last December the krone dropped to a record low against the

euro, as falling oil prices took their toll on the currency. But, as crude prices have stabilised, the oil producer's currency has fought back strongly.

The krone is one of the few currencies that has outperformed the dollar so far this year. Earlier in March, it rose more than 3 per cent to NKr6.694, before falling back slightly to 6.79. Against the euro it had soared 11 per cent to NKr10.925, before falling back to just under 9.

Sustained appreciation in the Krone is expected over the next 18 months and it is near, or at the top of the league among the world's 10 most traded currencies.

Norway's economy grew 1.3 per cent in the fourth quarter of last year and is not forecast to experience as big a downturn as most other leading economies this year. Moreover, Norway's government

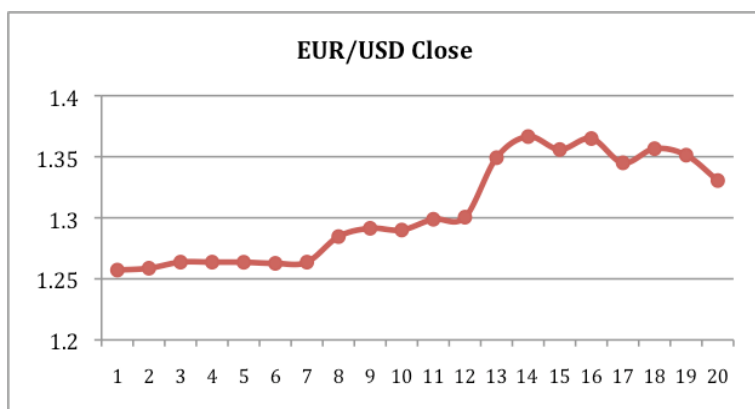


is unlikely to intervene to support banks or the economy in general, as its fiscal health is still very good.

The krone has the upper hand as its structural situation is boosted by a hefty current account surplus standing at 5 per cent of GDP – the biggest in the industrialised world.

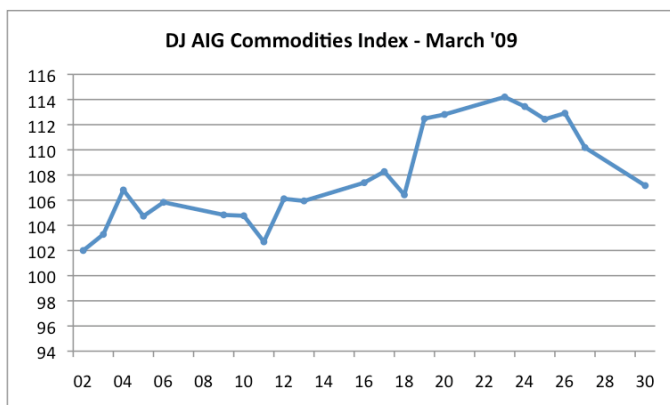
As with Australia (with a budget surplus at 1% of GDP), Norway's economy shows healthy prospects going forward and so the outlook for the krone and the Australian dollar are bearish. Norway's currency did however dip sharply after the Lehmann's Brothers collapse, so its status as a safe haven currency may be questionable, and the currency is also highly dependent on oil prices.

Overall the krone's status is one of the lesser of evils, as heavy fiscal stimulus packages are announced around the world.



## Commodities – March 09

**Oil** and Gold followed similar paths through March. Brent Crude opened the month slightly on the upside of 40 USD per barrel to close just shy of 50 USD, after a peak of 54.34 USD on 26<sup>th</sup> March. Certainly though this is an improvement on the prices seen in early February, in fact its' more than a 50% improvement.



Bearish equities markets drove oil higher through March, only to be dashed by later anxiety ahead of the G20 meetings. Base metals also retreated as a fresh wave of risk aversion swept across commodity markets amid concerns that General Motors and Chrysler could go bust after the US government refused to handover easy cash, and demanded improvements in business plans from both manufacturers.

Mid-March saw OPEC agree to keep production levels at their current level rather than raise them.

The longer-term prospect for Oil this year is still unchanged, and there is not expected to be renewed demand through 2009. Of course, more bullish activity in global equities markets could change all of that.

COMEX **gold** 1 futures was at a high of 958.80 USD for the month, and the month ended lower than it started, 920.70 compared with 940.00. It was a turbulent month for gold, but the overall prospects look good. Gold has outperformed both global equities and global commodities markets through the 90s, and any further shocks to the US financial system could send the price skyrocketing way back over the 1000 USD mark that was exceeded briefly in February this year.

Further confidence was expressed in gold as reflected in the news from March 17<sup>th</sup> that Paulson & Co spent \$1.28bn buying Anglo American's stake in gold miner AngloGold Ashanti on Tuesday as the New York hedge fund

moved from betting against banks to betting against governments.

Gold's turbulence through March does come as a surprise to many analysts because of the lack of a real safe haven currency during the month. The US dollar, Yen, and Swiss Franc all saw devaluations during March, with a slight recovery at the end of the month, with

the Norwegian Krone being touted as the new safe haven currency in these times of strife. So it is odd that the gold price has not risen more. At \$953 per ounce, it remains half

the level it reached, in real terms, at its 1980 peak. Looked at another way, the value of all gold reserves, some \$900bn, is worth a quarter of total money in circulation. If any asset looks vulnerable to a big speculative squeeze, it is gold.

Overall, commodities seem to have bottomed out. **Copper** is of some interest and has gained 40 per cent in dollar terms since it hit bottom in December. The broader Reuters CRB index is up

14 per cent since it hit bottom a few weeks ago. The Dow Jones AIG index for commodities is also dramatically higher since the low point at the end of February. In all cases, the trend, after a prolonged period on the floor, appears clearly upwards.

There are provisos. The most recent rebound in commodities is at least partially linked to the falling dollar. The CRB has gained only 5.5 per cent in euros since it hit bottom.

With copper, COMEX high-grade copper futures have seen a steady improvement through December 24<sup>th</sup> until late March, with prices bouncing back from 127.40 to 176.60.

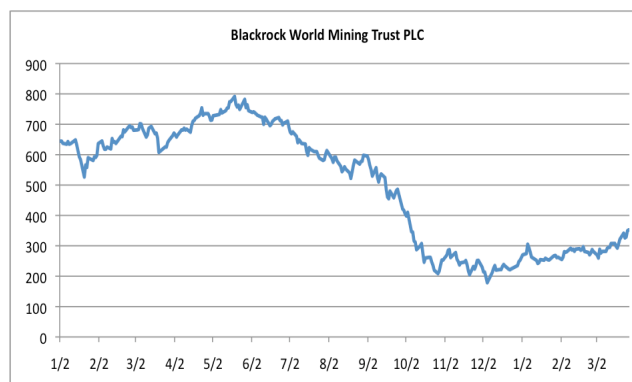
Some analysts however believe the real

fundamentals of copper are not so great, and stockpiling by the Chinese government was largely behind the bullish conditions so far this year. Beijing's State Reserve Bureau's decisions are shrouded in secrecy, making it virtually impossible to assess accurately how much the Chinese government has bought. Traders estimate that the SRB is in the process of securing 300,000 tonnes and speculate that it could buy up to 1.2m tonnes this year. One third of global copper consumption was in China in 2008.

Copper hit a 4-month London Metals Exchange high in March of \$4,075 a tonne, up 44.2 per cent from its four-year low of \$2,825 reached last December. This was also partly due to economic fiscal stimulus plans in the United States.

As of March 30<sup>th</sup>, the 3 month LME copper price per tonne was \$3925, and many analysts believe it's unlikely copper will go much over the \$4000 mark, making this a good time to sell.

Copper is of special interest because of some historical connections with the S&P 500 index and the price has closely



followed trends in bear and bull market developments over the years.

Recoveries in copper prices in the early eighties seemed to act as a leading indicator to the stock market recovery at that time. Russell Napier's Anatomy of the Bear goes into this subject in more detail but in bear markets throughout the 20<sup>th</sup> century, the same progression in global stock prices followed an improvement in copper prices. Commodity price increases in general point to a lead away from deflation and back to inflation, which is an important precursor of recovery. Copper price increases follow closely inflation figures from decreasing all the way through 2008 through to deflation at the end of 2008, and then inflation in the early part of 2009.

## Stories Translated into English from Local Media Sources

***Bisnis Indonesia, 17<sup>th</sup> march 2009***

### **State owned mining company PT Aneka Tambang Tbk is looking for strategic partners for various mining exploration projects.**

PT Aneka Tambang TBK, a state owned mining company (ticker: ANTM) is in the progress of finalizing a new alliance with Japanese and Chinese mining contractors, in order to develop bauxite mining projects in Tayan district, West Borneo, worth USD1,3billion. The so-called Tayan project, classified as CGA (chemical grade alumina) is projected for completion in 2013, whilst the Chinese investor being HJG (Hangzhou Jejiang Group – China) is classified as smelter grade alumina. This production is hoped to allow the reduction of imports of alumina from Australia.

ANTM has the following exploration projects in the pipeline, and has its door open for alliances with foreign investors:

Project name	Commodity	Partner	Investment
Tanyan CGA, W Borneo	bauxite	Showa Denko Marubeni	USD500mm
FeNi Halmahera, Moluccas	nickel	-	USD1,2bn
SGA, West Borneo	bauxite	Hangzhou	USD800mm
Weda Bay, Halmahera Molluccas	nickel	Eramet Mitsubishi	USD4bn
Copper Smelter, Gresik	copper	Looking for partner	USD700mm
Power plant	power	IPP (local investor)	USD300mm
Meratus Jaya iron, south Borneo	iron	KS (local inv)	USD80mm
Cibaliung, Banten region, west Java	gold, etc	-	USD37mm
Indonesia Coal Resources	coal		USD37mm
Anode slime, Jakarta	gold, silver, etc	-	USD22mm



#### *About Our Editor:*

**Ian Tibble** is a Technical Advisor and Financial Consultant for First Advisory (Indonesia). Ian has worked with some of the biggest names in the world of financial and IT services and consulting, and in the process has lived and worked in 15 different countries on 4 different continents. The majority of Ian's post-2000 risk management experience was with Verizon Business and PricewaterhouseCoopers, where his clients were big banking names from Thailand and Singapore, plus others around the region from Australia, Indonesia, Malaysia, Hong Kong, and Taiwan. Prior to 2000, Ian worked with IBM Global Services, working with various Square Mile clients in London.

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