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To: Undisclosed recipients;;

Subject: J.P. Morgan Eye on the Market, September 25, 2012: Watches, milk and beer

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Inline-Images: image016.png; image018.png; image021.png; image022.png; image023.png; image024.png; image025.png; image026.png; image001.png; image002.png

Eye on the Market, September 25, 2012 [pdf easier to read this week, and has a table that is not included in the email version]

Topics: For what it's worth, equity markets have usually been right about "weak economy" rallies; Private equity investing in Asia

A lot has been written about how the recent equity rally coincided with weak growth and weak leading indicators. That's true, as shown in the first chart. Normally, equity rallies take place when the global PMI manufacturing survey is either above 50 (denoting an expansion), or at least rising. In 2012, that hasn't happened: equities rose even as leading indicators like the PMI remained weak. The second chart shows the rise in P/E multiples over the summer.

Equity rallies usually coincide with high or rising leading indicators, but not in 2012, Index level



Source: Bloomberg, Morgan Securities LLC.

Reduction of "tail risk" contributes to multiple expansion Forward price-to-earnings multiple



Source: Bloomberg.

This is not as odd as you might think; since 1960, when equity markets and leading economic indicators disagreed (i.e., rising equities, PMI below 50 and falling), **markets were usually eventually "right"**. The data table in the attached PDF shows all the times when markets and economic data disagreed, along with the change over the next 2 years in both equity markets and the PMI measure. Only in July 1980 did equity markets get it wrong. Circumstances are different now given the fiscal and monetary issues in play, but in a purely historical context, the latest rally was not at all an anomaly.

The catalyst for this year's rally: central banks will expand base money until economies respond, irrespective of costs we can imagine and those we cannot. The party line from the Fed has a biblical ring to it: central bank expansion begets higher equities, which begets confidence, which begets consumer spending, which begets inventory accumulation and capital spending, which begets hiring. Not a lot of signs that the begetting is taking place yet, but the Fed will keep trying (half the fun, right?), with one Fed governor advocating monetary expansion until unemployment is below 5.5%. The Fed now owns more than 25% of all the duration in the US Treasury market.

To infinity....and beyond!!

Central bank balance sheets, percent of GDP



Source: FRB, BEA, ECB, Eurostat, BoE, UK Office for National Statistics, BoJ, Japan Cabinet Office.

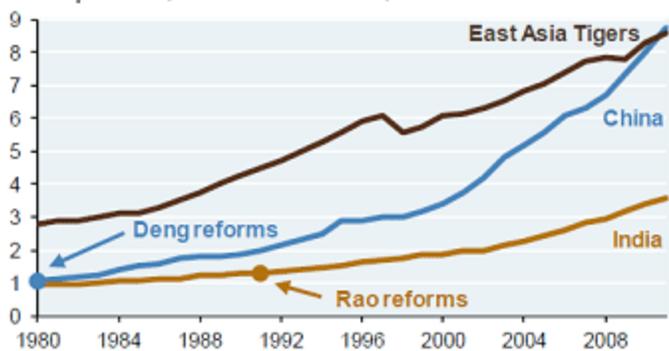
How does this kind of analysis affect our views on managing money? I did not expect a 15% rally in global equities this year, and thought that a high single digit return was in the cards. As a result, different kinds of public/private credit and hedge funds looked like attractive portfolio holdings for 2012. They generally delivered positive returns so far, although not as much as equities. This kind of research highlights the risks of straying too far from normalized risk levels when P/E multiples are already low, a concept we tried to build into allocations this year. **A world in which the level of equity markets themselves become a central bank policy tool, rather than being the by-product of corporate profitability, household wealth, fiscal solvency, etc, is a world we will have to adjust to.** It is not without its risks, which is what restrains us from positioning for a world that is truly “back to normal”. While I can imagine the contours of the begetting cycle playing out in the US (particularly as housing continues to recover, a topic our Chief economist Michael Vaknin has recently written on), I cannot see how any amount of money-printing will solve the structural problems of the European Monetary Union, and in particular, Spain. The Euro’s problems have re-surfaced secession debates in Catalan, another sign of the perverse outcomes of a currency union that does not fit its membership (see EoTM May 2nd, 2012). Something else to watch: the disturbing and steady rise in French unemployment, even as Germany improves.

Another disconnect: impressive growth and lackluster equity markets in Asia, and how private equity can play a role

As shown in the first chart, economic development in Asia has continued at a rapid clip since the Deng and Rao reforms in China and India. During the 1990’s, when these developments began to impact growth and profits, investors in Asian public equity markets were rewarded. Then in 1998, the Asian balance of payments crisis hit, and it took the region a few years to recover (*note to Europe: currency realignment played a large role in the recovery*), with Asian equities underperforming the US through 2002. Then, in 2003, Asian equity markets boomed after the region established a more sustainable model (less reliance on foreign capital, and currency intervention to maintain export growth), and almost tripled the return on US equities. However, since 2008 and more notably since 2010, Asian equities underperformed despite better economic and profits growth. We can speculate as to the reasons why (the cyclical nature of the global manufacturing cycle which now is centered in Asia, inflation and excessively easy monetary policy, the exhaustion of the benefits of currency intervention), but the bottom line is that Asian equity markets have not been a good way to benefit from higher Asian GDP or profits growth.

Structural reforms and per capita growth

Per Capita GDP, real constant dollars, thousands



Source: “Statistics on World Population, GDP and Per Capita GDP, 1-2008 AD”, Angus Maddison, University of Groningen.

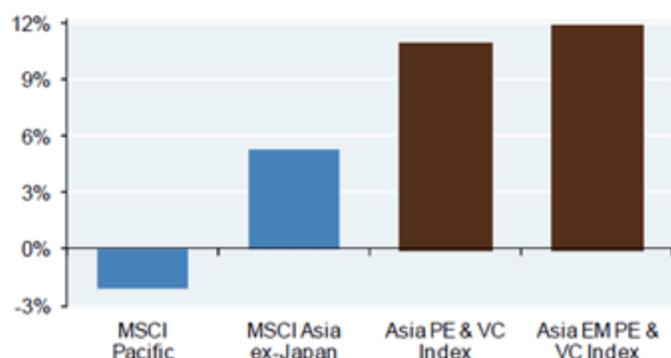
Annualized total return in USD

	1988 - 1995	1996 - 2002	2003 - 2007	2008 - 2012	2010 - 2012
S&P 500	16%	7%	13%	2%	12%
Asia ex-Japan	17%	-9%	31%	-1%	6%
China		14%	36%	-14%	-10%
Japan	1%	-10%	15%	-5%	0%
Europe		2%	24%	-5%	3%

Source: Bloomberg.

These trends began to emerge 5 years ago, which is when we began to focus more on Asian private equity. As shown in the chart, Asian private equity has outperformed public equity over the last few years. Individual funds will of course vary, given the concentrated positions that many private equity managers hold. However, our sense is that being able to focus on specific sectors may explain part of the performance gap.

Public and private equity investing in Asia
5-year annualized return through Q1 2012, percent



Source: Cambridge Associates LLC, Bloomberg.

What looks interesting to us is the continued increase in the Asian middle class. This does not always benefit publicly held companies like banks, utilities and airlines, and is sometimes more impactful on smaller, privately held companies focused on consumption. On the following pages, we walk through a few transactions we have seen in Asian private equity, and how they relate to the rise in Asian purchasing power.

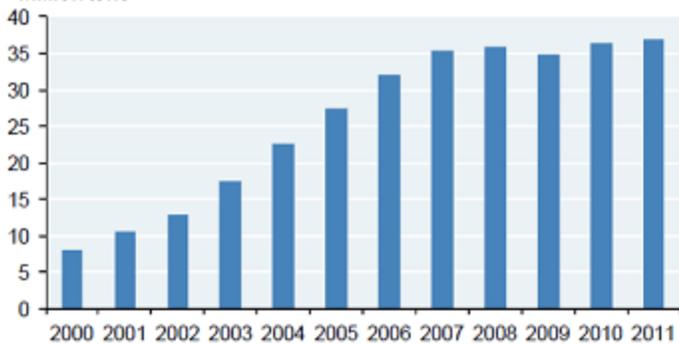
Got Milk? Safe milk, that is

First, some history: Chinese milk production quadrupled and consumption doubled from 2000 to 2007, but after the 2008 melamine scandal, consumption fell and production stalled. The fall in consumption doesn't have much to do with the market's *potential*; Chinese milk consumption is less than one third the level of both South Korea and Japan where milk isn't part of the traditional diet either. It's all about concerns related to the food supply, and the fragmented Chinese milk supply chain. The average farm in China only has 7 cows (many being fed on kitchen waste), compared to 115 in the US and 400 in New Zealand. Chinese milk tends to be deficient in vitamins and protein, which led to the melamine scandal (an artificial and toxic means used by some milk traders to increase protein content). Only half of China's 16 million cows produce milk, yielding 4-5 tons of milk per year per cow, which is what American cows produced in the late 1960's. Even after precautions and regulations in the wake of the melamine episode, significant problems remain: in the last year, carcinogenic mold was found in milk after cows were fed rotten silage; infant formula was found with traces of mercury; and milk cartons were found with traces of detergent. Most reports we read indicate that shortage of expertise (e.g., trained veterinary surgeons) is a bigger problem than shortage of capital.

With this backdrop, there's a lot of potential for a company that can allay consumer concerns about milk safety. One transaction involved the purchase of a minority share in what was at the time a small dairy farm in China. The investor's goal was to provide both capital and operational expertise to enhance management, improve operations with tightened disease and food safety controls, grow cow milk productivity and reduce feed costs. Over the last few years, the milk company has grown substantially: revenues and operating cash flow have grown at over 100% annually, and the company plans to grow its herd from 128,000 to 300,000 by importing cows from abroad. The company's business model does not entail distribution costs at the retail level: almost all the raw milk it produces is sold to one of the leading dairy product companies in China. The company also benefits from subsidies from the government, which is anxious to improve the domestic milk supply (right now, many Chinese consumers rely on more expensive imported powdered milk). It sounds simple, but part of the company's success has been linking compensation with improved safety measures. Another measure of its success: annual milk yield per cow of 7.8 tons in 2012, compared to the national average of 4.8 tons in 2009.

China's milk production

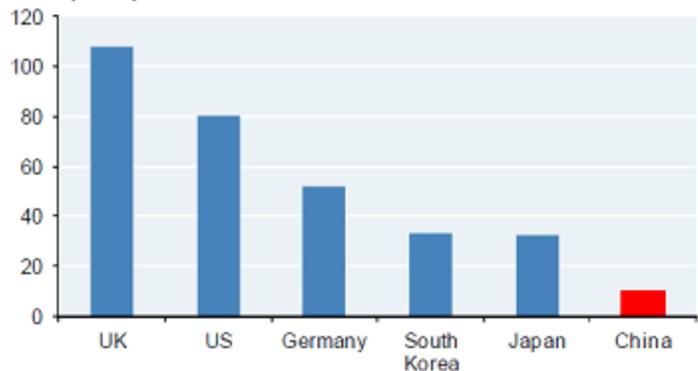
Million tons



Source: China Dairy Yearbook 2010, China Dairy Data Report 2012. Gavekal Research.

China's liquid milk consumption per capita is still low

Liters per capita



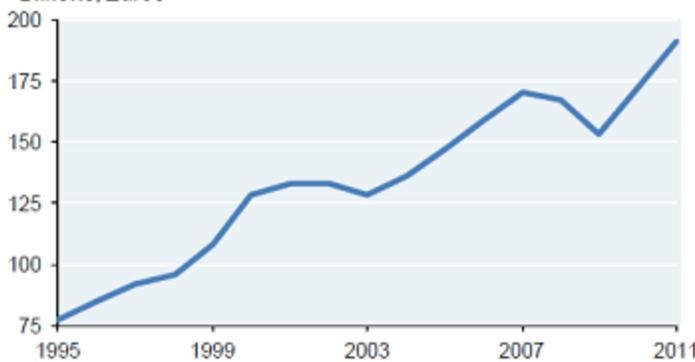
Source: China Dairy Data Report 2012. Gavekal Research.

“Does anybody really know what time it is?” Ask someone in Asia, they are likely to be wearing a watch

A lot further up the food chain from milk: luxury watches. I don't wear a watch and have never understood their appeal [a], but they are in heavy demand across Asia. In China, watches denote a cachet of prosperity, and industry reports note that 40-60 percent of the demand for European luxury watches come from Asia. A recent transaction involved the purchase of a Singapore-based retailer of luxury watches in 2009; brands offered include the usual suspects (Swatch, TAG Heuer, Franck Muller, Patek Philippe and Bulgari). The purchase price was at a considerable discount to the prior purchase given the impact of the global recession and the collapse in high-end consumption, and the bankruptcy of its prior owner. Since 2009, global luxury purchases have recovered sharply, led by the recovery in Asia (up 27% in 2010 and 2011), and by sector, the recovery in the “hard” luxury category of jewelry and watches (up by 23% in 2010 and 19% in 2011). See table for details.

Size of worldwide personal luxury market

Billions, Euros



Source: Bain & Company.

Region	2010 vs. 2009	2011 vs. 2010
Asia-Pacific	28%	27%
Japan	0%	2%
Americas	16%	9%
Europe	10%	7%

Sector	2010 vs. 2009	2011 vs. 2010
Art	2%	3%
Watches & Jewelry	23%	19%
Perfume/Cosmetics	6%	4%
Accessories	17%	13%
Apparel	12%	8%

Source: Bain & Company

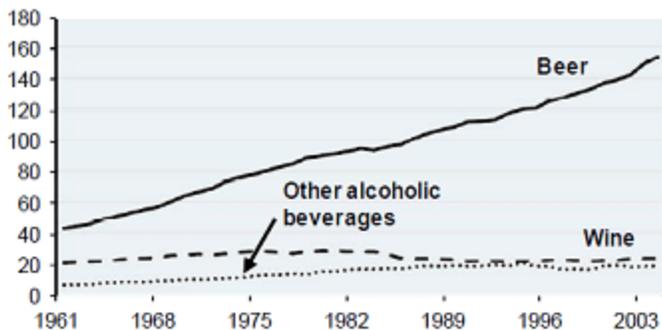
The company expanded its footprint to boost sales and growth across Asia. A geographical reach is important here: two thirds of future Chinese wealth is expected to come from so-called Tier 3 and Tier 4 cities, and in India, cities such as Chennai, Hyderabad and Pune are rising in importance alongside Mumbai and New Delhi. Certain brands (such as Rolex) are willing to sign exclusivity or distribution arrangements with retailers, which can be valuable if the brand has enough local recognition. The company was able to obtain distribution rights from Rolex, Jaeger-LeCoultre and A. Lange & Söhne, and exclusivity rights from De Beers in the region. Their geographical and product expansions are all part of an effort to transform the company from a family-run business into a larger enterprise. New pricing strategies, renegotiation of supplier input costs and greater inventory planning helped revenues grow by 30% per year, and operating cash flow by 50%.

Beer consumption returns to its roots, in Asia

The world still prefers beer to other spirits, and by an increasing margin when measured by volume (see first chart). Regarding increased consumption in Asia, beer is returning to its roots: there is evidence that beer was produced in China over 7,000 years ago, and beer was the preferred spirit at the height of the Egyptian empire. As with many Asian consumption stats, beer consumption trails the West on a per capita basis, but has caught up in terms of volume. Last year, a large global beer company took on several billion dollars of debt in conjunction with an acquisition. The debt was collateralized by asset sales, committing the company to a series of divestitures. One divestiture involved an Asian beer company domiciled in South Korea. The South Korean beer company has a storied history (founded in 1933) and now has

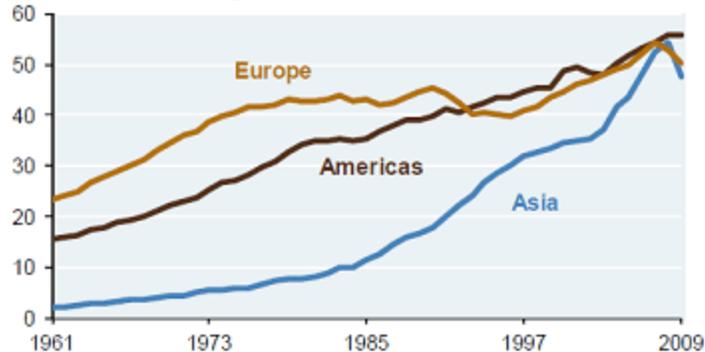
54% market share. Their local brands include Cass, OB Golden Lager and Cafri, and they exclusively license Budweiser and Hoegaarden. Beer dominates alcohol consumption in South Korea at 50% of the liquor industry. That's similar to beer-loving countries like the US, Germany, Canada and Australia, and much higher than levels in France, Italy and the rest of the countries in Asia. Consumption is growing steadily, supporting 30% operating cash flow margins with minimal capital expenditures (3-4% of revenues). There may be expansion opportunities outside South Korea (in China perhaps, where consumption is sky-rocketing from almost zero in 1980), but the transaction is mostly about maximizing domestic operations.

Global consumption of beer, wine and other alcoholic beverages in volume, billion liters



Source: "Beer Drinking Nations, The Determinants of Global Beer Consumption", Liesbeth Colen and Johan Swinnen, American Association of Wine Economists, 2011.

Another East-West convergence: beer consumption
Million tonnes, through 2009



Source: Food and Agriculture Organization of the United Nation.

The company is attempting to improve sales by focusing on growth prospects rather than just volume, and is implementing a variety of new sales management tools (training local merchants about product and store placement, etc). These initiatives resulted in higher revenue growth (16% in 2012 compared to 7% in 2009), 12% gains in market share since 2009, and further penetration of southern provinces where it had been underrepresented.

With all of these examples, much of the revenue and cash flow improvement is cyclical; it will take more time to evaluate what part resulted specifically from a restructuring or repositioning of the company. However, a good part of the private equity opportunity in Asia was the recognition that the 2009 collapse in asset prices did not reflect the long-term improvement in its household consumption trends, and that many companies still had good prospects for growth. At a time of slowing GDP and profits growth in the West, maintaining some exposure to higher-growth regions makes sense to us. As per the industry data shown above, private equity has been an effective way to benefit from it over the last few years.

Michael Cembalest
Morgan Asset Management

[a] I have never been interested in accessories like belts, watches and ties, since they are something of a nuisance, and have limited interest in jewelry. My wife picked out her engagement ring, out of fear that I would pick something in the shape of a dinosaur or a frog. I did find something interesting enough to buy her last time I was in France: Gustav Klimt-inspired enamel bracelets and earrings by someone named Frey Wille, based in Vienna.

Sources:

- "What Life For Milk After Melamine", Tom Miller, GaveKal Research, August 2012
- "Global ex U.S. Private Equity & Venture Capital Index and Benchmark Statistics", Cambridge Associates LLC, March 2012
- "Luxury Goods Worldwide Market Study", Bain & Company, May 2012
- "Beer Drinking Nations, The Determinants of Global Beer Consumption", Liesbeth Colen and Johan Swinnen, American Association of Wine Economists, April 2011

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