

Shoreline Financial Advisors, LLC

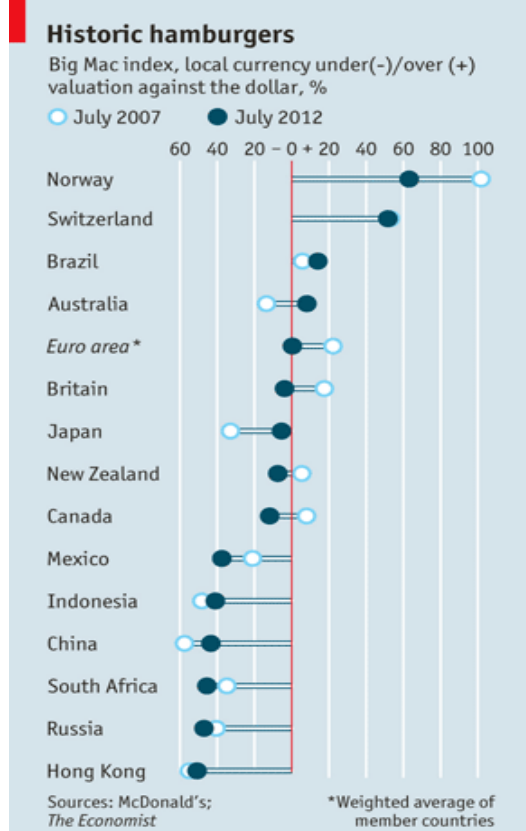
REGISTERED INVESTMENT ADVISER

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“Do the difficult things while they are easy and do the great things while they are small. A journey of a thousand miles must begin with a single step.” – Lao Tzu

A few quarters ago, we highlighted *The Economist's* Big Mac index to draw attention to

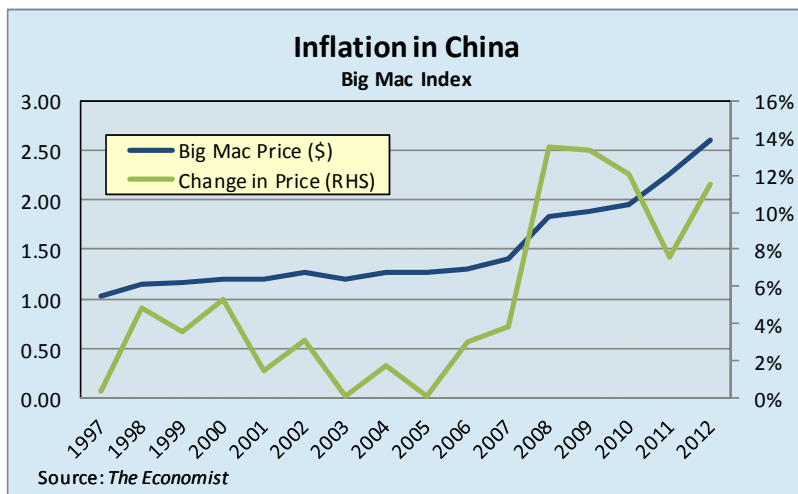


some of the imbalances within currency valuations at that time. The idea behind the index was to demonstrate purchasing-power parity (PPP), a theory that posits the price of an identical basket of goods should migrate to equilibrium over time. Through the pricing of one nearly identical and ubiquitous good, the Big Mac, this index attempts to illustrate this theory in an inexact but entertaining way. To the left, *The Economist* has taken their index and shown the changes in the five years ended July 2012. If the theory proves correct, then the blue circles for each country should be inside of the white ones. Essentially, all data should be moving to equilibrium or zero.

Although some data has moved more dramatically, we would like to highlight China as the renminbi, on this measure, was the most undervalued currency the last time we

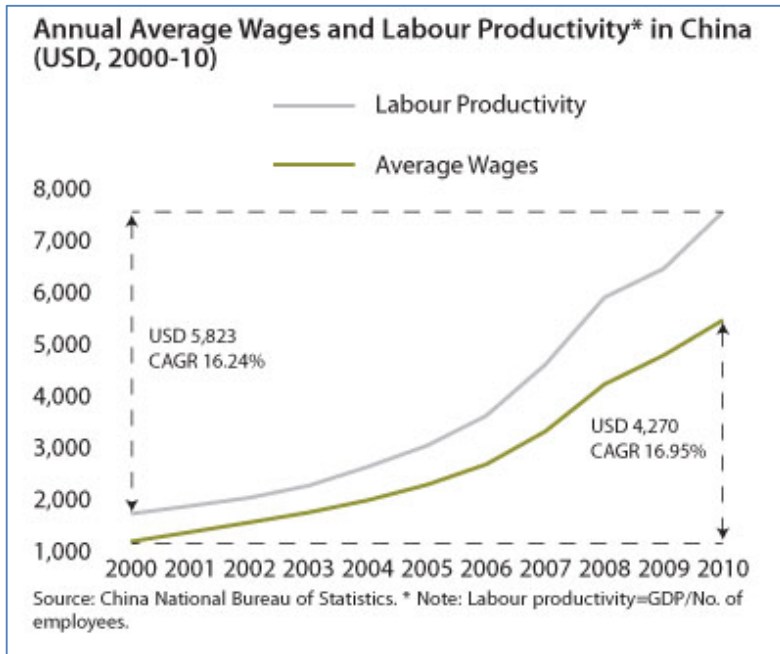
reflected on this index. The move towards equilibrium can be accomplished in one of two ways. First, a currency can strengthen or appreciate until the price of a Big Mac **when translated into dollars**

approaches the price paid in the United States. The chart at right deconstructs the price data from the Big Mac index for China translated into dollars. As you can see, the price of the burger in dollars has appreciated considerably;



particularly in the five years that correspond to the first chart above.

The second way equilibrium can be realized is through inflation. As the Chinese renminbi has only appreciated by approximately 20% during this time period, the brunt of increases in Big Mac pricing is being born by local consumers. In the chart below, there is data regarding Chinese annual labor rates expressed in dollars. Labor unrest, rising productivity

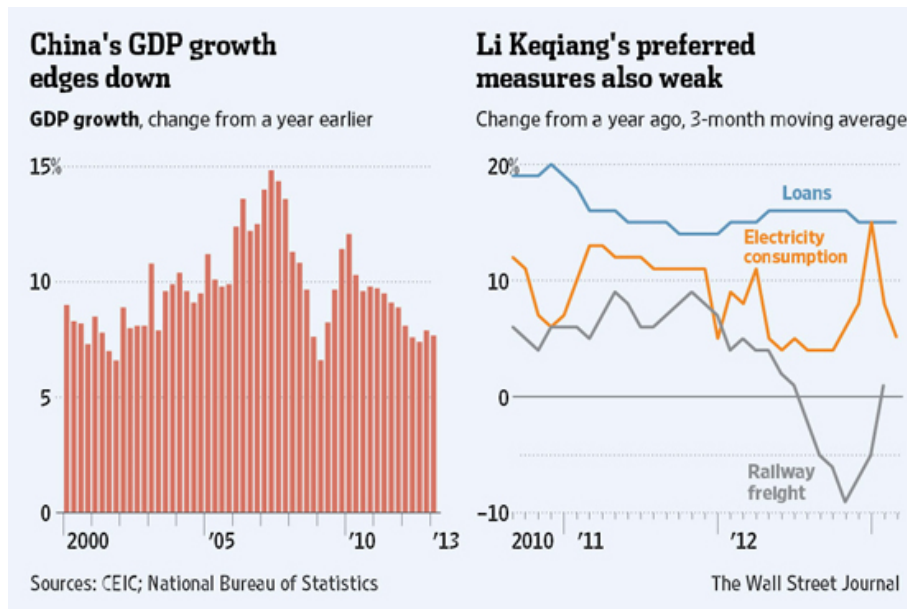


and increasing value added in Chinese manufacturing has greatly improved the disposable income of Chinese workers placing them in a better position to buy Big Macs and other consumer items at higher prices.

This is vital. Like many emerging market economies, China will need to transition from an investment and export led model towards

growth based on domestic consumption. This is a difficult adjustment and there will be volatility along this path. In the chart below on the left, the red bars illustrate economic growth over the past twelve years. The two bursts of activity in 2007 and 2010 represent massive investment led growth related to the Beijing Summer Olympics and recessionary stimulus packages funded by locally mandated lending by state run banks. The result has been a large

expansion of credit leading to a material increase to total debt. The chart chart on the right highlights recent trends with leading indicators such as lending and concurrent indicators such as electricity

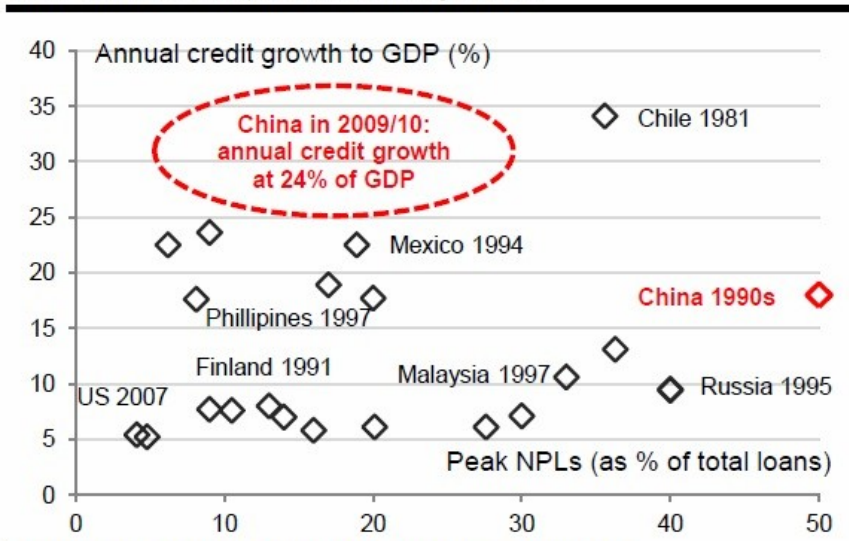


consumption detailing slowing growth. There is a fine line that China will need to travel in unwinding the credit growth that has fueled their economy.

China is not the first and will not be the last to deal with the aftermath of excessive credit expansions. The chart at right captures the fallout of these policies well.

Note the US in the bottom left of the graph. The vertical axis measures the growth in lending during the period in question while the horizontal

After credit booms, there are always NPLs



Source: Laeven & Valencia (2008), SG Cross Asset Research/Economics

axis measures the level of non-performing, or defaulted loans (NPLs) resulting from these policies. Countries like Malaysia, Russia and Mexico were transitioning from more state dominated economies; a path that China appears to be pursuing. Like many of the countries shown in the illustration, China will struggle with the economic consequences.

With the wisdom of Lao Tzu, all things can be accomplished before they become overwhelming. Although world leaders do not appear to be inspired to attack these problems while they are still manageable, we believe that they will muddle through this crisis and the capitalist system, while flawed, will lead individuals to allocate resources to their best use creating positive returns in the intermediate term.

If you have any questions, please feel free to contact our office. We thank you again for the trust and confidence you have placed in our firm.

Regards,

Shoreline Financial Advisors, LLC