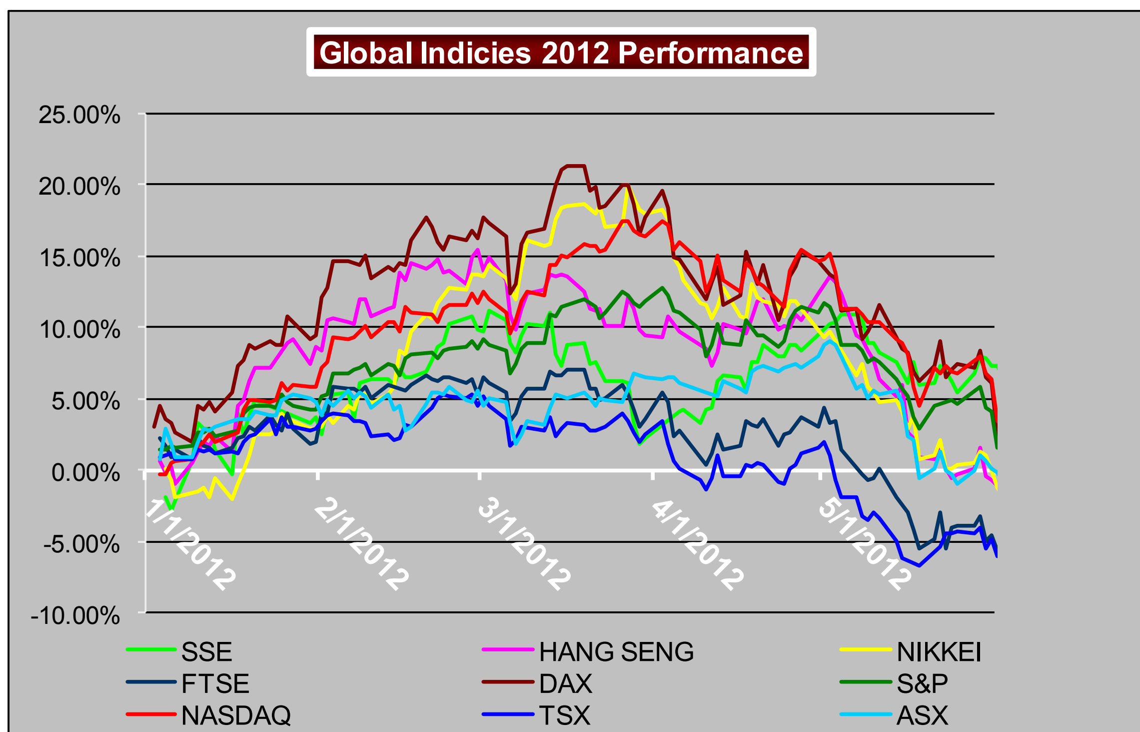
GDB July 2012 Newsletter

Monthly Market Summary:

2012 June Market Activity		
SSE COMPOSITE	***2,225.43***	-147.79 (-6.23%)
HANG SENG	***19,441.46***	+942.55 (+5.10%)
NIKKEI 225	***9,006.78***	+541.31 (+6.39%)
FTSE 100	***5,571.10***	+250.20 (+4.70%)
DAX	***6,416.28***	+156.52 (+2.50%)
DOW	***12,880.09***	+488.53 (+3.94%)
S&P 500	***1,362.16***	+52.29 (+3.99%)
NASDAQ COMPOSITE	***2,935.05***	+124.92 (+4.45%)
ASX 200	***4,094.60***	+18.30 (+0.45)
TSX COMPOSITE	***11,596.56***	+183.44 (+1.61%)
TSX VENTURE	***1,190.99***	-86.91 (-6.80%)



Investment Themes:

*"As an observer of markets – whenever everyone focuses on one thing – like Greece and Europe – maybe they miss issues that are far more important – such as a meaningful slowdown in India and **China"***

Marc Faber, author of the Boom, Glom & Doom Newsletter

In GDB Capital's December 2011 Newsletter, we have forewarned investors about the serious implications for the Chinese economy if there is a notable reduction in trading volume with the EU. To refresh our readers' memory, China's trade surplus with the EU represented approximately 2.2% of China's GDP in 2010. So if we shave that off from the 9.2% 2011's GDP growth figure, a crude estimate for 2012's GDP would be approximately 7%. The National Bureau of Statistics is due to release Q2 GDP along with industrial production, fixed asset-investment, and retail sales data in the middle of July. We believe these figures will confirm stress on the Chinese economy. The world's second largest economy, the growth engine that is expected to steer the global economy through a second global recession, is feeling the draft of the European storm. Here are some signs:

1. Stockpile of Raw Materials

Coal and iron ore, two of the most sought after commodities in China have seen significant deterioration in demand in the last couple of months.

Qinghuangdao, once called the largest coal port in the world, has seen coal stockpile reaching 9.5 million tons in June; in comparison, the normal inventory is around 6 million. This surpasses the previous record of 9.3 million tons set during the trough of the previous financial crisis in 2008. The next three largest coal storage areas in Tianjin, Caofeidian, and Lianyungang are also experiencing record high inventories. Coal price according to the Bohai Bay-Rim Steam Coal Price Index is below 700 Yuan (US$111), a decline of 20% year-over-year. Major slowdown in heavy industry, construction, chemical, and steel is the main contributor to the deterioration in coal demand.

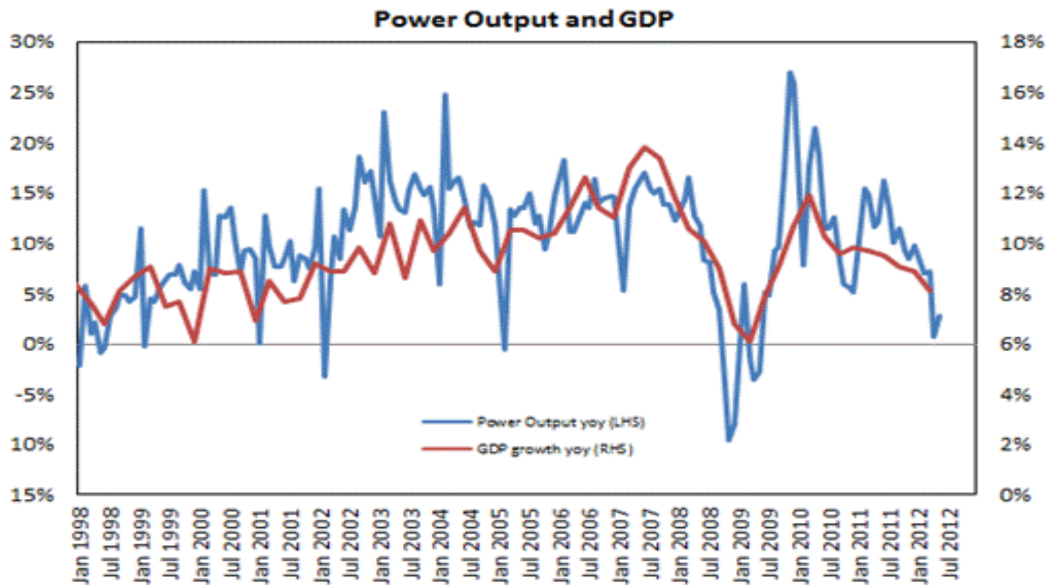
Iron ore stockpiles are also near historical highs. At the end of June, iron ore inventory in major Chinese ports reached 96.81 million tons. Qingdao port is one of the largest iron ore ports in China. It handles about 1/7 of the imported iron ore volume in the country. In June, it is estimated that there are 15 million tons of iron ore stockpiled at Qingdao port. The port is running out of storage capacity and had to convert its office buildings to accommodate for extra storage space.

Increase in iron ore inventory is a direct result from decrease in steel production. China's steel producers face industry wide margin compression and are challenged by reduced demand for steel from construction and real estate sectors. Many small to medium steel producers are struggling to break even and have ceased production. Even larger state owned firms such as WISCO is diversifying into non-steel related businesses such as pig farming, yes PIG FARMING, as the steel business in China is no longer profitable.

2. Declining Power Generation

The 9.5 million tons of coal stockpile at Qinghuandao would normally find a home at many of the nation's thermal-coal power plants, but not when coal power generation is down 1.5% year over year. Not just coal power, but overall power generation showed a meager year over year increase of only 2.7% in May after growing at its weakest pace in three years in April. There are also anecdotal reports from corporate executives in Jiangsu and Shangdong, heavy industry centers of China, that consumption in both provinces had dropped more than 10% in May from a year earlier.

Power output correlates to economic growth. Slower economic growth equals less power demand; so moderating power generation is a lagging indicator to confirm the economy is slowing. We will need to monitor this trend over a longer period as you can see from the chart below that power production tend to be volatile from month to month.



3. Slowdown in Luxury Spending and Casino Revenue

In times of boom, wealthy Chinese indulge themselves by taking trips to Hong Kong and splurge on luxury fashion and accessory items, jewelries and watches. And after retail therapy, Macau's baccarat table is the ideal destination to test their lucks.

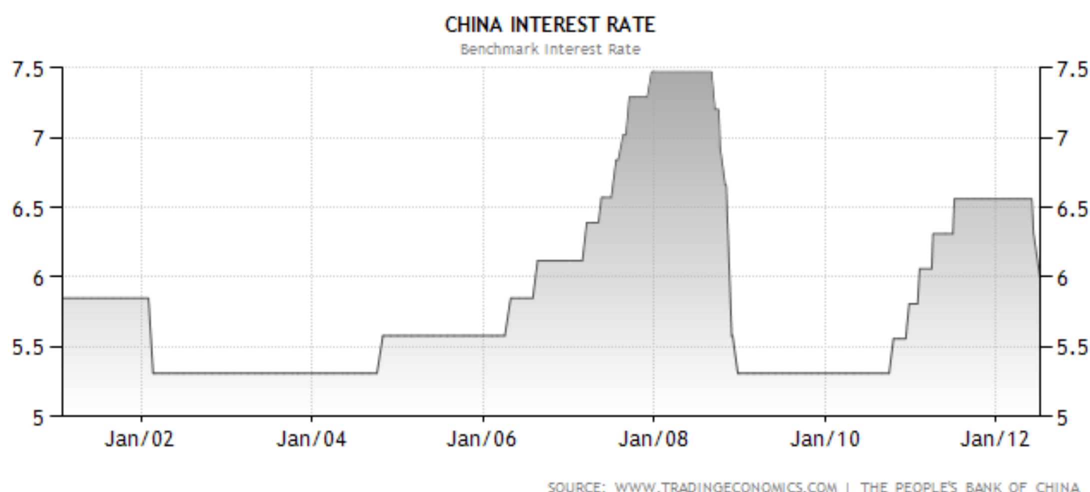
Hong Kong's retail sales growth increased 8.8% in May from a year earlier, although still growing, it grew at its weakest pace since 2009. Sales of jewelry, watches and clocks rose 3.1% in May from a year ago. In May of 2011, this figure was a whopping 61%. Tourism stats are showing mainland visitors have decreased in numbers and the above retail figures confirm they are cutting back on their spending.

In Macau, gaming revenue increased 12% in June year-over-year, a fraction of the 52% gain in the same month in 2011.

If China is to mitigate a slowdown in its export driven economy and turn on the switch of domestic consumption, it needs to rely on this segment of wealthy Chinese including property developers, entrepreneurs, corporate executives, and white-collar office workers to lead the initiative. If this segment is tightening their belts, what does it say about the general consumption pattern in China? Indeed, Chinese retail sales grew 13.8% in May, the smallest increase since 2006.

4. Aggressive Policy Responses

People's Bank of China (PBOC) has cut benchmark rate not once, but twice in one month. Looking back in history, the last time rate was slashed this aggressively was during the 2008 financial crisis.



Observing from monetary policy over the last year, China has always preferred to tweak the bank reserve ratio over direct interest rate adjustment. By taking the offensive and lowering interest rate twice in such a short period of time, the central bank is going on an offensive to spur growth. To warrant such aggressive moves, there must be legitimate concerns about the country's downshifting economy. We would like to remind our readers, it was only less than a year ago, PBOC was still increasing reserve ratio to keep a lid on an overheating economy. But since late 2011, PBOC has cut the reserve ratio three times and now two consecutive interest rate cuts in a span of a month. China went from hot to cold in a very short period of time. The velocity of its economic deceleration should draw grave concerns.

Aggressive policy response is not only happening in the realm of monetary policy. In June, China Securities Regulatory Commission announced it would allow international fund managers with as little as $500 million in assets under management and two years' of operating history to apply for QFII investment licenses. The previous threshold was $5 billion and a five-year record. QFII grants quota to selected foreign firms to invest directly in the domestic A-shares listed on the Chinese exchanges. Since QFII's launch in 2002, the quota has always

been meticulously controlled as to circumvent cheap international capital to flood the Chinese market. So why reduce the restriction in such a brisk and determined manner?

It is obvious the officials and regulators are taking notice of the country's economic headwind. Are the aggressive policies telling us things are considerably worse than people are expecting?

The above signs are showing us the "reserve engine" of the global economy that many hope will bring us out of the European crisis and a second global recession are showing strains. However, unlike the political set up in the EU and in the US, China's one governing body will take swift and effective policy actions to counter any significant economic malaises. However, the effectiveness of any monetary policy adjustment or stimulus cannot be predicted.

In such a scenario, GDB Capital recommends a commodity relative value trade that is popular among many hedge funds – long oil and short copper. The logic behind this trade is copper is far more dependent on Chinese economic growth than crude oil. China accounts for 26% of the global consumption of the red metal, while only 6% of oil. Furthermore, OPEC defends a minimum price for oil while only the law of supply and demand applies to copper. Such a position will allow investors to benefit from upside and minimize downside in whichever direction the Chinese economy moves. If China continues to grow, it will probably focus on growing its domestic consumer market, which is less copper intensive than real estate or infrastructure building, demand for oil will continue to grow. If China slows down further, the downward pressure on copper price will be greater than crude oil and the short copper position will kick in as a hedge. Over the past year, copper price have fallen 18% vs. 14.5% for crude oil.

Investment Opportunities:

1. **Sino-GDB Fund**
   Fund managed by GDB Capital. Investments using hedging strategies and combinations of long/short positions in derivatives of public traded equities. Also private equity investments with a focus on mid-markets growth companies, distressed assets, M&A, and buyout opportunities. Industry focus targeted at metals and mining, oil and gas, clean energy, fertilizer and agricultural chemicals, real estate, and technology. Fund targets gross pre-tax IRR of 20% per annum, minimum investment US$500,000.

2. **Clear Hill – Iron Ore**
   The Clear Hills properties consist of ten Metallic and Industrial Mineral permits and four Mineral Leases comprising 76,652 hectares. The Clear Hills property encompasses three main project areas, Rambling Creek, Whitemud Creek and Worsley.

   Estimate on Rambling Creek portion of the Clear Hills iron deposit contained 139,777,000 tons grading 33.04% Fe classified as Indicated Mineral Resources and 62,824,000 tons grading 33.70% Fe classified as Inferred Mineral resources.

   It is noted that the Rambling Creek Iron deposit is associated with appreciable concentration of vanadium pentoxide (0.21%). Early work indicates that the vanadium may be recoverable during the DRI process.

3. **Tampoon Resources Inc – Oil**
   $50,000,000 private placement. Proceeds used for oil and gas exploration in Western Canadian Basin Oil Property Acquisition and Farm-in opportunity. Currently producing ~300bbls/d with significant reserve/deliverability (Est. 600bbls/d flush; 200bbls/d aver prod); 600,000 barrels 38-42 API/well.)

4. **Open Range – Oil**
   $10,000,000 private placement of preferred and common shares. $5,000,000 preferred shares Series B – 8% Cumulative Dividend, Voting, Redeemable December 31, 2012 priced at $1.00 per share. $5,000,000 Common Share priced at $1.50 per share. Proceeds used to increase land ownership from 11,000 acres to 70,000 net acres. Projected production is estimated at 2,000 BOPD for 2011.

Properties located in North Dakoda where large US oil companies such as Hess, and Occidental Petroleum have both recently acquired a number of smaller firms.