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REMEMBERING THE FUTURE

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An Elegy of International Diversification: Part I

Introduction

Over the next few issues we will focus our attention on international issues, culminating with an analysis of China. We would like to offer the warning that such analysis, may justify a bearish stand on China, and the dangers it may pose for a possible collapse there, which will have significant consequences for geoeconomics and geopolitics, including currencies and the sustainability of the known global economic regime. We will examine the case of China as a possible giant “bubble” and what the consequences of a Chinese implosion would be on the U.S. and the global economic system as a whole.

As a prelude to that, we would like to offer the newly constructed leading and coincidental indexes produced in China over the last few weeks. As the following figure shows, both indexes - which are based on sound economic indicators such as consumers’ expectations, bank lending, orders of exports, capacity utilization, electricity generation, passenger traffic, the real estate sector, supply of raw materials, etc. – have turned down. When those newly constructed indexes are tested back in time, as far back as 1986, they predict with significant accuracy

what has happened to the Chinese economy over the last 25 years. Thus, these indexes, are our first hint that we may see an implosion in China over the next 18 months, with severe consequences for the global economic regime.

Figure 1: Chinese Leading & Coincidental Indicators



Our issue this month will focus on two cases, namely Canada and Africa. Assuming that the economic system continues on a normal path, both countries have a lot to promise in terms of investment opportunities and returns. However, in a case of a general

implosion, our estimates are that they can be better shelters than conventional places, due to their resources and the developments following such a general implosion.

In the next issue we will analyze other places of diversification (such as Russia and Australia). However, before we start on this issue's main themes, allow us to say a few words on current economic and financial developments.

Current Developments

We wrote last month that an environment of risk aversion has been at expanding. This could be verified by the fact that investors are looking for exits, especially in the European markets. The speculative shorting has contributed significantly to this endeavor. It seems that the only institutional investor left is the European Central Bank (ECB)! Some of the countries in Europe have difficulties refinancing their debts at reasonable market rates. Others, are unable to sell all of the newly created bonds (e.g. in mid May Spain failed to sell all their newly issued bonds). Spreads and yields are rising, demonstrating higher sovereign default risks. The LIBOR (interbank lending rate has almost tripled in the last month). The new regulations placed into the markets (e.g. in Germany), could potentially reduce liquidity, and thus contribute to another credit freeze. The divergence in government bond yields within the EU, as well as between the EU and the US, shows that the markets are treating some EU countries like emerging countries, rather than ones belonging to the Eurozone. The unfunded liabilities as we wrote in our April issue, are coupled with rising debts, stagnant economies, deteriorating

demographics and public finances, all of which increase risks.

At the same time, large institutional investors such as PIMCO are selling some of their holdings, and money-market funds question the viability of the short term loans they make, squeezing the liquidity of the interbank loans market. In addition, there are many questions as to whether the \$1 trillion rescue package for the EU will work out. Growth in the EU and in other places has started slowing down, reducing corporate profitability prospects and putting a break in consumer spending. It seems that a new era is unfolding, where artificial genomes find their maker in fiat/artificial currencies.

The Banking Sector in Canada

Canada's primary dealers have publicly articulated the anticipation of a rate hike of 25 basis points at the Central Bank's June meeting. If the public indications hold true Canada will be the first of the Group of 7 countries to raise rates and follow through on plans to lessen stimulus in coordination with fiscal measures such as repealing first-time home owner tax credits. After suffering from a contraction of 7% in the first quarter of 2009, Canada posted growth of 5% in the fourth quarter of last year. The nation's remarkable turnaround is worth investigating and exploring for an understanding of its investment environment and opportunities.

Canada has seen its fortunes rise for two primary reasons: its financial regulatory structure and its commodity endowments; the former mitigated Canada's downturn and the latter saw a dramatic rise in value as investors flocked to hard assets in the thick of the crisis. At this stage, and parenthetically we should

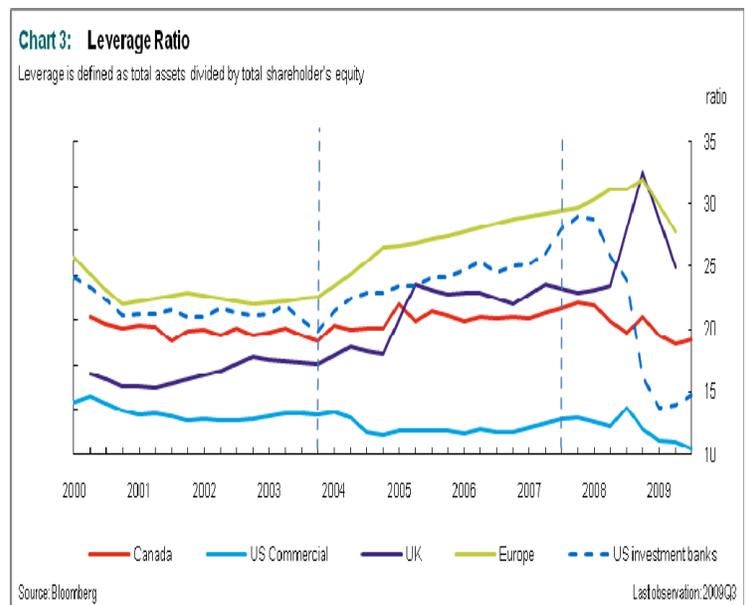
say, that if a future major crisis takes place then there is a good chance that Canada may suffer as well if oil prices decline, while gold prices continue rising.

Canada's finance minister, Jim Flaherty, has described his nation's financial system as "boring," but truth be told the complexity and sophistication found in the United States' banking sector can also be found north of the border. Four of the largest ten banks in North America are in fact Canadian according to Bloomberg. Like the U.S., the banking system in Canada is heavily concentrated with "the Big Five" dominating financial activity. In the midst of the crisis Canada's central bank also adopted new measures of providing liquidity and its prime lending rate mirrored that of the Federal Reserve's quite closely.

However, there are distinct differences between banking practices in Canada compared to the United States that has allowed for the former to recover from a steep downturn in a quick manner. Canada possesses a clear, comprehensive regulatory structure that defines lending standards and oversight of banking practices. Institutions such as the Canada Mortgage and Housing Corporation, the Department of Finance, the Canada Deposit Insurance Corporation, the Bank of Canada, the Financial Consumer Agency, and the Office of the Superintendent of Financial Institution oversee the sector and sanction violating parties. This centralization and standardization of practice isn't present in the U.S. which accommodated the formulation of complicated and opaque instruments that endangered American credit markets.

One of the most influential decisions implemented by these agencies is standards on leverage ratios. The developed regulatory structure in Canada allows for a transparent process of decision making and rule setting that allowed appropriate Canadian institutions to cap leverage ratios at approximately 20:1 for a bank. Figure 1 demonstrates a comparison of leverage ratios across multiple countries.

Figure 2: Leverage Ratios



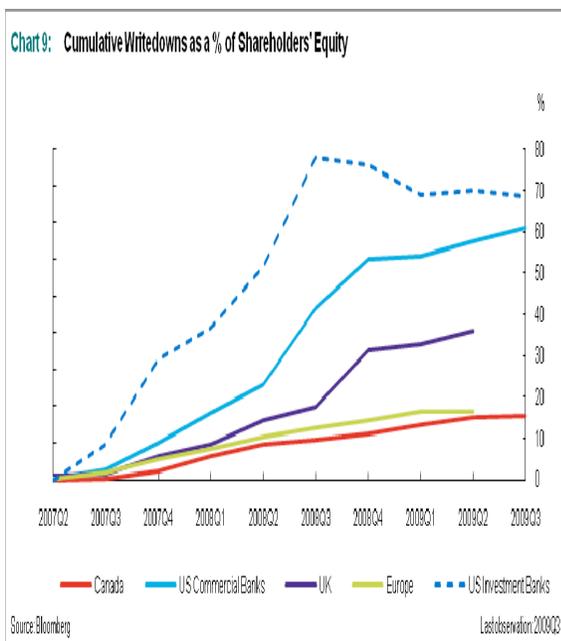
Better performing banks were sometimes granted exceptions to issue leverage at a 23:1 ratio but only after a thorough analysis that went through the appropriate regulatory mechanisms to validate the request. Banks that performed poorly would be restricted under the 20:1 ratio. This is entirely different from the U.S. where average leverage ratios were 25:1, but also when exceptions were granted by SEC Chairman Chris Cox to the five largest

investment banks to take on debt at a ratio of 33:1 as reported by the New York Times in the case of Bear Stearns.

Canada's financial system did not witness an explosion in securitization that American markets saw. According to James MacGee of the Federal Reserve Bank of Cleveland only 25 % of Canadian mortgages were securitized whereas that ratio reached 60% in the United States. Mr. MacGee also mentions that Canada's regulatory structure is much stricter on off-balance sheet instruments compared to the U.S. This reduces the incentive for banks in Canada to move toxic assets into an off-balance sheet venue or to even adopt such instruments in the first place. A paper in late 2009 by the Brookings Institute notes that this transparency further avoids the creation of toxic instruments, the pledging of worthless assets and other practices of "the shadow banking system."

A more comprehensive image of the health of Canada's financial sector, in comparison to the United States, is available in Figure 2, which compares the writedowns in multiple economies.

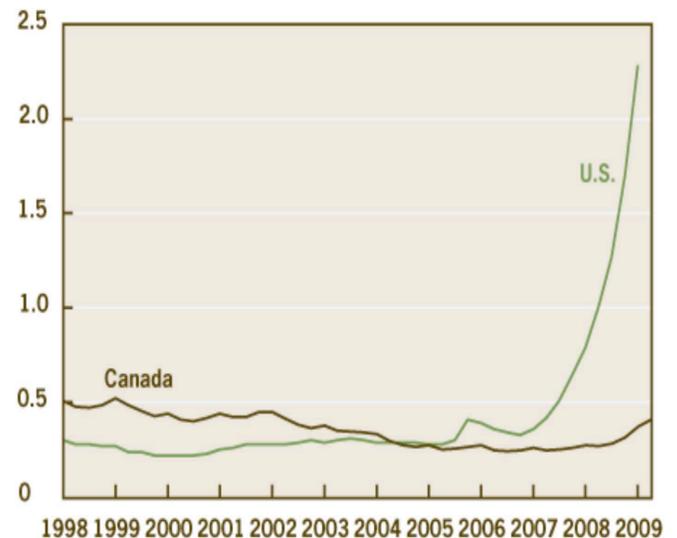
Figure 3: Writedowns



MacGee also noted the distinct differences in the composition of mortgages between Canada and the U.S. Canada's mortgage market avoided making loans in excess of 80% of a home's value far more often than the U.S. The result was less debt for borrowers and far fewer delinquencies as shown in Figure 3. Delinquencies only began to rise in Canada after unemployment levels increased, whereas in the United States that order is reversed, a key detail states MacGee. Thus, Canada's mortgage market was populated with loans of higher quality. Related to this trend in Canada is the fact that interest on mortgage payments is not tax-deductible, meaning borrowers take on less debt given the absence of this incentive which is offered in the United States.

Figure 4:

Delinquency rate



Source: U.S. Mortgage Bankers Association and Canadian Bankers Association, and Bloomberg

What the above demonstrates is that Canada has put in place a comprehensive framework of rules, regulations, standards and

practices that retain fundamentals in its domestic financial activity. This discussion also points out that Canada's more centralized structure is in no way too sclerotic to adjust to pressing needs, as their financial institutions also participated in liquidity provisional methods in order to address clogged credit lines. Most importantly, studying Canada's banking sector reflects a philosophy of prudent and responsible decision making is in place, which is the most comforting factor to any prospective investor. It's no wonder that the World Economic Forum named Canada's banking sector as the most sound in 2009 for the second time and its structure has been endorsed by Chairman and Paul Volcker.

Canada's Natural Endowments

Canada's rise out of the global economic crisis was made possible by its substantial natural resource endowments, which saw a dramatic rise in value in the midst of financial instability and fears. The systemic tremors that will persist for the next few years over the sustainability of the current global economic system will raise the demand for, and thus value of, hard assets. Thus, Canada's investment prospects for the future provide promise.

Alberta's oilsands are poised to become a dynamic factor in the global energy markets for years to come. According to a new report by Cambridge Energy Research Associates the region's oilsands production will be the largest supplier of crude products to the United States in 2010 and could provide up to 33% of U.S. oil needs within the next 20 years. Given that Alberta posted a budget deficit last year, the increased attention to its resources is strongly welcomed and will

continue to garner notice globally. The tragic oil spill in the American Gulf will concentrate more attention to regions like the oilsands as offshore drilling will undergo legal and practical reviews.

Sinopec, a Chinese oil company, has already announced plans to purchase a stake in Canada's Syncrude, the largest player in the oilsands. China has embarked on other ventures as well to hold a stake in the oilsands development. It is estimated that the value of these additional ventures reaches into the billions. The foreign investment into the sands is reassuring, given the high cost of the field's development and the needed construction of infrastructure. China will be a player for the long term in Canada's energy resources as the heads of Saskatchewan and British Columbia visited China to attract investment and open a trade office in Shanghai. Canada is so blessed to be endowed with multiple resources that economic resource risks are naturally diversified. Aside from oil Canada is blessed with natural gas, shale energy deposits, 26% of global uranium output (a further valuable hard asset), as well as other minerals. This wealth of resources will drive demand for Canadian dollars, bonds, and other CAD denominated assets. Again, parenthetically speaking, if China collapses, then whoever starts sweeping away Chinese assets, will be the great beneficiary of those tremendous assets.

The combination of diverse hard assets, a sound financial system, and growing relations with rising, hungry powers, allows Canada multiple avenues of growth instead of its current dependence on American growth, which was the primary factor in Canada's

misfortunes in early 2009. Moreover, the fact that Canada has demonstrated sound fiscal and financial policy in the wake of the worst global economic climate in 70 years, has allowed its economy to recover and has built a good cushion against future tremors. This stability in Canada's fiscal and monetary sectors allows for little interference from factors outside the price of the commodity to affect the value of investments in Canada. Thus, given that hard assets are currently undervalued, we believe that Canada can become a destination of an individual or institutional portfolio.

Some Perspectives on Africa

Development thinkers and economists often times refer to Africa as the last frontier in terms of progressing prosperity. Such an argument has been in place for decades as "development models" have morphed within the international community as to how Africa can escape its state of depravity. Yet over the last few years, thanks to the integrative and expansive effects of globalization, Africa has seen its prospects rise.

For example, the Johannesburg Stock Exchange has performed well when examining it with a long-term perspective (see Figure 1). The exchange has tripled in value since 2006 thanks to the many avenues of growth that South Africa possesses, which will be explained later. It is the most internationally exposed economy in all of Africa which explains losses experienced during the financial crisis of 2008, but has risen 50% since low points in 2009.

Figure 5: Johannesburg Stock Exchange



Source: CNBC

However, we prefer to look at the trends in Africa in more general terms as opposed to specific countries in this article. In this and in future issues, we will be making some specific assumptions and suggestions.

Africa as a continent has so many holes and so many needs that oftentimes investors view the uncertainty as a major risk and impediment to allocating funds on the continent. There is of course substantial political as well as financial risk with regards to African stability. But given the potential of how much further funds can go in Africa compared to developed economies, the investment prospects for Africa are indeed available if approached with prudence and rationality. Specifically, if Africa grows, there are certain avenues that the continent *has* to develop. Namely, infrastructure, telecommunications, banking, and commodities will expand regardless of whether African nations emphasize agriculture, industry, or services. It's with this

philosophy that investment in Africa is worth investigation. Moreover, natural endowments in Africa are abundant, thus assuming some legal, political and social improvements, Africa may turn out to be the story of the first half of the 21st century.

As has been continuously advocated, the medium and long-term economic forecasts will require hard assets in an individual's portfolio. Throughout Africa, hard assets and commodities are plentiful. Moreover, Africa's rise within the international sphere, given the continent's increased priority among nations such as China, India, and Russia, will assure the development and extraction of these hard assets.

On Commodities and Hard Assets in Africa

With the realization of sounding like a broken record, hard assets, and specifically precious metals, should be the primary asset of choice in portfolios in this economic environment. We are not out of the woods yet in terms of financial calamity. Thus, a scramble for Africa's natural resources and hard assets in general by state-run companies, sovereign wealth funds, central banks, and other institutions will continue.

Over the past several years, Africa has borne witness to numerous foreign entities and powers knocking on its door asking for natural resources. China, the most notable country, provides debt relief, aid, generous loans, arms, and other "gifts" to entice African leaders into awarding the Asian country concession agreements to satisfy its desire for minerals and oil. The Department of Energy reports that Africa accounts for

30% of China's crude oil imports and Angola is its largest single supplier.

The U.S. is also heavily involved in Africa's assets, particularly oil. 2005 U.S. oil imports consisted more of African oil than that of the Middle East. Nigeria alone accounted for approximately 11% of oil imports in 2005. The Gulf of Guinea provides enormous potential for Africa; estimates from the National Intelligence Council project that the region will provide 20%-25% of U.S. oil imports, which explains the massive infusions of capital the Gulf of Guinea has been seeing the past few years.

The enormous potential the Gulf of Guinea has for oil is simply an example of the continent's capacity as a whole. Gold deposits in Ghana and South Africa will be further developed and other mines will be heavily explored given the financial instability and thus the incentive to find new sources. The Congo is enriched with rubber. Zimbabwe is endowed with diamonds. Botswana has the highest average growth rate globally over the period of 1960-2005 thanks to its responsible management of diamond deposits. Kenya and parts of eastern Africa are blessed with agriculture. With the financial markets unstable and uncertain, commodities will see their values rise. Some, like crops, will be more subjective to fluctuations; minerals like gold however pose greater prospects given its new potential in a reorganized international economic system that adheres to more fundamental practices.

South Africa ranked third in global gold production in 2009 and finished the year with the largest stock of reserves among any single country according to a geological survey

by the U.S. Department of the Interior. Ghana also ranked high on that list and earlier this month announced increases in production of 20%. South Africa also ranks as the world's largest producer of chrome, platinum, manganese, and other minerals. The potential is clear.

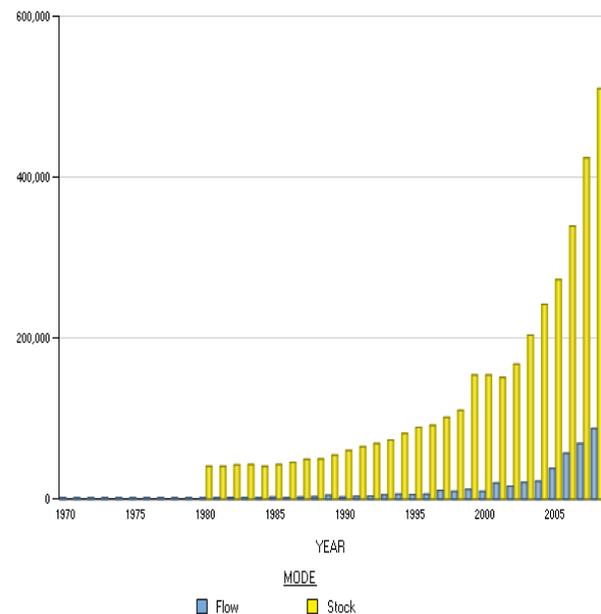
Combining the proven reserves and the potential of Africa's hard assets and the fact that these sectors are not as fully developed as their western counterparts provides the pieces for an untapped investment destination. For example, Sasol is the third largest public company on the entire continent. Specializing in energy and chemicals, Sasol's shares are priced at half the value of Chevron. MTN, the dominant player in telecommunication across the continent and fifth largest company in Africa is sold at just over \$12 per share.

While allocating portions of a portfolio into Africa will require extensive investigation and analysis we remain optimistic regarding the continent as a viable target for investing.

A Few Words on Africa's Telecommunications

Whether African nations choose to develop their economies through infrastructure construction, a service sector (like Rwanda), manufacturing (like Mauritius), agriculture (like Kenya), or natural resources (like Angola), telecommunications will follow every form of development. As foreign companies become more involved in Africa (see graph of FDI flows and stock in Africa) they will open factories, offices, train labor and so forth.

Figure 7: FDI in Africa; United Nations



Source: United Nations Development Report

Communications technology such as mobile phone towers, internet technology, and data mediums will grow in correlation to Africa's development. Such technology serves as a tremendous supplement to any development strategy. Moreover, the installation of such systems will spill over into Africa's civil society and accommodate domestic businesses as well as allow for new information flows, educational opportunities, and political accountability. What fails to get mentioned is that it further puts the African continent into a level of integration where it is viable in the global economy.

Figure 8: Fiber Optic Cable Route in Work by Main One Cable



Source: Africa Report, January-February, 2010

Countries like Ghana, South Africa, Kenya, Rwanda, and even Somalia have seen an explosion in telecommunications hardware, infrastructure, services, and companies. IBM has forecast Uganda's telecommunications sector will see expansion of 25% year on year for the next five years. Figure 8 shown above, demonstrates this far reaching initiatives process. This process with result in more reliable internet and communications technology that are transferrable across sectors and regions and further facilitate the formation of markets and networks.

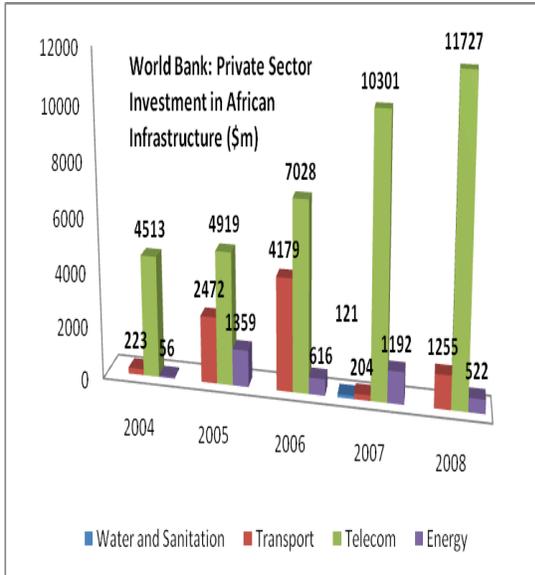
Cell phone coverage among Africans is expected to be spread to 85% of the continent's population. One factor that many investors (especially in the United States) do not understand about communications in Africa is that they provide services and flexibility that doesn't exist in the United States. For instance, mobile-banking is

revolutionizing rural communities. In Africa, a cell phone has the potential to function like a debit card by making financial transactions, informing producers of the markets with the best returns, and paying bills. Moreover, mobile phones are the prominent medium to the Internet given how their cost compares to a personal computer, and avoid the restrictive contracts found in Western markets. A study by the London Economic Policy Center found a 0.6% rise in GDP for a 10% rise in cell phone use. Another study by the UN found that 60% of South Africans (the continent's most developed country) did not have a bank account but did have a cell phone. Mobile communications and their various functionalities are elevating the scalability of micro-finance that has transformed numerous communities around the globe.

Finance and Infrastructure Prospects in Africa

Given the obvious and tremendous prospects of infrastructure development as well as the potential of other sectors, what needs to be realized is that such projects need to be financed. With Africa's hard assets and some glimpses of economic growth, more capital will be available to the banking sector to finance the needed investments of infrastructure, telecommunications, agriculture, and so forth. Figure 9, from the December/January issue of The Africa Report, demonstrates private sector infrastructure investment in Sub-Saharan Africa over the past few years.

Figure 9: Private Sector Investment,



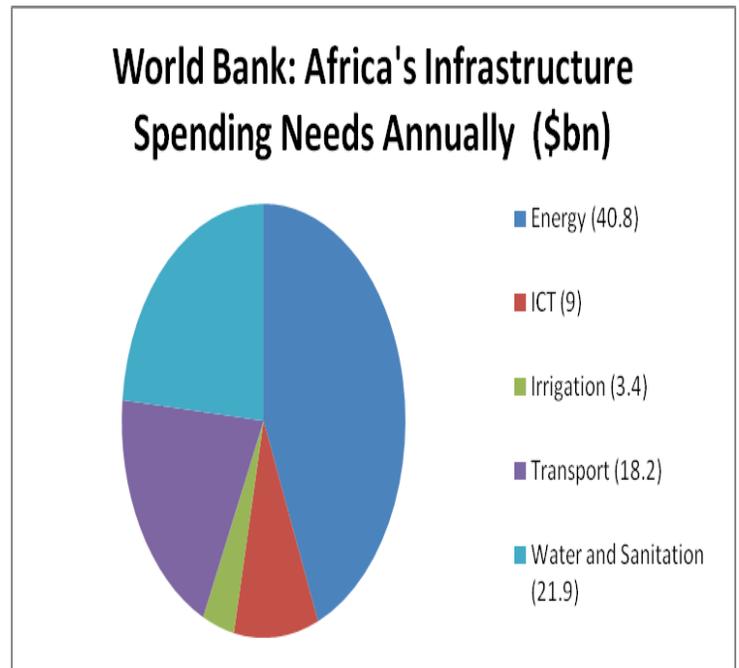
Source: The World Development Report, 2009

Thus, discovering banks inside and outside of Africa with a consistent presence in African communities can provide a reliable source of investment given that the need for financing infrastructure projects in Africa will remain. Worth noting is the fact that private sector investment rose throughout 2008, despite the many troubles that captured the financial industry. This demonstrates that Africa's enormous need for infrastructure compensates for the obvious risk inherent in the continent when assets are allocated responsibly and rationally.

Just as important to remember is that there is a tremendous need for infrastructure development. Figure 10 from the World Bank demonstrates the spending needs for Africa on infrastructure in 2010 alone. What isn't mentioned is the often foregone notion of maintaining infrastructure, something

Africans are grateful to China about. Often times, development efforts result in the construction of roads, bridges, or canals but the failure to follow up on projects with appropriate maintenance results in rapid deterioration.

Figure 10: Infrastructure Needs in Africa



As has been mentioned a few times, the safest investments in Africa are the sectors that have the greatest need or are correlated to rise with sectors that are of greatest need. The most obvious sector that provides attention and capital flows for the continent is commodities, as discussed earlier. However, having access to mine minerals or extract oil is worthless without the infrastructure to transport these assets across the country/countries or the ports to ship them out. Identifying companies that are awarded construction contracts to either build or maintain infrastructure in the five major areas (Energy, Communications, Irrigation,

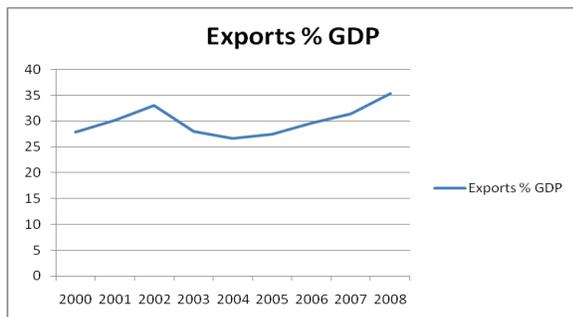
Transport, Water & Sanitation highlighted in Figure 10) could make a good start in the endeavor called Africa's promises.

Epilogue: South Africa and Ghana

The most important term or principle when it comes to any portfolio scheme is diversification. This allows for the mitigation and hedging of risk, numerous avenues of growth, and a balanced and proportionate investment strategy. The same philosophy can apply to South Africa, explaining how it has become the largest and most influential economy on the continent.

South Africa is the most integrated African country within the world economy. Export growth, as Asia can attest, can be a tremendous source for economic growth. With regards to South Africa, the country has numerous goods and services that allow it to take advantage of international markets. From minerals (like gold and platinum), to agriculture, to telecommunications (one of the continent's leading providers), to manufacturing and industry (South Africa has a sophisticated automotive industry). South Africa has a diversified export sector unlike numerous other African countries which usually depend on a single asset.

Figure 11: Exports as a Percentage of the GDP



Source: The World Development Report, 2009

Figure 11 above, demonstrates the substantial portion of the country's economy that is appropriated in exports and its ability to recover from dips. Over the same period of time South Africa used its revenues to develop its weaker sectors. For example, South Africa's Ministry of Trade and Industry reports that while agriculture continues to be a small share of South Africa's total exports, the value of the sector has grown 400% since 2000. Over the same period of time, manufacturing rose by 300%, thanks to the continued development of the nation's industrial sector.

In fact, South Africa invests over \$1 billion annually in other parts of Africa, making it one of the largest FDI players on the continent. Seven of Africa's ten largest companies are from South Africa and possesses one of the continent's best banking systems, which is vital towards financing the further development of the country. As a whole, South Africa's boasts a service sector that comprises 67% of its economy, one of the highest in Africa.

While South Africa was certainly harmed with the crisis' impact on trade during 2008, its vast mineral wealth mitigated its losses, which demonstrates our point regarding South Africa's strength of being a diversified and sophisticated economy and worthy of investment prospects.

Ghana is frequently trumpeted as a model of democratic procedures in the region of West Africa. Ranked as one of the easiest countries to do business in by the World Bank, Ghana, like South Africa, is well

recognized within the international economy as major corporations such as Chevron and Vodafone operate in Ghana.

Enriched with natural resources, Ghana is seeing raised growth prospects thanks to gold and oil. Gold production at AngloGold's largest mine is expected to double in 2010 and other corporations have planned large investments to raise production. Gold production in Ghana as a whole is rising faster than other major producers according to The Africa Report. The development of infrastructure and new technology in the oil sector will bring over \$1 billion in revenue per year from the Jubilee field. Economists hope that Ghana's democratic structure will allow it to prudently reinvest resources to uplift other sectors of the economy such as cocoa, another major industry in Ghana.

Ghana posted over 5% GDP growth in 2009 despite its internationally involved economy and expects growth to exceed 10% in 2011 and 2012. With a dedication to keep its country competitive in export sectors, Ghana will see holistic development take place. Infrastructure development involving roads, bridges, canals, electrical power, telecommunications, and ports is sure to follow and The Africa Report indicates the strong involvement of domestic financing in making the infrastructure transformation possible. Ghana is also avoiding the mistake many other resource-rich countries, like Nigeria, make in forfeiting their agricultural future. Rice, maize, sorghum, and millet production are all up. Cocoa, the national staple, is also seeing its production rise as well as its processing abilities so as to allow for further exporting.

A further development in Ghana in recent years is its tapping of the international capital markets. Although labeled with a junk rating (B+), if Ghana can maintain a stable economy, its bonds, which currently pay over 9%, could become an attractive asset target in the future. The simple attainment of a rating demonstrates that Ghana is a serious country hoping to elevate the development ladder.

Entertaining thoughts of placing a small portion of a portfolio in countries mentioned in this newsletter, carries idiosyncratic risks. However, the rewards may more than compensate for those risks.

While we contemplate that tremors may continue in the next six months, we also believe that the global economic system has avoided a major collapse for this particular time period. However, a warning is in order: 2011 (especially its second half) promises to be a very interesting ride.

As always, please enjoy the ride!

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