absolute return partners newsletter

july 2004

The unwinding of the "carry trade" continues to damage the performance of many investment strategies. In this month's issue, we take a closer look at how high interest rates are likely to go. We also take a closer look at the similarities – and dissimilarities – between the stock markets of the U.S. and Japan. Several people have pointed out to us that the U.S. is a mirror image of Japan, but we suggest that there are some important differences.

How Far to Go?

As this newsletter goes to print, the Fed governors are about to begin the second day of their two-day session, which is likely to end with a cycle-reversing jump in the Fed Funds rate of 25 basis points to 1.25%. The stage is then set for a number of incremental hikes between now and year end. 25 basis points in August. Another 75 basis points before the end of the year. This is what we should expect according to the Fed Funds futures market.

The problem is that, unless the U.S. economy hits a brick wall, the Fed will not stop there. 2.25% is, quite frankly, not even going to register on the financial version of the Richter scale. As discussed in our May 2004 Newsletter, a neutral Fed position implies a Fed Funds rate of 2% above the level of inflation or about 4.5% at the going rate.

In a recent report[1] analysts at UBS compared the current situation to the five major tightening campaigns that the Fed has embarked on in the last 20 years. The average nominal rise in the Fed Funds rate has been about 250 basis points but, more interestingly, the average starting point was 5.73% - light years away from the current rate.

In real terms (i.e. adjusted for inflation), which is probably a fairer way of looking at things, the current situation is also very different from past cycles. Today, the real Fed Funds rate is around -1.5%. In the five tightening cycles referred to above, the average real Fed Funds rate was 3.13% at the onset and 4.33% at the end.

Whichever way you prefer to look at the situation, the message is pretty clear. If history offers any guidance, Fed Funds rates will go much higher than the 2.25% priced in by the futures market. Obviously, the pain is likely to be drawn out over an extended period of time. Greenspan & co are unlikely to move from 1% to 4% or maybe even 5% in anything less than a couple of years.

Another way to put the UBS study into perspective is to look at Fed Funds rates relative to nominal GDP growth (nominal rather than real GDP growth because you capture both the growth and the inflation element of the equation). Again, according to UBS, over the past 20 years, Fed Funds rates have been on average 30 basis points below the level of nominal GDP growth. U.S. GDP is currently growing at 6-7% in nominal terms.

All of this leads to a somewhat unnerving conclusion. Either the U.S. economy will experience a rather dramatic slowdown (for the record, we do expect a moderate, but not a drastic, slowdown), or markets are mispricing U.S. interest rate risk.

What *really* concerns us, however, is the unwinding of the carry trade. The carry trade is the process whereby investors borrow cheaply and invest the proceeds in higher yielding assets. Due to very low borrowing costs, the carry trade has been phenomenally profitable in recent years, both in dollars and in euros.

In a recent report by Dresdner Kleinwort Benson, it is suggested that, whereas there are clear signs of reduced risk taking in commodities markets, there is little or no evidence of money coming off the table in global bond markets (with the exception of high yield bonds). *This is bad news!*

We have met numerous people in recent weeks who have claimed that the process of unwinding leveraged positions is well advanced. The facts suggest that the process has hardly begun.

Overconfidence seems to be at the heart of the problem. Investors usually trust their own ability to call the market top and hence do not rush for the exit at the first signs of weakness.

Some may think that this is a U.S. centric problem and will have little or no bearing on European interest rates. Wrong! Using leverage to enhance returns is as much a European phenomenon as it is a U.S. one. We would not be surprised if this leads to a steeper European yield curve, at least temporarily.

Add to that the general increase in inflation. Due to this, the ECB have probably buried any notion of lowering rates any further, as so clumsily suggested by politicians in both Germany and France not that long ago. If anything, the ECB could surprise and raise rates if the recent pick-up in the inflation rate turns out to be more persistent. Look towards the

[1] *Fixed Income Strategy Daily, 2nd June 2004.*

end of the summer or early autumn for any ECB action.

Should oil prices continue to weaken, this could all change again. Given that the inventory building for the busy U.S. summer season is largely behind us and that economic momentum in China is now slowing, we would not be surprised to see oil prices drop further in the short run, although we maintain our very bullish view longer term.

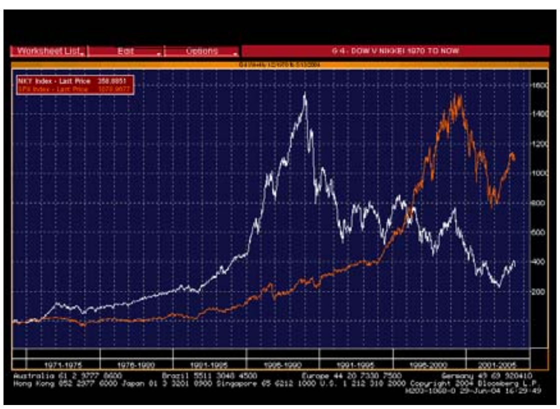
This would, in turn, give the ECB some breathing space, as a hike in late summer or early autumn would be immensely unpopular in both political and business circles. Not that ECB Chief Trichet necessarily cares.

Twin Peaks Revisited

Students of technical analysis[2] have long argued that what is happening in the U.S. stock market now is a replay of events in Japan a decade ago. Trading patterns are admittedly very similar, lending credit to the idea that history is in the process of repeating itself.

As long-term readers of this newsletter will be aware, we are not in the business of providing trading ideas. Trading is a difficult and demanding skill that few people master. Recognising our own limitations, our focus is instead on identifying great trading talent that we can bring to our clients.

On that note, and safely tucked away behind our desks, let us take a closer look at some startling 'technical' similarities between the stock markets of the U.S. and Japan. First, let us draw your attention to the graph below – the so-called 'Twin Peaks'.



Source: Bloomberg (white ~ Nikkei; orange ~ Dow Industrial)

The graphs tell a remarkable story of two stock markets moving almost in sync - only ten years apart. Allow us to highlight the following facts:

The Japanese bull market began in 1971. From its low point in January 1971 through February 1986, the Nikkei gained 520%. In the U.S., the bull market began almost exactly ten years later. Between its September 1981 low point and July 1996, the Dow rallied 550%.

Both markets then experienced an even stronger surge. Between February 1986 and August 1987, the Nikkei rose 100%. Ten years later, between July 1996 and July 1997, the Dow rose 49%.

At this point, both markets experienced significant setbacks. The Nikkei dropped 17% between August 1987 and December 1987. Ten years later, the Dow dropped 9% between July 1997 and October 1997.

Following the correction, both markets rallied once more. The Nikkei gained 80% between December 1987 and December 1989. Ten years later, the Dow gained 54% between October 1997 and December 1999.

Both markets have experienced a major correction. The Nikkei collapsed and lost 59% between December 1989 and July 1992. Ten years later, the Dow lost 34% between December 1999 and September 2002.

Following this correction, the Nikkei gained 42% between July 1992 and June 1996. Ten years later, the Dow has - so far - gained 34% between September 2002 and May 2004.

As far as property is concerned, in Japan, urban land values quadrupled between 1970 and 1989 and peaked in 1991 - two years after the peak of the stock market. In the U.S., house prices have more than tripled since 1981. In 2004 - four years after the peak of the stock market - house prices have not yet peaked.

Since the demise of the Japanese success story around 1990, some truly remarkable things have happened:

Short-term rates have continued to fall in order to combat deflation. Today they stand at 0%.

Understandably savings have continued to decline. Measured as a percentage of disposable income, they now stand at about 7% - down from 20% in the early 1990s.

Urban land values have continued to decline and are now 45% off their 1991 peak.

Equities have never fully recovered. The Nikkei is down 71% from its peak in 1989.

So what do we make of this?

Some have used the Japanese experience to argue that U.S. equities are in for a prolonged bear market, accompanied by low interest and savings rates, possibly deflation, and declining house prices. Their point is that, as we have seen in Japan, asset inflation is a dangerous beast and does immense damage once the bubble bursts.

The bubble is created as people borrow against the rising value of their assets with the proceeds being invested in higher yielding assets. The borrowing

---

[2] Technical analysis is used by many investors to predict future price movements on the basis of historical trends.

causes more asset inflation and, obviously, more debt. People continue to borrow more and spend more, and the assets continue their meteoric rise.

Eventually, the feast ends. The cost of borrowing may dictate at which point investors and consumers begin to de-leverage, but the cost of borrowing will probably not in itself cause the bubble to burst. An external shock (catalyst) is required. One can only guess which external shocks are in the waiting.

Others will describe the Japanese and U.S. similarities largely as coincidental and use the widely accepted argument that the Bank of Japan to a large degree created its own problems by not cutting interest rates quickly enough.

We are not so sure. Despite the many cultural differences between the U.S. and the land of the rising sun, the laws of nature apply to both. In the 1980s, the Japanese economy was booming and Japanese companies were the envy of the world. The same was true for the U.S. in the 1990s. Whether we like raw fish or steak with potatoes, we are all human and tend to get carried away when things are great. We slip into the hedonic habit of excessive spending and careless borrowing and, worst of all, we ignore warning signals. Such is the nature of man.

And yes, maybe the Japanese should have cut rates sooner. Or maybe things would have turned out differently, had the Iraqis not invaded Kuwait. Or perhaps one or two large conglomerates should have been allowed to go bankrupt instead of the Japanese authorities desperately trying to keep fundamentally unhealthy companies afloat. The truth of the matter, however, is that these events were just catalysts. Had these events not happened, other catalysts would have done the job.

There is, however, one major difference between the two scenarios that works in favour of the present day situation. The Japanese were navigating in unchartered territory. Much to their advantage, the central bankers of the U.S. and Euroland can draw from the experience of Japan and, hopefully, avoid some of the policy mistakes made there. With the benefit of hindsight, the Bank of Japan failed to lower rates quickly enough in what eventually turned out to be a very deflationary environment. The result was catastrophic. It is clear, however, that Greenspan learned that lesson.

However, in 1989-90, when the Japanese equity bubble burst, it was not immediately clear to anyone how strong these deflationary forces really were, so interest rates continued to rise until 1991, when the second shoe dropped in the form of a bursting property bubble. From this point, the Bank of Japan reversed its interest rate cycle and began a long journey of falling rates that has lasted to this day.

In the U.S., the equity bubble burst in 2000, and the unwinding of excess valuations is "work in progress"; actually a fairly orderly process so far, we are pleased to add. What is nagging us is the fact that the second shoe has not yet dropped in the U.S., and the Federal Reserve finds itself in a position to do little about it, should it happen anytime soon. We would actually go a step further and suggest that the rate policy currently being pursued by the Fed is looking increasingly irresponsible.

One of the primary responsibilities of central banks is to keep sufficient ammunition to fight the cascade of problems that may occur as a result of a bursting debt bubble. With the U.S. Fed Funds rate at 1%, where it ought to be *at least* 3% at this point in the economic cycle, the Fed could find itself in a very awkward position, to say the least, should an external shock require immediate action.

For this very reason, we believe that interest rates in the U.S. will be raised *less* than what is warranted, based on economic facts. The Federal Reserve is acutely aware that too much too quickly can actually cause the second shoe to drop. In the meantime, they will be praying that no external shock causes havoc with their carefully thought out plan. In that context, it is certainly a blessing that oil prices are on the retreat, at least temporarily.

As far as equities are concerned, we cannot tell whether the U.S. stock market will continue to mirror the performance of the Japanese market. Our crystal ball is no clearer than yours, unfortunately. But we do know that great parties tend to create big hangovers, and the stock market party of the 1990s was indeed the party to end all parties, so do not expect the hangover to go away quietly.

As discussed in great detail in our June 2004 Newsletter, we believe we find ourselves in a secular bear market. It is difficult, but not impossible, to make money in equities during secular bear markets. We will almost definitely experience good runs, where equities perform quite well. These periods may last many months, sometimes possibly even one or two years. If you can time you entry and exit points, there is surely money to be made. Timing is a difficult art, though, as stated to begin with. In fact, most academic studies dismiss the ability to time the market (we disagree with this notion but more on that at a later date).

So what should you do? We suggest you visit www.amazon.com where you can buy Benjamin Graham's famous book *The Intelligent Investor*. Reading it is hard work (trust us, we know) but hugely rewarding. It will leave you with great ballast, not so much as to when to enter and exit markets, but no other investment book comes even close in terms of providing you with the a-z of company analysis (i.e. when are stocks worth buying and when should they be sold).

Alternatively, feel free to call us, and we shall guide you to some of the truly great investors of this world. Enjoy the summer of 2004. Our next Newsletter will be out on or around 1st September.

The Absolute Investment Seminar

On Friday, 25 June 2004, we hosted a presentation with Dr. Horace Brook in our offices in London. One of the leading independent economists of modern times, Dr. Brook acts as an advisor to Absolute Return Partners. Below, we bring the highlights of Dr Brock's presentation in bullet point format. His presentation focused on four major themes. Please contact us, should you wish to learn more.

Is an Energy Sea Change Now Underway?

When compared to other commodities, the price of oil and gas is extremely sensitive to even relatively small changes in demand and supply.

Demand from India and China is grossly underestimated. 7-800 million people in the two countries are moving into the middle classes. They will demand access to modern means of transportation, heating and cooling systems, etc.

Production in many leading oil fields is either peaking (Middle East) or has already peaked (U.S. and North Sea). At the same time, there is a distinct lack of new fields of significant size.

Oil field technology is misinterpreted. There is indeed plenty of oil left in the world, but that is not the point. One should instead focus on the marginal cost of bringing that oil to consumers. That price is rising fast.

Overspending Our Way to Solvency

Baby boomers have saved half of what they now say they will need for retirement. At the same time, life-style expectations during retirement have inflated a lot.

The growth of family net worth between 2000 and 2030 will be half of that of 1981-2000.

The widely publicised inheritance "jackpot" will go to only 15% of baby boomers.

These facts have led to a projection that the social security system will bankrupt itself over the next 30 years. We disagree. Baby-boomers will have to work a lot longer, but it will happen, primarily because they cannot afford to retire.

Political implications: No more lies needed.

Sociological implications: Your spouse never wanted you home all day anyway. Your shrink will tell you that you will avoid depression and suicide. Your doctor says that you will live longer.

The End of "The" Market

Traditionally, the world has been dominated economically by the large OECD economies (EU, US, Japan, Canada and Australia).

Going forward, the world economy will be dominated by the EU, the US, Japan, China, India and Russia.

This has important implications for equity investors, as we predict equity return correlations to fall significantly.

This will make it much easier to diversify equity risk and bring a new meaning to the term market timing.

Deconstruction of the "Jobless Recovery"

Several facts about the 2001-03 U.S. economic recovery have been widely misunderstood. Most importantly, productivity growth has been underestimated throughout.

High productivity growth actually *caused* the jobless recovery, and high productivity raised output *and* profits *and* restrained inflation. This has kept the economy alive without additional tax cuts.

Outsourcing is employment neutral *provided* policies are non-discriminatory. *If* the Chinese Yuan had been allowed to appreciate as it should have (300% or thereabout), the effect of outsourcing would have been negligible. Now, the peg against the dollar has caused both output and employment to grow more slowly than it would have otherwise.

Ultimately, the Yuan will have no option but to appreciate against the dollar.