



The Absolute Return Letter

March 2005

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Summary

The world is out of balance. Economic growth is far from evenly distributed as demonstrated by the large U.S. current account deficit, which has created repeated calls for a lower dollar.

We argue below that it is not China or the value of the Renmimbi that is the main problem. Investors should instead recognise that a combination of extremely low interest rates in the U.S. combined with undervalued Asian currencies has created the prevailing situation.

Going forward, we suspect that one of two things (or maybe a combination of both) may happen. Either Asian countries will work with the Americans to revalue their currencies, or the Federal Reserve Bank has no choice but to increase interest rates significantly, which is in nobody's interest.

In our second article, we revisit the area of portfolio theory and we focus specifically on the concept of correlation and how you may use it to your benefit.

As usual, enjoy the read.

The Great Rebalancing Act

"The Renmimbi may be China's currency, but it is our problem". These words were uttered by the then U.S. Treasury Secretary, John Connally, in the early seventies. Some 30 years later the debate has hardly changed. Every other day, some new legislative proposal pops up in Congress, designed to kill Chinese exports to the U.S. Little do these people seem to realise (or care?) that China is not the root of the problem. In a recent report on the U.S. deficit problems, Stephen Roach of Morgan Stanley phrased it very well:

"US politicians just don't get the idea that budget deficits and the drag on national saving they produce are a major source of US current account and trade deficits. Nor do they seem to care that China doesn't set its currency on the basis of a bilateral trade imbalance with the US but on the basis of its multi-lateral trade position,

which is in near balance. And they don't appreciate that China's peg means there has been no change in competitiveness relative to the dollar over the past decade. But that's Washington".

However, before we get our knickers in a twist, let's step back and look at the issues at stake here. For economic prosperity to be able to sustain itself, it is important that growth is reasonably well balanced. Uneven distribution of economic growth leads to destabilizing currency movements, large trade and current account deficits and, ultimately, to its demise.

Even a casual observer will notice that the world today is anything but well balanced. The U.S. consumer has almost single-handedly kept the growth momentum going over the past couple of years, whilst consumers in Europe and Japan have been preoccupied with saving their income as if there were no (jobs) tomorrow. This has led to a sharp acceleration of the U.S. trade deficit and to a widening of the U.S. current account deficit, which now stands at about 6% of GDP.

This has again resulted in repeated calls for a lower dollar based on the view that this is the only way to fix the problem. Our response to this is (a) be careful what you wish for; a world out of balance is a dangerous place, and (b) the rebalancing act is more complicated than that, as we shall see below.

The Contestants

Let's begin with a line-up of the main contestants. What we are witnessing at the moment is effectively an economic dogfight of gigantic proportions with the U.S. in the blue corner and a variety of Asian countries in the red corner. In this battle, Europe has been marginalised but has nevertheless been forced to suffer the consequences as a result of the rising value of the euro versus the dollar.

Many Americans argue that the U.S trade deficit ex. China and oil is only moderately higher today than it was five years ago. Whilst correct, the

argument is then twisted to suggest that it is indeed China that is the root of America's problems today.

Meanwhile, the Chinese argue (and they have a strong case) that with only a very modest overall trade surplus, their currency is hardly undervalued as suggested by the Americans. Yes, the Chinese trade surplus with America has exploded in recent years, but China is actually running substantial deficits with a number of Asian trading partners. If the Renmimbi were grossly undervalued, as suggested by the Americans, the trade surplus would be much bigger than it actually is.

We would add to this observation that a revaluation of the Renmimbi along the lines suggested by many observers (i.e. 5-10%) would do diddly squat to rectify the situation vis-à-vis the United States. Given the low labour costs in China relative to those of the U.S., a Renmimbi revaluation of 40-50% would probably be required in order to eliminate the U.S. deficit with China. However much U.S. politicians wish for the deficit to go away, it is not likely to happen in the foreseeable future.

There is another potential outcome, though. If a currency is undervalued, the adjustment can take place either through a revaluation as suggested above, or you can inflate the difference away over time. China's inflation is indeed on the rise and is currently running at about 5% per annum versus 2.3% in the U.S. (ex. food and energy). Over time, assuming a constant exchange rate between the two currencies, China's competitive advantage will gradually diminish, as long as Chinese inflation is running faster than U.S. inflation. One should not disregard this option as the favoured one by the Chinese authorities. Only time will tell.

Morgan Stanley's Stephen Roach appears to be one of relatively few observers who realise that it is not China that is the (main) problem. He has calculated that the Renmimbi on a trade-weighted basis is worth about the same as it was in early 2000, whereas the Yen is 18% below the level of five years ago. In other words, whereas the world (and in particular the Americans) appear to be focusing on the Renmimbi, it is actually the Yen - and a number of other Asian currencies - that appear to be out of whack.

Another way to assess the scale of the problem is to look at U.S. exports versus imports. Imports are now about 52% higher than exports, making it almost mathematically impossible for the U.S. to export its way out of its current problems. One could actually make a rather convincing case that a further devaluation of the dollar of as much as 20-30% would only reduce the deficit marginally.

The only conclusion we can possibly reach is that any further weakening of the U.S. dollar makes little sense. Needless to say, that doesn't mean it won't necessarily happen. What is instead required, is one of two things (or a combination of both):

1. Higher real interest rates in the U.S.;
2. A coordinated revaluation of Asian currencies.

The Role of the Dollar

Before we discuss either of these options, let's spend a minute or two on the dollar's role in the world today, which is important to understand in the context of global rebalancing. Most of the world trade today is denominated in U.S. dollars, forcing central banks all over the world to keep substantial dollar reserves in order to meet trade requirements.

As the world is likely to see an increase in global trade, the need for dollars will actually rise, not fall. This argument is supported by recent research conducted by Morgan Stanley. They found that, despite all the hype surrounding central banks' desire to diversify away from dollars, global reserves of U.S. dollars actually rose from 2003 to 2004. Our friends at GaveKal Research have also dedicated significant time to this subject. Recently, they wrote the following:

"In a world with expanding trade flows, the only way to reconcile the central banks' need for reserves, and the trade's need for U.S. dollars, is for the United States to run a perpetual current account deficit. The important question is therefore not whether the U.S. has a current account deficit (the world needs for the U.S. to have one) but what the optimum current account deficit should be."

If the U.S. current account deficit is the main source of liquidity for the world (and it is), it follows that any attempt to balance the current account will have serious repercussions on global economic growth and hence financial markets worldwide. This is precisely why you ought to be careful what you wish for. Everything in small doses is fine. Too much may send the world into another recession.

Inflation

Let's go back to the case for higher interest rates. Inflation in the U.S. is currently running at about 2.3% (CPI ex. food and energy). The Fed Funds rate is 2.5%. In other words, the inflation-adjusted (real) Fed Funds rate is a meagre 0.2%. Meanwhile, even Greenspan & Co. are admitting that U.S. inflation is rising, although it took them a while to come out of the closet. With the pace of productivity gains moderating and plenty of commodity-driven price pressures in the pipeline,

we expect further upward pressure on U.S. consumer inflation in the months to come.

To compound this, the calculation of the US CPI number is flawed. As pointed out in last week's *The Economist*, rents are used as a proxy for the cost of home ownership when calculating the consumer price index in the United States. Rents account for 30% of CPI and are up about 2% in the last twelve months. However, over the same period, house prices have on average risen about 13%. One could therefore argue that U.S. inflation is quite seriously understated.

This, of course, will not have escaped the attention of the Federal Reserve Bank and supports our long-held view that the Fed will carry on raising rates for longer and to greater heights than most people expect at the moment. Given the up-trend in inflation and the need for U.S. households to save more, which will help to reduce the current account deficit, we would not be surprised to see the Fed Funds rate exceed 4% a year from now. Indeed 5% in this economic cycle is not as far fetched as some people think. That scenario is certainly not priced into today's financial markets.

Conclusion

Just like in any other line of business, under-the-table deals are made between central bankers. We have no hard facts to back this up with, but here is what we think could be going on at the moment:

Greenspan & Co. have quietly let central banks throughout Asia know that they have two options. They either work with the U.S. to gradually allow their currencies to appreciate against the dollar, or they will be facing significantly higher interest rates coming out of the U.S.

It may be a coincidence, but recent events in the foreign exchange markets support this thesis. The U.S. dollar has weakened since 1st January against the currencies of Korea, the Philippines, Taiwan and Thailand, whereas it has appreciated significantly against the euro (see the table below).

USD Performance versus:	1/1-2/3 2005
Won (Korea)	-2.8%
Peso (Philippines)	-2.6%
Dollar (Taiwan)	-2.9%
Baht (Thailand)	-1.5%
Euro	+3.2%

It is in everyone's interest to work towards the revaluation solution, but it requires 'fair play' from everyone in order to work. The question is

whether the Asians will trust each other enough to go along with this strategy. This has the added advantage that the euro should remain fairly stable versus the dollar, which is an important side effect. Europe hardly needs for the euro to appreciate any further against the dollar. Things are tough enough as they are for European exporters.

The truth of the matter, though, is that the world probably needs a little bit of both. Revaluation of Asian currencies alone may not do the trick but, in conjunction with moderately higher interest rates in the U.S., the world may become a more balanced place. And given the dire prospects for economic growth, should the Fed use only the interest rate weapon, Asian central bankers may have no choice but to cooperate at the end of the day.

In the meantime, this adds considerable risk to:

- (a) Dollar-financed leveraged investments;
- (b) Credit spreads;
- (c) Economic growth in parts of Asia;
- (d) Ditto in other emerging markets;

We would urge extreme caution in all these areas. As a consequence, in our model portfolio, we have further reduced our exposure to various equity and fixed income strategies, and we have initiated a position in gold (5%). You may argue that we are late. However, we would argue that there is no better hedge against the combined effect of higher (U.S.) inflation and a lower dollar.

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What Exactly Is It that You Guys Do?

This note is a continuation of an essay carrying the same name, which may be found in our December 2004 Absolute Return Letter on www.arpllp.com.

Before we go into an in-depth explanation of the concept of correlation, please allow me to paraphrase a few paragraphs from the December letter:

To answer the question of "what we do", the process is essentially as follows:

Step 1: Construct a portfolio consisting of different asset classes (e.g. bonds, stocks, etc.) based on a model we use. We call this 'strategic asset allocation'.

Step 2: Fine-tune the portfolio in accordance with our expectations going forward (the past and the future are often two very different things). This is known as the tactical overlay.

Step 3: Having identified a number of asset classes for investment, we subsequently select what we consider to be the best managers to represent each of these asset classes.

Step 4: After the portfolio has been established, we watch the managers and occasionally propose changes to the portfolio as conditions change.

Three elements are required to complete the first step - standard deviations, correlations and expected returns. In the December letter, I focused on standard deviation. This time I will look at the concept of correlation.

A correlation analysis is a statistical analysis that measures the relationship between two variables. In the world of investments, we talk about how returns are correlated. In plain English we look at how returns interact. When bond prices rise, does that have an effect on share prices or is there no interaction at all?

Chart 1:

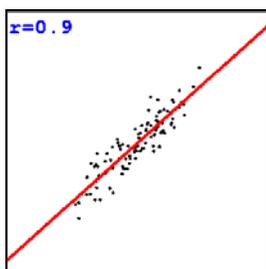


Chart 1 illustrates the interaction between two asset classes. Given the high correlation (r) between these two ($r=0.9$, with 1.0 being the highest), the chart could illustrate the link between, for example, UK 5-year gilts and UK 10-year gilts, which move more or less in tandem. We say that the two are almost perfectly correlated ($r=1.0$ equals perfect correlation).

Chart 2:

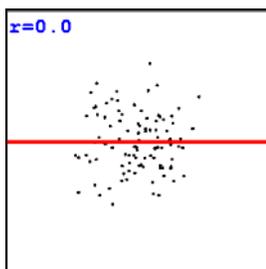
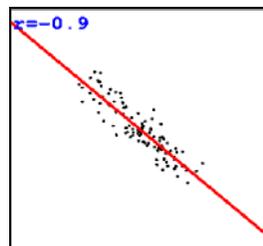


Chart 2 illustrates a very different scenario. Here the two asset classes are uncorrelated ($r=0$). You will notice that there is no detectable pattern in this chart. In the real world, European equities and commodities are virtually uncorrelated.

Chart 3:



In chart 3 we are looking at a scenario where two asset classes are moving in opposite directions. We say that they are almost perfectly negatively correlated ($r=-1$ equals perfect negative correlation). An example of this is gold and the dollar. Gold tends to appreciate in value when the dollar is weak and visa versa.

As we can see from the three charts above the correlation between two variables always moves between -1 and +1. But what do we use the correlation for? First, I would like to make a general observation. We often meet resistance in our attempts to convince people to diversify their investments. The perception is that diversification takes too much off the returns relative to the reduction in risk. In fact, this is not the case. Diversification, properly executed, reduces risk without sacrificing returns.

In other words, you can, to some extent, have your cake and eat it. The key to this rather counterintuitive fact lies in – you guessed it – the correlation between assets. The expected return of a portfolio will always be the weighted expected return of the assets therein. For example, if your portfolio holds only two assets, A and B, and the expected return on asset A is 10%, whereas the expected return on asset B is 20%, the expected return on your portfolio will always be 15%. This all makes perfect sense.

However, when we compute the standard deviation (risk) of the portfolio, things become rather more complicated. This is because the standard deviation of the portfolio is NOT the weighted average of the assets in the portfolio, UNLESS the returns on the investments are perfectly correlated (which is almost never the case).

If the assets are not perfectly correlated, we need to account for the correlation between the assets in the portfolio in order to calculate the risk profile of the portfolio. The important rule to remember is that the standard deviation (risk) will always be lower than the simple average of the constituents, unless correlations are perfect. This allows investors to eliminate significant amounts of risk without sacrificing expected returns.

The above is essentially the foundation of modern portfolio theory. There are many problems with this theory, but those issues are for another letter. Instead, I wish to focus on a few of the caveats in the use of correlations.

Firstly, as is the case with standard deviation, the estimates used for correlation analysis are based on historical values, but we cannot necessarily assume that past experience will repeat itself. During normal market conditions, historical numbers are usually quite predictive of future results, but it is not always the case. In times of extreme stress, this becomes particularly worrisome. We say that during times of distress, correlations go to one. (Actually, we use another expression along the lines of 'a certain substance hitting the fan', but that is not suitable for a high quality paper like this.)

The last time you saw this happen was during the Russian debt crisis in the summer and early autumn of 1998, which destroyed the performance for many managers that year. Asset classes that historically had not been correlated, suddenly were. For a brief period of time (a couple of months), all the fancy models could be thrown out of the window. This will undoubtedly happen again. The only consolation is that, after a stressful period, things usually return to some sort of normality again.

Secondly, sometimes correlation patterns are nothing but a fluke (in technical terms this is known as spurious correlation). A famous case of this is the correlation between stock prices and snowfall in January. There is no rational reason for this; yet the correlation is there for everyone to see. Do not be blinded by statistics if these cannot be rationalised. Statistics without common sense are dangerous.

Thirdly, sometimes the calculations are based on limited data points. You may draw some very inappropriate conclusions if you base your analysis on say 5 data points. This is accounted for via a so-called t-test. The t-test will disclose if the results are statistically significant.

Hopefully, the above provided some food for thought with regard to the strategic asset allocation process (Step 1 in the investment process). As for Step 2 (fine-tuning the portfolio in accordance with expectations), I can refer to this and prior newsletters that are freely available on our web site www.arpllp.com. You are also welcome to call us for a chat. In terms of selecting and watching managers for our investment platform (Steps 3 and 4), future letters will address this from time to time.

Finally, if you want to take one thing away from this letter, remember that you can eliminate significant amounts of risk without sacrificing

expected returns, as long as you use your knowledge of correlations between different asset classes intelligently. You can afford to forget everything else in this letter, as long as you remember that.

Mads Hansen

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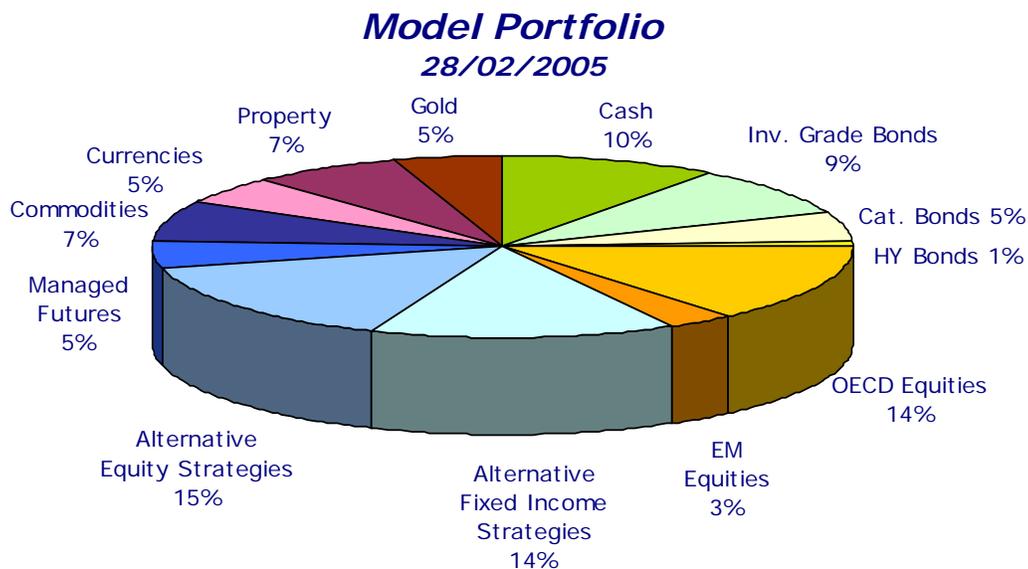
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