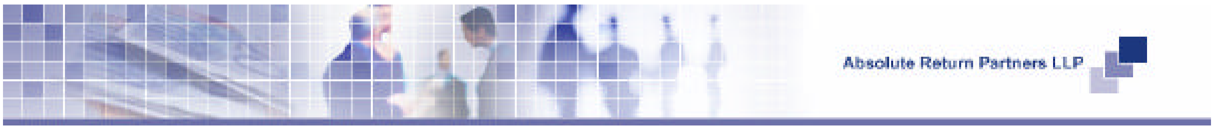


The Absolute Return Letter

June 2005

Summary

In this month's letter, we dedicate most of the space to one of the greatest challenges of recent times - figuring out whether the bond market is in for a rude awakening or if yields can continue to fall.

Some of the sharpest investors on the planet strongly disagree on the outlook for bond markets, so do not expect much help from the so-called experts. They are as divided as ever.

Nevertheless, we hope you will be able to take something home from this letter. Perhaps surprising to some readers, we conclude that European interest rates will probably fall further.

Towards the end, we make a few comments related to our article from last month, discussing the short- and long-term outlook for commodity prices. We argue that there is further evidence building of short-term weakness in commodity prices.

Enjoy the read.

Inflation and the Battle of Interest Rates

One of many lessons I have learned over the past 21 years in business is that financial markets rarely get things wrong. When they persistently send a clear signal, it is usually a costly mistake to ignore it.

Why do I bring this up now? Because bulls and bears fight like never before about the outlook for global bond markets. Bulls and bears will, by definition, always disagree. But the language used by both sides has turned increasingly antagonistic in recent months.

Not that we mind this. A bit of mud slinging is always good for entertainment value. However, when the bears accuse the bulls of having lost the plot completely, we sit up and listen.

Meanwhile, bond markets continue to defy the odds, sending a clear message that should not be ignored: Notably that the inflationary outlook may not quite be as it seems.

Let's begin our journey by reminding you of several important events that have unfolded over the past few years[1]:

- A costly war in Iraq (costly mainly to the U.S. and U.K.);
- Large U.S. tax cuts;
- "Irresponsible" fiscal policy in most major OECD countries (e.g. France, Germany, the U.K. and the U.S.);
- Extremely low interest rates (virtually everywhere);
- Rapidly rising commodity prices (absolutely everywhere).

Each of these five factors is inflationary. When combined, they constitute a potentially lethal cocktail which could have initiated the mother of all inflationary waves. So why has inflation behaved so well despite this dangerous cocktail? The answer: Because there are still some very powerful deflationary forces lurking underneath it all.

These "dark" forces have been largely offset by a combination of the factors mentioned above. And, in fairness to central bankers and politicians around the world who have frequently been accused of conducting irresponsible monetary and fiscal policies, one can make a very strong case for all this "irresponsibility" actually helping to avoid a potentially dangerous deflationary situation from developing.

Back to the bulls and bears. About the only thing that they agree on is that inflation is the key influencing factor in the performance of the bond market, so let's focus on that. The bulls base their argument largely on the power of globalisation, which has, they say, offset much of the inflationary pressure from rising oil prices, etc.

[1] *Yet again, we have been inspired by the thinking of our friends at GaveKal Research (www.gavekal.com).*

The bears, on the other hand, argue that inflation is slowly but surely getting a grip. The bulls, they say, will eventually have to pay for their complacency. They urge us all to focus on the "raw CPI" (CPI stands for Consumer Price Index) as opposed to the "core CPI", which has been seasonally adjusted and excludes the volatile food and energy components.

It is time to let you know where we stand in all of this. Our position is that inflation (at least in Europe) will drop from current levels. Before you get too excited about this prospect, though, consider the following: Low inflation is good but only to a point. When reaching a certain (low) level, investors start to worry about deflation, which can quite easily kick-start a vicious cycle of events, a little bit like what Japan has suffered from for the past 15 years.

Let's take a look at some data points. Evidently, the difference between the raw CPI and the core CPI numbers is significant, in particular in the United States. Whereas the core U.S. CPI number came in virtually flat last month (2.2% over the last 12 months), the raw CPI number was a much more worrisome 0.5% (3.5% over the last 12 months).

This has led many observers, some being taken more seriously than others[2], to conclude that rising oil prices, etc., are finally finding their way into consumer prices. Other commentators are much more relaxed about the inflationary outlook.

The latest player to have thrown his chips on the table is Bill Gross, the venerable CIO of Pimco (the largest bond investor in the world). In his recent letter to investors, which can be found on www.pimco.com, he declared in no uncertain terms that inflation risk is receding:

"If 3% inflation is all we can get from the past 5 years' asset inflation, it is hard to believe that we get more from what's left. [...] Long live our disinflationary King."

Bill's change of heart has come as a bit of surprise to many people. He was until recently quite bearish on the outlook for U.S. interest rates, and the change of opinion from one of the leading figures in the industry underlines the power of the message the market has for all of us.

He is implicitly arguing, and we concur, that with monetary policy tightening around the globe (outside Europe) and with economic growth already slowing in many places, it is quite likely that inflation is close to peaking. Perhaps it has already peaked.

If you add to that all the other problems that (old) Europe is facing, such as an almost complete lack of political desire to address many of Europe's structural problems, the often misguided efforts to support struggling businesses/industries (it is actually amazing that we didn't learn from the Japanese that it is *always* better to let struggling businesses go down) and last but not least the demographic outlook, it would take a brave man to bet that Euroland will meaningfully improve its economic performance over the next few years.

Even the OECD has come round to this conclusion and, in a recent report, recommended the European Central Bank to cut rates by at least 0.50%. The point *we* are trying to make is that whilst a euro rate cut is long overdue, it will do little to fix the real problems that Europe is facing.

ECB President Jean-Claude Trichet and his fellow decision makers are stubbornly sticking to the view that inflation is a simmering problem. They have maintained a view for quite a while now that the next ECB rate move is most certainly up, when virtually everyone else can see that it ought to be down.

Meanwhile, political leaders in Germany, Italy and France are lost in their own sedated world, which could quite easily lead to something akin to the "Japanese disease", i.e. chronically low growth, uninspiring equity markets and record low interest rates.

The risk of such a situation developing has, in our opinion, risen as a result of last week's no-vote in France. French politicians will almost certainly become more inward looking (i.e. become more protectionist) as a result of the vote; German, Spanish and Italian politicians will only be too pleased to follow the French lead and put the EU solidarity on hold for a while to focus on potentially inflammatory domestic issues.

All this is immensely negative for European equity markets. However, for better or worse, it has increased the probability that bonds in general, and long-dated bonds in particular, could turn out to be one of the most attractive asset classes over the next 12-18 months despite the less than compelling yields on offer.

We are becoming increasingly comfortable with our long standing view that the 10-year euro bond will break 3% in 2005 (it is currently 3.27%). Do not make the mistake, however, of assuming that lower quality bonds (high yield) will participate in this rally. During times like

[2] Many of the most vocal inflation hawks are what we call "gold anoraks". These people tend to be perma-bulls on gold and look for any opportunity to back their bullish position on gold with bearish data on inflation. As a result, their credibility is next to zero.

these, with slowing economic growth and deteriorating global liquidity, credit quality becomes far more important. Stick with the highest quality bonds for the best returns.

As a result of all of this, we have lowered the allocation to gold from 5% to 2% in our model portfolio (see page 4). Obviously, such a decision has implications for our new fund of funds, which we launched in early May. However, current legislation prevents us from discussing those changes in this forum. Feel free to call for further information.

Gold has been in our model portfolio for three reasons: (i) a hedge against higher inflation, (ii) a hedge against a collapsing U.S. dollar and (iii) a hedge against mayhem in financial markets in general.

We have not been unduly worried about the inflation risk at any point in the last couple of years. However, there was a time where the U.S. dollar looked really sick and warranted some protection. In the last few months, though, many of the reasons to be negative on the dollar have either diminished or disappeared altogether.

Only the third risk factor (general mayhem) is still very much alive, but we do not see this risk as significant enough to warrant a 5% allocation to gold.

An Afterthought on Commodities

In last month's Absolute Return Letter, we reiterated our enthusiasm for commodities. However, we also wrote:

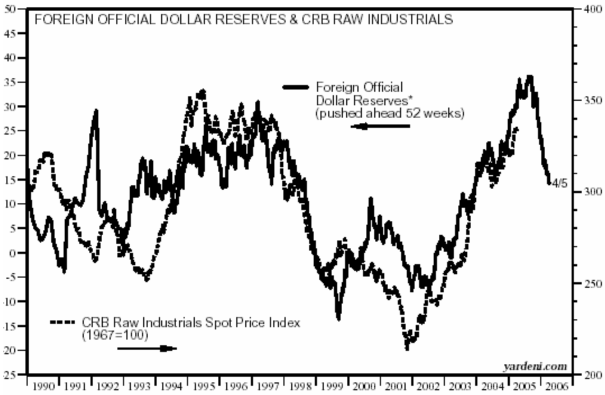
"On the other hand we must stress that even the strongest secular bull markets will experience occasional set-backs. We have written about the possibility of a temporary slowdown in China before. However, given China's dependence on export led growth, we should probably look to the United States for early signs of a Chinese deceleration.

Even a modest Chinese slowdown could have a significant effect on many commodity prices. And we have an inkling that China is indeed slowing down. In other words, the next 6 months may be turbulent times for commodity prices, but at least it will offer those who are not yet exposed to this asset class an attractive entry point. Buy on weakness."

Since these lines were written, a reader introduced us to the work of Dr. Ed Yardeni, who is a highly respected economist. Dr. Yardeni bases a lot of his work on global liquidity because it has proven to be an excellent leading indicator of many things, good and bad.

Dr. Yardeni compiles data on foreign (i.e. non-U.S.) official holdings of U.S. securities and uses the data as a proxy for global liquidity. When holdings rise, global liquidity improves and visa versa.

Dr. Yardeni has named this measure "FRODOR" (with no apparent link to "Lord of the Rings") and you can find examples of his work on www.yardeni.com. As you can see from the chart below, FRODOR has been rising dramatically over the last 3 years (notwithstanding the recent set-back), helping to explain the good performance of both stock and bond markets in 2003-04.



* Yearly percent change. U.S. marketable securities held in custody for foreign official and international accounts at the Fed. Monthly data from 1952 to 1990 include only U.S. Treasury securities. Weekly data from 1991 to 1999 include U.S. Treasuries. Weekly from 2000 on include U.S. Treasury and Federal agency securities.

Source: IMF International Financial Statistics and Commodity Research Bureau.

However, the yearly growth in FRODOR is also a good leading indicator of industrial commodity prices as you can see from the chart. Unfortunately, the chart is telling us that commodity prices (including oil prices – our long term favourite commodity) may be facing more difficult times, confirming our lack of enthusiasm for commodities in the short term as expressed in last month's letter.

If you are a trader (which we are not) you may wish to position yourself for oil prices approaching $40 over the next 3-6 months. Feel free to call us if you wish to discuss how such a strategy may be implemented.

Niels C. Jensen

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