The Absolute Return Letter

December 2005

Summary

Over the next few pages we shall - as we always do in December - provide you with a brief summary of how we view the investment outlook for next year. And, as usual, the conclusions come thick and fast. The back-up material to support our conclusions you will have to dig out of our monthly letters.

In our second article this month, we take a closer look at the Yen which has been struggling in recent months. A weak Yen is usually bad news for global equity prices, so expect difficult times ahead for equities. But the weak Yen also provides opportunities. It has given Japanese companies a massive competitive boost, so expect the Japanese equity market to continue to outperform global equity markets.

With these words we will close the chapter of 2005. The Absolute Return Letter will take a break for Christmas and New Year, but we will return on the 1st February.

Enjoy the read.

Investment Outlook 2006

It is the 1st December 2005. When I look out of the window all I see is a depressingly dark horizon. It's not raining right now, although it looks like it might begin at any moment. The weather is suitably subdued because the ECB has just announced the first rate hike in 5 years – from 2% to 2.25%. The date is important because it marks the beginning of the end for Jean-Claude Trichet, the President of the European Central Bank. He will ultimately have to take responsibility for a policy mistake so massive that it defies belief. It may take some time, but the end result is inevitable.

Governments all over Europe have told him. The OECD has told him. *"It is a classic case of bad timing"* says David Brown, Chief European Economist of Bear Stearns. As a result of the hike, in the last few hours, the yield on 10-year €-denominated bonds has dropped to 3.41%. European equity markets have gone through the roof and the euro has weakened against the other major currencies. Now the markets have told him as well.

We are delighted. The ECB has just handed us a great gift, supporting our bullish stance on European bonds. We have said for a while that € bond yields could actually fall next year. Today's move has made that much more likely.

Inflation in Euroland is running at 2.4% at the moment. Unlike the hawks at the ECB, we do *not* believe inflation is heading towards 3%. If anything it is heading below 2%. The key to our view is China. Whereas the ECB worries unduly about commodity prices, China exports deflation as if there is no tomorrow. China's own inflation rate has dropped from about 5% a year ago to just 1.2% today. Its problem is overcapacity in many industries due to excessive investments. The central government has tried to address this issue for a while now but is clearly struggling to deliver an effective remedy.

As we have mentioned before, Chinese producers are only too keen to underbid each other in a desperate attempt to survive an overcrowded market. Western consumers benefit. Chinese shareholders suffer, and the ECB sleeps in class. Some things never change.

The good news is that this is a trend that is not likely to go away any time soon. Only the other day Bill Gross, the CIO of Pimco, made some interesting observations. He wrote:

"We would suggest the U.S. and indeed many global bond markets have experienced a reduction in forward nominal and real short-term interest rates of as much as 200 basis points due to the aggregate global trends discussed […] and that these yields are likely to represent the norm for years to come. If true, that means in terms of current monetary policy that the Fed is much tighter than standard analysis would presume. Today's short rate of 4% is really equivalent to 6% in my view…"[1]

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[1] Go to www.pimco.com if you wish to read the entire article.

What Bill is really saying is that because the world has changed so profoundly over the last several years – and will continue to do so for years to come – we'd better get used to lower interest rates, because they are going to stay with us for a long time. It is all about economic globalisation but it is also about changing demographics and a few other things.

The risk, from an investor's point of view, is that the Fed overdoses (like central banks usually do) and kills the U.S. economy. If that happens, China will almost certainly choke as a full 35% of Chinese exports go to the United States. We definitely see a modest slowdown in the U.S. economy in 2006, but we do not expect an outright recession. We could bombard you with reasons why, but please allow us to quote just one statistic to make our case.

U.S. personal income rose by $618 billion in the twelve months through September 2005, whereas spending on energy increased $159 billion over the same period. Yes, rising energy prices is a tax on the economy, but it is not nearly enough to send the economy into recession.

Meanwhile, in Europe, the ECB seems to be determined to send Europe back into recession. We don't think they will succeed – at least not in 2006. But next year will be yet another year where many European countries will struggle to deliver more than 1-2% growth.

Asia presents a tricky challenge for investors. The falling Yen (which we discuss in more detail in the next article) is a huge advantage for Japan. Many other Asian countries, whose currencies are linked to the U.S. dollar, will be facing tougher times because of the relative loss of competitiveness. In our opinion, the only Asian country that has a decent shot at delivering a positive surprise as far as GDP growth is concerned is Japan.

Over the past few months we have written extensively about the global liquidity picture, and loyal readers of our letter will know that we are seriously concerned about the deteriorating outlook. We will not repeat all our findings here[2]. Suffice to say that a worsening liquidity outlook is generally bad for the riskier asset classes.

Asian equities tend to underperform during such times. Credit spreads often widen, so corporate bonds and emerging market bonds may get hurt. Commodity prices are also a victim of deteriorating liquidity. In the *Absolute Return Multi-Strategy Fund* [3] we have reduced the exposure to all these asset classes in recent months in order to position the fund for a 2006 which we expect in many ways will be quite different from 2005.

European equities will continue to do better than U.S. equities, not because the economy is doing any better in Europe than it is on the other side of the Atlantic, but because monetary conditions are more favourable and valuations more attractive, although the gap has narrowed dramatically over the past year.

2006 will not be a year, though, where equities shine. The tide is turning as exemplified by the ECB's rate hike today and equity investors will have to get used to more modest returns next year. Well, our U.S. readers will know what I am talking about. Their stock market has gone nowhere for the past 7 years. Our European readers had better prepare themselves for less than 20% returns.

Bonds will do surprisingly well. In the early part of the year, bond markets may wobble a bit, as inflation concerns continue to make their impact but, as the year progresses, bond investors will increasing subscribe to the view that their inflation concerns were exaggerated and bond yields will start to go modestly lower.

Property prices will not collapse as predicted by the world and her mother *as long as* bond yields behave. We may have to get used to more modest returns on bricks and mortar but don't believe in the Armageddon projections provided by some observers.

Gold will probably disappoint if our inflation outlook is reasonably correct. We have seen wildly optimistic projections for gold - $7-800 per ounce in some cases – but we cannot see those prices justified unless we misread the situation completely. We would certainly recommend some gold in your portfolio, as we expect it to offer a good hedge against more difficult market conditions, but it won't be the home run predicted by some.

Well, this is what we believe and, as always, we will get some of it wrong. We would like to wish you and your family a Merry Christmas and a very prosperous 2006. Do not forget to let the markets be markets and concentrate on family and friends at this time of the year.

Nick Rees
Jan Vilhelmsen
Niels C. Jensen

[2] Go to www.arpllp.com if you wish to see the two articles in full. They can be found in the September and October issues of the Absolute Return Letter.

[3] The Absolute Return Multi-Strategy Fund invests in both regulated and unregulated funds and is not suitable for all investors.

Time to Buy Yen Assets?

The Yen has had a horrid year so far – down about 14% year to date and down 10% in the past 6 months alone versus the U.S. dollar. *"So what?"* you may say. After all, your portfolio doesn't have much Yen exposure so you are not too worried. *"Wrong answer"*, we say. There are several reasons why you shouldn't ignore this development. Here are some of them.

First a bit of background. It is not at all unusual for the Yen to experience large fluctuations in value. The value of the Yen dropped by 43% between 1995 and 1998, bounced back 21% from 1998 to 2000 only to drop 21% again between 2000 and 2002 (all against the U.S. dollar). Finally, during the period 2000-04, it regained 21% in value. In other words, this year's move is by no means extraordinary. On the contrary, past experience suggests that the Yen could fall further.

But why is the Yen falling? There is plenty of evidence that the Japanese economy is now on a relatively firm path to recovery. All other things being equal, shouldn't the Yen strengthen in value? In theory, yes, but all other things are clearly not equal. Something else must be astray.

We have been through piles of research in recent weeks, looking for answers. Nobody has provided a better answer than GaveKal Research. It is really quite simple. As you can see from table 1 below, Japan is by far the largest foreign holder of U.S. government bonds - almost $700 billion worth.

Table 1:
10 Largest Foreign Holders of U.S. Treasuries:
(Billions of U.S. dollars)

Country	Sep. 05	Jan. 05
Japan	687.3	679.3
China	252.2	223.5
UK	182.4	101.1
Caribbean	102.9	94.2
Taiwan	71.8	68.3
Germany	63.5	53.8
Korea	61.7	53.6
OPEC	54.6	67.0
Hong Kong	48.1	45.3
Canada	47.8	35.4

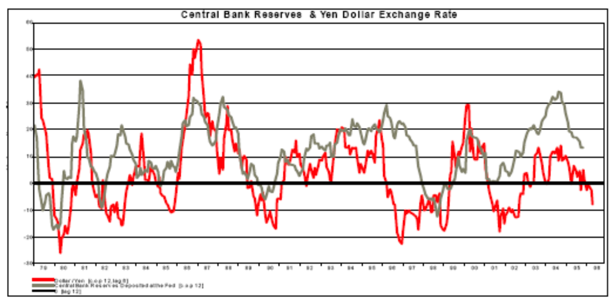
Source: The Federal Reserve

In recent years, the Japanese have hedged their currency risk, *because it was cheap to do so* (when then Fed Funds rate was 1% it would cost about 1% per annum). The Japanese were still left with a very attractive return when compared to Japanese government bonds. Now, with the cost of hedging much higher as a result of the Fed Funds rate having moved from 1% to 4% in just 18 months, the Japanese continue to be net buyers of U.S. government bonds as you can see from table 1, *but they no longer hedge*. The net result? Less support for the Yen, so it falls out of the bed.

From experience we also know that when the global economy begins to lose momentum, Japan's current account surplus shrinks and the Yen usually starts to decline in value. So perhaps the Yen is telling us that the global economy is weakening, even if the economic data is not yet confirming it.

Take a closer look at chart 1 below. There appears to be a strong link between the USD/JPY exchange rate and central bank reserves (a measure of global liquidity), although reserves lag the exchange rate by about 6 months on average.

Chart 1:
Central Bank Reserves v. USD/JPY Rate:



Source: GaveKal Research

In other words, the falling Yen could very well be telling us that global liquidity may deteriorate further before things start to improve again. And, as you know from our letters in September and October, deteriorating global liquidity is a bad omen for global economic growth. Could it be that the sick Yen is a sign of slowing economic growth?

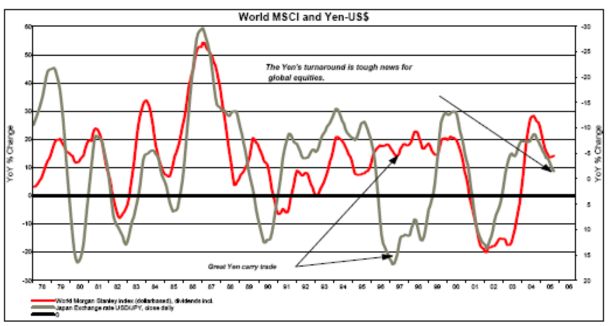
Secondly, if you invest in Asia, you are strongly advised to remind yourself what currencies can do to stock markets. If you remember 1997-98, you would probably agree that Asia is one of the most currency-sensitive regions in the world. Many Asian countries continue to link their currencies closely to the U.S. dollar. The reliance on exports for economic growth becomes a problem when the currency you are linked to appreciates in value as much as the U.S. dollar has against the Yen in recent months.

Thirdly, even if you don't own a single share in Asia, you still have reason to worry – in particular if you own European equities. With the depreciating value of the Yen, Japanese exporters have received a massive competitive advantage over the past several months when compared to both European and U.S. competitors. This is probably less of an issue for the U.S. economy given the fact that the US consumer is still going strong. In Europe, however, export-led growth is absolutely critical.

For those European exporters that compete with the Japanese, this is not just a minor distraction. This is a massive blow to their competitive advantage. Corporate earnings amongst European exporters will face challenges next year as a result of the weakening Yen which we do not think markets have factored in at this point in time.

In fact, if you look at chart 2 below, it is not just European stock markets which tend to weaken when the Yen falls in value. A falling Yen tends to drag down global stock markets as demonstrated in the link between the MSCI global equity index and the USD/JPY exchange rate.

Chart 2:
Global Equities v. USD / JPY Rate:



Source: GaveKal Research

The solution, one might suggest, may be to load up on Japanese equities instead. After all, if Japan is strengthening their competitive edge as a result of a lower exchange rate, why not buy Japanese equities?

Well, that is precisely what many investors have done and explains why the Nikkei index has doubled in value since its low point in April 2003. So you are not exactly early to the party, although there is probably a fair bit left in it. We do not proclaim to be experts on the Japanese equity market, but we hear that the bull run of the last couple of years has been driven largely by foreign investors – with hedge funds playing a significant role. Japanese investors, on the other hand, have not been aggressive buyers of their own equity market.

Therein lies the opportunity, because it means that there is plenty of purchasing power left in the system, should the Japanese get a taste for their own market again. Partly for that reason, Japanese equities are probably one of the more attractive propositions available to global investors today.

At the same time that raises another risk factor which you can hardly afford to ignore. Since 1990, U.S. bond yields and Japanese stock prices have moved pretty much hand in hand (with a correlation of over 90%) suggesting that Japanese investors have played a significant part in driving down U.S. bond yields, as they gradually swapped out of poorly performing domestic equities into U.S. bonds.

If Japanese investors decide to come back to their own equity market, the obvious thing to do would be to sell their U.S. government bonds, in particular now where they are sitting on very handsome profits following the fall of the Yen. So a return of domestic money to the Japanese equity market could occur to the detriment of U.S. bond yields.

Bottom line, we think the risk/reward on Yen based assets is very attractive. Japanese equities should benefit from an improving local economy and stronger exports at the same time, although weaker prospects for global equity markets in general may reduce the upside potential somewhat.

Meanwhile, the Yen is starting to look desperately undervalued relative to both the euro and the U.S. dollar. So, although the Yen could fall another few per cent over the next several months (a possibility but not a certainty in our opinion), if you are prepared to look beyond the current bear market in Yen, there is probably 20-30% upside over the next 3-5 years.

By investing in Japanese equities you effectively bet on two horses for the price of one. We don't think it is very likely that you get both of them wrong as long as you remember not to hedge your Yen risk.

Niels C. Jensen

Absolute Return Partners

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The Absolute Return Multi-Strategy Portfolio
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