The Absolute Return Letter

March 2006

Summary

In our first article this month, we discuss the worrying signs of inflation creeping in across parts of Asia. Even more alarmingly, central banks have done little to stem the tide so far. This poses a significant risk to Asian stock markets.

In the second article we take a closer look at the shape of the yield curve and we reach two conclusions.

Firstly, a moderately inverted yield curve should be interpreted with caution. Due to the growing importance of global flows of funds, the yield curve probably needs to be more inverted than has been the case in the past in order to be a reliable forecaster of recessions.

Secondly, central banks are likely to use interest rates more aggressively in the future than they have done in the past in order to control economic activity.

Enjoy the read.

The (Not So Apparent) Risks of Asia

A not so widely recognised consequence of the long-running boom in U.S. consumer spending is the high growth that most Asian economies have enjoyed in recent years. Strong export driven growth has in fact more than compensated for relatively weak consumer demand in many Asian countries and allowed the region to grow out of the problems it faced during the crisis in the late 1990s.

The argument in favour of investing in Asia goes approximately like this: *"Under no circumstances do I want to invest in U.S. dollar assets. With the big fiscal deficit and the large and growing current account deficit, it is an accident waiting to happen. I think the opportunities are far more exciting in the fast growing region of Asia, as strong exports and rising standards of living will continue to fuel growth."*

Now, here is the problem with this argument. *If* the U.S. economy cracks under the weight of its indebted consumers (which, in our opinion, is not a given but certainly a possibility), Asia could be seriously negatively impacted. So attempting to hide from the U.S. imbalances in Asia is a strategy which could backfire spectacularly.

The other problem facing large parts of Asia is the current combination of high (and rising) inflation and central bank inactivity. But before we go there please take a minute or two to consider the fundamental change in the dynamics of the world economy which is unfolding in front of our eyes.

It is obvious even to the untrained eye that volatility in economic growth has receded in recent years – at least in our part of the world. In other words, recessions occur less frequently than they used to do, and when they do happen, they are less violent than in prior decades. For this, central banks are often credited. There seems to be a widely held opinion that modern day central bankers are simply better at managing the economy than their colleagues of days gone by.

Perhaps they deserve some of the credit (they probably do), but we urge you to consider the following fact. Over the past few decades our economy has been transformed from being predominantly production-driven to being largely service orientated. We still need the production to take place for our society to function. But we have (successfully, we might add) moved much of the production to places like Katowice and Kuala Lumpur, where production costs are lower and profits therefore higher.

With the outsourcing of large parts of the production legs of the modern Western economy, much of the economic volatility has been exported at the same time. If this thesis is proven correct - and only time can tell if it is indeed correct - Asia and other outsourcing markets will turn out to be significantly more volatile than economies of the 'old world'.

If you don't accept this line of thinking, please consider the following. Whereas it remains a mystery to many that, following the rapid rise in commodity prices, old world inflation is still relatively subdued, the situation in Asia is very different. Countries across the region (in particular India, Indonesia, the Philippines and Thailand) are experiencing worryingly high consumer price inflation. Even more alarmingly, the central banks of these countries have done virtually nothing to curtail inflation. Sooner or later, they will have to make some difficult decisions.

Consumer Prices in Selected Asian Countries:

Country	**Consumer Prices (YoY)**	**Latest Report**
India	+5.6%	Dec.
Indonesia	+17.0%	Jan.
Malaysia	+3.2%	Jan.
Philippines	+6.7%	Jan.
Thailand	+5.9%	Jan.

Source: The Economist

So why are the central banks of these countries taking little or no action? The most likely explanation lies in the region's dependency on economic growth. The crisis of 1998 is still fresh in many people's minds. Rapid growth has proven an effective tool in terms of revitalising the region, and Asian central bankers are probably under immense pressure not to kill the good run.

Unfortunately, as we know only too well from prior experience, this is *exactly* the wrong thing to do. Inflation rarely disappears on its own accord. Ultimately, the central banks will be forced to act, but then it is probably too late. With a bit of bad luck thrown in, exports will start to slow at the same time as the central banks start their tightening cycle. The probable result? A classic case of stagflation.

At the same time asset inflation is rampant in many countries, but nowhere is it more apparent than in India where the local stock market has tripled in value in less than 3 years. Overvalued assets. Export dependent growth. Rising inflation. Inactive central banks. In some cases, large fiscal deficits. In a few cases, also large trade deficits. It is a movie we have seen before. And, unlike most Hollywood movies, this one does not come with a happy ending.

Niels C. Jensen

The Forecasting Powers of the Yield Curve[1]

Much has been written about the yield curve recently – some of it more thoughtful than other. A battle is raging and it is about the predictive powers of the yield curve. The "traditionalists" take the view that an inverted yield curve (i.e. with short term rates being higher than long term rates) signals a recession coming, whereas the other side point out that this time "things are truly different".

The dissidents argue that long term rates are artificially suppressed (for reasons we shall discuss later), resulting in a yield curve which is much flatter than it would normally be at this point in the economic cycle. Hence the recessionary signals coming from the yield curve should not be taken at face value. The most famous proponent of this view is none other than the U.S. Federal Reserve Bank, itself in charge of setting short rates in the U.S.

So why is this debate so intense right now? Partly because an inverted yield curve has, over time, proven to be by far the most accurate tool in terms of predicting the next recession, partly because the U.S. yield curve has inverted only recently.

Our U.K. readers should note that the U.K. yield curve has been inverted for many months now, whereas the Euroland yield curve is still positive with 10-year rates being almost one full percentage point above the 3-month rate.

In the last 40 years, the U.S. economy has faced five recessions[2] - six if you count the 1980-82 double dip as two recessions. In every single case, the U.S. yield curve inverted beforehand (usually 6-12 months in advance). Only once (in 1967) has the yield curve inverted without a recession following within 12 months. No wonder the traditionalists believe in the forecasting powers of an inverted yield curve.

All of this leaves us in a mild state of bemusement. As much as we subscribe to the view that history usually repeats itself, we suspect that things are perhaps a little bit different this time around. Take a look at one of our favourite charts, borrowed from GaveKal Research in Hong Kong.

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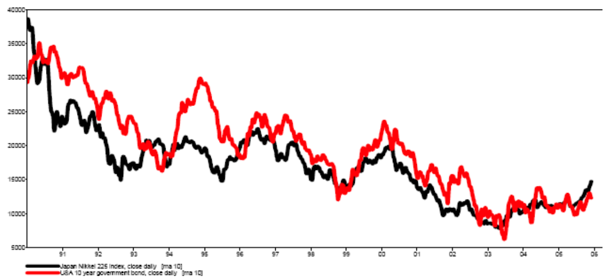
[1] *This article was inspired by Bill Gross, CIO of Pimco, who made some interesting observations in his February 2006 Invest Outlook.*

[2] *We shall use U.S. data to demonstrate the link between the yield curve and recessions, simply because our data library goes back longer for the U.S. economy than it does for most European countries. We are confident, though, that our conclusion would be no different, if we were to use European data.*

Nikkei 225 v. U.S. 10-Year Gvt. Bond Yields



Source: GaveKal Research & Ecowin.

We have brought this chart to your attention in previous newsletters and we will probably use it again in the future, simply because it tells an important story. Over the past fifteen or so years, the Japanese equity market and U.S. bond yields have moved virtually in tandem with a correlation of about 0.9.

The rationale behind it is quite simple. As yield starved Japanese private investors started to buy U.S. Treasuries in the 1990s, the correlation was established. And because the numbers were so compelling, trillions and trillions of yen were poured into U.S. treasury bonds.

As U.S. short rates hit 1% a few years ago, the higher yield on U.S. long bonds could be locked in at virtually no cost, eliminating the risk of adverse currency movements. No wonder U.S. treasuries sold like hot cakes.

The link will probably not be severed until the day they (a) get convinced that the Japanese stock market rally is for real and/or (b) Japanese bond yields become more competitive. This view is supported by the following table, which we have borrowed from Pimco.

% of U.S. Treasuries Held by Foreigners:

Maturity	Central Banks etc.	Private Investors	Total
Bills	35.1%	9.6%	44.7%
<1 Yr	43.5%	13.9%	57.4%
1-2 Yrs	49.7%	17.8%	67.5%
10-15 Yrs	6.4%	21.8%	28.2%
15-20 Yrs	7.0%	17.5%	24.5%
20-25 Yrs	5.2%	16.8%	22.0%
25-30 Yrs	7.6%	30.9%	38.5%

Source: Pimco
Note: Selected maturities only.

As you can see, private investors are much bigger holders of long dated U.S treasury bonds than are central banks. It is not evident in the table above but, trust us, the Japanese account for by far the largest part of private purchases of U.S. treasuries.

This leads to two important observations. Firstly, do not believe the scare mongers who say that Asian central banks effectively control the yield on the U.S. long bond. This is simply not true. Secondly, if you want to worry about something, you should instead be concerned about the implications should Japanese private investors change tactics. *That* could have a dramatic impact on the yield of the U.S. long bond and hence global bond yields.

So, the only conclusion we can arrive at, is that global flows of funds are now far more important than they have ever been before, and that the shape of the yield curve can therefore not necessarily be assumed to contain the same predictive powers as in the past. This is broadly the same argument the U.S. Fed under Greenspan has put forward. However, if the traditionalists amongst us are proven correct, we may have to join Mr. Bernanke & Co for a light serving of humble pie!

The reason we are slightly bemused, has to do with how we see the economy changing around us. The last time the world faced a *serious* recession (1980-82), the financial services industry was nowhere near as important to the overall economy as it is today. Only recently, it was reported that financial services now account for over 30% of the U.K. economy. Although somewhat smaller in most other European countries, financial services play a critical role in most countries around the world today.

Why is this important? Because - as pointed out by Bill Gross - capitalism as we know it today requires a positively sloped yield curve to function. Hedge funds, insurance companies, banks, etc. are finding the going much more difficult in a flat or inverted yield curve environment since they typically borrow short and invest long.

We also suspect that the relatively flat yield curve has had a substantial effect on credit spreads. In search of higher returns, investors have increasingly moved further out on the credit curve, squeezing credit spreads to levels rarely, if ever, seen before.

To our shock and horror, we learned very recently that long dated Iraqi government bonds are now yielding only 8.5% (this was a couple of weeks ago, so the yield may have moved a bit). What has the world come to if a country on the verge of civil war, held together only by a rather lukewarm military alliance, yields no more than

400 basis points above U.S. treasuries. Or have we lost the plot?

Anyway, going back to the importance of the financial services industry, if 30% of the economy is not firing on all cylinders, the odds are in favour of a slowdown. As simple as that.

Thankfully, central bankers are not oblivious to this fact. What it probably means is that if the economy starts to show signs of a serious slowdown, you should expect the Fed, the Bank of England, the ECB or whoever is in charge of the slowdown, to ease quite aggressively, because this will kick the single most important industry into a higher gear.

Putting it all together, we arrive at the following two conclusions:

1) A moderately inverted yield curve should be interpreted with caution. Due to the growing importance of global flows of funds, the yield curve probably needs to be more inverted than has been the case in the past in order to be a reliable forecaster of recessions.

2) Central banks are likely to use interest rates more aggressively in the future than they have done in the past in order to control economic activity. If the economy shows serious signs of weakness, do not be surprised if interest rates are cut aggressively over a relatively short period of time. However, given the relative size of financial services, this strategy is more likely to be pursued in Anglo-Saxon countries than in, say, Continental Europe.

Niels C. Jensen

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Absolute Return Letter Contributors

Niels C. Jensen	njensen@arpllp.com	tel. +44 20 8334 7020
Jan Vilhelmsen	jvilhelmsen@arpllp.com	tel. +44 20 8334 7021
Nick Rees	nrees@arpllp.com	tel. +44 20 8334 7022

The Absolute Return Multi-Strategy Portfolio
1st March, 2006