The Absolute Return Letter

April 2006

Summary

For the first time since we launched the Absolute Return Multi-Strategy Fund, and indeed the first time since our model portfolio was established a little more than 3 years ago, we are downgrading the long-term outlook for global interest rates and reducing our exposure to long-dated bonds.

A number of factors have driven us to make this decision. Amongst them are the new economic policies in China, the continued hawkishness of central banks globally, evidence of a more sustained recovery in Germany and general pension fund behaviour.

In our second article this month we take another look at the global liquidity situation. We argue that the Fed and the ECB may find it more difficult to cool down the economy and/or asset prices than they would ideally like, as long as other large central banks (e.g. in Japan or Switzerland) are prepared to continue their support of the carry trade with low borrowing costs.

As usual, enjoy the read.

Bangladesh Here We Come

For the first time since we launched the Absolute Return Multi-Strategy Fund, and indeed the first time since our model portfolio was established a little more than 3 years ago, we are downgrading the long-term outlook for global interest rates and reducing our exposure to long-dated bonds.

Make no mistake about it. We do not forecast a watershed move in global interest rates. But we see a more troubled period ahead where bond investors will have to swim against the tide after years of enjoying relatively benign investment conditions.

For a long time we have shared the view that global deflationary forces (e.g. strong productivity gains, overcapacity in the manufacturing industry in China) would keep inflation in check. And with inflation under control, we assumed that long bonds would do quite well. By and large, that strategy has worked out well over the past few years.

However, one or two things are changing, causing us to review our interest rate forecast. Let's explain.

Firstly, in China, a string of new policies have recently been implemented, designed to address the overcapacity problems which continue to damage the profitability of the Chinese manufacturing industry (and help suppress inflation in our part of the world). Our initial reaction to these changes was broadly similar to that of most other China watchers: *Big Deal. Heard this song before.*

So, with the poor track record of Chinese policymakers in mind, what makes us think that perhaps things are little bit different this time? Well, in our opinion, China simply cannot afford to get it wrong. The cost of doing business in China is rising at a frightening rate. On the human resource side, skilled workers are paid 30-40% more than 12 months ago. As far as natural resources are concerned, chart 1 below tells an ugly story. Many international companies operating in China are now either openly critical of the situation (e.g. Flextronics) or quietly moving their production elsewhere (e.g. Timberland).

If jobs start to migrate to places such as Bangladesh in larger numbers, as Timberland is rumoured to be doing, the entire growth strategy of the Chinese leadership may be undermined, and the economic miracle will have ended before it really took off. Therefore, failing is not an option. We expect the Chinese leaders to adopt increasingly draconian measures in order to get the overcapacity problems sorted out. Over time, that has negative implications for inflation.

As a result of us downgrading our long-term outlook for global interest rates, we have reduced our exposure to long-dated bonds in the ***Absolute Return Multi-Strategy Fund.***

In the ***Millennium Wave Fund****, where our exposure to directional strategies is minimal, the change has not had any impact on our asset allocation.*

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Chart 1:

Chinese Raw Material Purchasing Price Index v. Consumer Price Index

Source: Simon Hunt Strategic Services, CEIC Data, CLSA Asia–Pacific Markets

Furthermore, given the rising cost of doing business in China, it must be very tempting for the Chinese to pursue a weak currency policy. Allowing the renmimbi to devalue against the U.S. dollar will be seen as an act of provocation in Washington and is not an option. But the Chinese may have another option at hand which is not often discussed – orchestrating a fall in the value of the U.S. dollar, which will effectively devalue the renmimbi against a long string of currencies.

As you may recall, last summer the Chinese moved away from an exchange rate fixed against the U.S. dollar towards a basket of currencies. However, the U.S. dollar remains by far the biggest component of that basket. So a fall in the value of the U.S. dollar will effectively mean a fall in the value of the renmimbi.

So how can they provoke a fall in the value of the dollar? Well, the easiest way to do this would be to dump U.S. treasuries in the open market, which will not only put pressure on the dollar but also cause U.S. bond yields to rise. The more politicians in Washington make fools of themselves by calling for sanctions against China, the more tempting it must be for the Chinese to retaliate in this fashion. Unfortunately for the rest of us, everyone would pay the price.

For all these reasons, we think events in China could put further upward pressure on global bond yields. But that is by no means the only reason we are concerned. The second reason we are advocating a more cautious approach to bonds has to do with the language adopted by the world's central bankers in recent months. Not only are the three principal central banks of the world in tightening mode together for the first time since 1980, but the language remains quite hawkish.

In the U.S., the Fed Funds rate now stands at 4.75% after the 15th consecutive hike in less than 2 years. If you look at the price of Fed Funds futures, the market clearly expects the Fed's job to be very nearly done. However, that is not what the recent Fed language suggests. As one of our managers pointed out to us recently: *Ignore the first 10 hikes as they had minimal impact. They only brought the Fed Funds rate back up to where it should have been in the first place.*

The only conclusion we can reach is, be prepared for more. The Fed won't stop at 5% as predicted by many observers. Where exactly it will stop depends on when and how fast the U.S. economy cools down when it does so eventually.

To make matters worse for global bond markets, the language coming out of Frankfurt and Tokyo is becoming increasingly hawkish as well. We wonder what it is they see that we don't. We are not entirely sure, but we do know that, in battles between central bankers and markets, central bankers tend to prevail.

In the search for answers, we suggest you pay a visit to a very interesting website called www.shadowstats.com. The author of this website tracks U.S. consumer price inflation, using the methodology applied in the years before the Clinton administration started to play silly games.

What he finds is very interesting to say the least. U.S. consumer price inflation now runs close to 7% if one applies the pre-Clinton approach. We haven't checked if the Europeans and the Japanese have been up to similar voodoo tactics, but it is no wonder that the world's central bankers are perhaps a little bit more scared of inflation than the rest of us seem to be.

Thirdly, there is growing evidence that Germany is finally pulling itself out of its long slump. Well to be entirely fair, one could argue that it is the rest of the world which is pulling Germany out, since it is the export side of the economy which performs really well, but let's leave that for now.

The official statistics coming out of Germany continue to tell a mixed story, but anecdotal evidence gets stronger and stronger by the day. And in a country which continues to be divided economically between East and West, we believe anecdotal evidence tells a better story than government statistics.

We hear it through clients, as well as friends and family living in Germany. If you haven't been to Germany in recent times, book yourself a few days in one of the leading German cities. There is no question that Germany is emerging as one of the cheapest places to do business in Western Europe, whether you are shopping or you produce industrial goods.

Obviously, the ECB will have noticed this too. A stronger Germany means a stronger Europe and the ECB, having been prevented from acting for so long because of the fragility of the German economy, is now busy draining liquidity from the system. Pay particular attention to the growth rate of M3. Whereas the Federal Reserve no longer deems it necessary to even publish this number, the monetarists of the ECB in Frankfurt continue to pay due attention to this number. And the current growth rate in excess of 10% will undoubtedly have unsettled them. As is the case in the U.S., our bet is that they will carry on tightening for longer than most of us expect.

Fourthly, following the large drop in equity values in 2001-02, pension funds across Europe found themselves facing large funding deficits. These deficits gave birth to the philosophy of "liability matching", which has been driving the thinking of pension fund managers ever since. We are not against liability matching per se, but we are against liability matching when it is implemented on autopilot. And that is what many pension funds have been guilty of over the last two or three years, where the buying of long-dated bonds has taken place indiscriminately and regardless of valuations.

Now, with global equity markets in much better shape, pension funds are allocating more to equities again. In other words, as we see it, pension funds will provide much less support to global bond prices over the next couple of years than has been the case in recent times.

Finally, the first signs of stress in financial markets are becoming apparent. We have maintained for a while now (see our September 2005 Absolute Return Letter on global liquidity) that, with the world's central banks being busy draining liquidity from the system, the risk of a more severe setback is rising. In the past, when global liquidity has deteriorated, riskier asset classes (including bonds with credit risk) have performed poorly.

Over the past few months, there have been plenty of accidents for investors to burn their fingers on; however, virtually all of them have occurred around the fringes of financial markets (e.g. Icelandic kroner, NZ dollars, Middle Eastern stock markets, etc.). Only time can tell if these incidents are signs of things to come. We certainly wouldn't bet against it.

This in itself does not necessarily spell bad news for global bond yields. In fact, during times of stress, high quality bonds will most likely benefit (the flight to safety syndrome). The problem is, riskier bonds, which are sitting in so many portfolios, will pay the price of investor complacency.

For all these reasons, we are reducing our exposure to long-dated bonds. Just to repeat - we do not expect large losses going forward. But it will be hard work to achieve anything better than the coupon. And we think we can do better elsewhere.

Niels C. Jensen
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An Update on Global Liquidity

In recent weeks, analysts from Morgan Stanley have grown fond of saying that the 'excess liquidity' argument is flawed and that 'carry trades' have not been a key source of global liquidity as broadly assumed.

For those of our readers not comfortable with terms such as *excess liquidity* and *carry trade*, allow us to quickly summarise:

Excess liquidity is used to describe the ultra-easy monetary policy (i.e. very low interest rates) pursued by the world's central banks since the bursting of the equity bubble in 2000. The fact that the collapse of global stock markets coincided with a global deflationary scare in 2001-02 only made central banks throughout the world even more eager to lower the price of money.

Low interest rates have raised investors' appetite for risk, as access to credit has been cheap and readily available. If one can borrow at less than 2% (as is currently possible in yen) and invest in emerging market bonds yielding 7%, we say that the trade has a positive carry of 5%. The bigger the carry is, the bigger the incentive is to put on carry trades like the one described.

It follows from this that low borrowing rates have created an environment which encourages risk-taking and the use of gearing. Consequently, the almost universal rise in asset prices since the spring of 2003 can be explained by this phenomenon, or so the argument goes.

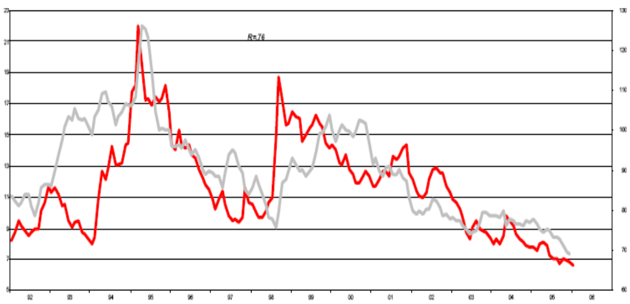
Now, what Morgan Stanley is saying is that there is in fact little evidence of any excess money being printed by the world's principal central banks, hence the excess liquidity argument is flawed, they say.

Apart from some very apparent weaknesses in their argumentation (they complete ignore, for example, that the carry trade has become a global business, i.e. borrowers are happy to borrow in one currency only to invest in a different currency), it reminds us of the weather forecast which states that we won't see any rain today. Yet, when you look out, it is pouring down. The meteorologist in charge of the forecast forgot to look out. He looked at his computer models instead.

When we look out of our window, we see plenty of evidence of excess liquidity at work. We see it in investors' portfolios. We see it in the behaviour of certain asset classes. Take a closer look at chart 2 below. We don't believe the close link between the performance of high yielding emerging market bonds and the yen exchange rate is any coincidence. The circumstantial evidence is indeed very strong.

Chart 2:

Emerging Market Bond Yields Less Financing Cost in Yen (red) v. Yen Exchange Rate (grey)



Source: GaveKal Research & Ecowin

On the other hand, there is no question that the aggressive hiking of rates in the U.S. over the past couple of years has caused a dramatic slowdown of the growth in global U.S. dollar liquidity. And, as we pointed out in the first article of this month's Absolute Return Letter, the ECB seems determined to slow down the growth of the European monetary growth.

However, in a world which is becoming increasingly globalised, the central bankers of the U.S. and Euroland must be painfully aware that, as long as other central banks are prepared to provide an ample supply of cheap money, their efforts to cool down the economy and/or asset prices may be jeopardised.

In this context it is worth noticing that Japan is not the only "culprit". Money is very cheap in Switzerland as well, and it is our experience that European investors are far more comfortable borrowing in Swiss francs than in yen. In our experience, a very high proportion of continental European private investors have borrowings in Swiss francs. So much for Morgan Stanley's assertions.

All this leads us to conclude that, so long as the central bank clampdown on cheap money is not coordinated, the carry trade will continue in some shape or form. Only after large numbers of investors are hurt financially (and it will most definitely happen – it is only a question of when), will the appetite for risk cool down meaningfully.

This puts our bullish view on yen at risk, at least in the short term. If investors continue to borrow happily in yen, it will put a lid on the yen's ability to rise from currently depressed levels. However, the longer the carry trade runs for, the more borrowings are accumulated in low cost currencies such as yen and Swiss francs. We probably do not need to remind you that, all other things being equal, when the appetite for these trades wanes, exchange rates are capable of moving faster than you can liquidate your borrowings.

Niels C. Jensen

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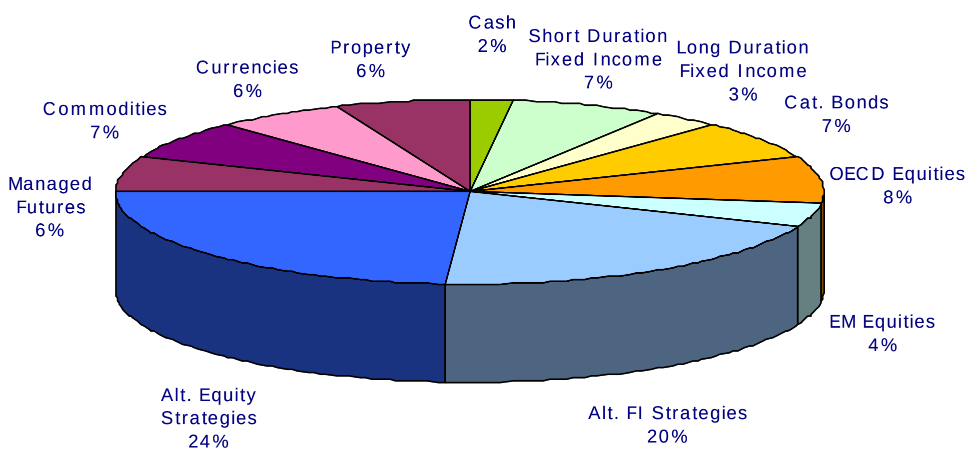
The Absolute Return Multi-Strategy Portfolio
1st April, 2006



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