The Absolute Return Letter
February 2008

For Richer, Not Poorer

> *"It is well enough that the people of the nation do not understand our banking system, for if they did, I believe there would be a revolution before tomorrow morning."*
>
> *Henry Ford, Sr.*

The great enigma unveiled

2007 was a very tricky year indeed - not so much the first half which offered mostly fair weather sailing; however, the second half reminded me of walking through a mine field (not that I have actually tried it, but let's ignore that for now). To me, the greatest enigma of 2007 was the resilience demonstrated by global equity markets. As the wheels came off virtually all parts of the credit markets back in July, one of the surest bets – or so we thought – was the imminent demise of the equity bull. It happened eventually, but it took six long months.

Time to reflect

Now, with the wounds wide open after four weeks of falling stock markets, it is time to reflect. Large sums of money have been lost in recent weeks and even larger sums of money can be made in the months to come if one can read the situation correctly. We humans tend to behave like sheep, though. Where the leader goes, the flock will follow. Having said that, the biggest fortunes have been made not by sheep but by investors prepared to walk where the flock would never go. We have identified a number of investment themes which we believe will define the investment year 2008. However, we cannot promise you that other, more important, issues will not surface during the course of the year.

 # 1: Bank crisis to run and run

Let's begin our list with what we believe is the most delicate problem the world has faced for years – the banking crisis. We predict that the crisis which has engulfed large parts of the world in recent months will run for longer than most people imagine. There are two reasons for this. Firstly, there is now clear evidence that the credit problems are spreading well beyond subprime mortgages. Prime mortgage debt, credit card debt, auto loans and corporate debt could all be hit – and not just in the US. This is fast becoming a global crisis. Sadly, it is all a function of greed because money was too cheap for too long.

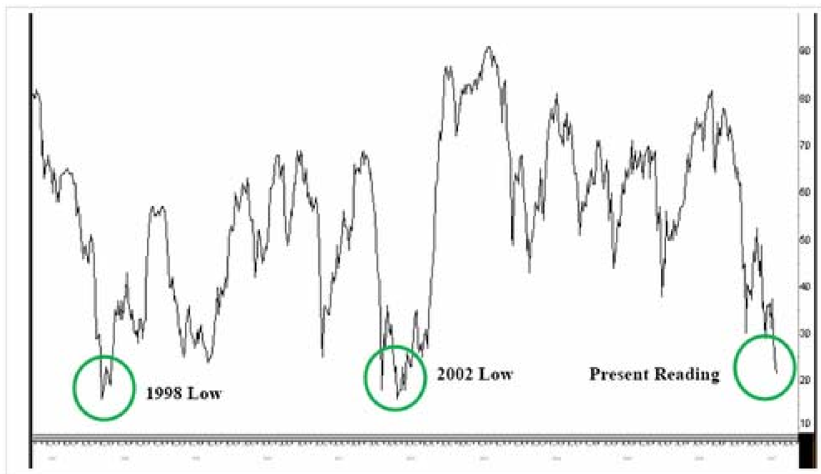
Are write-offs 'managed'?

Secondly, we suspect (but have no proof) that conventional accounting standards have been suspended in a number of cases. If banks were to follow standard practise, bad debts would be written off as soon as they were recognised. However, we hear from well informed sources that actual losses far exceed what has been written off so far. Since it is in nobody's interest that one or two of the largest financial institutions in the world keel over, some banks have been granted permission to 'manage' their write-offs, allowing them time to raise fresh equity capital. If this is correct, banks will continue to write off bad debts for the rest of 2008 and possibly into 2009.

 # 2: Recession to spread

Partly for that reason, we predict that it won't be long before a host of countries other than the US face the prospect of recession. In fact, it is conceivable that the US might just escape recession as it is typically defined (two consecutive quarters with negative GDP growth), whereas a number of other countries may have already been sucked into it. Furthermore, the U.S. equity market has now largely discounted a recession based on various sentiment indicators (see an example hereof in chart 1). Unless the recession turns out to be much more prolonged and/or severe than generally expected, much of the damage in US markets is probably done at this point in time.

Chart 1: % of Stocks on NYSE Trading Above Their 200 Day Moving Average



Source: www.fusioniqrank.com

Is Japan already in recession?

Not so in other parts of the world. Whereas US policy makers are busy addressing the problems confronting the US economy, many European (and to some degree also Asian) leaders continue to be in denial and do not seem to have noticed the rapid gathering of storm clouds. Leading recession candidates include Japan which is very dependent upon exports to keep the economy afloat. A strong yen combined with slowing export markets is a deadly cocktail. Meanwhile, the Japanese housing sector is weak, albeit not for the same reasons as in the US. It is, in fact, quite likely that Japan is already in recession.

Singapore, Spain and the UK?

Another country currently flirting with recession is Singapore. GDP actually turned negative in the fourth quarter of last year and recent bulletins from Singapore suggest no improvement in trading conditions. In Europe, Spain assumes the dubious role as being the most likely country to enter into recession first. With almost 20% of GDP coming from construction, the Spanish economy is in a league of its own in terms of being exposed to the slowing housing market which is rapidly turning into a global disease. The UK could be the next in line. The UK housing sector is starting to show signs of indigestion and let's not forget that the current crisis is first and foremost a banking crisis. Other than Switzerland, no country in the world is more dependent on the financial services industry than the UK.

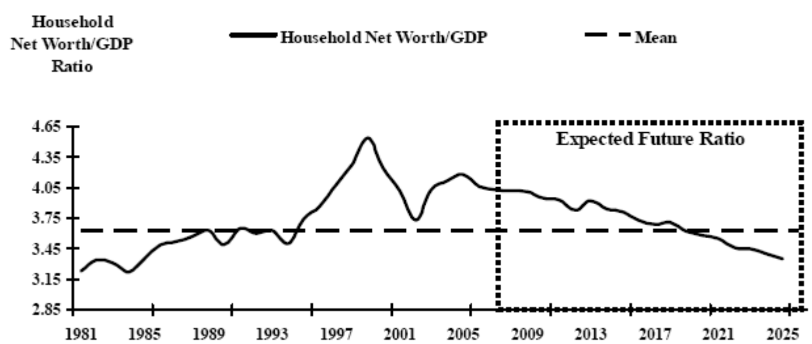
US stocks likely to outperform

To sum up it up, whereas the US may be responsible for putting the world into the mess it currently finds itself in, the rest of the world may end up suffering more. It won't be the first time that has happened. Blessed with more flexible labour and money markets than most other countries, the Americans will probably deal more swiftly with the problems facing them than most other countries will be able to. For this reason we predict that US stocks will actually outperform most other markets this year (with the possible exception of emerging markets which traditionally are highly correlated with the US market).

 # 3: US savings ratio to rise

The dramatic slowdown in economic activity and fall in property and equity values will have another implication. In order to understand how things work, let's re-visit a chart produced by our economic advisor, Dr. Woody Brock. Woody has maintained for a while that, over the long run, asset prices cannot grow any faster than the underlying economy[1]. In the United States, the household net worth to GDP ratio has averaged 3.4 times since 1950 and 3.6 times since 1981[2]. Now, with a 25 year equity bull market behind us, asset prices are well ahead of economic fundamentals, not just in the US but globally. What neither we nor Woody can tell you is how long it will take to unwind the excesses built up since the mid 1990s when the ratio went decisively above its long term mean value (see chart 2). However, judged by the severity of the sell-off in equities over the past three weeks, we could very well be back to the long-term average within a few weeks!

Chart 2: Mean-Reverting Dynamics of Net Worth



Source: Strategic Economic Decisions, Inc.

Shop till you drop

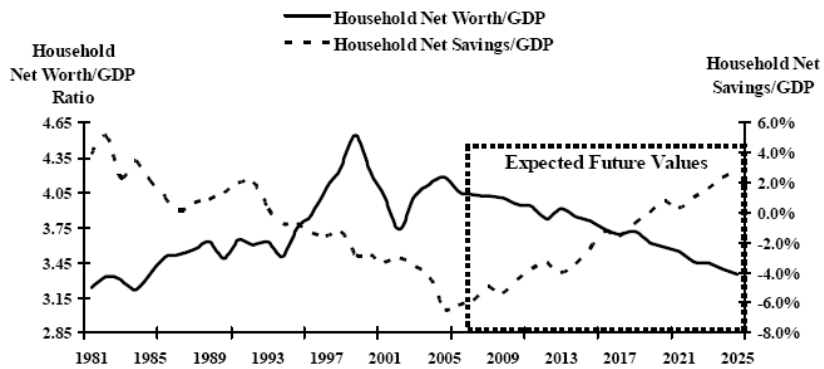
Joking aside, many commentators have long maintained that it is in the DNA of Americans to consume and that the propensity to shop is essentially the root of the American economic problem today. The point often missed by the critics is that Americans have had no need to save in recent years, as rising property and equity prices have done the job for them[3]. Now with the retirement savings dwindling by the day, many Americans are faced with two options – either work a few more years before retiring or start saving by consuming less.

We therefore predict that 2008 will likely be the year where the trend of falling savings ratios in the United States finally reverses itself (see chart 3). Americans will start saving more of their income not because they have suddenly lost their appetite for consumption but because

[1] *There are very valid economic reasons why that is. Feel free to call us for an explanation.*
[2] *The mean ratio has risen slightly due to the effect of recent years' abnormally high returns on both equities and property.*
[3] *The rising (or falling) value of household assets is not included in the savings ratio which is calculated as aggregate income less aggregate consumption.*

they *have to* unless they want to spend retirement in poverty. This has profound implications for the US current account and therefore also for the value of the US dollar (more about the dollar later), as well as the stock market.

Chart 3: Long-Run Wealth Effect Impact



Source: Strategic Economic Decisions, Inc.

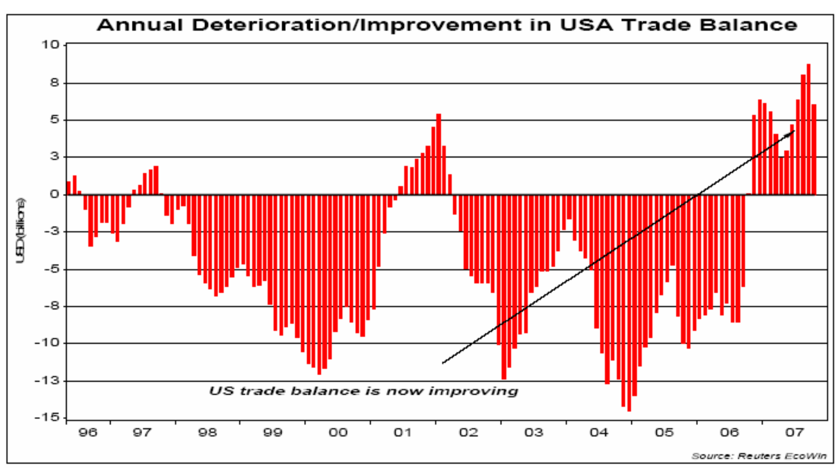
 # 4: Dollars v. Euros

Next on the list is the US dollar. We predict that the US dollar will surprise most investors later this year – by starting to appreciate in value after years of depreciation. There are three reasons behind this bold prediction. Firstly, as the US is likely to be amongst the first countries to enter recession (or so it looks like), it is equally likely to be ahead of most other countries as far as the interest rate cycle is concerned. This will start to work to the dollar's advantage later this year.

The trade deficit is improving

Secondly, the trade improvement is in full swing. Although it has gone largely unnoticed, the US trade deficit has improved significantly in recent quarters (see chart 4 below). The latest US GDP report was published earlier this week. It showed that exports made a net contribution to US economic growth of 0.55% in the last quarter of 2007. Exports have not had such a positive effect on US growth since 1991. Assuming the trend continues, it will provide strong support for the dollar longer term.

Chart 4: US Trade Balance



Source: GaveKal Research

The euro is inherently unstable

Thirdly, we are becoming increasingly concerned about the future prospects for the euro. 2008 could very well be the year where its robustness will be tested for the first time. The European monetary pact is inherently flawed. Macroeconomic conditions across the union are too uneven to make the euro work smoothly. The ECB has managed to get away with a flawed concept for a number of years because economic conditions have been too benign to seriously undermine the structure. However, with a recession looming, the appetite for harsh measures amongst the weaker countries within Euroland will be tested for the first time. Perhaps that is why the spread between Italian and German government bonds has widened to an all time high of about 35 basis points recently. For that reason we expect a euro crisis at some point in the next year or two. That will obviously benefit the dollar

The only caveat with respect to our dollar forecast is the near term visibility which is very poor. It is quite possible that you may have to wait until the second half of this year before the uptrend is established, and there could very well be more downside risk in the interim.

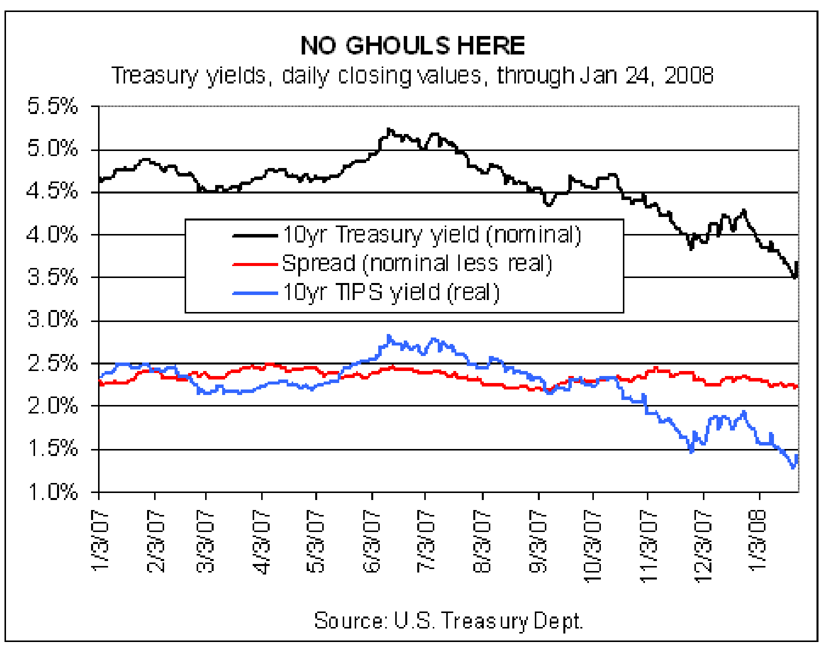
 # 5: Bonds v. commodities

Moving swiftly on, we believe there is a serious disconnect between bond prices and commodity prices. Monetary authorities around the world are facing a classic dilemma – do they focus on the banking crisis and steepen the yield curve in order to improve the operating environment for banks or do they pay attention to the nagging inflation (which just won't go away) and keep rates stable despite the weak macro environment?

Are bond yields too low?

Market participants have until now assumed that inflationary pressures will gradually fade away as the global economy loses momentum and, if history provides any guidance, that is indeed the correct assumption to make. However, many aspects of the global economy are different today when compared to prior recessions. Most importantly, we face global competition for many commodities today - a phenomenon the world still has to adjust to.

Chart 5: US Inflation Expectations



Source: www.capitalspectator.com

Looking at chart 5, inflation expectations (the red line, defined as the difference between the yield on 10-year Treasury bonds and 10-year TIPS) have barely changed over the past year despite the fact that inflation has actually risen a fair bit and despite continuously high commodity prices. Something has to give. Either bond yields will have to rise or commodity prices will have to come down. Or both. Make your pick.

 # 6: Sovereign Wealth Funds

Let's finish where we began – with the banking crisis. The so-called sovereign wealth funds have played a pivotal role in the crisis by providing fresh equity capital to banks in need. Sovereign wealth funds are funds controlled by various government or quasi-government institutions around the word where vast amounts of money have been stacked away as a result of large budget surpluses (oil money, etc.). During the past few months, as the banking crisis has unfolded, these funds have come to the rescue of many a crisis hit bank. As you can see from chart 6, despite having coughed up well over $100 billion in order to rescue Citibank, Merrill Lynch, UBS, etc., this is little more than pocket money for these extraordinarily wealthy state owned funds.

Chart 6: Total Assets in Sovereign Wealth Funds

League of nations

Sovereign-wealth funds

Latest

Country: name	Assets* $bn	Inception year
UAE: Abu Dhabi Investment Authority	875.0	1976
Norway: Government Pension Fund - Global	380.0	1996
Singapore: GIC	330.0	1981
Saudi Arabia: various	300.0	*na*
Kuwait: Reserve Fund for Future Generations	250.0	1953
China: China Investment Corporation†	200.0	2007
Singapore: Temasek Holdings	159.2	1974
Libya: Oil Reserve Fund	50.0	2005
Qatar: Qatar Inv. Auth.	50.0	2005
Algeria: Fond de Régulation des Recettes	42.6	2000
US: Alaska Permanent Fund Corporation	38.0	1976
Brunei: Brunei Inv. Auth.	30.0	1983
Other	171.4	–
Total	**2,876.3**	–
of which oil- and gas-related	*2,103.4*	–

*Estimated, excluding Norway
†Includes Central Huijin Investment Co.
Source: Morgan Stanley

Source: The Economist

The fire sale is on

Now, we predict that, before this crisis is over, these funds will increasingly be perceived as the thieves of undervalued US assets. As things stand, US banks and policy makers alike can hardly afford to alienate any of these knights who have come to the rescue at a time when quite a few large reputable banks are looking into the abyss, but there will come a day when foreigners will be accused of having 'stolen' US corporate assets (memories are short in this business).

Too early to buy bank stocks

Since we predict that most large banks have more write-offs in the pipeline, the risk to investors is that the relationship between rescuers and banks turn sour before this mess is over. The banks need the funds. There are not too many investors you can approach for $10 billion or more of fresh equity capital. However, in a US election year, with a bunch of narrow-minded congressmen desperate to please the man on the street, we wouldn't bet against this turning into a hot election topic with the shareholders of the banks becoming the inevitable losers. Put slightly differently – it is still too early to pick up bank stocks.

Conclusion

Adding it all up, we predict that it will be a tricky year but also a year that is likely to end on a much more upbeat note than it began. US dollar denominated assets will, to the surprise of many investors, perform better than most other assets, and the euro will disappoint. Commodities (with the likely exception of agricultural commodities) could quite possibly have a surprisingly weak year. So could bonds. Enjoy the year. The one thing we can guarantee you is that it will not be boring.

Niels C. Jensen

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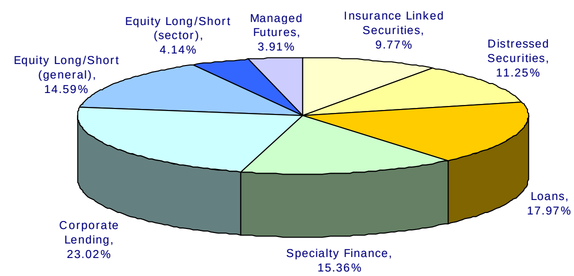
The **Multi-Strategy Portfolio** as at 31st December, 2007:



The **Millennium Wave Portfolio** as at 31st December, 2007: