

The Absolute Return Letter April 2009

The News Which Never Made the Front Pages

March was a weird month. Whilst our American friends submerged themselves in a rather ludicrous and altogether unproductive debate on who is to blame for the fact that the 'crooks' at AIG nicked a bonus for themselves, on this side of the Atlantic, Gordon Brown, whose political career is now on life support following a number of embarrassing hiccups, has dedicated the last few weeks to making sure that the G20 summit will go down in history as a resounding success. Even the banks, which continue to show little appetite for lending, have found that the last month offered some unexpected relief, as the preparations for the G20 meeting forced Brown and his lieutenants to focus on other matters.



Source: Matt, Daily Telegraph

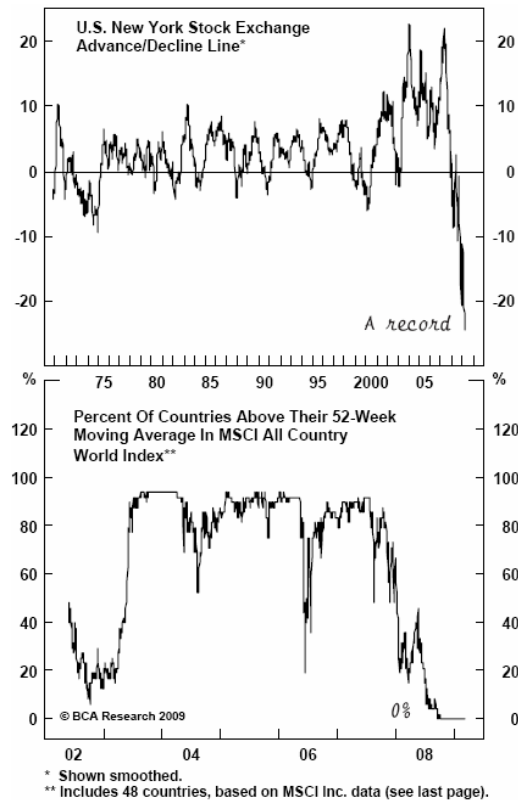
Now, these distractions are not necessarily bad news because it means that news which would normally hit the front pages won't always get the attention it deserves which, in the world of finance, can only be regarded as an opportunity. And that is precisely what this month's Absolute Return Letter is about – events which have happened over the past few weeks which didn't get the attention they deserved.

Credit falling behind

Let's begin with equities which did very well in March. Following a desperately poor February, global equity markets bottomed out approximately one week into March, and it has been pretty much one way traffic ever since. From trough to peak, US and Asian markets gained about 20%. European markets were less buoyant but still

finished the month with gains well in excess of 10% as measured from the bottom of the bear market in early March. In retrospect, this should not really come as a surprise. As shown in chart 1 below, global equity markets were desperately oversold going into March, leaving plenty of scope for positive surprises.

Chart 1: Advance/Decline Ratios



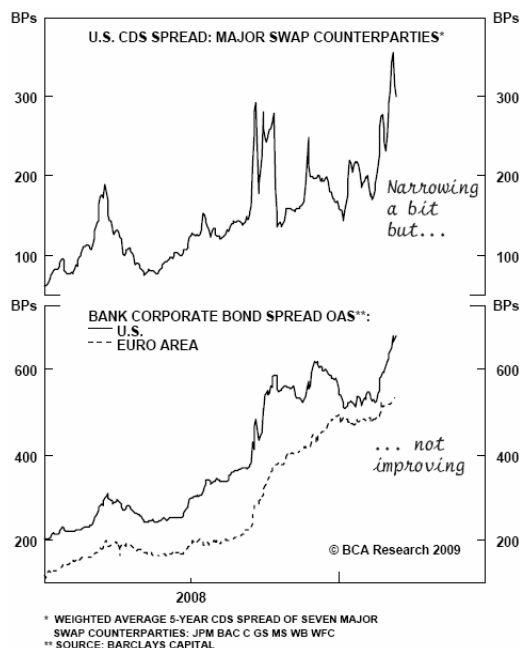
Source: BCA Research

What equity markets have failed to recognise, though, is the complete lack of response from credit markets (see chart 2). We have repeatedly pointed out, and will do so again, that any upturn in equity fortunes will prove temporary *unless* credit markets lead the way. This is no ordinary recession. It is a credit/solvency crisis first and foremost and credit conditions *must* improve for the equity bull market to be sustainable. Unless that happens, I am absolutely convinced that the good fortunes of March will prove to be a false dawn.

Demand for US bonds is off

The second piece of news which escaped most newspaper editors was the worryingly big drop in foreign demand for long-term US government bonds. As you can see from chart 3, net foreign purchases have been falling steadily in recent months and have now turned into net sales (I didn't include the chart here; however, the picture on corporate bonds is very similar). Now, this doesn't necessarily mean that foreign investors have suddenly gone cold on US bonds. Foreigners, and in particular Asians, often buy these bonds as a result of the large current account surpluses they enjoy vis-à-vis the United States.

Chart 2: CDS and Credit Spreads

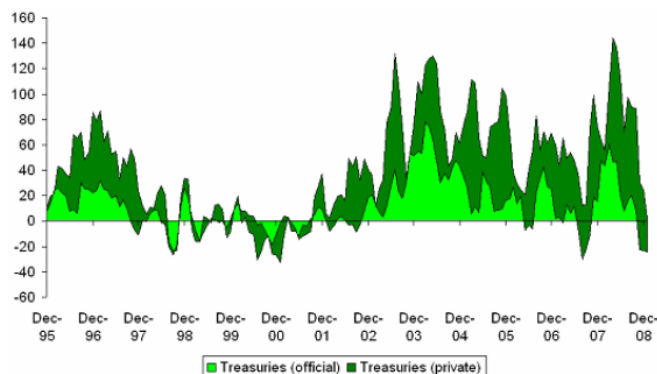


Source: *BCA Research*

With the recent collapse of Asian exports, foreign currency reserves are no longer growing at anywhere near the rate of recent years, so the need to invest in dollar paper is falling. Going forward, this may cause some headache for Obama’s administration, though. With the US fiscal deficit running at levels not seen since World War II, Washington will have to issue an awful lot of paper to finance its spending spree. With the waning appetite from abroad, the Americans may have to rely on domestic investors to buy all those bonds. Are yields high enough to generate sufficient interest?

It is not only the Americans who may struggle to offload their bonds. You may have noticed that only ten days ago the UK Debt Management Office (which is in charge of issuing gilts) had to admit that its March auction for 40-year gilts had been an unmitigated fiasco. The cover ratio of only 0.93 was the lowest in history and doesn’t bode well for future auctions.

Chart 3: Foreign Purchases of LT US Treasuries

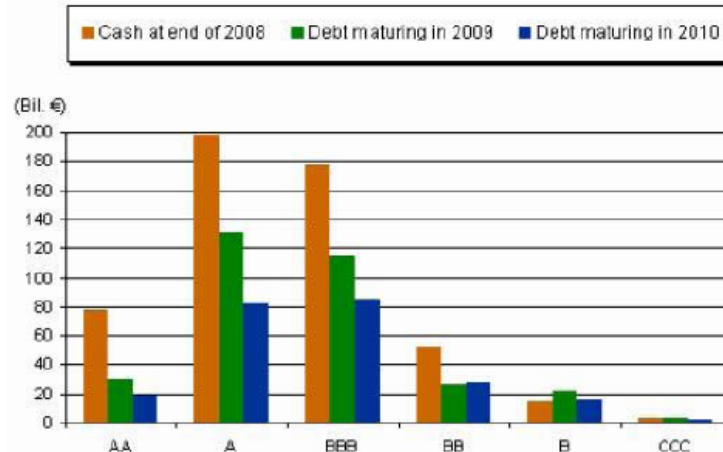


Source: <http://blogs.cfr.org/setser>

Refinancing risk is high

And it is not just governments who may wonder where to look next for risk willing capital. European corporates, which on average are almost twice as leveraged as their US counterparts, face a major refinancing cycle over the next couple of years. According to a new study published by Standard & Poors, almost €330 billion of European corporate debt mature in 2009 with another €235 billion set to fall due in 2010 (see chart 4). Last time I checked, the appetite for European corporate debt wasn't that overwhelming and you would be forgiven for wondering where the money is going to come from to roll these loans over.

Chart 4: Refinancing Needs for European Corporates

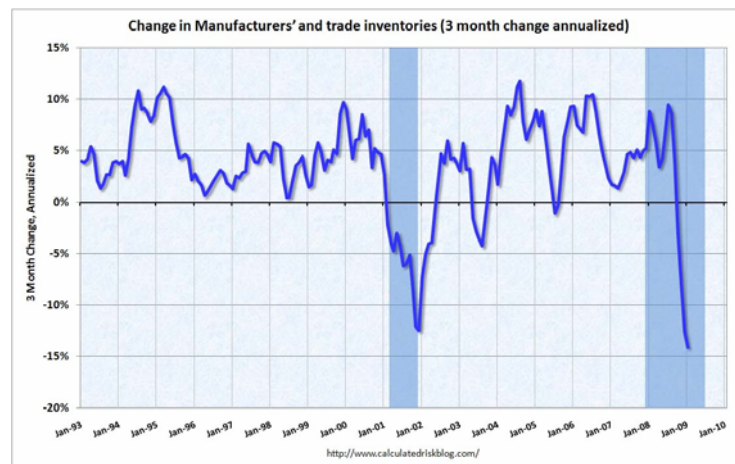


Source: Standard & Poors

Inventories are collapsing

Turning my attention to the global economy, after a rather muted beginning, manufacturers around the world have now begun to react aggressively to the economic downturn and inventories are falling aggressively. Chart 5 below depicts US manufacturing inventories as published recently by the Census Bureau. Inventory changes can have a meaningful impact on GDP. There is one example from the 1981-82 recession where the inventory correction subtracted 5% (annualised) from GDP in just one quarter. The current inventory correction is very negative for GDP in Q1 and possibly also in Q2, but it is very difficult to quantify the effect it is going to have. We will have to wait and see.

Chart 5: Change in US Manufacturing Inventories



Source: Calculated Risk

However, as we must remind ourselves, the stock market is not trading on what is going to happen in Q1 and Q2 of this year. Projecting at least 6-9 months ahead, the stock market is probably already looking ahead to Q4 and possibly even Q1 of next year. And the inventory adjustment currently underway is *very* bullish for GDP growth later this year and into next. The reason is simple. Manufacturers always overreact. Come Q3 or Q4, they will suddenly sit up and realise that inventories have fallen too much and that they need to produce more. There is no reason to believe that this recession will be any different.

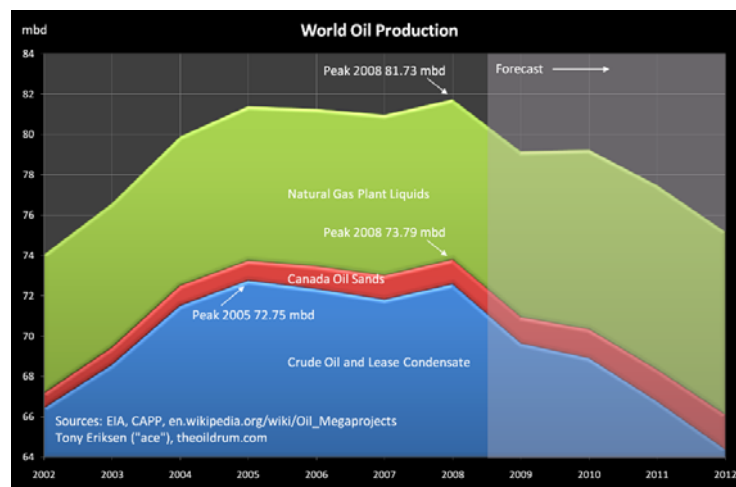
Oil offers mixed news

The other factor which is going to help the global economy as the year progresses is the steep drop in oil prices which (mostly) took place in the second half of 2008. WTI averaged \$104 in April of last year, rising to \$126 in June and July. Only by November did it come down to \$50 where it trades currently. A rise in the price of oil is effectively a tax on consumption and the much lower prices we enjoy this year as opposed to last year will provide a much needed kick to the consumer's buying power. BCA Research has calculated that, here in Europe, it could provide as much as a 2% contribution to GDP – a point missed by many observers.

Unfortunately, the oil story is not all good news. A couple of weeks ago, a website dedicated to oil research and commentaries ran a story which was largely ignored because newspaper editors only cared about whether President Obama would succeed in taking the bonuses away from the executives at AIG. The article which can be accessed on <http://www.theoil Drum.com/node/5177> is a well researched piece on the phenomenon of Peak Oil which we have written extensively on in the past.

The gist of the story is that global oil production has *already* peaked and will probably never reach the same levels again (see chart 6). This also explains why oil prices have held up relatively well despite a very gloomy outlook for global economic growth. Quite frankly, had I known a year ago what I know now, I would have predicted oil prices to fall substantially more than they actually have. Obviously, the last thing the world needs right now is rising oil prices, but the implication of this is that when the global economy starts to fire on at least 6 of its 8 cylinders again, oil prices are likely to move much higher.

Chart 6: World Oil Production



Source: www.theoil Drum.com

The race is on

I spent the first two weeks of March in Asia. Whilst out there, on the 12th March, Switzerland took the world by surprise by intervening in the foreign exchange markets, seeking to drive down the value of the Swiss Franc. In fairness, the news got a fair bit of attention in the Asian media but less so in Europe and North America. The Swiss economy has been suffering for a while, partly because of the strong currency. Together with the Japanese yen and the US dollar, the Swiss franc has been amongst the most widely used by speculators when engaging in the so-called carry trade. As borrowing levels have been pegged back in recent months, all three currencies have appreciated significantly in value. For a large exporter like Switzerland, this poses a problem.

The Japanese have been quick to state that, unless they can obtain international approval, they will not follow the Swiss example. On that basis, one might be tempted to conclude that, for now at least, the risk of a 'nuclear arms race' in the currency markets has been avoided. On closer inspection, such a conclusion seems rather naïve, though. Most of the financial de-leveraging is behind us now, removing much of the support for the yen. Secondly, in February, Japan's long lasting surplus on the current account turned into a deficit, a trend which is likely to continue for quite a while. Thirdly, the Japanese economy is amongst the hardest hit in the current downturn. Fourthly, deflation in Japan is a real risk, just as it is in Switzerland. All these factors point towards a weaker yen. It would certainly take a brave man to bet against it.

It is therefore possible that the yen suddenly takes a turn for the worse. Should that happen, a fair few export dependent Asian countries may be tempted to engineer a fall in their own currencies in order not to lose out to Japan in the global battle for competitiveness. Such a race could get quite ugly and cause all sorts of problems. Protectionism tends to show its ugly face when things get desperate, and they rarely come more desperate than what we are currently witnessing.

The silent tsunami

On the 6th March the IMF published a research paper¹ which, for some inexplicable reason, was almost universally ignored by the financial media. Only Martin Wolf in the Financial Times made a mention. The good people at the IMF have produced a high quality report where they take a closer look at the direct as well as indirect costs of the current crisis. Table 1 below, which forms a key part of the conclusion, has been lifted straight out of the report.

The way to read the table is as follows: The numbers in the column named 'Crisis' measure the estimated cost of the current crisis as a % of GDP for each country and for the G20 as a whole. As you can see, Spain and the United States are burdened with the highest costs – approximately 1/3 of total GDP. At the other end, Germany and Canada are likely to take the smallest hit with 'only' 14% of GDP.

It is the next column where things become *really* interesting. The numbers in this column measure the estimated cost (net present value) of the changing demographics – i.e. the aging of the population. As you can see, for the G20 as a whole, the cost of the current crisis represents *only* 5% of the combined cost!!! If you think the credit crisis is a challenge, just wait and see what the changing demographics will do to our world as we know it today.

¹ "The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis", IMF, March 2009.

Spain and the United States face a double whammy. Not only is the credit crisis particularly damaging to those two countries, but both of them face insurmountable costs to their societies as their people age. Obviously, nobody can afford costs of this magnitude, so the welfare model will have to change in virtually all G20 countries (and beyond). Pension systems and health care models as we know them today will most likely disappear. We simply cannot afford them.

**Table 1: Net Present value of Impact on Fiscal Deficit
Current Crisis versus Age-Related Spending (% of GDP)**

Country	Crisis	Aging	Crisis/(Crisis + Aging)
Australia	26	482	5.1
Canada	14	726	1.9
France	21	276	7.1
Germany	14	280	4.9
Italy	28	169	14.2
Japan	28	158	15.1
Korea	14	683	2.0
Mexico	6	261	2.2
Spain	35	652	5.1
Turkey	12	204	5.6
United Kingdom	29	335	7.9
United States	34	495	6.4
Advanced G-20 Countries	28	409	4.9

Source: <http://www.imf.org/external/np/pp/eng/2009/030609.pdf>

The problem we are up against is that our political leaders are a bunch of cowards who, rather than tackling the problem head on, prefer to pass the baton to the next generation. They know that dealing with a problem of this magnitude will not win them many votes; instead they pretend that the problem does not exist.

Is FASB 157 about to change?

The last bit of news which I wish to point out to you is still work in progress. As you may recall, back in 2007, the US Financial Accounting Standards Board (FASB) introduced rule 157 which introduced a three tier classification of financial assets and effectively forced banks and other financial institutions to mark most assets on their balance sheet to market.

FASB 157 has been widely criticised for accelerating the banking crisis, as (or so the argument goes) forced liquidations have artificially depressed many asset values. Senior secured loans, for example, are marked close to par on the books of most European banks whereas, on the other side of the Atlantic, FASB 157 forces US banks to mark those same loans in the 60s and 70s.

A couple of weeks ago FASB proposed a rule change which would allow banks to price assets based on mark-to-model provided the market is deemed distressed. FASB is set to vote on the proposed rule change later today (Thursday, 2nd April), following a two week hearing. I am just flabbergasted that this news has not yet made the front pages. It is potentially *very* big and could result in US bank earnings being much stronger than expected, providing a lift to the entire stock market.

Conclusion

Summing it all up, March offered a mixed bag of news but, at least as far as the immediate future is concerned, the news was on balance quite positive. The inventory story, the oil price comparisons and the FASB rule change could very well explain the change of sentiment over

the past few weeks and could quite possibly drive the market higher in the short run.

On the other hand, for what it's worth, be careful. The parameters are not yet in place for the revival to be sustainable. My money is therefore on the good times to prove temporary. The stock market run may last a few months and so may the economic revival which, by the way, is still at least 6 months away. Ultimately though, economic growth will begin to fade again until the structural problems we face (such as high consumer debt, negative home equity, etc.) get resolved, and that will take much longer.

In the meantime, the strategy on both sides of the Atlantic seems to be to drive down government bond yields to levels where investors will have no choice but to take a serious look at riskier investments. Ultimately it is the appetite for risk which must return before we can put this crisis behind us once and for all. And governments and central banks are doing everything in their power to stimulate our appetite. The question is whether it is enough.

Niels C. Jensen

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The ARP Structural Alpha Portfolio as at 28th February, 2009:

