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Newsflash

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Punctuated by numerous public holidays the month of April was relatively quiet in terms of news flow and trading volumes on the main bourses were generally low. This did not translate into a dull month for investment returns, with most asset classes delivering strong returns. Equity markets were supported by better than expected company earnings results, while government bonds also rallied on growth concerns. Events in Japan and the Middle East continued to command investors' attention but the focus has increasingly shifted towards the outlook for fiscal and monetary policy, and the effects thereof. Headwinds abound and many investors have been surprised by the resilience displayed by markets in the face of real problems which could easily have knocked the current bull market in equities off course.

Many economies and their respective policy makers are in uncharted territory as global markets remain distorted, in particular by negative real interest rates and a surge of liquidity from quantitative easing programmes, with added difficulty coming from a highly elevated oil price. The effect of these factors on the inflation dynamic is uncertain and the risk of a policy mistake is unambiguously increasing. Central bank reactions are likely to vary though, not just due to the underlying strength of their economies, but due to the nature of their inflation target. For example the Federal Reserve in the US targets core inflation which excludes volatile items such as food and energy, and therefore the 44% rise in the oil price over the last twelve months will probably prove to be deflationary, by subduing economic activity. Across the Atlantic in Europe the European Central Bank (ECB) instead focuses on controlling headline inflation which has risen substantially. Germany and France, the two largest economies in the Eurozone, are currently booming as they grew by 1.5% and 1.0% in the first quarter. As a result of these dynamics – and after some 700 days of inactivity by policymakers in Europe, the US and the UK – the ECB complied with market expectations and became the first of the main central banks to hike interest rates, by increasing the Main Refinancing Rate by 25 basis points to 1.25% early in April. In his post meeting address, ECB President Jean-Claude Trichet's hawkish tone was interpreted by many commentators as raising the prospect of a further rate hike as early as midsummer. Meanwhile in the UK, the Monetary Policy Committee voted to maintain the current loose monetary policy conditions in light of weaker than expected growth – the economy did not grow in the past six months to the end of Q1 – and in anticipation of some setbacks to consumer spending following the introduction of fiscal tightening measures. Elsewhere the Royal Bank of Australia elected to leave rates unchanged at 4.75% which was broadly in line with market expectations. Such a high interest rate relative to other developed countries has not gone unnoticed by the markets and as such the Australian Dollar has soared past parity to end the month at 1.09 versus the US Dollar, an all time high since the currency floated in 1983.

The Australian economy has been among the most direct beneficiaries of China's increasing demand for commodities – with prices climbing to new highs over the month. Although agricultural commodities declined (-2.1%) the Rogers Broad Commodity Index added 3.0% for the month bringing its year to date gain to 13.1% in US Dollar terms. A 9.0% increase in the price of oil was a large contributor to this return with Brent crude reaching a peak of $127 early on in the month as a result of disruption to supplies from North Africa. Meanwhile the backdrop of inflation worries, sovereign debt concerns and a weak US Dollar set the conditions for strong appreciation from precious metals including gold (+7.3%) and platinum (+5.6%). The standout performer, though, was silver which rallied by 27.1% over the month bringing its year to date gain to 54.9%. This is potentially a cause for concern for commodity-bulls given that it is often the more speculative, lower quality areas of asset classes that enjoy the strongest performance towards the end of a bull market as a result of investor overconfidence. Certainly the fact that commodities do not generate an income stream makes it difficult to determine a fair value, meaning that any such marginal shifts in supply and demand dynamics can drive significant price changes.

Staying on the subject of commodities, during the month details emerged regarding the IPO of the world's largest commodity trading company, Glencore, whose business is built on finding buyers and sellers for commodities such as oil and sugar around the world, as well as other assets such as ships and mines. The Swiss company is set to list on the London and Hong Kong stock exchanges in May with current pricing indicating a market value of around USD 60 billion. Historically the public listing of a key industry player has often signalled a major market top for the industry and the Glencore IPO could prove to be another prescient occasion. Historically key industry players have usually gone public after business conditions have been good for a long period of time, thus attracting investor appetite, and valuations have climbed high enough for insiders to want to sell (which probably means that prices are not attractive to buyers). Examples include Goldman Sachs in 1999, just before the US equity market reached a secular peak, and the private equity firms, KKR and Blackstone, in 2007 at the peak of the credit bubble. Although the commodity-complex may not have reached a peak yet there are clearly enough indications to make investors cautious, and the risks appear stacked to the downside.

Equities enjoyed another month of strong returns as the MSCI World returned 4.3% bringing the year to date return to 9.3%, just shy of the full-year return for the index in 2010. The S&P 500 index gained 2.9% as it reached its highest level since June 2008. In local currency terms all major equity regions except for Asia Pacific ex Japan (+4.8%) underperformed the global equity index, although only Japan declined (-2.0%) in local currency terms. This pattern of returns was largely

Source: RMB Asset Management / Bloomberg. April 2011.

a function of local currency strength enhancing returns as the euro and Sterling both appreciated by over 4% versus the US Dollar. With US monetary policy set to remain loose for a considerable period of time yet and potentially further quantitative easing around the corner prospects for the greenback look bleak. Indeed the amount of monetary support raises questions about the pace of equity market gains and begs the question of whether equities will be vulnerable once such balance sheet expansion begins to slow.

Emerging markets renewed their underperformance versus developed markets in April with a 3.1% return in USD. In fact, the local currency return was considerably lower at 0.8% since emerging market currency strength was a meaningful component of the US Dollar return. In the eight months since the end of August 2010 the effect of emerging market currency appreciation has been significant, adding about 10% to US Dollar returns. During April consumer related stocks outperformed while energy was the only emerging market sector to post a decline. Rising inflation remains a key concern for investors and has led to tighter monetary policy in Brazil, China, India, Korea and Turkey. China's GDP release of 9.7% year-on-year was higher than expected and further highlighted the divergence in growth trends between emerging and developed markets.

Bonds also delivered strong returns over the month as developed and emerging government bonds returned 3.1% and 1.4% respectively in US Dollar terms. Once again currency effects contributed to the global return but nonetheless US Treasuries delivered a decent return of 1.2%, while inflation linked bonds (TIPS) gained 2.6% as ten year implied inflation expectations reached a high for the current cycle of 2.65%. There are no signs that the Federal Reserve is in a rush to exit from the current policy measures but rather would prefer to ease out gradually so as to avoid significant market disruption. Given the lack of a plan to deal with a growing budget deficit S&P placed the US Governments much coveted AAA credit rating on negative watch, although this did not have a significant effect on markets. Across the Atlantic the peripheral European states continued to test the nerve of the bond markets. Ireland started the month by accepting its fifth bailout: a further EUR 70 billion from the ECB, while Portugal officially sought financial support for the first time in the form of a EUR 80 billion bailout. Meanwhile comments from German officials regarding a possible Greek debt restructuring led to two and ten year Greek bond yields surging to 21.6% and 16.0% respectively, despite Greek officials denying the need to restructure. Finally, the success of the euro-sceptic True Finns party at Finland's general election presented further potential future problems given their likely opposition to such bailouts.

Credit performed well across most markets outperforming government securities. US high yield added 1.5% in the month to marginally lag higher grade credit which gained 1.7%, while European high yield returned 1.7% taking the year to date return to 5.9% in euro terms. Global convertible bonds gained 3.0%, nearly keeping pace with the global equity index over the month, as is also the case year to date as well with the asset class having gained 7.7% in US Dollar terms.

Source: RMB Asset Management / Bloomberg. April 2011.

Asset Class Performances

Asset Class/Region	Index	Currency	Apr 2011	YTD 2011
Equities				
United States	S&P 500 NR	USD	2.9	8.9
United Kingdom	FTSE All Share TR	GBP	3.1	4.2
Continental Europe	MSCI Europe ex UK NR	EUR	3.7	5.7
Japan	Topix TR	JPY	-2.0	-4.2
Asia Pacific (ex Japan)	MSCI AC Asia Pacific (ex Japan) TR	AUD	4.8	7.6
Global	MSCI World NR	USD	4.3	9.3
Global Emerging Markets	MSCI World Emerging Markets TR	USD	3.1	5.2
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	1.2	1.0
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	2.6	4.7
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	1.7	2.6
Us High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	1.5	5.5
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	2.0	1.1
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	GBP	2.1	3.1
Euro Government Bonds	Citigroup EMU GBI TR	EUR	0.4	-0.8
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	1.0	1.0
Euro High Yield	Merrill Lynch Euro High Yield 3% constrained TR	EUR	1.7	5.9
Australian Government	JP Morgan Japan Government Bond Index TR	AUD	0.4	-0.3
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.5	2.3
Global Government Bonds	JP Morgan Global GBI	USD	3.1	3.7
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	3.0	4.3
Global Convertible Bonds	UBS Global Convertible Bond	USD	3.0	7.7
Global Emerging Market Bonds		USD	1.4	2.1

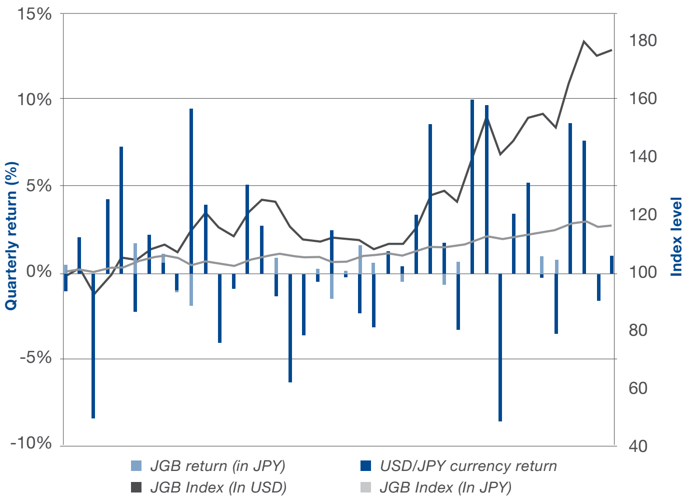
Source: Bloomberg, April 2011.

Asset Class/Region	Index	Currency	Apr 2011	YTD 2011
Property				
US Property securities	MSCI US REIT TR	USD	5.7	12.2
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	5.8	12.0
Europe ex UK Property securities	FTSE EPRA/NAREIT Europe ex UK TR	EUR	2.7	6.0
Asia Property securities	FTSE EPRA/NAREIT Asia TR	USD	2.8	-1.6
Australian Property securities	FTSE EPRA/NAREIT Australia TR	AUD	6.0	10.7
Global Property securities	FTSE EPRA/NAREIT Global TR	USD	5.0	8.2
Currencies				
Euro		USD	4.6	10.6
Sterling		USD	4.1	6.5
Yen		USD	2.1	0.0
Australian Dollar		USD	5.8	6.8
Rand		USD	2.6	0.4
Commodities				
Commodities	RICI TR	USD	3.0	13.1
Agricultural Commodities	RICI Agriculture TR	USD	-2.1	3.3
Oil	ICE Crude Oil CR	USD	9.0	34.2
Gold	Gold index	USD	7.3	9.4
Interest rates	**Last meeting**		**Current rate**	**Change at meeting**
United States	27 April 2011	USD	0.25%	No change
United Kingdom	5 May 2011	GBP	0.50%	No change
Eurozone	5 May 2011	EUR	1.25%	No change
Japan	28 April 2011	JPY	0.10%	No change
Australia	3 May 2011	AUD	4.75%	No change
South Africa	12 May 2011	ZAR	5.50%	No change

Source: Bloomberg, April 2011.

Focus: Japanese Government Debt

Our clients will know that we have been running significant underweight positions in Japanese Government debt for the best part of eighteen months, suffice to say that this investment strategy has not worked (yet!). The biggest contributor to the performance of Japanese bonds in global portfolios (measured in US Dollars) has been currency returns, much more so than the growth stemming from the income and capital appreciation components of these investment instruments, as the graph alongside (quarterly JGB returns in measured in JPY, and the effect of exchange rate fluctuations) clearly illustrates. Over the last ten years Japanese government bonds have returned a little more than 77% (5.9% p.a.) to US investors and only 16.4% (1.5% p.a.) to their Japanese counterparts.



Seeing that more than 95% of Japanese sovereign debt is held by Japanese, it follows that few in the global investment community (with non JPY liabilities) would have benefited from this strong US Dollar performance of Japanese bonds.

In a recent publication Jonathan Allum (from Mizohu) neatly set out the three camps of thought with respect to the view on Japanese sovereign paper, this succinctly echoes our view. Mizohu has kindly agreed that we may publish an unaltered version of this report:

Three views of Japanese Government Debt

Anyone with the temerity to argue the bullish case for Japanese government debt, will inevitably have to wrestle with the three Ds – Demography, Debt and Deflation - which for many investors constitute a cast iron argument against any investment in Japan. I have had a number of bruising encounters with each member of this unholy trinity and since I have no reason to believe that I have succeeded in dislodging entrenched views I am reluctant to enter the ring again. But faint heart, as they say, never won fair lady, so I will gird my sagging loins and drag my aching and bruised body to grapple once again with the demon Debt.

There are essentially three views of Japan's fiscal position:

- The Horsemen of the Apocalypse. These guys seem to be everywhere – they infest the blogosphere, they write for the Daily Telegraph, they appear on CNBC, they run American hedge funds. They have been forecasting the demise of Japan, its government, bond market, economy, currency etc, They have been making these bloodcurdling predictions for a decade or more – they have been consistently wrong but they are undeterred by this persistent failure which they wear as a badge of honour – unless, of course, they have backed their own beliefs by shorting JGBs, in which case they will have gone bust.
- The Default Deniers. This is a much rarer breed. They argue that not only is a fiscal collapse à la Grecque improbable for Japan (or the US and most other developed economies), it is actually inconceivable.
- The Muddled Middle. This, inevitably, is where the BLAH! and most investors are to be found. We are more numerous than the other two categories but, lacking the confidence of our (lack of) convictions, we make rather less noise than the two groups above. We reluctantly accept the possibility of a fiscal apocalypse in the indeterminate future but believe that apocalypse now is just a film by Francis Ford Coppola.

Whilst remaining a man of the centre, my own position has shifted over the years. I was never an apocalyptician, for aesthetic as much as analytical reasons (all that sturm und drang malarkey is so vulgar – and very tiring). I did subscribe to a milder form of the doomsday scenario viz. the lose/lose theory of the JGB market. This theory is/was very straightforward – the JGB market had to be a SELL because either a) the economy would recover, inflation would return and thus yields would go up or b) the

Source: Jonathan Allum (Mizuho), The Occasional Blah! #11, 10 May 2011

economy would not recover, thus the fiscal deficit would expand, the market would take fright at the deterioration in the nation's creditworthiness and thus yields would go up. The theory had everything – simplicity, elegance and symmetry. There is just one teeny flaw – it has been consistently wrong. So, I abandoned it.

The Horsemen, whose views have proved equally incorrect, have shown greater fixity of purpose, **THE APOCALYPSE SHALL COME!** I am an instinctive liberal (defined by Robert Frost as "a man too broad minded to take his own side in a quarrel") but I am drawn to the intellectual purity of total intransigence, even if the apparent enthusiasm with which they contemplate Japan's demise is more than a little unnerving. One is reminded of Sellar and Yeatman's description of Cromwell's Roundheads as "Right but Repulsive" or the fondness of mild mannered Fabian socialists in the 1930s for Josef Stalin, a man not famous for the mildness of his manners. However, one comes back to the inconvenient truth that these people have been consistently wrong.

But, they will protest, history will vindicate us. This defense, however, fails on two levels. Firstly, in financial markets, to be excessively early is to be wrong since, as Keynes famously observed, markets can remain irrational longer than you can remain solvent. There is, however, a more profound epistemological problem. Any prediction of significance i.e. the Japanese government will default, has to establish its credentials by some testing against reality. Any a-temporal forecast of fiscal collapse violates this requirement. One accepts a certain amount of leeway in establishing when the curtain will finally fall on this once prosperous nation but there must be some timetable, some set of intermediate landmarks on the road to ruin that can be specified and which will enable the open minded observer to compare the Horsemen's roadmap against reality. The reluctance to provide any such roadmap raises serious philosophical doubts about the whole apocalyptic project.

Just as some in the 1930s felt able to transfer political allegiance from Hitler to Stalin (or vice versa) so should men/women in the middle like myself consider the other end of the intellectual spectrum i.e. the Default Deniers, for whom a Japanese default is not only improbable but is conceptually impossible, which arises from what philosophers call a "category mistake" viz. regarding a government as analogous to a corporation or household. This point is well put by Anatole Kaletsky (in his book "Capitalism 4.0"):

"Public finances cannot be understood by imagining the government as an aggregation of individual families or as a supersized business firm. This is because governments do not borrow or spend anything in their own right. They only transfer resources from one group of citizens (the taxpayers) to others (for example, pensioners and government employees). In doing this, today's governments create obligations for future politicians to undertake another transfer of resources – from a third group of citizens (the taxpayers of the future) to a fourth group (the future owners of government bonds). All these transfers, provided they occur within a single nation, have no effect on the nation's total wealth.........A nation cannot go bankrupt by borrowing from itself any more than an individual can go bankrupt by writing a check for $1 billion and then posting it to himself. The possibility of government insolvency arises only if a nation, or more precisely a national Treasury borrows from other countries in a currency it cannot control"

Default Deniers do not (typically) dispute the wisdom of reducing the deficit over the longer term but they typically do not regard the recent rise in government indebtedness (in Japan and elsewhere) as the unmitigated disaster in the way the Horsemen do. It is rather seen as a response to – and arguably an inadequate response to – the rise in private sector saving as the financial crisis brought about a wave of deleveraging. In a recent presentation to the INET Conference at Bretton Woods, Richard Koo of Nomura repeated his view that the growth of the Japanese deficit since the collapse of the bubble economy has been money well spent in that it prevented the sort of 1930s type depression that might otherwise have resulted from the collapse in asset prices. Koo points out that, despite this collapse, Japanese GDP, whether measured in real or nominal terms, never fell below the level reached at the peak of the bubble.

The irony of the position of we muddled middlers is that we find ourselves being constantly battered over the head by the views of the Horsemen despite two inconvenient truths namely a) that there is no empirical evidence whatever for their views and b) however much we may protest, we are all horsemen at heart in

Source: Jonathan Allum (Mizuho), The Occasional Blah! #11, 10 May 2011

that we recognise the possibility of default but just push it out into the indefinite future.

The views of a single strategist are of little consequence. The more important battle for hearts and minds is taking place within the government and more broadly within the Japanese ruling elite here the signs are that the fiscal hawks are in the ascendancy. The view that most muddled middlers could sign up to - that physical reconstruction should precede fiscal reconstruction – is losing ground to an alternative approach– for which there seems to be popular support – that the two processes should proceed simultaneously. This is, perhaps unsurprisingly, what the OECD advocates in its recent report on Japan:

"In light of the debt situation, this may need to be funded by shifting expenditures and by short-term increases in revenues, appealing to the Japanese people's sense of solidarity....Tax reform should be spelled out and announced in FY 2011, and tax increases should begin as soon as possible......A doubling in the consumption tax to 10% would be a first step"

First step or last straw? There are, of course, a number of European countries tightening fiscal policy at a time of economic contraction – Greece, Ireland and Portugal are the names that come to mind – but they do not control their own currency and thus have no choice. Japan – despite what the OECD, Mr. Yosano and all the Horsemen tell you – does.

Let us end by returning to Robert Frost whose most famous poem begins:

"Some say the world will end in fire, some say in ice".

In their typically melodramatic fashion the Horseman believe in a fiery ending. Of course they exaggerate. The danger is that the acceptance of their views will usher in a new economic ice age in Japan.

Source: Jonathan Allum (Mizuho), The Occasional Blah! #11, 10 May 2011

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