Manager Commentary, December 2010

There Are No Policy Remedies for Debt Deflation

"He became a surgeon because he was afraid of knives. He got married because he was afraid of women. He had a child because he was afraid of responsibility. Now his marriage over and his child no longer speaking to him, he turned off all the lights in the house because he was afraid of the dark."

Michael Ventura, *The Zoo Where You're Fed To God: A Novel*

Michael Ventura made me write. He confronted me with uncomfortable questions that have no answers. Do I write because I'm afraid of writing? Did I become a hedge fund manager because I'm afraid of risk? Is Bernanke set to wreak economic havoc in the twenty-first century because he misunderstands the malaise of the early twentieth century? In truth, the quote emanates from a book that I bought over the summer when I mistakenly read its title as "*The Zoo Where The Fed Is God,*" I thought it sounded like a contemporary narrative on today's risk markets. But it has succeeded nonetheless in motivating me to share my thoughts with you once more. However, I must warn you that my views have not changed. Therefore some of you may wish to look away now.

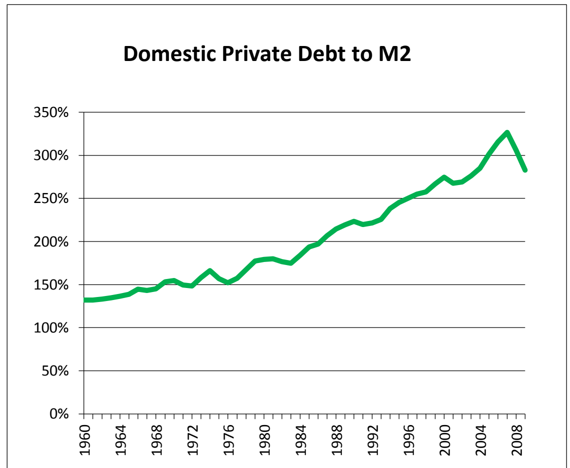
I Sing The Body Eclectic?

As you know, I have not written at length for some time. You need to understand that my timing is heavily influenced by both the push and the pull of Robert Prechter and Walt Whitman. Prechter because he recommends that one should write more when certain and less when uncertain. Like I said, nothing has really changed and consequently I have been in no rush to repeat myself. To me Whitman is influential because he spoke like a hedge fund manager ought to: "all faults may be forgiven of him who has perfect candour," "be curious, not judgemental," and my personal favourite, "have you learned the lessons only of those who admire you, and were tender with you and stood aside for you? Have you not learned the great lessons from those who braced themselves against you, and disputed passage with you?" But the clincher, for me at least, was his life-long endeavour, a book of poems he entitled *Leaves of Grass*, which he periodically updated, republished and embellished as he grew older and wiser. Think about it: one book, one life. I would like to think these investment letters are written in the same spirit.

Described as a courageous attempt to weave, "the muscle of the male and the teeming fibre of the female," Whitman's poems succeeded, of course, only in shocking their prudish late nineteenth century audience. I fear that just as Whitman's musings on sex and sexuality seem rather tame to the modern eye, a later generation might feel the same way about our squeamish reaction to the Fed's initial stab at quantitative easing. They might guffaw, "two trillion dollars, how quaint. And they thought that might produce inflation!?" For a not so distant future generation may bear witness to far greater monetary debauchery.

This has been my argument in April 2009. Given the impediment of such a large quantity of private sector indebtedness, I speculated that should the global economy suffer a further debilitating setback over the course of the next two years, the Fed and especially its acolytes at the Bank of Japan would print much, much more paper money. And only under such dramatic economic circumstances would we establish the pretext for a truly gigantic monetary intervention which would surely undermine the fiat system.

Today, however, we are learning that additional money, perhaps $600bn, is to be printed even without the occurrence of a serious crisis. This has come as something of a surprise to me. I had thought that intense scrutiny and political discontent from the US Congress would have tempered the ardour for such intervention. The QE announcement has also produced a rise in the risk premium associated with term structure. The yield on the ten year Treasury has shot up from just under 2.5% in August to almost 3% in November. Yields on government bonds with shorter tenors (where we have directional exposure) have also been dragged up as the market factors in a heightened probability that QE2 will lead to a rise in policy rates sooner than had the Fed shown greater restraint. This has proven detrimental to the Fund's short term performance. Yet despite it all, I remain persuaded by the argument that the additional proposed easing is not a tipping point and accordingly on its own is unlikely to do much to alter the course of US or western inflation. Perhaps I have some explaining to do.



Source: Federal Reserve

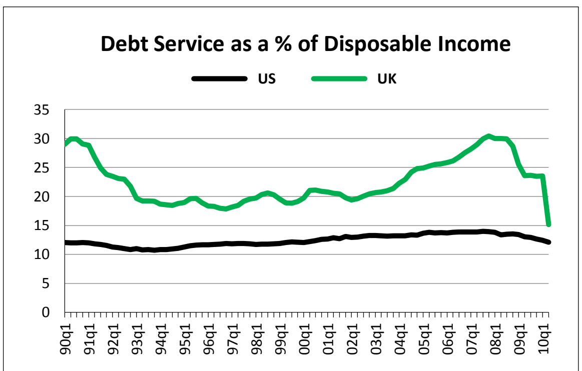
War!

Evidently there is an all-out war being waged between what we might refer to as the Fed's fiat money (the ability to increase dollar banking liabilities), and the private sector's debt-based money (the willingness of the private sector to hold dollar banking assets). The market favours the prospect of fiat printing winning. Perhaps the outcome is a foregone conclusion. However, I continue to argue that the odds seem stacked against this outcome occurring in the short term.

Consider that the US authorities are battling against the $34trn of gross debt added by the private sector since the start of Greenspan's tenure as Fed chairman in 1987. This is a formidable obstacle to quantitative easing as it added only $9trn to income and has therefore left the private sector with misgivings as to its on-going ability to service such a huge quantum of liabilities, never mind add to such exposure. The crucial question is how much of this lift in income is a recurring flow, a product of wise investment spending, and how much was debt fuelled asset speculation with little capability of servicing interest payments and principal repayment. This is especially pertinent because, as the chart reveals, despite the helicopter money drop of last year, the ratio of private sector liabilities to Fed-induced base or fiat money (M2) remains elevated by historic standards. For instance, it is twice the level that prevailed in the 1960s and three times the level of the 1950s.

No one has really addressed this issue except Professor Steve Keen in Australia, who is starting to win much justified acclaim. He compellingly argues that some form of aggregate demand analysis is especially apt in describing why the Fed's initial dalliance with $2trn was insufficient. Defining demand, or total spending in the economy, as nominal GDP plus the change in gross public and private sector debt, total spending in the US shrunk from $18.2trn in the year concluding in the summer of 2007 to just $13.9trn this year. Effectively, the US economy has spent $4.3trn less on the purchase of goods, services and assets (houses, shares, hedge funds, private equity investments, etc.) despite the rise in gross debt from $47.5trn to $52trn. In other words, monetary and fiscal accommodation have been overwhelmed by the 10% contraction (much of it involuntary and taking the form of default) in the private sector's debt-to-GDP ratio from its peak of 3x in early 2009.

Recognising this vulnerability, the actions of the Fed since the onset of the crisis are easier to comprehend. With such a large quantum of debt it was imperative to reduce the cost of servicing it. Policy rates were cut to zero. However, the Fed's aggressive interest rate cuts had only a mild impact on the servicing of household debt in America with its preponderance of callable fixed rate mortgages. The effect was more pronounced in the UK where mortgage lending was predominantly variable and rates were previously priced off the one-year swap with only modest additional term and counterparty premium. Arguably, the institutional differences between the two countries' mortgage markets made QE almost inevitable, in the US at least. Last year the Fed bid for probably a third of the outstanding stock of ten year Treasuries; the Fed's holdings climbed from $450bn in early 2008 to $767bn at present day. But they had to concentrate the majority of their ammunition on purchasing mortgage backed securities, buying over a trillion dollars' worth, to ensure that the cost of servicing the household sector's debt would not rise on the back of elevated risk aversion in the banking sector. I salute this round of easing.



Source: Federal Reserve/UBS

Fooling All of the People, All of the Time

Unfortunately, in my humble opinion, the additional monetary stimulus, takes the Fed back to dancing around a bubbling cauldron rubbing two chicken bones together. For flush with their success in having reversed the negative trend in nominal GDP, the Fed's ambitions seem to have soared. Bernanke has publicly reasoned that they should go further and boost the economy's animal spirits in order to increase aggregate demand in the economy. The implicit thought process is that if they could only encourage the private sector to believe that the trend in rising asset prices will endure then perhaps speculators will once more volunteer to risk taking on more debt, secure [?!] in the belief that higher future asset prices will allow for it to be repaid in full. This reasoning, whereby the stock market acts as a contributory factor to GDP growth, invokes parallels with Thomas Huxley's *The Principal Subjects of Education*. Sometimes it seems that next to being unequivocally correct in this world, the Fed has concluded that the next best of all things is to be clearly and definitely wrong.

Capturing this unrepetentantly bullish autumnal mood, the Greek finance minister, in Washington for the annual IMF meeting, opined that, "smart money is realising Greek bonds are a good investment." Remember this is the same guy who said, and I quote, "we are deluding ourselves as a country in thinking we have a tax system!" Politicians and their central banking cousins are of course the ultimate expression of the prevailing consensus. The finance minister had no doubt been buoyed by the decline in Greek ten-year bond yields from 11.7% at the end of August to just below 9% and the FOMC's confidence was likewise lifted by the slide in the ten-year yield from 4% in April 2009 to less than 2.5% in the weeks preceding their last meeting. But with Greek yields back at their highs, Ireland sinking into the mire, the solvency of the entire European banking sector in question and Treasury ten-year yields challenging 3%, it makes me think that the character Vernon God Little, from DBC Pierre's novel had it right when he said:

What I'm learning is the world laughs through its ass every day,
Then just lies double time when the sh*t goes down…

The Rule of Society by the Wealthy

My greatest complaint however is that the Fed is producing a plutocracy by demonstrating that they are willing to go to all lengths to prevent a market inspired liquidation of the economy's bad debts. This is what happened in Weimar Germany. Huge private fortunes were amassed during a time of little economic prosperity, exactly what has transpired in recent years in Britain and America with the rise of hedge funds and private equity firms. Success with money has become intimately connected with inflation – people have got rich not through productive, wealth-creating activity, but because they bought a house or stock at a time when general asset prices were rising. We have confused talent with being bullish.

Into this fray stepped a prominent and hugely successful (if somewhat uncomfortably brash) hedge fund manager who proclaimed himself the leader of this red-light gang. In his call to arms he claimed that making money was "so easy" and "you can't lose." You see, he has influential friends at the

Fed, at the People's' Bank of China, at the Bank of Japan, at the Bank of England, the IMF and the ECB. He has so many friends...if the economy improves from this uncertain economic patch, supposedly a mid-cycle breather, then equities will make him money. But if it reverses back into its torpor, and he gets caught on CCTV in places he shouldn't be, then don't worry. His friends will bail him out with their monetary largess; heads he wins, tails he wins. I believe his swagger and confidence moved the market (the global MSCI jumped 9.1% in dollar terms in September). But what is good for my exceptionally talented hedge fund friend is not necessarily good for the rest of us. Let us consider the malady afflicting Europe.

Angela of the North

The euro project has not gone according to plan. It reminds me of the story of the James Bond character Q, based on the British intelligence officer Charles Fraser-Smith. It was he who invented a compass for spies hidden in a button that unscrewed clockwise. The contraption was based on the simple yet brilliant theory that the unswerving logic of the German mind would never guess that something might unscrew the wrong way. This is really what happened with the Euro. New member states were supposed to take lower interest rates and invest their resources wisely to improve and deepen their productive capacity. Instead, they used the advantage to finance speculative asset bubbles. The world screwed them the wrong way. The Germans are unhappy.

But, desperate to cling to the euro project, the other European sovereigns have opted to default on their spending promises to voters rather than impose a haircut on their financial creditors. In the 1920s the payoff structure had been very different. The First World War took an intolerable toll on the typical household both in terms of the loss of life and financial well-being; everyone had become poorer. Accordingly there was little willingness on the part of the ruling political class to force austerity measures to redress the fiscal imbalances. The people had suffered long enough. Consequently, there was much procrastination and fiscal deficits persisted way beyond the end of the War, making capital markets reluctant to accept government paper and forcing the sovereign to rely on the central bank's printing press.

"Working people are not about to be used to allow passage of policies that will bring the worst barbarity we've seen in the past thirty-five years."

Aleka Papariga, Head of Communist Party of Greece

This time around however the political class has concluded that the Greeks (especially the Greeks!) and the other peripheral states have done so well on the back of the euro project that it is their turn to shoulder the burden. They calculate that the social pain would be less severe than the financial costs of a debt default and/or a euro exit. Of course this is to neglect the financial consequences of bailing out the banks in 2008 and the ensuing impact on the ordinary household. Can an analogy be drawn between war and the banking bailout? Certainly both events had a disastrous impact on the sovereign fiscal balance and consequently the social mood darkened considerably. Emotions clearly run high and the term speculator has become pejorative. Today's media are clearly of the opinion that the people have suffered enough. Just look at how the Suddeutsche Zeitung altered my picture to make me look sinister. And I'm on their side!

Wachhunde des Kapitalismus

Ireland is indicative of the social pain. Nominal incomes in that country have already fallen 14% and the working population has endured job losses and wage cuts. Their reward for all this is a second austerity package. The average household is now being asked to pay a new property tax and an additional $4.1k annually in income tax (that's 7% of per capita income), plus minimum wages are to be slashed and further job losses are a virtual certainty. The country itself is only held together by the unintelligible premise that the economy will grow by 2.75% per annum for the next four years. Dream on. I believe the European bureaucrats have badly misjudged the public mood.

Perhaps they are too closely aligned with the plutocracy of the financial and banking sector. Contrast the mood of the ordinary household with that of my hedge fund billionaire friend. Today the average European long/short fund is running its most bullish risk exposure in many years and is feeling ebullient regarding the rising tide of corporate profitability as businesses pare back employment levels. My grumble is that I suspect the omnipotent powers of my peers' central bankers might be found wanting just when they are needed most.

I have always held the view that Europe will have its Asian Crisis moment when the popular mood in Germany rejects any further bail-outs and concludes that it is every one for themselves. And with the precedent of Germany, quite rightly in my opinion, of insisting on the imposition of financial creditor haircuts, I believe the "sunny" monetary prophecies of such hedge fund inflationistas could be held in check over the course of the next two years by significant deflationary risk emanating especially out of Europe but also out of Japan. I'm especially positioned for the latter. But before exploring what that might entail, I need to comment on the current inflation debate.

Psychic Blindness

Let me be succinct: QE1 succeeded. In combination with the largest fiscal stimulus in sixty years, the economy reversed its freefall. If there was any failure it rests squarely with investors' fear that the rate of price inflation would accelerate; it has not. For just as Jesus failed to turn up on the 22nd of October 1844, a modern generation of Millerites has had to bear witness to another dramatic and troubling no-show. The Fed's hotly contested money printing scheme has failed to generate the prerequisite rate of inflation, never mind the hyper-inflation expected by some market seers and academics. Indeed, despite the hysteria, core prices in the US economy are rising at their lowest year-on-year rate since the series began in 1957. Inflation, at least as measured by central bankers, has not proven to be a monetary phenomenon so far.

Elvis Lives!

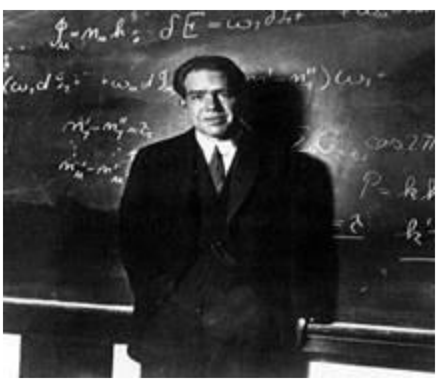
Unabashed still, our contemporary Millerites admonish inflation's refusal to return by arguing that it is with us if not physically then certainly in spirit and point to the rise in commodity and asset prices and the simultaneous weakness of QE currencies such as the dollar and Sterling. But are they not confusing a rise in relative prices with a rise in general prices? The British experience is especially confusing: in March 2009 year on year retail price changes fell below zero for the first time in 50 years but today they are rising by almost 5% year-on-year. Which is the more telling figure?

I am sympathetic with the central bank argument that the weakness in the currency has raised the price of imports, which represent a third of total spending, and that food and energy price hikes, as well as the increase in VAT, are deflationary. And, with no evident monetary expansion in the UK, these relative price hikes serve only to moderate the demand for domestic goods and services. This proved to be the British experience following the pound's ERM eviction in 1992; why should it prove any different in 2011 with such on-going paralysis in the banking sector and the most severe public-sector squeeze in fifty years?

Nevertheless I am acutely aware of my contentious posturing. I accept the inevitability of inflation. Indeed I refuse to acknowledge its presence in the UK price series, and I stick doggedly to fixed income strategies that assume no change in central bank target rates. Furthermore, I do not disagree with the prevalent Friedman logic that, "inflation is always and everywhere a monetary phenomenon." So what gives?

Quantum physics

Consider the quantum theorist and Nobel Prize winner Niels Bohr, who noted that the opposite of a profound truth might well be another profound truth. Could it be that applying the logic found in Bohr's quantum physics, one can suggest another profound truth? With the prevailing level of private sector debt many times greater than historic norms, sustained de-leveraging by corporations and households necessitates that the amount of public sector fiat money printing is so huge that the required inflation is always and everywhere a political phenomenon resulting from a serious economic malfunction in order to legitimise the actions of the central bank? That is to say that without a further economic crisis, the central bank never gains the political goodwill necessary to intervene sufficiently to reverse the decline in the rate of general price increases across the economy.



Goethe apparently wrote that Hamlet was a man asked to do something that seemed impossible for him to accomplish. The Fed's mission seems equally intolerable. They have printed $2trn and yet the US is close to outright deflation on the core CPI measure. Does this institution truly have the mandate to print the necessary quantum of money necessary to change the course of prices?

Springtime For Hitler

I was thinking along these lines when I had a conversation with the former vice chairman of the Fed's Board of Governors, Donald Kohn, in Washington for the annual IMF meeting. Accepting that historical arguments suffer from the empirical lack of a null hypothesis I nevertheless pressed him on what was so bad about the Great Depression. I declared my view that Adolph had it just about right. This caused him considerable consternation. Was I really an advocate of National Socialism and the rise of Nazism? Of course he never figured that I was referring to Adolph Miller, one of the original governors of the Federal Reserve Board (actually I could equally have had another notable luminary in mind, one Paul **Adolph** Volcker, but that's another story for another time.)

It was Miller who reined in the monetary stimulus of George Harrison. Just to clarify, I assured Kohn that I was referring to the head of the New York Fed in 1929 who took control following the untimely death of Benjamin Strong and not the sitar-playing Beatle from the 1960s. The Washington Board of Governors agreed with Treasury Secretary Mellon that the monetary system had to be purged of its speculative excesses in order to place the economy on a firmer footing and indeed had successfully applied such a doctrine back in late 1919 with no troubling outcomes. Kohn retorted that this time around the stock market lost 80% of its value and the real economy fell 29.3% from 1930 to 1933. But he was oblivious to 1934's 10.8% GDP growth rate being the US economy's best ever year. I accepted 1934's rather easy base comparison but nonetheless insisted that within twenty years the US had recovered sufficiently to seize the mantle of an economic super power; he countered with the role of the Second World War.

Pushing on a Wet Noodle?

Our problem was that we had no empirical ability to test the null hypothesis of the Great Depression. How does one prove that it was the Fed's failure to intervene and print money that was to blame? What if there are no policy remedies for a debt deflation? What if the speed and magnitude of the Great Depression's contraction served to clear the market and allow the US to come back stronger?

However, it is just possible that Japan's experience with debt deflation for **two** decades offers an alternative, mutually exclusive hypothesis. For Japan, I would contend, continues to sign its own suicide note by not following Adolph's real bills doctrine. Instead, it offers a glimpse of a society that has done everything to prevent a destabilising purge of its bad debts from its system. It has printed a lot of money. The Bank of Japan's balance-sheet holdings of domestic sovereign debt are now almost triple those of the Fed as a percentage of GDP. And having initially de-geared its economy, debt has risen remorselessly to almost six times GDP. What do they have to show for it? Within twenty years the US ruled the world, but, over a similar time frame of public sector meddling, Japan's economy has become an also ran. Who had it right Donald?

Japan's policy elite includes very few gamblers and writers such as Karl van Wolferen have noted that the unpredictable scares them to an extraordinary extent. It was arguably this frame of mind that recommended a policy of quantitative easing in the first place. It has undoubtedly succeeded in sustaining the economy's substantial debt load, allowing them to increase debt leverage. Furthermore, the private and public sectors can borrow more cheaply than anywhere on the planet. But at what cost? I believe the pain is self-evident.

The Japanese are no longer interested in the future and are now pursuing a policy of instant gratification; of living hand-to-mouth. Freed from the conventional shackles of worrying about the uncertainty of profit and economic trends extending out beyond the present, they are displaying worrying signs of poor judgment. Consider the financial establishment. The banks have lost their economic rent – no playing the yield curve for them. Finding themselves bereft of the financial gains from positive roll down, and without the risk temperament to make commercial loans, they humbly accept ten-year corporate paper yielding one per cent and compound their risk further by selling credit protection to augment their paltry income. However, the stock market has an acute sense of foreboding: the Topix Banks Index is making all-time lows. It may be that having sought to avoid unpleasant shocks our Japanese contemporaries have made their plight more precarious today than it was at the peak of the asset price bubble; I fear they have forsaken their financial security.

They say that coming troubles cast their shadows before them; the only oddity is that the catastrophic share price performance of the banks underwriting the world's third largest economy with a $5trn GDP (vs. India's $1.5trn and Germany's $3.5trn) receives so little attention in our daily financial press. Investors' lack of curiosity can be traced back to Japan's dwindling share of the MSCI World Equity Index effectively means that a major global financial institution can ignore the Japanese stock market. But with gross debt of almost $30 trillion dollars or 60% of global GDP we choose to ignore this economy at our peril, especially as credit risk has become so endemic to their system.

Chuck Prince Would Be Proud

Those who dance are fools; those who don't are fools. Since both are fools, it's better to dance.

Traditional Japanese Saying

The Japanese are chasing yield. But not any kind of yield. Now if it where the shares of NTT DoCoMo which yield almost 4% I could understand; the business is a dull but dominant mobile phone oligopoly. The company runs modest net cash balances and pays out less than half its annual earnings. If I were running a domestic pension fund, it would represent the sum of all my joys: a stable, low risk and domestic yen asset that if gently re-leveraged through modestly raising the dividend pay-out ratio over time would yield 4% and have an attractive positive nominal growth rate. But the dominant social mood in Japan is bleak and regardless of the facts, the notion of owning a high-yielding equity is very unappealing.

Hyperbolic Discounting

Much better to think of sunnier climes that have not endured a bear market: fixed income. The ten year JGB yields just 1.1%. Now here is where it gets weird. Nippon Steel, a mammoth and operationally cyclical business with $37bn of sales and $16bn of debt, issued ten year paper in August yielding ten basis points over the prevailing JGB or 1% to you and me. What were they thinking? For this is not discounted cash flow, it is hyperbolic discounting. Academic studies show that when confronted with the choice of $100 today or $110 tomorrow, most choose the cash up front. But lengthen the time horizon to one month and one day and most defer for an extra day to secure the higher payment. In other words as the present encroaches short-termism prevails.

The Sun Always Shines On TV

But to aggravate matters more, the same institutions that are willing to tolerate such insanity will sell you five year credit protection for 50 basis points on the same name. This is addressing risk by looking backwards. Japan historically has not suffered a large incidence of default and the central bank stands ready to inject more liquidity, so there is the presumption of a free lunch in selling credit protection. It is reminiscent of the sub-prime disaster in America. In Japan, the mispricing of credit has encouraged corporates to issue more and more debt. But of course the more they issue, the less likely the debts will be repaid. Nationwide house prices can never fall, right? And Japanese companies can't go bankrupt?

In September, and more recently in October, as they slowly wake up to what is spooking the market for bank shares, Japan's omnipotent bureaucrats expressed an intention to buy $60bn of risk assets such as corporate bonds. Note how small the intervention is versus the economy's gross indebtedness of $30trn and when the net debt of just one issuer, Tokyo Electric Power (TEPCO), amounts to $90bn. It is true; they are pushing on a wet noodle.

Astute readers may have noted that TEPCO was at last persuaded of its potential financial jeopardy and announced a $6.6bn rights issue in October, the shock and awe of which promptly knocked the shares down 25% from their high of the year. I truly question the value of Japanese shares when their principal function today seems to be that of a sop to prevent further credit downgrades by the ratings agencies. To borrow from the colourful language of Nassim Taleb, Japan has never been as fragile and its policy prescriptions make homeopath and alternative healers look empirical and scientific.

I own some one year, at-the-money puts on Nomura. Whilst its Basel III equity tier one ratio of 10% is positively gigantic versus the 5% class of Bank of America, my niggle is that the Swiss may insist that UBS and Credit Suisse run tier one ratios of 15%. And with Japanese finance appearing so brittle, and with numerous press stories indicating their desire to buy another overseas financial franchise, my fear is that the long suffering shareholder in Nomura will be asked once more for extra equity funding. Note the shares fell 15% on the day of their last rights issue and still trade a further 15% below the issue price; call me old fashioned but I don't like companies that issue paper below the previous rights price.

But returning to our steel example the fundamental risks become obvious. At its peak during the bubble economy, Japan consumed 80 to 90mt of steel slabs and pig iron annually. Today it consumes 60mt, or slightly more than half of domestic capacity. Nippon and JFE, the country's largest two producers, each run close to 40mt of capacity; JFE has $31bn of sales and $18bn of net debt. This industry should be a bloodbath like in cement where domestic demand has halved from its peak and demand runs at a 40 year low; the largest cement player, Taiheiyo Cement, has a market cap just one fifth of its net debt or 15% of sales.

But Nippon and JFE are thriving because they can export 45% of their output to the rest of Asia and utilisation rates runs at over 90%; for steel companies they are very profitable. US Steel by contrast is unable to export from the States into Asia and therefore the subdued nature of domestic steel demand means that plant utilisation hovers close to breakeven (in the low 70s) and there is no earnings visibility. US Steel's revenues are a third of their Japanese peers and it carries $3bn of net debt; its dollar CDS trades at 500 bps.

I'm actually long some one-year US Steel and Mittal puts. I figure the market's psychology is the reverse of where it was six years ago. A friend recounted his experience as a long investor in another steel company back in 2003/04. Earnings had risen fourteen times between 2003 and 2004. However the stock only doubled and was incredibly cheap. Like him, I was long every "old economy" cyclical stocks and indeed the Fund made 50% in the calendar year of 2003. But the idea of a big super commodity cycle was still alien to the majority of investors. Accordingly investors had shorted the stock despite the best steel dynamics since the 1950s. There was a huge disconnect between reality and sentiment: these stocks had been dogs for years and any period of out-performance was an opportunity to sell. Once perceptions caught up with the earnings power however these stocks went up another six times.

Today I believe sentiment and fundamentals are similarly out of whack. These stocks levitate and any period of under-performance is viewed as an opportunity to buy more, owing, I suspect, to their spectacular price performance between 2004 and 2007. Except you need global capacity utilisation rates in the nineties to have any hope of real pricing power and I just don't believe that is coming back anytime soon. With both ArcelorMittal and US Steel's blast furnaces running in the low seventies you can forget about upside surprises to earnings forecasts. Eventually I anticipate a reverse of what we saw five years ago. When sentiment aligns with reality once more these stocks could have huge movements to the downside.

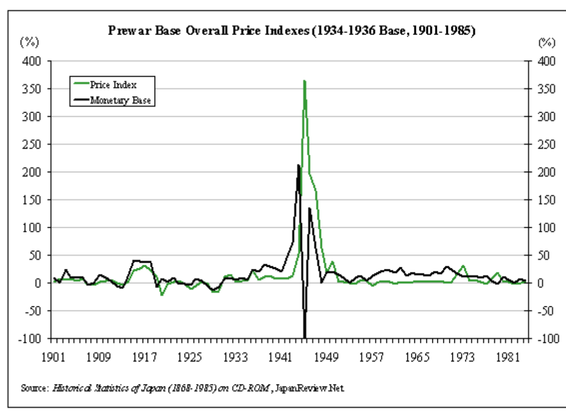
Something extraordinary and difficult to bring about may unexpectedly occur.

The Iron Tree Blossom

Now what could go wrong for Nippon and JFE Steel and those financial institutions that are long their credit? In short, it is their exposure to the value of the yen. Mercantilist regimes are ultimately undone by a double whammy of the rest of the world adopting their strategy and/or by having too much of their **specie** held overseas; Japan is no exception. It is like a one product, one customer, company. Its biggest customer imploded and its biggest competitor stole its magic formula and gained an enormous cost advantage.

To aggravate matters, the forty years of persistent trade surpluses invoiced in dollars has led to little of the trading currency, the dollar, being held within the country. Instead Japan has accepted the accumulation of a huge foreign dollar asset. But under conditions of economic duress and domestic asset price deflation Japan could, and is, finding that it needs to convert its dollar claims back into yen. This process of repatriation can prove debilitating as it typically sends the value of the mercantilist's currency (the yen) spirally higher and so robs it of its most precious commodity, its price and cost competitiveness just when it is needed most.

This can go two ways. It can set in motion a deflationary austerity drive to restore cost competiveness. This is where Japan is at now; enormous productivity measures are being implemented by the exporters to offset the currency's move to the low 80s versus the dollar. However, there is a tail risk that the currency spikes higher, especially if events in Europe deteriorate further, and I fear that this could produce political and monetary mayhem. One likely result could be the repudiation of the economy's debts through hyperinflation. Remember that despite its domestically financed sovereign debts in the 1940s, Japan chose to renounce its war debts through its government's abuse of currency issuance which saw them experience an annual inflation rate of 568% in 1945. Profound crisis have the ability to turn one sector of the domestic economy against another. This time around the battle may be staged by the elderly versus the young salary man.



Turning micro once more, it is my contention that all of the ingredients are in place for a binary change in the profitability of the Japanese steel industry. They have effectively given their Asian customers a free put option. Remember they are not obliged to take expensive steel from Japan indefinitely. Already the steel producers are struggling with price competitiveness and the Korean group, Hyundai, is very close to commencing production at its new eight million ton mega blast furnace plant which will represent almost 10% of Japan's total steel output when it is running at full tilt. It will change the competitive landscape dramatically: Korea, Japan's largest overseas steel market, will go from a net importing country to a modest net exporter.

What if JFE and Nippon Steel have to confine themselves to their domestic market? In early 2009 the financial crisis briefly saw their utilisation levels drop into the low fifties. Their smaller domestic competitors fell into the low thirties. I have good protection here. These smaller guys typically run just one sub-optimal blast furnace; they exist owing to the good grace of others. But should these huge steel titans, JFE and Nippon, return home, the higher and less flexible cost base of the domestic producers will bankrupt them. Remember their biggest customers are the car manufacturers, the ship builders, electrical goods manufacturers and the construction industry. When the rest of Asia does not want Japanese steel, I can assure you that domestic Japanese demand will not take up the slack. The delta is potentially huge; like Ireland they have the ability to shift from hero to zero in an extraordinary short period of time. The beleaguered salaryman will not be best pleased by such a savage turn of economic events and displaced from the warmth of his iron steel furnace, he may turn his fury on the gilded pensions of his elders.

Eat Bitterness

I do not think it is an exaggeration to suggest that modern Japan has increasingly come to resemble the final years of the Second World War. Back then of course it was the Japanese military elite that had gone berserk, leading the country to certain disaster, while powerless civilian governments in Tokyo formed and fell every few months. Political turmoil is already a reality with the country on its sixth prime minister and eighth finance minister since Koizumi saw out his five year term in 2006. Although no faction has yet to formally declare "Tora! Tora! Tora!" I fear that should we see further yen strength, and the bankruptcy of a major industrial sector (such as the steel industry), then one of Japan's warring factions could be persuaded to show its hand.

Worryingly, we found out recently that I am not so alone in this heretical currency view that I first expressed in May's letter. Toshiba's Chief Exective was recently quoted speaking of his plans to deal with ¥70. "People" he said, had assured him that, "the yen would never go to that level when we came up with this plan last October, but looking at the weakness of the dollar and the strength of the ¥ now, that may not be too far from reality." But what if goes to ¥60 or into the ¥50s?

Perhaps Japan needs a good hanging?

It was Samuel Johnson who noted that when a man knows he is to be hanged in a fortnight, it concentrates his mind wonderfully. In a similar vein the recent special report on Japan published by the Economist noted that it might, "take bankruptcy to change attitudes in Japan, but that would be a good thing." Like them, I agree this would be a good thing. Back in the 1930s it was the politicians that were bumped off. The former prime-minister Takahashi Korekiyo is the only president of the Bank of Japan to have appeared on a Japanese banknote. But the military killed him in 1936 after he attempted to reduce their budget. This time around I reckon it will be the politicians that stick the knife in and bankrupt the country's ageing and rich retirees who like the deflationary status quo. I reason that should the currency appreciate to levels previously thought unimaginable, and jeopardise the viability of the country's export model, the workers could unite to press for dramatic institutional change.

And so I end where I began. Should a grotesque series of debilitating financial events, from disarray in Europe to a growth shock in Asia, set the yen racing below 70 to the dollar, it could establish the pretext for a truly gigantic monetary intervention. It is conceivable that the Bank of Japan would be nationalised and with the politicians galvanised by public fears and recriminations an era of hyperinflation would surely beckon. Inflation would indeed be a monetary phenomenon.

Conclusion

The truth is I couldn't guarantee it…Neither of us should have tried to predict the future.

Tony Blair, *A Journey* (2010)

The world of investment has parallels with theology. Repetition and the passage of many years, especially a decade, can transform the rational into the fanatical. I think we are approaching the end of a chapter that began with much cynicism directed towards China and commodities and is closing with fervent devotion. As an example, the gold price has risen more than fourfold since 2002 and has climbed every single calendar year for the past decade; only the twelve year sequence of consecutive up years from 1978 to 1989 in the Nikkei can beat it. I have no beef about gold, but how likely is it to be the next big trade?

Of course I'm still on the dark side. A number of western economies have yet to surpass their nominal GDP highs of 2007 and I am not persuaded that this is a typical economic recovery that requires double-dip considerations; it feels like a mild depression to me. The debt of the private sector remains too high and as the events in Ireland highlight it can even hobble the security of the sovereign. Why is it so contentious therefore to declare oneself cautious if not downright pessimistic? Could the next great trade be a bear trade?

We have a number of such trades that all have asymmetric payoffs and are largely predicated on the notion that there are no policy prescriptions for a debt deflation. Accordingly the astonishing profits of the carry down trade in Japan in the 1990s remain our fascination and focal point for our rate trades. Simply put, we think the market is overstating the risk premium of the term structure. That official policy rates are unlikely to rise for some time in Europe and the US.

But I also cannot completely shake off the analogue of the 1920s/30s. In 1929, global economic growth was to be found almost exclusively in the creditor country, America. From 1927 to 1929 the debtor countries of Europe struggled to reconcile the savagery of austerity cuts without having recourse to a weaker currency. The fixed gold standard offered no redemption to soften the tremendous social costs of unemployment. And when domestic demand finally faltered stateside, the decline was made more dramatic by this lack of offsetting economic growth elsewhere.

Today of course the analogy runs true with the Asian countries, especially China, representing the only story in town. But the comparison breaks down when it comes to assessing how pro-cyclical the Chinese have been in thwarting the steep recession of late 2008. According to the thirties analogue the Chinese should have displayed monetary hawkishness concerning their domestic speculation and soaring asset prices. But this time around, the dominant creditor has shown great monetary extravagance and as a result global GDP growth is bounding back.

The only hope for my analogue comparison is the recent Chinese hysteria concerning the Fed's QE2 program. I find the very vocal Chinese admonishment of the Americans strange. Sure they own over a trillion dollars of US short dated Treasuries and the value of this asset is vulnerable to inflation. But so what? The Chinese are not running a fixed income hedge fund; there is no consideration of two and twenty. Indeed I would happily wager that they would accept an almighty paper loss on such securities should it underwrite a robust cyclical economic recovery for their largest customer, the US. Remember all economic policies in China are predicated on maintaining the Communist Party's hold on power. The true nightmare for the Chinese has to be a prolonged Japanese style recovery in the west where US nominal GDP fails to grow beyond its debt fuelled peak of 2007/8.

Arguably their QE2 misgivings say more about their anxiety of food price inflation taking root and threatening their precious social cohesiveness. As other interventionists have learnt much to their chagrin, you can game the monetary system but you cannot beat it. China's insistence on undervaluing and managing its currency whilst capital flight to its shores pushes more freshly printed renminbi back into its expanding banking system is evidence of the international economic order seeking equilibrium if not through the external value of the renminbi then through higher domestic Chinese prices.

The Chinese have been the global economy's magic tooth fairy these last two years, absolving us from our economic sins and making the fallout from the crisis of 2008 more manageable than bears like myself thought possible. But it is just about possible that their benevolence is changing as they seek to rein in their own domestic price inflation. Charity to strangers has come with a cost and their bureaucrats are frantically twiddling their knobs to cool the monetary system down. The danger is that a credit bubble when starved of its marginal credit soon exhibits a sudden and sharp reversal in asset prices. So the time is nearing when we might experience the world's two most successful creditor nations (Germany and China), seeking, if not a purge of the rottenness, then certainly its moderation. This is an environment rich in policy error contingencies and justifies, I believe, your ongoing and much appreciated investment in the Fund.

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