

April Newsletter

'Will Japan bloom or wither in the aftershocks?'

Bill Emmott (The Times, 11/4)

Key Issues – For investors, Japan's earthquake and tsunami provide a fresh opportunity to re-access the stagnant economic and political landscape that has endured for over 20 years.

Key recommendation – with coordinated G7 intervention drawing a line in the sand for \$/¥ at 80, the prospects for further yen depreciation now seem open, **euro/yen should lead the charge higher**. However, Japan's consensus style decision making makes a broader call on a dynamic economic revival more difficult to make.

Mother Nature makes an occasional, but dramatic, intervention into the modern world. At Alvine, we had long steered clear away from Japan, perhaps waiting for an outside event to break the torpor. **The Fukushima 'Black Swan' forces us to reconsider what is still the world's third largest economy**. With the bear market in equities entering a third decade, and with valuations at attractive levels, an investment opportunity may present itself.

However, western investors should beware assuming decisive fiscal or monetary policy to now galvanise Japanese society. An ageing population and a semi-paralysed political process should caution assumptions about a bold rebuilding process. There is no Ben Bernanke figure to decisively make the move forward.

Fukushima is a big event

Nikkei reports that the Government estimates that the direct costs of the recent quake could be ¥25 trillion, compared to nearly ¥10 trillion for the Kobe disaster of 1995. The 2011 event, of course, included a tsunami as well as a serious nuclear accident. William Pesek, writing for Bloomberg, called this a '**Lehman shock**' for Japan's Central Bank head Shirakawa (Source: Bloomberg.com, 31/3)

The very size of the problem presents a requirement to expect not necessarily the same policy and market reactions as occurred in 1995.

Japanese history – big events have caused profound changes

Two previous events marked big turning points in the country's path.

When Admiral Perry sailed with the USS Mississippi to Edo in 1853, the ease with which modern American weapons made light of the Japanese defences caused a sea-change in society. Over the next 50 years, the once feudal ways were over turned by a revolution.

In a similar way, the defeat in 1945 and the occupation by General MacArthur forced a complete break with the past. In 1951, Japan's GNP was \$14.2 billion, a third of Britain's. By 1975, Japan had not only overtaken all European countries, but GNP was now double that of the UK (Source: Japan Reference).

The causes of the post-war economic miracle are, needless to say, myriad, but it is also fair to say that an aggressive activist industrial policy orchestrated by MITI was part of this process.

What can be done now – a lesson from the Fed?

In fact, it was the Japanese that started the whole process of 'quantitative easing'. The Americans have watched closely how it was done, with the Federal Reserve Bank of San Francisco publishing a report on its effectiveness. This five-year experiment from 2001'tended to support the notion of ...strengthened financial conditions...and had the impact of reducing the call rate' (Source: Federal Reserve Bank of San Francisco website).

Japan may have led, but the US was quick to follow. Now the US is firmly committed to QE II, with the Fed buying \$60 billion per month of treasuries and having expanded their balance sheet to over \$2 trillion, can lessons not be learned about the effectiveness of this policy?

One is dealing in semantics to try and contrast different crises, but the effectiveness in Japan's programme was very much in Ben Bernanke's mind when weighing up monetary policy.

While no less a public figure than Sarah Palin may have complained that QE is a 'dangerous experiment' and wouldn't 'magically fix economic problems', others have explained this 'was **a key factor in taking deflation risk off the table**', for example Peter Hooper, chief economist at Deutsche Bank (Source: Bloomberg.com, 17/3). Moreover, the almost move-by-move recovery in the stock market has helped to boost the wealth effect. While many questions remain about how to exit from what comprises a very large numbers of assets purchased, attention has now been drawn as to whether Japan can go down this route.

William Pesek notes three possible choices to pay for the rebuilding. 'One, issue loads of debt that may prompt credit downgrades and raise taxes. Two, dump its \$886 billion of US

debt, destabilising the biggest economy and enraging a key ally. Three, **get the BoJ to monetise public debt**' (Source: Bloomberg.com, 31/3).

Conclusion – a big problem but a not certain solution

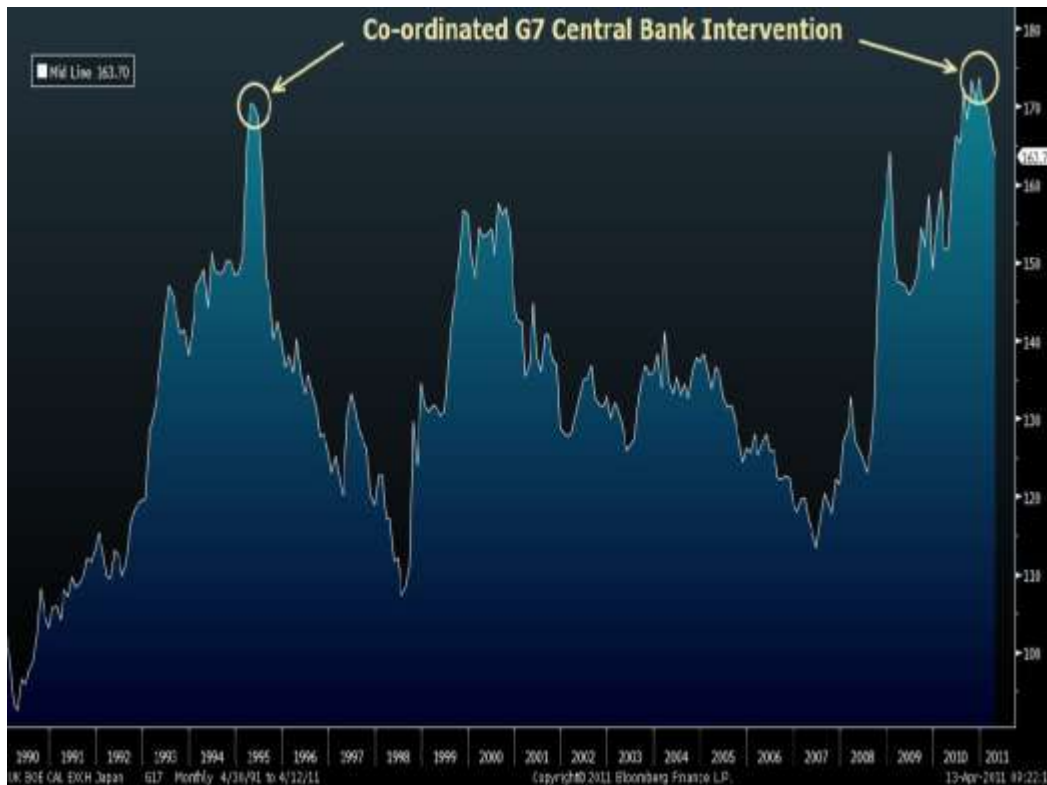
With a New Yorker at the helm, it would not take much imagination to see what would have happened in Tokyo. The tried and tested monetary big guns would now be deployed to rest the initiative. Investors would be seeing through the problems and Japanese stocks would be booming.

Disasters have galvanised Japan before, so this could be the moment. For the yen, it is.

Interest rates key for the yen

Currencies move for all sorts of reasons: balance of payments; capital flows; political sentiment; etc., but, for now, it is short-term movements in rates. With all major economies having ultra-low levels either side of 1%, even 10bp will generate a significant difference in total return. For this reason, **the yen, like the dollar, is at the bottom of the pack** with other majors like the euro set to benefit from a programme of higher rates. **Even if there is no further monetary printing, the yen is likely to weaken further especially versus the euro.**

Help is also at hand from G7 for the yen, where international concerns about a market meltdown in Tokyo enabled a quick response when the yen threatened to spiral higher, as it had done in 1995.



Coordinated G& Central Bank Intervention (Source: Bloomberg)

Coordinated intervention gave a clear message with **$\$/\text{¥}$ 80 as the line in the sand**. Contrast this with sole Central Bank intervention that has not tended to succeed.

We feel confident that this support will continue. There is evidence to suggest that increased imports to help the reconstruction process will also affect real currency flows, and that the yen's seemingly inexorable advance has ended.



USDJPY over 30 years (Source: Bloomberg)



EURJPY over the past decade (Source: Bloomberg)



GBPJPY over the past decade (Source: Bloomberg)

No domestic support exists for Japanese policy makers. It is here where we draw a more cautious conclusion. In a comprehensive article on the readiness of Japanese society to embrace unconventional moves such as aggressive monetary stimulation, Business Week found a more cynical attitude amongst the populace. ‘A quick chat with the man on the Tokyo street is all it takes to understand just how disenchanted many Japanese are’ (Source: Businessweek.com, 17/3). One interviewee, Natsu Hasegawa, commented, ‘there is so much conflicting information, and everything is said with ‘maybe’ and ‘possibly’, nothing specific’ (Source: Businessweek.com, 17/3).

It is not inconceivable that some sort of continued monetary stimulation will take place, much like what has been started in the immediate aftermath of the tragedy. But a game changing event that will galvanise both the economy and society similar to what took place in the 1950s and 60s is harder to predict.

For this reason, we remain cautious on Japanese equities/real estate and other assets as an investment theme. A depreciating currency will hurt absolute returns, together with the demographical time bomb, are still major concerns. The Shirakawa earthquake may be seen as one more small step towards decline.

Model Portfolio—the Teflon market

March was a cruel month for outside events, catching quite a few seasoned hedge fund managers off guard. The mid-month low represented a good clear-out of positions.

However, the primary trend in equity and other risk remained intact. Why did higher oil prices, instability in the Middle East and the Japanese disaster not derail this 'risk on' environment?

The bull market has been founded on one serious theme: easy money. While this is maintained, especially in the world's biggest economy, then abundance of liquidity will swamp other investor fears. **As long as we pay close attention to the Fed's future policy direction, then we can still be confident of the market's movements.**

Some of the Fed's policy makers (Bullard, Plosser and Kocherlakota) have started to question the need to complete the QE11 programme and, indeed, if the era of loose policy should now come to an end.

But as Patrick Allen of CNBC put it, **'listen to the coach, not the quarterback on rates'** (Source: CNBC.com, 6/4). The key decision makers (the Chairman and his deputies Dudley and Yellen) are still firmly in the dovish camp. Speaking immediately after the release of the latest non-farm payroll numbers on 1 April, William Dudley was emphatic in dismissing the revival in employment as being insufficient to change course. **'Even if we were to generate growth of 300,000 jobs per month, we would still likely have considerable slack in the labour market at the end of 2012'** (Source: Bloomberg.com, 1/4).

The Fed's policy is well telegraphed, and has profound implications for both equities and the dollar. We remain of the view that the US equity market in particular is in the throes of a major bull phase we and are comfortable with our **year end target of 1,550 for the S&P500.**

For the external value of the US dollar, we are also gratified that our year-end call of a weaker currency (especially against the euro) has been vindicated. With the ECB in rate hiking mode, and the latest sovereign debt crisis past, our 1.45 target has already been met. We are now emboldened to lift this to **1.52.**

ALVINE CAPITAL ADVISORY MODEL PORTFOLIO

Asset Class	Alvine Capital's Market View	Fund	SAA	TAA	Mar-11	SAA attribution	TAA Attribution	Return 2011
Cash		DB XTracker US money Market	5.0%	5.0%	0.0%	0%	0%	0%
Fixed Income	Negative view on government bond yields in Developed markets. The current macro environment suggests low interest rates in major developed markets, which are unattractive.	Ishares \$ Try Bd 1-3	7.5%	3.0%	1.4%	0.1%	0.0%	-3.5%
		Ishares Markit IBoxx \$ Corp Bd	5.0%	2.0%	-0.6%	0.0%	0.0%	-0.3%
		Ishares Euro Gov Bd 3-5	7.5%	3.0%	3.7%	0.3%	0.1%	3.5%
		iShares Euro corp xFin 1-5yr	5.0%	2.0%	-0.4%	0.0%	0.0%	-0.8%
			25.0%	10.0%		0.3%	0.1%	
Equities	Positive view despite ongoing imbalances in the global economy. Valuations are reasonable and given firmer economic development and low interest rates there are reasons to believe earnings will continue to improve, albeit less strong than last year.	MS INVF US ADV	5.0%	6.0%	1.5%	0.1%	0.1%	4.6%
		Threadneedle US Eq	5.0%	6.0%	1.2%	0.1%	0.1%	4.5%
		Neptune US Opportunities	5.0%	5.0%	-0.4%	0.0%	0.0%	-2.7%
		Threadneedle Am Sm Comp	3.0%	3.0%	3.1%	0.1%	0.1%	7.1%
		Blackrock European Focus	3.0%	4.0%	-3.6%	-0.1%	-0.1%	-1.1%
		Invesco Pan European Str Equity	3.0%	4.0%	-0.5%	0.0%	0.0%	2.0%
		Henderson Horizon Pan Europe	3.0%	4.0%	-1.3%	0.0%	-0.1%	0.3%
		Odey Pan-European	3.0%	3.0%	-5.6%	-0.2%	-0.2%	-5.7%
		M&G Japan	4.0%	3.0%	-13.1%	-0.5%	-0.4%	-11.8%
		Aberdeen Asia Pacific Fund	4.0%	6.0%	3.5%	0.1%	0.2%	-1.9%
		Nevsky Eastern Europe	2.0%	6.0%	3.8%	0.1%	0.2%	10.1%
			40.0%	50.0%		-0.4%	-0.1%	
Hedge Funds *	Positive view. Macro economic imbalances suggests Global Macro still has room to perform. CTA provides uncorrelated sources of return and good diversification. Equity Long/Short should have room to improve given less correlation between stocks. Event Driven should be able to perform given increasing M&A activity	Danske European Equity	1.3%	1.7%				-2.05%
		Futuris	1.3%	1.7%				-1.36%
		GLG Alpha Select	1.3%	1.7%				-0.20%
		Pacific and General Investments	1.3%	1.7%				1.43%
		JabCap EMEA	1.3%	1.7%				3.10%
		Visio IV	1.3%	1.7%				-0.50%
		Lynx	1.4%	1.7%				1.82%
		CQS Diversified	1.7%	2.1%				1.94%
		GAM Global Rates	1.4%	1.8%				2.26%
		Winton Futures Fund	1.4%	1.7%				1.58%
		Argonaut	1.4%	1.8%				-1.06%
		GAM Trading II	1.4%	1.7%				-0.81%
		Lyxor / Paulson International Fund	1.7%	2.1%				3.01%
Lazard Rathmore Fund, Ltd.	1.7%	2.1%				4.57%		
			20.0%	25.0%				
Real Estate	Positive view to commercial property in selected regions such as UK and US. There are signs of recovery and together with a stabilising financial sector this should underpin returns.	IShares GIBPrpt	5.0%	10.0%	1.4%	0.1%	0.1%	0.5%
			5.0%	10.0%		0.1%	0.1%	
Commodities	Negative. Commodities have performed and are starting to look overvalued at these levels. Stay clear for now.	ETFS Forward All Comm	5.0%	0.0%	1.3%	0.1%	0.0%	6.6%
			5.0%	0.0%		0.1%	0.0%	
						0.03%	0.16%	

* HF's have not provided return numbers for March. YTD is to February

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