GAM Investment Meeting Notes

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Japan

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- Japanese 10-year government bond yields hit a seven-year low of 1.13% last week, and today fell even lower to 1.076%. Bank deposits are up to JPY 140 trillion from JPY 110 trillion at the end of the first quarter, and individuals have been cashing in their foreign exchange products, which has further contributed to the recent mini-surge in the yen. The equity market does not seem as volatile as it has in previous sell-offs – there are very few buyers, but very few sellers as well, and the market is just trickling down on pitifully low volumes. The economy has slowed since last year's recovery, but it is still ticking along and, despite all the market turmoil, both business and consumer confidence seem to be extraordinarily robust.
- Naoto Kan, the new Japanese prime minister, recently said that 80% of the policies in Japan are made by bureaucrats rather than elected politicians, and has pledged to change this. The previous prime minister, Yukio Hatoyama, fired the first shots across the bows in this particular battle, but he was forced to resign in early June after just 10 months in office because he broke an election pledge to move a US military base away from the island of Okinawa. Kan is different from a typical Japanese prime minister – for a start, he is not the son of a politician but the son of an ordinary salaryman, and he began his career as an environmental and social activist, which I think is a first for a Japanese prime minister.
- Tax reform is back on the table. Japan's consumption tax is 5%, which is among the lowest in the world, but there is now a growing body of opinion that it should be increased. The tax take in Japan as a proportion of GDP is extremely low – tax rates are very high, but the capture rate is low because thresholds are high and there is a phenomenal number of loopholes.
- As far as our funds are concerned, we have changed very little recently. As I have mentioned previously, we have reduced our exposure to China and technology, and the portfolios have become much more balanced compared to the market. However, we haven't had enough defensive stocks, so we have slightly underperformed in May and June – although not by as much as we would have done had we left the portfolios as they were in January.
- We are still ahead of the index year-to-date in the yen class of GAM Star Japan Equity. However, it has been a very different story with the other currency classes, where our currency hedges have really hurt us. Japan has not joined the 'race to the bottom' of competitive devaluation that other countries have participated in, and the yen has gone from being stupidly overvalued to being obscenely overvalued. It hasn't moved light years away from its typical range against the dollar, although obviously events in Europe have hurt the euro class of the fund, where we have hedged 67% back into the euro. I am reluctant to change things too much because I do not want to move too early only to then get whipsawed; besides, I believe that the situation will come back to work in our favour – it worked in our favour last year, and I think it will again.
- As part of our attempt to reduce our exposure to China and technology, we have raised our exposure to All Nippon Airways (ANA) and Kirin Holdings. Airlines have been crucified in recent years, but in the new world of less credit, less securitisation and less private equity, they appear to be a good bet on a 10-15-year view. The rise of budget airlines has reached a plateau, the national carrier JAL has gone bust, Haneda Airport in Tokyo is opening new international slots and ANA has a very credible restructuring plan.

Long Only and Absolute Return Fixed Income

Tim Haywood, Investment Director, GAM Absolute Return Bond Fund

- Once again, bond markets around the world are rallying, as some weaker data has prompted investors to look for safe havens. UK gilts are doing well on the back of the recent Budget. Credit spreads are not really widening meaningfully, in contrast to the blow-out that we saw in early May. Furthermore, there is some new issuance taking place, which we view as another mildly positive signal.
- Among the new issues, there is an increasing number of covered bonds (ie those secured by assets), which is leading the previously issued senior debt to gradually become unsecured subordinated debt. It is not a major feature of the market yet, but we are certainly watching this development.
- As bond markets are rallying, yield curves have flattened, which has caused 30-year bonds to become quite cheap compared to swaps, particularly 10-year swaps. Consequently, we have bought 30-year UK government bonds against their respective 10-year swaps in the Absolute Return Bond strategy – a trade also applied in the Global Rates strategy. We are also looking for opportunities in this area in the US. If there is a double-dip recession, the ongoing flattening should boost these positions. Additionally, the austerity measures announced by the new UK government are turning gilts into better-quality investments than they were deemed to be only a few months ago.
- The ECB is in the spotlight at the moment: a three-month facility is being extended to banks today, while the one-year facility ends tomorrow. This means that the approximate EUR 440 billion that

the ECB lent to banks one year ago will now have to be repaid. If banks were to refinance more than around EUR 250 billion of the EUR 440 billion through the new three-month facility, the market would be disappointed and assume that banks have not made the necessary balance sheet repairs during this one-year window. The pressure certainly remains on banks to offload assets and shrink balance sheets as they are facing the real prospect of new regulation.

- Various European governments have extended their guarantees by a further three months and we own some bonds that are covered by these extended guarantees, which has been a positive. In our view, the canary in the coalmine is local emerging market bonds. Over the past 10 years, whenever there was a crisis, there were outflows from the asset class, but so far this has not occurred this time.
- The way the ECB has used its new powers of quantitative easing by buying Greek bonds in the market has cost it a lot of credibility. It was harshly criticised for going down the route of quantitative easing, and the amount of PIGS debt that it actually bought – around EUR 55 billion – was not very meaningful in the vast world of government bond trading. After a brief rise into the mid-90s, Greek bonds maturing in 2013 have dropped back down into the low 80s, where they had traded before the ECB's intervention. The ECB now holds EUR 55 billion of junk-rated bonds without having really achieved anything except sacrificing its credibility.
- The problem with Greece is that even a restructuring of the kind being discussed by commentators would not solve the problem. The budget deficit of 13% or more would not be sustainable even if a portion of the debt, eg 50%, were written off. So the most important step for Greece is to balance its books – otherwise no level of debt is sustainable at the rate of the current budget deficit.

Source: GAM