

GAM Investment Meeting Notes

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Interest Rates and Currencies

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- GAM Star Global Rates has had a difficult summer. On the interest rate front, we have not had strong directional views, so returns in this area have been broadly flat. On the currency side, our short positions in the Swiss franc proved premature and were stopped out. We offset some of the correlations of the Swiss franc with short positions in the Australian and New Zealand dollar. Until recently, these two currencies have held up surprisingly well, also detracting from returns. The Australian dollar was particularly resilient as we faced a situation where the domestic economy was weakening and the local market went from pricing in 50 basis points (bps) of rate hikes to 75 bps of rate cuts. We also saw a pick-up in risk aversion and volatility, yet the currency held up very well until recently, so this was problematic for us. We have also typically been long the Mexican peso.
- At the start of 2011, we had around 90% of our risk in currency markets, but as a result of the market turbulence over the summer, we have now taken risk down to 10% in favour of rates.
- August was flat for the fund. While risk assets continued to be hit, the correlation was much reduced. Overall, our positioning reflects greater risk allocation to interest rates and more focus on relative value macro trades. For example, we think that Canada's economy is healthier than that of the US and that rate hikes will materialise in Canada before they do in the US. The market generally is not pricing in this scenario so we are executing trades such as being short Canada while receiving rates in the US. As this trade is quite range-bound, we are putting the trade on at around 20 bps and taking profits at around 60 bps. The UK and US markets swing within a fairly confined range so we are playing that range by being short the UK versus long the US.
- Within our macro themes, we have a flattening trade on in the US, which has become very directional – if bonds rally the yield curve tends to flatten because the front end cannot rally any more. We are also positive on 30-year gilts against swaps and 10-year swaps.
- We are currently pursuing three main themes within currency markets. We are short the euro against the US and Canadian dollar, which has been working well for us in recent weeks. We also hold shorts in the Australian and New Zealand dollar, although most of those are against the Canadian dollar and the Mexican peso. We are long Korea against the US dollar, which has been less successful and has offset gains made in the euro trade.
- Europe has become the big issue that markets are obsessing about. If we can get some form of resolution in the region, then some interesting opportunities should start to emerge. We

believe some currencies have been oversold and there has been a massive increase in correlation across all markets.

- Recent price action has been focused on positioning. For example, in the past few weeks, the Turkish lira has been outperforming because investors are short Turkey. In contrast, some of the more popular markets have come under a lot of pressure, particularly in Asia. If things begin to stabilise, trades such as the Mexican peso, which is currently very cheap, will become more attractive, as will the Polish zloty against the euro.
- More generally, bond markets are very expensive. Having suffered more bad news overnight and further equity weakness, it is interesting that today (14 September), the front end of Europe – 2-year Schatz – are continuing to sell off. We see this as an early sign that the front end of the market has limited scope to rally much further. With a little more stability, we would be looking to short selective front ends that are pricing in rate cuts. Canada looks interesting and could be exploited by paying one-year rates in one year's time outright or by a one-year/two-year steepener, for example.
- The volatility associated with the potential for default in Europe continues to cause problems for the fund. While the political goodwill to try and address Europe's issues seems very strong, the reality is more problematic. Looking at Germany, there is very little popular support for further bailouts. A recent survey showed 80% of the German population are against the eurobond solution, making it difficult to see how a resolution will be achieved. It is possible there will be a contained Greek default, with the European Financial Stability Facility (EFSF) continuing to buy peripheral European bonds. The political hurdles we face would indicate the situation will remain unresolved over the next few months, although the ultimate outcome looks likely to be an eventual Greek default.
- Potential default in Portugal and Ireland looks less likely, primarily because global policymakers would be extremely adverse to the ramifications of such an outcome, particularly with the global economy being so fragile. However, this does not mean the market will not price in such a possibility.
- Interest rate trades still offer the potential to generate reasonable returns, particularly if one uses more leverage, which is what we have been doing, despite our overall risk levels coming down. Once the market stabilises, we hope that some of our currency positions will start to deliver real opportunities.

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