GAM Investment Meeting Notes

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18 May 2011

Pacific

Michael Lai, Investment Director, GAM Asia Equity, GAM Asia Equity Hedge, GAM Star Asian Equity, GAM Star Asia-Pacific Equity, GAM Asia-Pacific Equity, GAM Star China Equity, GAM Greater China Equity Hedge

- We are seeing a material economic slowdown in China, although the average full-year growth rate is still likely to come in above 9% thanks to a strong first half. Some of the slowdown is driven by the fact that electricity production has been curtailed – it is uneconomic for power producers to produce electricity following a 30-40% rise in thermal coal prices over the past 6-9 months – a period when electricity tariffs have risen by 2% at best. The inability to raise tariffs is linked to the government's concern over inflation.
- Headline inflation is currently running at 5.3% annualised, which is not high relative to India's 9% for example. It is still manageable and unlikely to get out of control like in previous period of 2004-05 and 2007-08. Headline inflation is likely to come down as commodity prices have started to ease in the past month or so. However, the rise in core inflation, buoyed by rising prices in non-food items – such as services – is a concern. It is based on strong wage growth of 10-15%, which inevitably pushes up prices across the whole economy.
- Inflation worries mean that credit conditions are also tight. That has led to a lot of low-quality issuance in the bond markets, particularly in the high-yield and offshore CNH (Hong Kong RMB) markets by companies with no formal credit ratings. Credit remains tight even if some banks have been circumventing credit limits by securitising loans off the balance sheet and offering them as high-yield products to retail customers. The government is aware of the practice but so far has not stopped it from becoming more widespread. We expect the government to tighten credit availability even further.
- We are also likely to see a lot of equity issuance in the coming months, especially the listing of such names as Prada, Samsonite and Coach, alongside some Australian resource companies, on the Hong Kong exchange. That is likely to drain a lot of liquidity out of the markets.
- Although we are not forecasting a hard landing for the Chinese economy, we are cautious because of the likelihood of continued monetary policy tightening. China lacks the policy flexibility to deal with its inflation problem because of its currency's USD peg. As a result, we are underweighting China and have a relatively defensive positioning within the market, avoiding the more cyclical segments, including financials such as real estate stocks. Overall, we prefer to invest in countries with more flexible exchange rates and thus better tools for tackling inflation.

Long Only and Absolute Return Fixed Income

Tim Haywood, Investment Director, GAM Absolute Return Bond Fund, GAM Star Dynamic Global Bond

- The problems facing the bond markets are quite unprecedented. On one hand, we have the potential for the 'reprofiling'/'restructuring' of Greek debt, and the strange situation of a debt ceiling in the US that could create a technical default on the globally-acknowledged supposedly 'risk free' asset. On the other, we have a powerful slowdown in short-term growth data and UK inflation running at 4.5%, with the Bank of England clearly sacrificing some short-term credibility in order to create some for the long term. Despite these problems, bond markets are performing pretty well. Fund flows into the credit and emerging market sub sectors (hitherto the risky end of the bond spectrum) of fixed income remain robust, and are translating into localised rallies. Corporate results seem fairly good and the credit market appears set to remain strong.
- Volatility in the credit, equity and foreign exchange markets is also surprisingly low. Performances for the year-to-date – for instance within the high-yield market – show virtually no dispersion. That is remarkable. Concerns such as sovereign default seem to be brushed off by the majority of market participants.
- GAM Star Dynamic Global Bond, which launched in early April, is a US dollar-based fund that prospered as the dollar weakened at first. Convertibles and long-dated Brazilian bonds have been performing nicely; Irish debt and Greek debt (under English law], despite modest holdings and significant hedges, have detracted. We believe that Ireland will just be able to avoid a default, as long as every other European country avoids major disruption, which may be a proviso too far. High yield longs have yet to add value.
- The fund owns a lot of credit protection on the European financial sector, as we believe the outlook for that sector remains at best misleading. Banks would have us believe that they are in great shape, but our view is that they have not really sorted out their positions held on an accrual, rather than mark-to-market basis. The protection is not kicking in as we would like at the moment, but we believe it is necessary. Overall, the fund is long peripheral government debt, and effectively short a multiple of the likes of Belgium, Portugal and Austria on the assumption that Europolitics will sustain peripheral Europe for the time being, and that Irish bonds, to mention one country, will recover some recently lost ground. However, if there is an imminent peripheral sovereign default, we believe the financial sector will be severely dented given unresolved risks.

Emerging Markets Fixed Income and FX

Paul McNamara, Investment Director, GAM Star Emerging Market Rates, GAM Emerging Market Rates Hedge Fund

- We believe Greece is effectively bankrupt, but that the consequences of that are likely to be pushed out into the future. There has been much discussion of the 'reprofiling' of Greek government debt. However, our view is that a fully voluntary restructuring will not lead to a sufficient reduction of its debt burden. Although it may nevertheless end up being called voluntary, we expect Greek bondholders to be coerced into a more substantial restructuring process that will trigger a CDS payout. The timing of that could be 2012 or 2013, as Europe appears willing to keep the country afloat for the time being. Although that does not fix the problem for Greece, it brings short-term relief to Portugal and Ireland, and above all Spain.
- The voluntary restructuring of Greek debt might mean that, for example, a 5% bond maturing in 2013 would be turned into a 5% bond maturing in 2018. That would lead to a net present value (NPV) loss, but not a reduction in the total debt burden. We do not know why debt holders would agree to that, as they could just as easily cash in maturing bonds and reinvest the proceeds in five-year bonds yielding 15-20% in the intervening period instead of the 5% on offer. There are mechanisms by which the authorities can coerce holders to agree to such restructurings. For instance, the ECB could refuse to accept non-restructured bonds as collateral for loans, rendering the debt very, very unattractive for a European bank. Such a move would almost certainly trigger CDS and would therefore be considered a default.
- However, there are sufficient numbers of individual bond holders that do not care about the ECB repo facility and would be unlikely to take part in the restructuring process. That would mean a huge subsidy being paid by those who are taking part to those who do not. It would increase the size of the haircuts required and would end up being politically unacceptable. To us, everything points to a broad-based mandatory restructuring in 2012-13. Thus, we would not hold any Greek debt even at the current low prices.
- Some have drawn parallels between a potential European debt restructuring and the issuance of Brady bonds by Latin American countries in 1989. Brady bonds were the result of softer restructuring efforts that did not work. At that time, interest rates were generally much higher and the countries involved were able to cut 8-9% coupons to 2-3% coupons while retaining the nominal value of debt unchanged. Today's situation is different in that interest rates are much lower and typical coupons are 4-5%, which makes it much less effective for countries to lower the coupons.
- In emerging bond markets, we note two key issues at present. The first is the apparent slowdown in the Chinese economy, even if we do not expect a crash. The significant tightening of China's monetary policy in the face of rising inflation appears to have led to a marked slowdown in construction activity in particular. That has implications for commodity prices, which appear likely to weaken a little further. We are not major bears on commodities as such, but find it appropriate to stay out of them as well as commodity currencies for the time being.
- The second issue is the tidal wave of corporate issuance within emerging markets, especially in China. The quality of issuance is very low. The problem with the emerging markets corporate universe is its low levels of sponsorship – demand from the dedicated investor base amounts to just 5 cents for every US dollar of emerging markets corporate debt, as opposed to 70 cents for every dollar of emerging sovereign debt. Demand for emerging corporate debt is strong for the moment, but when sentiment turns, this lack of a dedicated investor base can lead to sharp sell-offs, as was seen recently in the case of a Kazakh bank. We find emerging market hard currency debt relatively expensive across the board, but find that sovereign debt at least has a backstop bid that is not there for the corporates. Hence, we approach the segment with caution.

Source: GAM

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