

The background of the slide is an abstract composition of thick, expressive brushstrokes. The top half is dominated by various shades of blue, ranging from a deep, dark indigo to a bright, light sky blue. A prominent horizontal band of vibrant yellow runs across the middle of the slide. The bottom half features darker, more textured blue and purple tones, with some areas appearing almost black, suggesting a sense of depth and shadow. The overall effect is dynamic and artistic.

# KENMAR

## **FOURTH QUARTER 2010**

### **Market Commentary and Strategy Outlook**

*“We’re in the midst of an international currency war. This threatens us because it takes away our competitiveness.”*

— Guido Mantega, Brazilian Finance Minister, September 28, 2010

*“If rapid fluctuations in the yen harm Japanese firms’ appetite for investing at home and push them to shift their factories overseas, that could further worsen job conditions and affect (our efforts) to overcome deflation. I will take decisive steps if needed from now on as well.”*

— Naoto Kan, Japanese Prime Minister, September 16, 2010.

*“In the present situation it is extremely important that we can have in the framework at the level of global finance and the global economy a strong dollar.”*

— Jean-Claude Trichet, ECB President, September 28, 2010

*“There’s a divergence of analysis between the Chinese authorities and the European authorities. We think the Chinese currency is broadly undervalued.”*

— Jean-Claude Juncker, October 5, 2010.

Clearly, every country appears to be voicing its preference for a weak currency. The flare-up of currency wars is but a manifestation of a deeper underlying problem—anemic global demand and chronic excess capacity. Growing dissatisfaction with trade outcomes is a product of ongoing private sector balance sheet retrenchment in most of the advanced economies. Depressed private investment and secular deleveraging by households that dampens consumption rates in the United States, Europe, and Japan are creating a chronic weakness in demand. Although government fiscal policy has limited the demand shortfall, the measures have been insufficient in preventing dissatisfaction with high unemployment. Moreover, with efforts to restrict deficit spending around the world threatening—or, in some cases, already beginning—to cut further into demand, the problems are only going to get worse. In this environment, some countries’ efforts to help their economies by pursuing policies aimed at improving their trade balances are stoking counter measures and resentment.

The primary benefit of international trade is a higher standard of living made possible by increased specialization. Moreover, although the pursuit of trade surplus is, in and of itself, a zero sum game, international trade is generally a positive sum game. When resources are close to being fully employed, expanded trade is accompanied by greater investment and rising employment. Unfortunately, with the present chronic overcapacity and high unemployment in much of the advanced world, expanded trade will not be accompanied by the usual boosts to fixed investment and employment. They will be seen as beggar-thy-neighbor policies, stoking trade tensions.

Some economists claim that competitive devaluation of currencies lessens the problem of global economic weakness because it involves an easing of monetary policy as central banks lower interest rates or increase the supply of their currency in circulation.

However, while this by-product of currency war may have existed in the 1930s, there is no such effect today. In the 1930s, the gold standard had fettered monetary policy, so abandoning the standard—a de facto competitive devaluation—actually enabled stimulative monetary policy where it was not possible previously. However, today competitive devaluation is unlikely to create much monetary stimulus; in the United States and Japan, monetary policy is already about as easy as it can get and European monetary authorities are not far from that point. Emerging market countries with higher interest rates could ease monetary policy in the process of weakening their currencies by undertaking currency interventions without sterilization, but they are unlikely to do so at this point out of fear of unleashing domestic inflationary pressures and credit bubbles. In fact, China’s renewed large trade surpluses are at least partly a reflection of its desire to combat domestic inflation and credit growth without adversely affecting overall growth and employment.

What we wrote in our last quarterly outlook still holds true now: “For the past two decades free market and free trade had a practically free rein, and politics was on the backfoot in the developed world. When the private sector is expanding robustly, driving growth, jobs and asset price gains, political movements against free markets, free trade and migration gain little traction. Ross Perot’s failed presidential bid in 1992 pretty much marked the apogee of anti-trade movement at least in the U.S. However, the long untrammelled reign of free markets and free movement of goods and people is likely to face increasing resistance in the years ahead. When the private sector is retrenching, unable to generate jobs, create wealth and deliver prosperity and the government is forced to shoulder the burden of propping up the system, it is natural that politics will be on the ascent. People in the developed economies are distressed about their jobs, incomes, homes, wealth and quality of life and they have lost faith in the experts who have sought to explain and address the problems.”

### Quantitative Easing 2.0: Ultimately an Exercise in Futility

*“It is true that monetary policy cannot directly target those parties that are the most constrained. Nevertheless, balance sheet policy can still lower longer-term borrowing costs for many households and businesses, and it adds to household wealth by keeping asset prices higher than they otherwise would be.”*

— Brian Sack, Executive Vice President, Federal Reserve Bank of New York, October 4, 2010

Clearly, the anticipation of Quantitative Easing 2.0 (“QE 2.0”) is having a significant influence on the financial markets. However, for the financial market optimism to be vindicated and sustained, quantitative easing must eventually influence the real economy and significantly alter its course. The excerpt above from the Fed official’s speech reveals the powerlessness of QE 2.0 as currently envisaged, as well as wishful thinking based on the tremendous success of Fed policy in stoking credit expansion and wealth effects over the quarter century leading up to 2008.

Quantitative easing comes in various forms. Done in the context of lender-of-last resort operations aimed at providing liquidity to risk assets—as during the crisis in 2008 and early 2009—it is potent in stabilizing financial conditions. However, currently financial market conditions are relatively stable, and quantitative easing as proposed consists of buying up longer-term Treasuries with the aim of reducing long-term rates. Long-term rates are already at generational lows and it is unclear what another 50 basis points are going to do what 500 basis points of cuts in short-term rates and 300 basis points decrease in long rates have not been able to achieve.

Monetary policy affects the real economy by reducing the cost of borrowing and inducing credit-fueled rise in fixed investment and spending on durable goods. Currently, investment in housing, offices, malls, hotels, and in capital equipment is not being hindered by interest rates but by a massive overhang of supply, the desire of households and businesses to deleverage, and the poor credit quality of a significant chunk of the population. Moreover, the moderate reduction in long-term yields that QE 2.0 may achieve is hardly going to change the price dynamics of housing and commercial real estate such that it significantly alters the collateral level in the marginal properties.

Presently, the biggest stumbling block for the U.S. economy is the poor financial health of vast segments of the household sector. All other problems, such as commercial real estate woes, and state and local financial distress, stem from the hobbled household sector. QE 2.0’s influence on the vast majority of households is marginal at best. Yes, QE 2.0 is having, and may well continue to have, significant short-term influence on the markets but when the real economy shows no follow through, the markets will reverse course. In the end, QE 2.0 may add a whole lot to market volatility and further loss of credibility for policymakers.

## ECB: Successful So Far in Quelling Liquidity Crisis

The eurozone faced a dire outlook following the eruption of its sovereign debt crisis in the spring, and the probability of a financial breakdown and eventual recession was not insignificant. However, actions by the authorities have reduced the risks, albeit not nearly as much as the decline in the popular perception of the danger. Public concern has been assuaged by a string of better-than-widely-expected economic data, especially data showing strength in Germany, which provides a nice look in the rearview mirror and not much else. The eurozone's troubles this past spring raised the question—given the political dimension of the crisis and the lack of precedent—of whether the European Central Bank would prove an effective lender of last resort by acting promptly and without constraint to stabilize financial conditions. Since then, however, the ECB has been forceful in intervening in the sovereign bond markets and providing unlimited emergency lending to banks, especially those in the weaker eurozone countries. The ECB's actions have reduced the risks of a spontaneous systemic financial crisis undermining the economy in the year ahead.

In May, the ECB implemented two separate programs to contain the crisis and to prevent a large scale banking system crisis. Under the first program, announced alongside the multi-billion dollar EU-IMF bailout, the ECB has bought €61bn in government bonds of the weaker eurozone economies since May 10. The second program—an earlier program that germinated in 2008 and was reinstated this year and extended to January 2011—effectively provides an unlimited lender-of-last-resort window, offering banks loans for up to three months. Although sovereign spreads on the shakier eurozone countries remain high and the spreads of interbank lending rates in euros over overnight index swaps are higher than their dollar and sterling counterparts, the ECB's actions have so far been successful in containing the crisis in the European banking system. Thus, the risks of some of the more adverse scenarios triggered by escalating financial instability and the possibility of politically based delays in the ECB's response have abated, at least for a while.

Although the ECB's active bolstering of the banking system has lessened the near-term threats to the region's economy, threats remain, and the "signs of recovery" that have reassured the markets do not reflect a continuing trend. The small recent pickups in investment and consumption are unlikely to last, especially as fiscal policy becomes more "contractionary". Bank credit is not frozen, but is tight, and lending to households and nonfinancial businesses remains weak. Banks remain concerned about capital and future loan losses.

European economic conditions will almost surely weaken in coming months, and the probability of a recession in 2011 is reasonably high. The global inventory bounce and the slowdown in the United States may create serious problems in Europe due to its heavy dependence on external conditions.

## Japan: Private Sector Has Deleveraged, but Confidence is Missing

*“Japan goes from dynamic to disheartened.”*

— *New York Times, October 16, 2010*

In many ways, Japan is a bellwether for the rest of the advanced world. It was the first modern economy to deploy massive monetary and fiscal intervention to cushion, if not combat, debt deflation. That Japan has yet to see the light at the end of the tunnel after nearly 20 years of stagnation is seen by many as a disheartening omen for the other advanced economies. Indeed, Japan holds many parallels for the present travails of the U.S. and Europe, as Richard Koo has noted in a recent book about Japan's lesson for the world. However, pushing the parallels too far has its own peril—there are many unique aspects to Japan's experience that do not easily correspond to the U.S. case.

While it is easy and fashionable to be pessimistic about Japan, few notice that Japan has managed the debt deleveraging process with unemployment never even reaching 6% and with real GDP actually growing. More important, per capita real GDP has grown close to 17% over the past twenty years—hardly a case of collapse.

However, the problem in Japan is that households and firms have become excessively pessimistic, even though private sector balance sheets are relatively healthy and flush with liquidity. The process of cushioning the decline may have prolonged it and by dragging out the adjustment it has fostered a vicious cycle of entrenched expectations of deflation begetting stagnation and in turn perpetuating deflation. Moreover, contrary to popular imagination, Japan's policymakers have been relatively conservative in terms of adopting “unconventional policy measures.” Last but not the least, Japan is experiencing a demographic headwind that is inherently inimical to growth.

U.S. policymakers in contrast to Japan have been far more aggressive early in the game. Consider:

- Japan's bubble burst in 1990 and the Bank of Japan did not lower overnight borrowing rates to below 3% until 1993. Japanese rates were only lowered to zero in 1999, whereas the Fed got to practically zero in less than a year.
- Japan's government was running a surplus until 1992 and the deficit was 2% of GDP in 1993, a swing of 3 percentage points from 1992 and 4 percentage points from 1990. In contrast, the U.S. federal government deficit swung a massive 6 percentage points from 2008 to 2009.

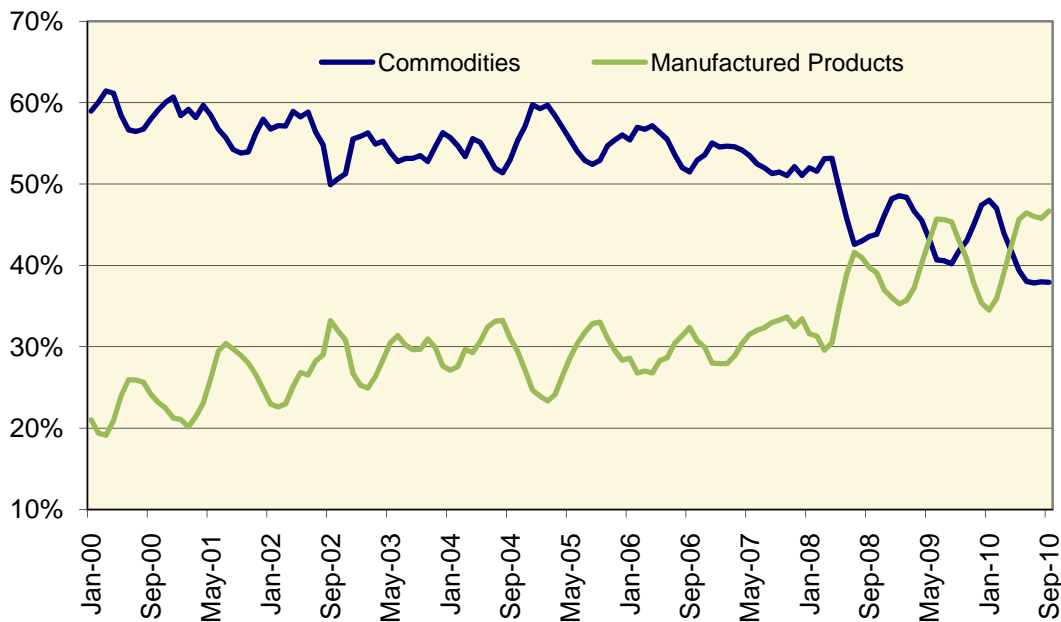
To be sure, the levels of household distress in the U.S. is already far higher than they ever were in Japan. On the other hand, industrial overcapacity is much less chronic and corporate balance sheets in far better shape in the U.S. How the U.S. comes out of its balance sheet retrenchment remains to be seen but looking to Japan for a clue may be a dead-end.

These attempts at deficit reduction, coming at a time when much of the developed world is struggling with high unemployment and financial strains, may largely backfire. If deep cuts are implemented, they will tend to be socially disruptive, recessionary, and deflationary. Falling incomes will undermine tax revenues, increase social transfers, such as unemployment benefits, and render the deficit reduction measures largely self-defeating. In this context, Latvia's example is illustrative. Latvia embarked on an austerity plan under IMF guidance in January 2009. Since then, public sector wages have been cut by about 20%, GDP has declined by a similar amount, and the government deficit has barely budged. Estimates for the government deficit for 2010 remain near 9% of GDP compared with 10% in 2009. The economy continues to contract.

**Brazil: Wary of the Dutch Disease**

Brazil raised the IOF tax on foreigners' investment in fixed-income securities to 6% from 4%, just two weeks after the raised it from 2% to 4%, in a bid to stem the inflow of foreign capital and the rise of the real. Brazil has seen the exports of its commodities surge past the 2008 peak even as its exports of manufactured products remain well below the peaks. As the chart below shows, Brazil has seen the share of manufactured products in its exports decline steadily over the past decade. Given the volatile history of commodities, and Latin America's past economic problems compounded by long bear markets in commodities, Brazilians are rightly desirous of maintaining a diversified export base. They are also concerned about Dutch disease, the dreaded foe of commodity-based economies that results in a loss of competitiveness that arises from an appreciating currency when commodity prices and their exports are strong.

**Brazil Shifts to Commodity-Based Exports**  
% of total exports, 3-month moving average



Source: Ministerio do Desenvolvimento, Indústria e Comércio Exterior

Tackling the Dutch disease is not easy and often requires heavy interventionist measures. This explains why Brazil has already raised the IOF tax three times and it may not be enough. More government intervention is bound to create more volatility in the markets, even as it creates opportunities.

## Investment Implications

### *U.S. Fixed Income*

- Just as the ten-year Treasury bond was showing some sign of wobbling, the expectation of QE 2.0 triggered another rally and sent yields below their August lows. Any further rally will critically depend on the direction of the global economy. If the developed countries appear to be slipping into a recession, bonds will quickly breach 2%. On the other hand, with inflation declining, decent real yields, and little prospect for a significant acceleration in the advanced economies, the scope for a steep rise in yields in the near term is minimal.
- Low topline growth and a strong liquidity profile favor bonds over stocks in the corporate capital structure. The corporate sector's liquidity profile is the best it has been in more than four decades. Firms have used the revival in the corporate bond market to replace short-term debt with long-term debt and thereby reduce exposure to rollover risk. Moreover, free cash flow is near record levels. Although bonds no longer present a great upside potential, the downside in the near term is limited as well.

### *U.S. Stocks*

- One unique feature of this business cycle is that big businesses have captured shares from small businesses, and the trend appears to be continuing. This has enabled corporate profits to register robust growth even as proprietors' income has failed to recover and the broader economy has remained disappointing. Still, with anemic topline growth and margins at or near record levels, it is hard to imagine how the corporate sector is going to keep delivering the earnings growth that the market still expects.

### *Emerging Markets (EM)*

The performance of emerging markets so far this year seems to have done everything to justify investor fervor. Year-to-date through September 2010, EM government bonds are leading the investment returns scorecard, up 14.8%, while the runner-up spot goes to emerging market corporate bonds, up 13.7%. Both these categories beat U.S. high-yield bonds as well as investment-grade bonds, which both returned about 11% to 12%. And they handily beat the 3% gain in U.S. stocks over the first nine months of 2010.

Still, emerging economy financial markets remain tightly coupled to the global economy even if their economies may be increasingly becoming less dependent on the developed world. Thus, the risk of sell-offs triggered by global risk aversion remains a threat.

- EM equities have experienced a steep correction. Still, the risk of further declines cannot be ruled out. Unlike their developed world counterparts, many emerging economies are facing tightening labor markets, increasing wage pressures, and consequently, rising risk of monetary tightening. The long-term outlook for emerging markets remains solid and further steep declines may provide an attractive entry point.
- With sovereign CDS spreads indicating a cumulative probability of default for Brazil in the same ball park as that for Japan, EM sovereign bonds are not cheap. Still, further spread compression cannot be ruled out, given the growing concerns over fiscal sustainability in many developed market economies and the generally solid balance sheet of EM sovereigns.

### *Emerging Markets (EM) – Continued*

- EM corporate credit may offer the best risk/reward at this point in the cycle. Their limited duration means that they carry the least interest rate risk. Moreover, EM corporate bonds are trading at double the spread of similarly rated companies in the developed markets, despite the fact that they have similar capital structures, higher growth potential, and lower leverage.

### *Commodities*

- Commodities are being swirled by powerful cross currents. While all the trade indicators—the Baltic Dry Index, the ISMs around the world, freight data—point to a cresting of the global restocking phase and a moderate weakness in commodities, ultra cheap money and the absence of real investment opportunities in the developed world cannot but be a major positive for commodities. How this plays out remains to be seen. We expect commodities to trend sideways over the next several months even though many commodities may be breaking through to new highs. Looking further, robust EM growth, the continued weakness in supply response, and growing tensions over secure access to resources (note the spat between China and Japan over rare earth metals) is creating the perfect environment for a parabolic rise in commodities. Note on gold: we have always maintained that the key to a more bullish gold outlook will be a serious weakening in the confidence in the dollar. Whether that is happening or not, the market perception is that the Fed is signaling a willingness to provide practically unlimited dollar liquidity.

### *Currencies*

- Expectations of QE 2.0 are driving the dollar down, but even before QE 2.0 began to be anticipated by the markets, the dollar was weakening thanks to a stream of soft U.S. data coupled with stronger-than-expected data out of Europe. Europe outperforming the U.S. late in the cycle is usual, and the euro tends to strengthen with it. Recall that the euro peaked in mid 2008, well after the U.S. recession was underway. True, the ECB's purchases of sovereign bonds has stemmed the growing fear in the interbank markets and quelled doubts about the ECB's ability to deal with liquidity crisis. Still, the medium- and long-term outlook for the euro is anything but sanguine.
- Emerging markets, such as Brazil and India, are beginning to experience widening current account deficits and are loathe to see their currencies strengthen further, especially as long as the renminbi shows no major appreciation. Chinese moves to let the renminbi appreciate significantly could relieve the pressure on other EMs, but it remains to be seen how China acts.

*The following section details Kenmar's outlook for various hedge fund strategies.*

QE 2.0 is being seen by many as carte blanche for buying any asset except the dollar. Practically every asset and every currency, including the "über"-bearish yen, has rallied against the woeful greenback in recent weeks. Yet, the rising correlations within and across asset classes, the risk-on, risk-off binary financial market pattern, and declining volatility are all hardly indicative of healthy financial conditions. The financial landscape is strewn with landmines—fiscal problems in the eurozone, state and local debt woes in the U.S., global trade tensions, adverse regulatory changes and geopolitical flare-ups. Flexibility and nimbleness remain paramount.

Kenmar remains focused on liquid, trading-oriented strategies and prefers smaller, more nimble traders who have the ability to navigate quickly if the situation so demands. Asset/Liability matching has always been a key feature of Kenmar's allocation process. We believe that this will continue to be a critically important aspect to consider when evaluating strategies and managers. Not only does Kenmar strive to ensure that the liquidity of the managers in which we invest matches the liquidity that is offered to our investors, we strive to ensure that the liquidity offered by the managers is appropriate for the underlying investments in their portfolios. This asset liability framework is critical to our ability to honor redemptions without imposing gates during periods of major market dislocations.

### **Global Macro**

Global macro managers have had a modest year thus far. Still, given the major influence of macro forces, the environment continues to be unusually conducive for global macro managers.

**Conclusion:** We believe that global macro funds are not only a good line of defense but perhaps the best way to play offense in a rapidly changing environment. We are selectively looking to add macro managers that complement our current exposures.

### **Managed Futures**

High correlations and powerful see-saw moves suggest that markets are increasingly becoming technically-driven. In fact, the performance of both momentum and mean-reversion traders has improved in the past few months. The environment will increasingly generally favor technically driven strategies as flow factors predominate fundamentals on a day-to-day basis.

**Conclusion:** Managed futures should continue to have an important role in our portfolios as the strategy has historically offered protection during market dislocations and opportunity as a standalone investment.

### **Commodities**

The commodity space is showing significant dispersion—many markets are breaking through to new (or multi-year) highs while others remain range-bound, largely reflecting differing fundamentals. Greater dispersion will create more opportunities for alpha extraction from fundamental knowledge.

**Conclusion:** While we are still believers in the secular bull market in commodities, we remain mindful of the possibility of corrections. As such, we are careful to maintain a balance of strategies, styles and investment tenors in our portfolios.

### *Long/Short Equity*

Kenmar has an eclectic approach to long/short equity strategies. We recognize that, given the enormous breadth and depth of the global equity markets, there are numerous potentially successful ways to generate attractive return streams from this marketplace. Generally, we prefer allocations to low beta strategies where the intent is to extract only alpha from the long and short sides.

**Conclusion:** At present we are generally avoiding significant market beta exposures and prefer managers with low net exposures. We look for managers with comparatively smaller assets under management who can be nimble. We also believe that shorter-term and event driven trading strategies can be profitable in the present market environment, as opposed to longer-term fundamental strategies.

### *Diversified Arbitrage*

The pedigreed managers that Kenmar employs in this space have performed well in 2010. The current opportunity set is not as attractive as it was last year when pricing divergences were extraordinarily wide. Moreover, the low implied volatility and increasing correlations are not very good portends for this strategy.

**Conclusion:** We will continue to be very selective in picking funds in this space, as few managers have distinguished themselves over the past two years. Moreover, experience, infrastructure and pedigree are essential and rare in this sector. Finally, our experience has shown that smaller managers can stay more focused on their core strengths and may be more nimble in the event of market disruption.

### *Fixed Income Arbitrage*

Greater fixed income volatility combined with a steeper yield curve is generating more trading opportunities with short time horizons and requiring far less leverage than historical norms. Since we focus on experienced managers with strong risk controls, our performance in this sector has been very strong in 2009-2010. Going forward we are interested in slightly macro leaning fixed income managers that have demonstrated an astute awareness of the market environment. With significant opinion dispersion in economics, interest rates and the removal of market liquidity measures, the environment remains fertile for the sector.

**Conclusion:** We have added G-10 fixed income relative value managers that may benefit from central bank activity, increased fixed income volatility and a steeper yield curve.

### *Convertible Arbitrage*

The market has snapped back so far so fast that the strategy is not as attractive as it was even a few months ago. If history is any guide for convertible arbitrage, we should see a more normalized environment, relative to 2008/2009, for the strategy in going forward. A consideration is the role and availability of leverage in the coming year and we are less interested in allocating to managers generating returns from increased leverage.

**Conclusion:** We are reviewing some prospective convertible arbitrage managers that have traded well through this volatile period and may increase exposure to event style convertible managers.

### *Merger Arbitrage*

We have renewed interest in the strategy as the current environment is one where top line growth is difficult, cost-saving measures have been enacted and corporate cash levels are high. We should see a much improved deal flow environment.

**Conclusion:** We are reviewing some potential candidates to add in this strategy.

### *Fixed Income Asset Backed Securities*

The agency mortgage and credit sensitive markets both performed quite well in 2009-10. Government programs to improve liquidity have had a noticeable impact.

**Conclusion:** We have reduced our exposure to some very profitable managers because we believe that the upcoming environment will be less favorable to their niche focus and have invested with managers that have demonstrated strong trading skills in the sector.

### *Distressed*

Distressed has performed solidly thus far in 2010. Defaults are expected to drop from their peak levels of the cycle, but there remains plenty of potential supply for distressed participants thanks to prior issuance of low rated corporate debt and challenging growth environment. As companies struggle to improve the top line while many have acted where possible to improve the bottom line, a great number in the sub investment grade universe are reliant upon rolling existing debt.

**Conclusion:** We are currently underweight distressed and are monitoring the strategy with an eye toward the more liquid segment of the market for a potential candidate that meets our preferences and liquidity requirements.

### *Long/Short Credit*

Liquidity has returned to the credit markets and the corporate bond issuances have been strong. As the refinancing window is open, corporate defaults are declining and rating agencies see much lower default levels by the end of 2010. Given the record free cash flows, credit indicators are likely to show ongoing improvement. Moreover, the structural changes in the economy continue to drive dispersion in inter- and intra-sector performance, creating good opportunities for long/short credit managers.

**Conclusion:** There are attractive risk-adjusted returns in the sector with managers that are able to trade from both the long and short sides. Selection of appropriate funds with matched time horizons in their asset-liability structure is important.

### *Emerging Markets*

While the economic outlook for emerging markets is looking increasingly solid, equity returns are much more subject to international investor sentiment and capital flows. The potential for a wide variety of shocks to affect investor flows makes chasing EM beta not particularly appetizing. On the other hand, alpha-centric emerging market strategies were among the few strategies to turn out consistent positive performance in 2008 and also show robust performance in 2009. They represent a more durable investment strategy.

**Conclusion:** We have identified a group of EM fund managers that apply more sophisticated strategies and have shown the ability to take advantage of the increased opportunities for hedging and shorting in the EM space. We expect to increase our exposure to EM in the coming months.

### *Volatility*

We consider managers in the volatility space to be tail protection for the portfolio and a sensible insurance policy. While volatility has plummeted, we believe that an extended period of low volatility is unlikely. From this perspective, we seek managers that have a relative value approach to the sector and do not lean heavily in one direction.

**Conclusion:** We reduced our exposure from our prior levels and are comfortable with our allocation in this sector. We continue to monitor the sector for attractive portfolio additions.