Baldwin Investment Management, LLC

<u>IN SEARCH OF ALPHA</u>

"The sky is falling! The sky is falling!" shouted Chicken Little, fluttering about and flapping his wings vigorously, declaring that the sky was falling. Like Chicken Little, negative nabobs who forecast years ago that the markets had to go down finally have had their day in the sun. Why did the markets have to go down? Simply because they had not done so for too long a time according to these "nervous nellies". A correction was needed but no one could point to a cause for the potential set back. Nevertheless, there had to be one in order for the world to keep spinning on its axis. Luckily, the Chinese at the Shanghai stock exchange heard our pessimists' plea and decided to help markets around the world. On February 27th, Shanghai fell by approximately 9% and a global cascade began.

Investors Seek Safety of Treasurys

China-Triggered Selloff Damages Junk Bonds, As Dow Drops 416.02

Made in China (Then U.S.)
Stocks' slide in China is captured on a "green" screen (above). Hours later, as stocks fell in the U.S., Dermot Clancy talks on a phone on the NYSE floor.

S&P 500	**-3.5%**
DJIA	**-3.3%**
NASDAQ	**-3.9%**
SENSEX 30/(INDIA)	**-1.3%**
RUSSIA RTS	**-3.3%**
BOVESPA/(BRAZIL)	**-6.6%**
FTSE 100 (UK)	**-2.3%**
IPC ALL SHARE (MEXICO)	**-5.8%**
10 YEAR U.S. TREASURY	**+0.8%**

Why did it begin in Shanghai and why did it spread to London, Paris, New York, Mexico City or Tokyo? It started in Shanghai because several corporations which went public in mainland China several years ago had their lockup agreements finally expire. These were agreements which forbade already existing shareholders (i.e. Chinese government entities) from quickly selling their stock soon after the companies went public. After several years of superlative stock market performance, and with the shareholder agreements expiring, several of these government entities decided to take advantage of the situation and lock in some profits – seemingly a very natural reaction. These entities did not entirely liquidate their holdings. They simply took some money "off the table" by selling shares. So the rumble started in Shanghai, a market where Americans are not really allowed to participate and echoed around the world. So what does this seemingly rational (i.e. take some profits) isolated market reaction in a small marketplace have to do with the rest of the world? The simple answer is nothing. A fundamental answer is nothing. A sentimental answer might be that some now are perceiving the glass to be more empty than full.

Over the past couple of years we have had other incidents of such broadbase corrections. In the Spring of 2006, very similarly, the markets gave up all that they had gained earlier in the year. During such episodes, there seems to be very little value in diversification – because all markets go down. According to Merrill Lynch, the Russell 2000 index of small American companies has had a 94% correlation with the S&P 500 over the past five years. International stock markets have shown a 95% correlation with the S&P 500. Most startling of all was Merrill's finding that hedge funds have recorded a 94% link with the S&P. Even real estate has correlated to the stock market to the tune of 81%. Why is this happening? Some would posit and we would agree that world liquidity must play an important role in these results. With the sea of dollars coming out of the Far East (i.e. China and India) and the Middle East (i.e. Saudia Arabia, Kuwait, etc) the first stop was the biggest, most liquid market in the world, the U.S. Treasury market. After driving down yields there, investors sought higher returns in "riskier assets". Thus institutions like endowments and pension funds moved over to real estate, pushing yields down there. The next stop was emerging markets and emerging country bonds. Ultimately, with the yields shrinking everywhere some of the more " sophisticated investors" (i.e. hedge funds) decided to "juice up" their portfolios, borrowing in very low yielding currencies (think Japanese Yen) and buying higher yielding pieces of paper (think Brazilian or Icelandic bonds) and creating what is called the "carry trade". This last group of investors (hedge funds) are not a patient sort, however. Their charter in life is absolute returns and to lose no money. Consequently when a trade begins to go against them they very quickly reverse course and sell out. This is unlike much more patient money which can withstand even long periods of time when certain assets underperform, because their timeframe is more long term. So perhaps the new investment environment is one where there are relatively long periods of calm with asset prices marching upwards nicely. Then "out of the blue" comes a catalyst which promotes a cathartic correction – unnerving investors all over the world.

If this is the case, then where do investors find Alpha, or out performance? Where can one find shelter from the storm when all markets are going down? Recently the only safe haven has been the U.S. Treasury market – because it is safe and it is liquid. As investors are not fearful of inflation, they did not rush to embrace commodities. So it would seem that the place to find Alpha is the world's safe harbor of U.S. Treasuries – the yin to the yang of equity markets. It is good to have balance!

ON TO JAPAN

Mentioned above was the development of the "carry trade" which has as its epicenter the Japanese loan market. Over a number of years investors have shorted the Japanese Yen by borrowing money in Japan and then converting that currency into another and investing the proceeds in high yield markets around the world. This has been a very profitable business and has lasted a great deal longer than many thought it would. The primary reason for the longevity of this particular trade has been the fact that Japanese interest rates have been at such extraordinarily low levels (i.e. 0%, .25% and now .5%) for an extended period of time because Japan suffered through what many would describe as a depression for nearly 10 years. Real estates prices went down. Food prices went down. Wages went down. Asset values across the board went down! In order to get the economy jump started, the central bank of Japan decided it had to utilize a radical strategy and drop interest rates to zero. Amazingly, the cheap money did not have much effect for quite a period as Japanese consumers were just too scared to buy anything. Finally as fortunes improved, business picked up and some inflation (which is not a bad thing when moderate) was reintroduced to the Japanese economic system. As a result of this improvement, the Bank of Japan decided to increase interest rates and did so in two jumps – with the rate now being at 0.50%.

Some pundits have worried that any increase in Japanese interest rates would have an immediate currency spillover effect, increasing the value of the Japanese Yen which would be very damaging to the carry trade. Why? If an investor borrowed in Japanese Yen and the Japanese Yen appreciates versus the currency which the investor has invested in, then the investor would at some point have to liquidate his investment and repurchase more expensive Japanese Yen to close out a deal. No doubt some day Japanese interest rates will be attractive enough that investors will rush to Japan to invest in Japanese securities. That time has not yet arrived – nor do we feel it is around the corner. The government in Japan is very leery of any increase in interest rates which might damage the Japanese economy and it has put political pressure on the central bank of Japan not to increase interest rates too rapidly. The Bank of Japan has acceded to this point. Recently, statistics out of the government suggest that inflation in Japan is still not worrisome and in fact there are still hints of deflation remaining. This would seem to argue that the central bank will not be in any rush to increase interest rates, which probably means that the Japanese Yen will not be shooting up any time in the near future. At the end of the day, this is good news for the carry trade because investors will not have to worry about unwinding positions. This is also good news for various higher risk investments in which the carry trade investors have put money, because it means those investments will not have to be sold which could create havoc in the marketplace if everybody rushed to the exit door at the same time. So we do not believe that the carry trade is going to get unwound at this level of Japanese interest rates. At substantially higher interest rates, there certainly is that risk. But, it would have to be at substantially higher interest rates.

PREDICTIONS FOR 2007	**COMMENTS**
1. The dollar will slowly slide versus the Euro & Yen	Yes vs. the Euro – No vs. the Yen
2. The Fed will reduce interest rates in second half of 2007	Still looks correct
3. President Bush will become a dealmaker in working with Congress	Some evidence
4. Oil prices will settle at “around” $60/BBL	So far
5. Japan’s economy will continue to gather steam along with rest of the world	Yes
6. Inflation will not be a worry	Yes
7. The U.S. consumer will continue to spend	Yes
8. Corporations will spend more	Have been – but some signs of hesitation
9. Housing will stabilize in 1st half of 2007	Still think so
10. The U.S. stock market will go up but not at the 2006 pace	Still believe

A FINAL THOUGHT

"Don't feel so bad about this. I'll give you a receipt for tax purposes."

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