



Investor Letter – February 2011

Comments on Recent Market Developments

We believe that the events in Japan in the near term are quite deflationary and as such we have seen a strong dose of risk aversion as well as a move into fixed income. This comes on the back of many market players positioning aggressively for inflation by way of either commodities or shorting bonds. We think the reversal the last few days shows that many of the more crowded positions in these assets have been cleaned out. Longer term however we feel that the events in Japan will be “inflationary”. We put this in quotes because while we believe that the world suffers from demand deficiency, we also believe that central banks are willing to print money with relative abandon. Our view is that the events in Japan will mean that policy makers will likely assume they need to maintain a fairly aggressive expansionary policy stance. Unless the events in Japan have a real medium term global economic impact, at the margin we think this will only push many of the aforementioned inflation trades back to or beyond where they were before the earthquake. Most particularly, for an already cheap Japanese stock market that is down over 12% this year, we see panic as creating opportunity.

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We are reinvesting capital into a few areas that we will discuss briefly below.

1. We think the Nikkei trades at generationally attractive levels. We understand that Japan has real problems (we had the CDS trade in for this reason) but there are many great companies in Japan and the country now has one of the cheapest stock markets in the developed world even when one adjusts for lower returns on equity. The panic selling in recent days has created an opportunity for us to begin building a large position in the space. We feel that our job is to over allocate capital to areas of value and technical dislocation and this area checks both boxes. In the beginning of the year Japan's equity market screened very well to us (their debt market screened the worst) and as such we were ready to pull out our checkbook when this situation presented an attractive entry point.
2. We think the Koreans are near and medium term beneficiaries of the events in Japan. They compete aggressively with many Japanese businesses and in some ways Japan's loss is Korea's gain. Further the strong Yen favors Korean exporters. Moreover, Korea is running a very loose monetary policy for a country that will likely heat up even further. If oil prices come down a bit (Korea is a big importer as percentage of GDP), then the trifecta is in place. We are paying rates at the five year point as the rate has collapsed the last few days even though we feel the medium term outlook may be better for Korea than it was a few weeks ago. For many of the same reasons we put on a similar trade in Taiwan.
3. We have discussed soybeans and corn with many of you in the past. Our research efforts here stretch back over nine months so we will not bore everyone with too much detail but needless to say the positioning became very crowded. This selloff has taken care of that problem and corn and soybeans are down 9% to 12% recently. For us the situation has not improved at all and we are using the selloff to size up these positions in option form.

We are happy to chat with any of you but we wanted to give a brief update and let you know that the recent volatility has finally provided us an opportunity to start increasing our favorite positions that were not nearly as attractive a few weeks ago.