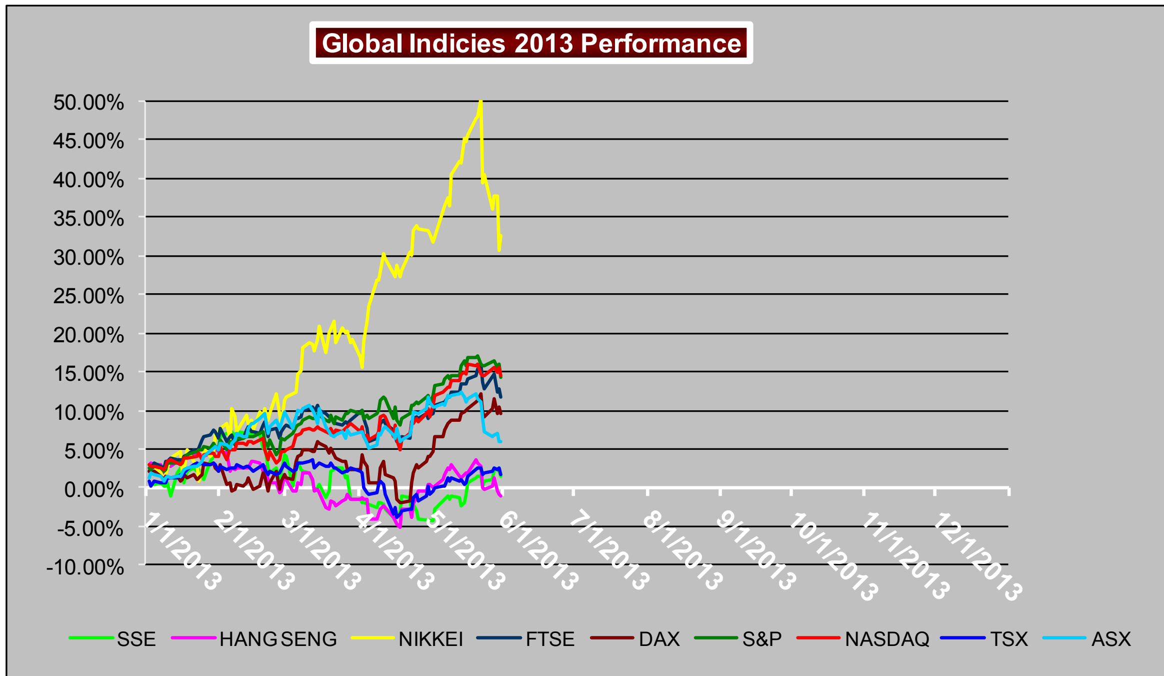
GDB June 2013 Newsletter

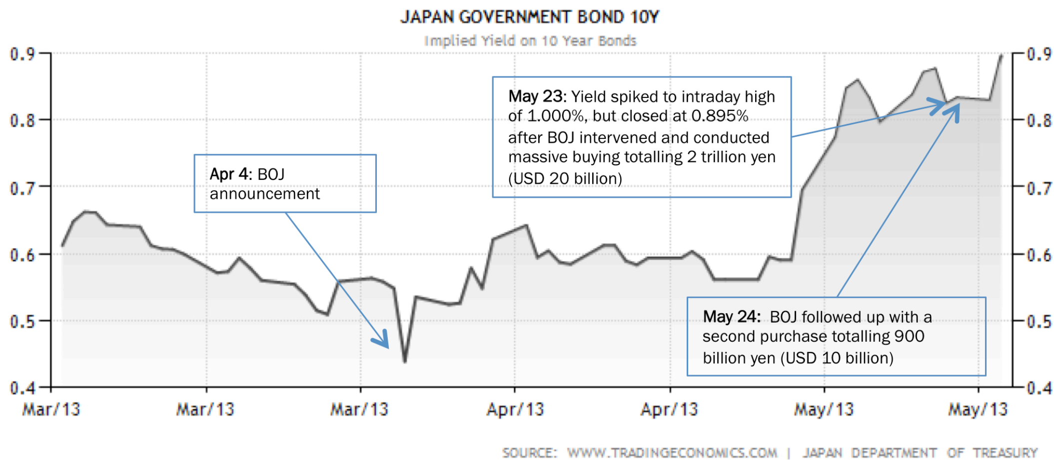
Monthly Market Summary:

2013 May Market Activity		
SSE COMPOSITE	*2,300.59*	+122.68 (+5.63%)
HANG SENG	*22,392.16*	-344.85 (-1.52%)
NIKKEI 225	*13,774.54*	-86.32 (-0.62%)
FTSE 100	*6,583.10*	+153.00 (+2.38%)
DAX	*8,348.84*	+435.13 (+5.50%)
DOW	*15,115.57*	+275.77 (+1.86%)
S&P 500	*1,630.74*	+33.17 (+2.08%)
NASDAQ COMPOSITE	*3,455.91*	+127.12 (+3.82%)
ASX 200	*4,926.60*	-264.60 (-5.10%)
TSX COMPOSITE	*12,650.40*	+193.90 (+1.56%)
TSX VENTURE	*965.83*	-3.42 (-0.35%)



Investment Themes:

During the month of May, activity in Japan again drew our attention. This time, it is the spike in the yield of 10 year Japanese Bond (JGB). After Bank of Japan's (BOJ) unprecedented monetary easing announcement on April 4, we saw the 10 year JGB yield initially dip to an intraday low 0.315% on the following day, but instead of heading lower like the BOJ hoped it would, the yield reversed and headed steadily higher until it hit an intraday high of 1.000% on May 23. The BOJ then decisively intervened by injecting a massive 2.9 trillion yen (USD 30 billion) on May 23 and May 24 in attempt to tame the volatility. Relative to the size of the economy, the BOJ intervention would be equivalent to the Fed buying USD 90 billion in treasuries in just two days.



For our readers who are not familiar with bonds. A spike in yield is inversely correlated to bond price.

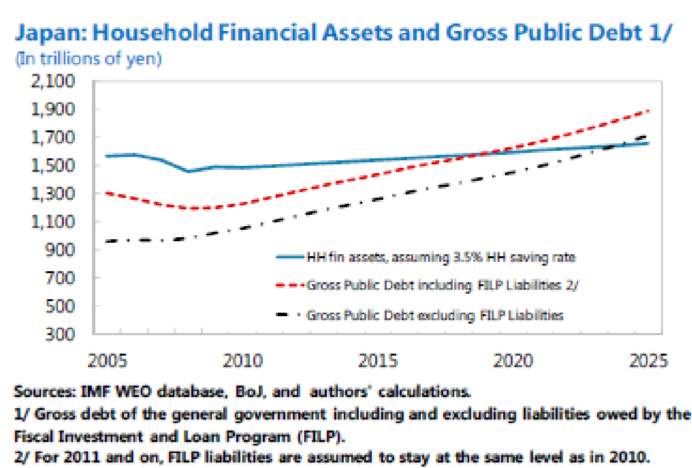
$$\text{Yield} = \text{coupon amount} / \text{price}$$

A rise in yield is the result of reduced price in the security given the same coupon payment, and a decline in yield occurs when the price of the bond rises and coupon stays the same. For investors already holding a bond, a rise in yield is negative, but for new investors the increase in yield is attractive.

The rise in JGB yield is counterintuitive initially since BOJ has pledged to inject USD 1.4 trillion into the economy via massive asset purchases including JGBs to try to inflate the economy to a target of 2%. More bond purchases translate to higher demand for JGBs which should increase its price and bring down yields. We see the market initially responded to the announcement in such fashion as the yield dropped from 0.559% the day prior to the announcement to an intraday low of 0.315% the day after the announcement. Then what we believe caused the reversal is that the market participants actually realized what BOJ set out to do is contradictory. On one hand BOJ wants to introduce inflation which puts upward pressure on fixed income yield (investors in an inflation environment demand higher nominal yield to offset inflation); on the other hand, its asset purchase program is artificially trying to suppress the yield. At 2% inflation, a 0.315% yield would mean a negative real interest rate of -1.685%!

Over the long term, we do not believe the BOJ can keep the yield artificially low. There are multiple market forces that lead us to draw such a conclusion:

1. ***Aging demographics.*** Despite Japan's high level of public debt estimated at USD 12 trillion, the high domestic ownership of JGBs provides key support for stable and low yields. The household sector has been financing more than half of JGBs directly or indirectly through banks. Going forward, with its fastest growing aging population in the developed economies, Japan's household surpluses will decline. This will translate to diminished capacity for the household sector to absorb new debt and put upward pressure on JGB yield.



Sources: IMF WEO database, BoJ, and authors' calculations.
1/ Gross debt of the general government including and excluding liabilities owed by the Fiscal Investment and Loan Program (FILP).
2/ For 2011 and on, FILP liabilities are assumed to stay at the same level as in 2010.

2. ***Corporate sector supply declines.*** If the BOJ stimulus program proves effective, more corporate spending will be channeled to capital investments and spending. The reduction in corporate surpluses will result in lower demand for JGBs. However, the incremental tax revenue from private sector spending should offset some of the debt servicing burdens and additional debt financing.

3. ***Japanese financial sector shedding JGB exposure.*** Japan's banks hold huge chunk of JGBs on their balance sheet. If yields rise, the value on their portfolio can take a significant hit. Since the BOJ has openly committed to purchase JGBs to artificially inflate demand, this is a perfect opportunity for the Japanese banks to unload JGBs to the government to reduce exposure.

4. ***Inflated domestic equity market.*** The relentless rise of the Nikkei of late makes investments in stocks more attractive. Asset allocation from debt to equities will further erode demand for JGBs and cause yields to rise.

Following the above analysis, to reach market equilibrium, the yields on JGBs must rise. However, this equilibrium is temporarily distorted by BOJ's aggressive monetary intervention. Japan's public debt is 230% of the nation's GDP. At this level, it is one of the most over leveraged countries amongst the developed nations. What is more worrisome is that the size of Japan's gross debt is 2,700% of the countries annual tax revenue. So if the yield were to go higher, imagine the additional debt servicing burden that will be placed on the government. So it is in the government's best interest to artificially keep the yields low so it can meet its current debt servicing obligations and minimize any rollover risks on new issuances.

In the short-term, we can already guess BOJ's hands from their recent actions. Prior to the latest asset purchasing announcement, the 10 year JGB yield is at 0.559%. This tells us that BOJ originally intended to suppress the yield at least at or below that level. On May 23 and May 24, when the yield spiked to 1.000%, we saw massive intervention taken place which hints us to believe that BOJ ideally would not want the 10 year yield to rise above 1.000%. So in the short-term, we can put a floor of 0.559% and a cap of just over 1.000% on the 10 year JGB. We would long the 10 year JGB when the

yield is at or above 1.000% to front run the BOJ before they conduct open market purchases to drive down the yield. And when the yield is at or below the 0.559% level, we will turn around and short the JGB.

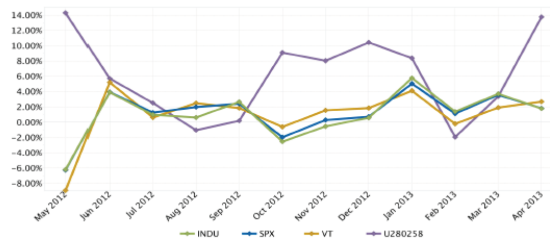
Over the medium to longer term, we do not believe BOJ's patch solution will resolve Japan's debt problem. Unless real fiscal policy adjustments are made to boost real economic growth that leads to healthy tax generation, the government will face enormous risk of an imploding bond market.

Investment Opportunities:

1. Sino-GDB Fund

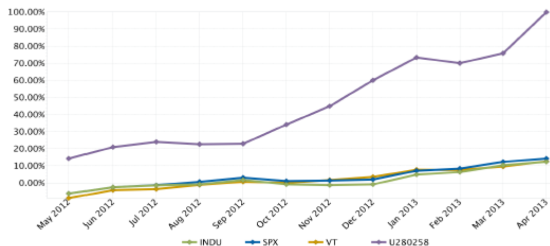
Fund managed by GDB Capital. Event-driven investments using hedging strategies and combinations of long/short positions in equities, futures, and commodities and their derivatives. Fund targets gross pre-tax IRR of 20% per annum, and returned 107% in 2012. Minimum investment US$100,000. GDB will insure against investment losses up to 5% of investor's original investment. Following are the benchmark comparisons of GDB Fund performance against the major US Indices.

Time Period **Benchmark Comparison**



Date	INDU	SPX	VT	U280258
May 2012	-6.21%	-6.27%	-8.93%	14.32%
Jun 2012	3.93%	3.96%	5.23%	5.73%
Jul 2012	1.00%	1.26%	0.63%	2.53%
Aug 2012	0.63%	1.98%	2.48%	-1.03%
Sep 2012	2.65%	2.42%	1.87%	0.18%
Oct 2012	-2.54%	-1.98%	-0.60%	9.12%
Nov 2012	-0.54%	0.28%	1.55%	8.03%
Dec 2012	0.60%	0.71%	1.86%	10.43%
Jan 2013	5.77%	5.04%	4.11%	8.38%
Feb 2013	1.40%	1.11%	-0.19%	-1.94%
Mar 2013	3.73%	3.60%	1.91%	3.37%
Apr 2013	1.79%	1.81%	2.68%	13.77%
Average	1.02%	1.16%	1.05%	6.07%

Cumulative **Benchmark Comparison**



Date	INDU	SPX	VT	U280258
May 2012	-6.21%	-6.27%	-8.93%	14.32%
Jun 2012	-2.52%	-2.56%	-4.17%	20.86%
Jul 2012	-1.55%	-1.33%	-3.56%	23.92%
Aug 2012	-0.93%	0.62%	-1.17%	22.64%
Sep 2012	1.69%	3.06%	0.67%	22.86%
Oct 2012	-0.89%	1.02%	0.06%	34.07%
Nov 2012	-1.42%	1.31%	1.61%	44.84%
Dec 2012	-0.83%	2.02%	3.50%	59.94%
Jan 2013	4.90%	7.17%	7.76%	73.35%
Feb 2013	6.36%	8.35%	7.55%	69.98%
Mar 2013	10.33%	12.25%	9.60%	75.71%
Apr 2013	12.31%	14.28%	12.54%	99.90%
May 2012 to Apr 2013	12.31%	14.28%	12.54%	99.90%