Investment Strategy For a Crumbling World, Update and Rant

It is a sad state of affairs when the markets (populated by rational investors (we hope)) look to politicians for direction. In Europe this is a futile affair. The French seek a Socialist and egalitarian solution while the German's baulk at paying for it. Perhaps it is the French experience from the Treaty of Versailles and its consequences for the debtors that advise them. Perhaps it is that same experience that drives the Germans. Either way, there is no consensus, and there is much confusion among the politicians and regulators. From these, the markets hope to find direction. Good luck. Europe seems in a bind. Inflation has been persistently high while economic growth slumps. There is a word for that sort of thing. The ECB is caught between Scylla and Charybdis. Even as the Eurozone economies falter, banks teeter on the brink, and people take to the streets to protest home made austerity, the DNA of the ECB cast in the fires of the Weimer Republic, remain hawkish on inflation.

In the US, between a foundering Fed and an increasingly partisan Congress, (no comment on the President), the Senate still managed to gird itself for a potential trade war with China, precisely when the US is most reliant on exports and indeed export data seems to be improving. In the meantime, the US economy which has been in recession for the past year may be bottoming, yet the efforts of politicians continue to confound a real recovery.

Apart from the US, the rest of the world seems to be stewing in the heat of inflation, due in no small part to the US Fed printing money furiously to try to cushion a sagging economy. Such inflation confounds monetary policy which needs to be looser to spur economic growth out of its current slump. Fortunately the inflation pressures in the emerging markets have shown some signs of moderating which have given central banks some room to ease.

Banks. On the one hand governments require banks to be the open conduits of credit, to aid and abet the economic recoveries they try to engineer, and on the other, their regulators require them to hold more capital and to be more conservative of their capital deployment. Utter confusion and chaos. The financial condition of banks remains unknown, in some cases to their own CFOs. The fractional reserve banking system is more efficient than it is robust and established risk mitigation metrics and methods can seem naïve in crises. A bank levered 10X only requires a 10% variation in asset values to wipe out its capital. Marking assets to market or fair value can be more than inconvenient to a bank. The market now frets about European banks' exposure to poor credits such as Greek, Italian and Spanish sovereign bonds, whose variation in value could pose a threat to banking solvency.

Sometimes the best investment advice one can give is to do nothing, or to do very little. As described above, markets are seeking direction from politicians and regulators who are themselves as clueless as the rest of the market. Market realized volatility has surged. Returns dispersion has also risen significantly. It doesn't take a big position to move the needle on the P&L. It is not the time to make big bets.

At the same time, the indiscriminate selling, the schizophrenic swings in the markets, the manic depressive sentiment rippling from every meeting of the Eurozone, the Fed, the BoE, the ECB, has led to clear mispricings in asset markets. Arbitrage is available; if only investors didn't demand liquidity on an hourly basis. But then if investors were patient and rational, arbitrage opportunities probably wouldn't exist. Arbitrage is the result of fearful, greedy, panicky, 'trembling hand' investors, sadly the investors that many an asset gathering hedge fund or arbitrageur is trying to raise capital from… And around and around it goes.

Today, I would do relatively little. I would use sharp drawdowns to pick up assets on the cheap, but be aware that more downside is always possible and even probable. I would be seeking out the arbitrage opportunities, but fully aware that mark to market volatility is always a risk, albeit not one that I have to crystallize if I understand what I am doing. I would be trading small risk capital tactically until clearer trends emerge. I would not be taking long term directional investment bets. Not until the P&L from my short term trading tells me that a trend has taken hold. The arbitrage book is more systematically built; it is accumulated whenever dislocations occur and left to ripen in the back pocket. In the meantime, the politicians may fiddle while Europe burns…