

Burnham Banks Q&A 2018 01

Markets did very well in 2017 and are off to a very strong start for 2018. Are you happy with conditions?

The economy is as strong as it has ever been in the last 10 years. We've had bouts and pockets of strength but the current expansion is as broad as it is deep. Europe is growing at a rapid pace, America is growing at a stable pace. Developed markets growth is surprisingly strong. Emerging markets have shrugged off trade worries and commodity markets are rising.

It doesn't seem to matter that the Fed is raising rates and shrinking its balance sheet, that the ECB is not far behind, that the PBOC is increasing regulation and curbing credit expansion. There is widespread optimism.

Conditions look very good indeed. Is there anything that causes you concern?

Markets are driven by inflexions and rates of change, not by levels. A synchronized expansion is vulnerable to change, to a country or region slowing down, to a deceleration. General conditions are so good now a deterioration will elicit a stronger response than an improvement.

We spent the last 10 years being cautious and facing a European crisis, a China stock bubble, various turns of QE and then its taper, all manner of political turmoil – mostly yet to be resolved, and what we got was a raging bull market. What will optimism bring? The market has not been this bullish since 2003, and before that 2000. It was right to be in 2003 but not in 2000. In 2003 it was coming off a recession, in 2000 it was coming off a high.

Valuations are high in both equities and credit. They only

look reasonable in the context of low interest rates. If interest rates climb, financial assets could look very expensive indeed. Since we have a correlating factor, a common factor, the risks certainly have risen. You have to get your interest rate call right.

Financial market performance has correlated quite well with the monetary accommodation of the Fed, the ECB, the BoJ in the last 8 years. The Fed is done with QE, the ECB could be done with it soon. We will soon discover how dependent financial markets were on QE. I suspect they were but nobody knows for sure until we reverse the experiment.

There is a small risk that inflation reacts perversely to interest rates according to the Neo Fisherian view. If so, the Fed could be creating inflation with its rate hikes. In any case, inflation could pick up as base effects take effect. Also, commodity and in particular, energy prices are rising. If inflation rises significantly it could change the interest rate outlook on which so much hangs.

So we should be taking risk of the table?

The market can stay irrational longer than you can stay solvent, said a great man. I wouldn't underestimate the power of the herd and currently the sentiment is with the bulls. Markets over shoot when they rise and when they fall. They've already overshot reasonable levels but there is momentum and the overshoot could go further.

Buy some protection. Options are cheap at the moment and it makes sense to remain long the market, but buy some put protection. If you are a value investor, there is no value in sight except for the options market. Implied volatility is not realized volatility, it's the market's best guess of what the realized vol will be going forward and it is acutely low at the moment.

As for fixed income, I'd certainly be hedging duration. The market is probably underestimating the determination of the Fed to normalize and raise rates. It's also probably underestimating the potential for inflation to rise as well. With the breadth of the economic growth we are experiencing, I wouldn't be betting on lower EUR or JPY rates either. Credit is another matter. The corporate bond market is as tight as a drum and there is certainly very little value there. If you want to invest in credit you have to find cheap conduits, cheap vehicles, to access corporate credit, and there just aren't that many.

We hear that equity valuations are near historical highs and credit spreads are extremely tight. Are markets really expensive?

In absolute terms, equity markets are very expensive and credit markets are acutely expensive. You can find cheaper access vehicles to credit but you'll have to accept some complexity and illiquidity. There are pockets of value in ABS, in particular in RMBS. But generally markets are expensive. The only way to justify valuations is to compare them to sovereign bond yields. It's cold comfort because all that says is that sovereign bonds are even more expensive. Further, it means that one should expect markets to be very sensitive to the sovereign bond market and to interest rates.

So in summary, general conditions are healthy, good even, but markets are expensive and investors are complacent. Is that a fair characterization of the market? How would you invest under these conditions?

I think that sums it up quite well. That the underlying economy is growing is a comfort, so one should be long the market, not short. That markets are expensive means you should

be cautious and therefore look to buy put protection. There are some fairly valued markets around such as the US mortgage market, but you can't have all your eggs in one basket. Banks and financials are cheap, and facing a more forgiving regulatory outlook. And if you have to buy something expensive, it better be growing fast, so selected emerging markets like India, or Vietnam, some turnaround economies like Japan but you don't want to over pay for pedestrian growth just because that economy happens to be in a cyclical upswing. It has to be a more durable growth than that.

But caution means you will miss some upside and some opportunities. If you are unwilling to miss out, you have to capture all the upside, you will inevitably capture a good part of the downside, when it comes. If you are lucky, the end comes late and you will have compounded a sizeable return by then. If the end comes soon, then, not so lucky and it will take some time to recoup losses. It depends on how reliant you want to be on luck. There's certainly an element of it in everything.

Tell us what you make of Bitcoin and all these crypto currencies. A fad or the real thing? Will they last and are they worth that much?

Honestly don't know. And yet, they have strong parallels to fiat currency. Fiat currency, the USD, the EUR, have value because an authority said so and we accept that it is so. Cryptocurrencies have value because a group of people say so and because sufficient people accept that it is so. Bitcoin is too volatile to be a medium of exchange because no one would ever pay with it as it is rising. Its not really a good numeraire since its value changes by so much in so short a time. It is a good store of value because it's been rising but the since late Dec 2017 till mid Jan 2019 we've seen a lot of volatility. If you paid 18,800 USD for a Bitcoin, you're store

of value has fallen by over a quarter and then rebounded some. Is it a fad or will it last? I really don't know. There will be insufficient coin to facilitate trade as long as the speed of mining is artificially handicapped. It's tempting to say that cryptocurrencies aren't real, that their value is arbitrary or dependent on the greater fool, but the same could be said of fiat currency. Perhaps the greatest thing about cryptocurrencies will be what they teach us about our perception of the financial assets and objects which we are so familiar with. Familiar to the point that we fail to examine them objectively.

What are your best investment ideas for 2018?

A portfolio is not just a collection of investment ideas. At all times a portfolio should be constructed so that it has the desired exposures and diversifies or hedges away unwanted exposures. I am invested in US mortgages, residential and commercial. I have non agency exposure and I have agency CRTs as well. I have a little emerging market hard currency credit exposure, not currency or duration exposure. I access corporate credit through CLOs which cheapen the access a little and also provide better diversification and credit enhancement. One of my main themes is banks and I have a significant exposure to bank's contingent capital, especially in Europe. The result is that the credit book is quite risk on. What little duration there is is hedged not with swaps or futures but with long bank equity positions. Beyond a hedge, I expect banks to outperform the broad equity market and so have a significant overweight position. I am optimistic about India and Japan and am overweight their equities. Tech may come under pressure from increased regulation so I am underweight. The equity allocation is roughly neutral but I own put protection as implieds have been cheap and it makes sense to

own some vega. I have a tactical trade in a 2 and 30 USD curve steepener betting on the flattening of the curve being overdone and inflation being underpriced. I'm watching the Italian elections closely to see if there might be an opportunity to buy BTPS against shorting bunds.