Investment Strategy For a Crumbling World Nov 2011

The beginnings of a proper recovery are emerging in the US driven by exports and the repatriation of manufacturing. This has not yet but will soon translate into jobs and wage growth which will revive investment and consumption. The government can help this along by lowering marginal tax rates and simplifying the tax code, but hopes of rational government are always and everywhere wishful thinking.

The risk to this recovery lies with China and the emerging markets which represent the USA's export markets. US consumers remain cautious and as a result emerging market exporters remain disadvantaged. China's economy still relies on investment and government expenditure on infrastructure to grow. There are signs that the extraordinary credit creation to finance this infrastructure investment may be leading to a bubble on the edge of bursting. Until or unless that happens it is business as usual. China builds, prints, the West like Germany and the US supply capital goods and technology.

Expect this to be a long term phenomenon with any credit crisis in China, hard landing or soft that it may precipitate, a temporary set back.

For equity investors this is merely a continuation of a trend which has lasted the last 2 years, of rising globalized companies with exposure outside the US and struggling domestic businesses.

The same theme is mirrored in the emerging markets with exporters to the developed world continuing to struggle while domestic businesses flourish.

The Euro is no longer a risk. The damage lies in plain sight. Any solution leaving Greece in the Euro is no solution and should be sold into. Italy is a different mess. It suffers more from a crisis of confidence than of real insolvency, although of course the solvency of a sovereign, unlike that for real businesses is almost entirely a matter of confidence. The European banks are likely collectively and individually insolvent but markets have lived on thinner myths before. Again there are rich pickings of European based or listed companies with Lat Am, Asian or MENA exposure.

The US and European equity strategies remain the same as for the last couple of years. The emerging market equity strategy needs some adjustment. Where previously in Asia it paid to be long domestics and short exporters, things are no matter that simple. Chinese banks are at high risk. Chinese domestic companies will face a dearth of credit. If as expected the government starts to ease policy on the back of inflation easing up, it may start a broad based rally. But these are more tactical positions. There is no clear long term position to take in China. Elsewhere in Asia, inflation remains persistent, although there may be some respite from the turmoil in Europe and the weak growth in the US. Don’t forget that the call on a recovery is a very early signal and current indicators remain weak. Resource rich countries in Latin America and the Antipodes will likely continue to benefit from China’s voracious appetite for resources. With its exports still weak China will continue to build. This could confound the technical risk-off view on currencies like AUD.

Until further notice a rational strategy for equities is to maintain a trading stance with the old position of being long developed world exporters and short domestics. The emerging market strategy will be highly tactical shorting consumer goods exporters. Shorting banks all over the world might make academic sense but the propensity for governments to ban shorting when their banks are decimated make this a risky trade.

Fixed income has to be traded tactically as well. Its no use shorting PIIGS debt any more. An unstable ECB policy and the uncertain fate of the EFSF make buying or shorting Euro debt highly risky. US treasuries will remain the market of choice for risk on risk off trading. The curve is likely to remain flat or flatten as the Fed executes Op Twist. But the credit quality of the US is not great and US treasuries have basically become PIKS so even this trade is a game of chicken.