Investment Strategy for a Crumbling World

A Crumbling World

I think the market agrees that the Fed has no more bullets left. The curve is flat, rates are near zero, mortgage rates are low, and still the economy is weak.

The mortgage market is broken so no matter how low interest rates are prepayments are slow and the transmission of lower rates through to household wallets doesn't work. Is the market right in its indictment of the Fed and the government? I think it is.

I think the market agrees that the Euro doesn't work, at least not for everyone and is voting Greece and possibly Italy or Spain out of the Euro. That governments are not heeding this vote is creating turmoil. The market is also voting that Greece eventually defaults and that bailouts will ultimately fail. Is the market right? Again I think it is.

As the highest up the food chain the US and Europe are important to the emerging market's listed economy. And emerging markets on that basis are voting against any easy or quick recovery in the developed markets.

Are there patches of strength in the global economy? Emerging markets domestic economies appear to be fine. This is reflected in market prices of developed world companies exporting to emerging markets as well as emerging market domestically exposed companies. Is the market right? I think the market may be underestimating the risk in emerging markets.

Emerging markets have primarily been export economies. Since developed world consumption and thus demand for emerging market exports was decimated in 2008, infrastructure spending, a form of fiscal stimulus, has replaced exports as the engine of emerging market growth. Domestic consumption remains weak. Conspicuous consumption, however, is a different matter. Crossing borders, the divide between rich and poor has grown and remains persistent. This has been reflected in the market prices of luxury companies. Returning to infrastructure spending, this has been financed out of credit. A big dollop of it. Let’s hope the liabilities match the assets. In China for example, in the 2.1 trillion USD SIV like Local Government Funding Vehicles, they do not. At some stage there may be a need for the federal government to backstop the funding. This will swell the public balance sheet in quick order.

The world has seen roughly 7 years of plenty, OK, slightly less. Its payback time. Literally. And this is without even considering the underfunded status of many a corporate, or government pension plan, or social security, or public medical insurance. Its mostly looking pretty bad.

So what can we do in a world that is crumbling around us? We could buy gold but even that has its risks depending on what form the exposure takes. And buying gold is a bit of a cop out. You buy the most useless material because everything else is crumbling. Surely there are more intelligent ways to turn a profit.

Trading

Uncertain markets exhibit volatility. Often, though not always, this volatility can be traded. The problems in the world are colossal. And solutions exist. However, governments will always seek to convince the people that less painful and less protracted solutions exist than actually do. When markets are persuaded by these devices, they rise, and when reality bites, they fall. The ability to read when governments lie and when they tell the truth is helpful. So is the ability to read the psychology of the herd. Markets are voting mechanisms after all. Knowing how to manage risk and how to manage one’s own emotions are important in trading. This is not the time for dogmatic investing unless one has the long term capital and appetite for pain to do so.

Secular trends

- I do believe that the inequality of income and wealth will tend to increase up to a point of discontinuity. It is the primary motive of humans to gain at the expense of others. The concept of relative welfare is not lost on our species. And since we are defined by our intelligence, the bulk of human ingenuity is dedicated to increasing inequality. Inequality is only addressed as a constraint, which in the breach results in revolution. Buy luxury businesses.

- Inflation is another secular trend. Not the kind measured by CPI but the real kind that captures the debasement of fiat currency. The scale of debt in the world today needs not only to be paid down but to be eroded by inflation. Human ingenuity will be deployed to engineer an acceptable or undetectable inflation. This is the case for buying the useless yellow metal. It is so useless as to be priceless; it cannot be priced for its marginal product in any useful production. It is just the alternative to paper money which is devalued in its oversupply. TIPs and curve trading can also be used to express a view on inflation.

- Invest in the shadow banking industry. The banking industry will henceforth face increased regulation more commonly applied to utilities. Expect ROEs to converge to that of utilities. Yet economic growth needs more desperately than ever to be financed by innovative means. The private finance arena will pick up the slack. This means venture capital, private equity, hedge funds and asset based lending. While the private finance industry will not escape regulation entirely, the regulation is of a different nature, and will not impair their ability to generate robust returns over the long run. The logic is the following: Banks are not just providers of credit, they are the safe custodians of the assets of the masses. This safe custody aspect is what will limit their ability to continue to generate high ROEs. Provision of credit remains crucial to economic growth and the world needs economic growth. The shadow banking industry provides an alternative financing route for growth and will achieve the ROEs that banks used to achieve when regulation was less draconian.

Short term opportunities

- Convertible bonds have been acutely weak and represent good value both outright and hedged. Some Asian issues are trading wide of the straight bonds and CDS presenting arbitrage opportunities. While valuations have not approached late 2008 levels, they are attractive. They are likely to get weaker though so the window for execution is fairly wide.

- Capital structures are heading for dislocation again. Senior versus subordinated arbitrage opportunities are beginning to appear where a trade can be constructed with positive to non negative carry while having positive jump to default. Even where a pure arbitrage is not available the relative pricing between senior and subordinated liabilities is such that implied recoveries and default rates are inconsistent across capital structures. Relative value intra issuer trades are presenting very attractive risk return opportunities.

- European equities are presenting very cheap exposure to emerging markets. I like scavenging in distressed equity markets. Europe is replete with companies that do significant proportions of their business in the relatively resilient emerging market economies and yet may have been sold down due to misunderstanding of where those companies' risks lie. Companies which sell to China, India and Latin America but who are listed in Spain, France or Germany are attractive risk return opportunities.

- The US yield curve is pretty flat, particular at the long end. The curve is likely to continue to flatten over all sectors, even with the short end pinned at close to zero. Bank buying provides the base line demand and periodic panics when investors realize that governments are in less control than they (both) think, provide the rallies.