

Second Quarter 2013: Investment Thoughts

The first quarter of 2013 has ended with risk assets mostly higher than at the end of 2012. It would seem that the optimism that greeted the new year was well placed. Indeed many of the problems in the world have been solved, patched or postponed.

The big picture remains very much the same as it had been in the past 4 to 5 years. A credit bubble had been inflated with inflated collateral. The bursting of the bubble was precipitated by falling collateral values which led to a nasty feedback loop exacerbated by excessive leverage. So acute was the problem that governments were forced to step in and bail out the bankrupt, meaning mostly the lenders to the borrowers whose collateral was no longer sufficient to cover their debts. Most of this collateral was residential real estate. The impact was a retrenchment in consumption and thus profits and thus investment and thus employment. These were the effects on the private sector. For the public sector, bailouts are not free and as a result fiscal positions were severely impacted. This meant questions about sovereign solvency which were answered by successive rounds of debt monetization, an apparatus quite indistinguishable, and conveniently so, from quantitative easing, a perceived lesser evil.

With the private sector largely bailed out, a real economic recovery has taken place in most places except where structural impediments have confounded efforts by the private sector operating in market economies to heal themselves. No where is this more apparent than Europe, where the Euro suppresses price discovery and coupled with sticky prices in some markets, such as the labour market, result in a failure of such markets to clear. Elsewhere, the healing takes place,

at least in the private sector. The public sector, however, languishes in a risky state of uncertainty and personality disorder.

Absent a strong ideological compass, public sector policy has been pragmatic, itself a laudable quality, but lacking conviction, lacking vision and ultimately, lacking firm theoretical basis.

Where government is weak, indecisive, divisive and chaotic, the private sector has moved on. Some reservations remain, which may constrain longer term investment, but by and large, market mechanisms allow the private sector to move on. These economies correlate with poorer fiscal positions and lower growth.

Where government is more pervasive, invasive, authoritarian and has historically been relied upon to lead the private sector, recovery is slower, less firmly entrenched or unbalanced. These governments, correlate with countries with better fiscal positions and higher economic growth.

A caveat over the government finances. If bank balance sheets are hard to read, country balance sheets are mostly indeterminate. Strong accounting standards can mitigate some of this risk but mostly the problem lies not in accounting standards but in risk management. If either the intention or the ability to manage risk is compromised then so is the endeavor.

The desperate throes of the developed markets' central banks in their efforts to support their sovereigns, revitalize their moribund economies and inflate away the public debt has led to a number of side effects. Most of all, the expected inflation has not surfaced at home, but rather has manifested abroad, where economic growth is less somnolent. In a world with open capital accounts, this was bound to happen.

Globally open capital accounts and having a currency widely

used as a reserve asset together make for effective quantitative easing / debt monetization. It affords the central bank good control over the entire yield curve. Relaxing any of the above assumptions endangers this thesis. Widespread recognition of this phenomenon may also trigger vigorous resistance, most likely by a limited restriction of capital mobility, hopefully not much worse.

A global economy also spawns global businesses or global companies. When investing in businesses, whether it be in their equity or debt, sweeping macro considerations are best replaced by the bottom up analysis of the multinational, multiregional nature of these companies.

This does not mean that macro investing is not useful. However, the tools of macro investing are more often than not currencies, interest rates and sovereign bonds. Equities cross too many borders to yield to macro analysis. Real estate, whether its equity or its debt, is also another highly locally driven asset class. But here, the line between macro and micro is nothing more than a factor of magnification.

Very often, what is and what should be do not converge. This is often a source of opportunity. The Euro is an interesting example. Its use to the investor lies in its inefficiency and inappropriateness. Forcing a single currency upon a region with differing factor productivities and sticky prices must create imbalances which tend to gradually build and then break. This creates trading opportunities for the astute investor with an eye for fundamentals and a sympathy for the rhythm of market psychology.

A more fearful divergence lies in the very model of our economy. Capitalism. Mathematically elegant, it has become diluted and perverted, by the absence of a nemesis, ever since the fall of Communism. Moral hazard taints all capitalism today. The asymmetric treatment of gain and loss invalidates all the mathematical underpinnings of efficiency of production

and allocation under a free market. The arbitrary bailouts mounted by central banks and governments have only served to enhance the reputation of interventionism and big government. Government involvement in an economy should only be to provide contingent measures when the free market is unable or unwilling to supply a good or service. Yet current public opinion, and indeed, the opinion of conventional economists, is that governments need to do more. This has serious repercussions in the longer term. Understanding the motivations of economic agents and macro economic behavior will require new models and new insights.

Finally, before I sign off, there is still a vast amount of debt which remains to be repaid, defaulted upon or inflated away. So far, it has just been moved about and refinanced in rather creative ways.

There are some specific strategies that arise from the above:

Overweight companies with intellectual property and brands. These are more easily found in the US and Europe. They will confound their own countries' macroeconomic ills.

Buy the US housing recovery. This continues to be best expressed through the non agency mortgage backed securities market.

Avoid Chinese financial risk. The Chinese shadow banking industry is not bad for being a shadow banking system but for its opacity and the resultant difficulty of assessing the priority of claim. The risk that any default or run on the system could turn out to be disorderly is high. By extrapolation, one should be cautious of any associated risks in the real economy and its businesses.

Overweight hard duration in developed markets like US, UK and Germany. Inflation created by QE is surfacing in emerging markets where one should expect yield curves to steepen relative to

developed market term structures.

Overweight the USD. The trade position of the US has changed for the better. While the Fed continues to operate QE, so does the BoJ, BoE and the ECB. At the same time, China isn't exactly tightening monetary policy and is accumulating debt at an alarming pace.