

This Protectionist, Mercantilist, Non-Cooperative Landscape.

You can't have your cake and eat it. The economy is a complex system and like most systems it has a number of variables or parameters. Some of these you can control. Others are the consequence of what you control. It isn't always possible to choose all the controls and consequences. Choosing a bunch of controls automatically render other variables as consequences. Some variables are mutually exclusive controls. Attempting to arbitrarily define sets of controls and states, either by design or accident often leads to unintended consequences.

Hedge funds have been some of the most successful money makers since hedge fund records have been available. Since 2008, even the best managers with long track records have stumbled. Things just don't work the same way as they used to anymore.

The approach to solving the problems that continue to ripple from the 2008 financial crisis is an example of trying to have your cake and eat it. The Euro is a specific example. You cannot have a single currency and expect to have convergence in factor prices. Not unless you have a convergence in factor productivity, economic policy and political and social ideology. You might be able to get convergence in interest rates or other factor prices but you will need multi currencies since exchange rates will automatically become system determined variables. (An interest rate peg, how interesting. I wonder how many crazy ideas we can conjure up.)

So far no one has been able to profit from the Euro crisis. Why? In a recession when credit default rates rise, distressed debt funds are able to step in to assume risks that other investors cannot or will not. The rule of law, chapter 7 or

chapter 11 in the US for example, guides the process and assigns the rights and obligations of the different claims. There is no equivalent law or regulation governing countries who default. Neither is the balance sheet of a country sufficiently defined that one can value a country let alone one of its claims. Investing in distressed sovereign debt is thus risky and highly uncertain business.

The investment landscape has become doubly difficult. Pre 2008, fundamentals were fairly straightforward, and once they were estimated, investor behavior was fairly straightforward as well. Markets have always been moved by investor psychology and how it interprets fundamentals. But now fundamentals have become dependent on more than just commercial realities and cold rationality. As the economic pie has shrunk so strategic concerns have increase in importance. The world has become more protectionist and mercantilist as peoples and their leaders seek to avoid loss and disadvantage. Hedge fund managers who have found their fundamental approach to investing confounded point to increased macro risks. This can arise from strategic policy impacting macro variables in unexpected ways which in turn impact industry conditions. As the world adjusts to this new reality, so too has the psychology of investors changed. The same information finds different interpretations. The problem for traders is that the prevailing interpretations are just not what they used to be. Investors are reacting differently to how they used to react to the same pieces of information.

The minor question is, how do we invest and profit from this new reality? We have seen relative value strategies in infinite duration assets fail miserably while arbitrage strategies within capital structures in finite duration assets have obtained encouraging results. Arbitrage it seems is the only safe play, and as we all know, arbitrage is rare, difficult to identify, difficult to implement, and often requires pre-defined gestation periods.

The bigger question is, as policy attempts the impossible, what are the consequences? Can a debt bubble induced depression be solved by the creation of more debt? Can fundamentally insolvent organizations continue to fund themselves ad infinitum? What is the final solution to the problem of excess debt?

Even more fundamentally, is today's capitalism capitalism? Will the rolling legacy of moral hazard ever be addressed?

PS

Government Policy Put.

Governments the world over, in an effort to avert recession and disaster have written government policy puts (QEs, LTROs, Optwists) in such vast notional size that their negative gamma must be killing them.