Investment Strategy In a Crazy World April 2012

The erratic path taken by macro economic data and by asset prices such as stocks, bonds, commodities etc are the confluence of long, medium and short term cycles. The long term cycle took a turn in 2008 and remains decidedly poor.

A substantial relief rally in 2009 and an LTRO and BoJ morphine induced rally in the last 4 months do not indicate a healthy global economy. They are indicative of a poorly global economy, one which is over-levered and still in the process of being de-levered, which policymakers have kept afloat by further credit creation, much like putting a fire out with gasoline, and infrastructure build in emerging markets. The long term picture is the following: we have collectively spent more than we earned and created a disproportionately large hoard of debt which will need to be paid down over time. Given the strange way we measure and account for GDP, credit creation adds to GDP growth and now as we reduce the size of the global balance sheet, credit destruction will detract from GDP growth. The long term is therefore fairly simple to understand and remains gloomy.

Does the short or medium term cycle reinforce or contradict the long term cycle? Large scale debt monetization and fiscal reflation can and has buoyed the economy and asset markets for short periods of time and can be credited for the local bull markets in 2009, 2010 and 2011. The last significant reflationary policy was the 3 year LTRO operated by the ECB in Dec 2011 and Feb 2012. The liquidity injection has supported sagging asset markets and indeed propelled some of them to local highs. This is likely to have run its course.

The economic recovery in the US which took everyone by surprise, and which began in Sep 2011 if you were watching closely, was triggered and driven by exports which indirectly can be traced to the infrastructure binge undertaken by China as its export markets dried up. China's credit driven infrastructure binge is over. This will reveal local weaknesses in the Australian economy, weaken demand in the resource economies, and with a lag, depress the US economy once again.

Long Term Prospects

- The long term trend in economic growth is weak.
- A significant part of this is due to the need to de-lever stretched private and public balance sheets across the globe.
- Asia's balance sheets are not as healthy as many believe if shadow banking statistics are consolidated. That is, off balance sheet credit creation has been more than we understand it to be.
- The West will be in savings mode for longer than many expect. Also, the West will evolve into export economies while EM countries evolve into consumption economies. This will put upward pressure on the USD.
- An international shortage of USD and the lack of external demand for US government debt will likely place upward pressure on USD interest rates. A 30 year bull market in bonds is likely over.
- Risk is likely to decline generally as carry trades and leveraged investments decline due to rising costs of debt.

Medium term view:

- Equities remain cheap but valuations are sensitive to bond yields. Equities are therefore vulnerable. High yield is also vulnerable on both duration and spread bases. The risk reward in any case is poor. Sell.
- Carry trades are riskier now than ever since the mark to market impact on borrowing short and lending long is likely to be negative. Pull in duration.
- China's economy is slowing and will have global impact via commodities. Sell.
- China may not have room to lower interest rates as much as the market expects due to food price inflation. Don't count on a rally in Chinese stocks.
- Commodities likely to suffer from a slowdown in China.
- Prospects for a US QE3 rise but it is not clear how the Fed will expand its

balance sheet. The most likely asset is US treasuries. This could delay rising rates. Sell receivers.

- The ECB is likely to be done with its QE. Sell receivers.
- BoJ has begun its cycle of QE and Japan equities likely to outperform.
- USD likely to strengthen against majors as well as EM currencies.
- USD curve to steepen relative to EUR, GBP and JPY curves.

Who knows if the above will work out. But here I can time stamp my own expectations. And this serves me more as a aide de memoire than anything else.