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Investment Letter: 12th March 2012

January's rally continued into February as a greater portion of the investment community applied a greater proportion of their assets aboard the equity market rally.

Our short term thesis (that is, for the rest of the year) is that three broad macro influences need to hold sway to sustain the mood. First, Europe must continue to skip over its reckonings and elongate its crises, so that they are not conflated into one deflationary bust. The communion of private sector creditors in relation to the swap and write-down of Greek debt is one such hurdle cleared. Debt crises, however, present many periodic challenges with repayment dates springing forth like Dementors in a Harry Potter tale.

Secondly, China must fulfil a requisite notion of a soft landing of its economy. It is hard to be definitive here, but there are clear signs of strain in official policy: the *volte-face* in credit provision we reported on last month and, more recently, the decisive halt, and perhaps reversal, of the strengthening bias of the Chinese currency versus the USD. Both are the product of incontrovertible evidence of weakness in broad aggregate activity.

Thirdly, the improvements in US activity need to continue to broaden and culminate in growth in aggregate credit. We are no particular fans of the statistical end of economics as it pertains to investment markets – most leading indicators are nothing of the sort, more like lagging, or coincident at best. That said, we note that the recent rate of improvement will prove difficult to sustain – a chart of the aggregate surprise index shows that the rate and level of surprises tend to top out at two standard deviations above the mean, and that is where we are today. A slide from these elevated levels does not imply that the news becomes bad, just that the rate of improvement has cooled. If so then the rate at which equities (US equities in particular) are being rerated upwards might also slow.

We shall keep tally of the relative and aggregate contributions of these three areas of influence as we expect them to form the song sheet for the rest of the year.

Telescoping forward to a more appropriate investment horizon: the next three to five years, we return to the broad observation, held by us unprofitably for some time now, that mainstream government bond markets provide extraordinarily poor value at their current levels. Nominal bonds (and inflation protected bonds where they exist) imply a loss of value in real terms at current prices. Given our view that core Central Banks will continue to press the button on unorthodox monetary policy as long as credit growth remains in abeyance and unemployment uncomfortably high, and thereby take some risks on inflation, bonds present a set of unwarranted threats.

We argue that either the bird-bath shaped recovery takes gradual hold, and bond yields slowly rise to reflect this, as Central Banks sell down their holdings, or the fissures in credibility begin to open up and the adjustment is much quicker. Either scenario presents a losing proposition for the bond investor. The scenario pitched against these two is that, if the threat of debt cannot be offset, a more broad deflation or Japanese-style disinflation takes hold, perhaps in conjunction with policy failures or policy constraints.

If we hold to this balance-of-probabilities, favouring an inflationary outcome, then long term investors in equities will fare better than predominantly bond or cash investors. Whilst not being entirely ironclad against sudden or catastrophic inflationary adjustments, they offer better inflation protection.

Not that the looking glass is clear. A sober assessment of global conditions point to a range of estimates of growth potential that has low nominal growth at the upper end of expectations. It is indisputably true also that corporate efficiency, in terms of margins, is at a modern day high. Labour is weak, finance charges are low and could not be lower. What is more, the earnings cycle lacks any oomph. Combine the macro with the micro and we will probably need an upward rating shift in equities to bring in much more than the dividend rate of growth in the next few years. Having been a valuation-oriented strategist whilst stationed in Asia, this writer is wise enough not to offer predictions on this front. All that can be said is that if, at the end of the year, the equity portion of our portfolios are rated more highly than at the beginning, we shall pack that into our Christmas pipes and smoke it after the feast, and not before.

Recent portfolio inflections have been more gradualist than revolutionary.

Target weightings to gold have been reduced somewhat. Although gold has claim to defensive capacities in both deflationary and inflationary environments we rather think that the most recent part of its 12 year bull-run has been underpinned by negative real interest rates and the eventual shift to normalisation will prove exceptionally difficult for gold investors. Normalisation, in any normal sense, should be accompanied by improved economic fundamentals and rising interest rates, both at the short and the long end, developments that we think will prove inimical to gold. The timing of this remains hazy.

We have begun to reduce somewhat exposures, where they exist, to currency pairs based strategies and extraneous currency overlay activities. Post 2008, we developed the view that currency investment would be a source of profit as fault-lines developed in the world. The main fault-line would be, according to our thoughts at the time, between emerging and developing countries with emerging recording superior growth rates that would be also reflected outperforming currencies. A second fault-line then opened up between the Anglo money printers (UK, US) and Germanic budget cutters (Eurozone). However, making money on both a weak or strong euro scenarios has proved to be hard yards for the specialists. Further confounding the picture has been a series of interventions, the Swiss against the franc and most recently the Japanese against the yen. As referred to above, China has just chipped in to this competitive race to weaken their currency.

The intended consequence of these confounding interventions is to remove oxygen from the currency based investors' bell jar, resulting in a reduction of capital from the area, lower than expected volatilities and hence lower profit opportunity. It appears to have been successful. The FT reported last week that "volumes in the world's multi-trillion foreign exchange market have

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dropped to six-year lows, as nervous investors have shied away from trading the euro and central banks have continued to maintain a tight grip on the value of their currencies."

The topical chatter in markets last month was dominated by a seeming change in policy by the Japanese: adding Y10tn to their asset purchasing programme and revealing a target to attain a positive inflation of 1%. In short order this has added five whole numbers to the USDJPY cross rate and lifted the TOPIX by +7.9% since the announcement on February 14th. Not surprisingly, Japanese equity specialists have been getting the hot flushes again. Although our approach to multi-asset class investment does not over-emphasise country selection over the other major decisions: asset class selection, asset class weightings, manager selection and security weightings, neither is it absent. Our equity weightings have emphasised the US in the past two years but US equities now look relatively pricey. We have excised broad US exposure in favour of more narrowly defined mega-cap quality and diversified globally: into Japan, into Europe, into Asia. As mentioned above, these are incremental moves, not wholesale shifts.

James Spence
Managing Partner

Cerno Capital Partners LLP 34 Sackville Street, London, W1S 3ED
Telephone +44 (0) 20 7382 4110 Facsimile +44 (0) 20 7382 4122 Website www.cernocapital.com