CERNO CAPITAL

Investment Letter: 5th April 2013

Most UK based equity investors with geographically diverse holdings should have reason to be happy with quarter-end valuations. A portfolio invested in developed world equities, simply following MSCI weightings, would have generated a good return, provided there was no currency hedging back to GBP. A 50% weighting to equities on this measure would have returned +7.7%.

A similar effect was obtained from investing in UK large cap stocks: a 50% exposure to FTSE 100 was worth +4.9% in sterling terms over the quarter.

Cash investors with no exposure to equities but 50% exposure to the USD will have enjoyed a +3.3% gain on translation over the quarter. Sterling was weak against all majors bar the yen, so all forms of currency base diversification were helpful. A slide in the international value of sterling was the principal topic of discussion in March, until a nasty taverna punch-up kicked off in the Eastern Mediterranean.

On sterling, comments have been made from all points of the compass: political – as a reflection of Labour's likely win in 2015, monetary – as a means of anticipating further loose policy under a new BoE governor, economic – as no more than just deserts for an economy that is flat lining.

Our own analysis is somewhat more phlegmatic and leads us to think that the "maxi" bit of a maxi-devaluation may not be on the cards. Context matters. We find it *more* difficult to explain the upward re-rating in sterling's Real Effective Exchange Rate (REER) that took place between 2009 and 2012, than its recent puncturing which has brought back into a closely described range with other major exporting blocs.

While we do not have a forecast for sterling's rate at this year's end or next, we invest globally and this activity is natural dollarisation. Hitherto, we have enjoyed the effects of holding some investments priced in the world's reserve currency. Henceforth, we can contemplate the prospect of the dollar gaining strength under its own footing. First because signs abound that the US economy may be approaching selfsustaining mode, secondly on account of a pronounced shift in the US' energy import requirements and consequent recalibration of its trade balance.

Whilst we are prone to invest sympathetically to this trend, we have one gimlet-eye fixed on its negative consequences. Then as now, these will be felt most keenly in the emerging world. As emerging currencies tend to float up with a strengthening dollar, it exposes their external sectors. If dollar strength is met by local currency weakness, either by natural processes or by fiat, it will undermine the fundamentals of emerging bond markets. This in turn could stimulate money outflows, creating further weakness. At the epicentre of this possible maelstrom lies the country with seemingly the most stable currency regime and external financing position: China.

Not so long ago some investors spoke of China's currency as delivering 4-6% over the USD per annum on a reliable basis. In the past five years, the currency has moved a good deal less than underlying manufacturing costs: re-pricing has taken place within the economy.

The power of the great economic narrative of our generation has faded. China’s legendary reserves are not so redoubtable as they seem.

Two weeks have elapsed since the flash-point of the Cyprus crisis. We might expect other startling events and information to come our way. The resignation of a Finance Minister may come to be seen as one of the more prosaic occurrences.

There are numerous discussion points stimulated by Cyrpus’ crisis, but two issues keep throbbing away like an Achilles strain. It is hard to defend the consideration of abrogation of the €100,000 deposit guarantee that was thought of as a pan-euro, indeed pan-EU, safeguard. Cyprus’s own President may have been the proposer, but Troika members were present and sanctioned this as part of the first attempt at a bail-in. Although it did not come to pass, its confidence sapping effects will be felt all across southern Europe. It is the nature of pandemics to have a parochial origin.

Secondly, European economic policy is inimical to growth for all but the Germans. Even in good times, banks are but a sliver of equity on a mountain of debts. The deflationary pall of policies is likely to further compress equity buffers all around the bloc. An unintended consequence of these policies is that a great deal more bailing will be required. In, out and shake it all about Mr. Dijsselbloem.

The new monetary programme of the Bank of Japan is freshly announced. It is lifted from the book of the Federal Reserve but extends the scale well beyond what the Fed has done: both in pace and magnitude. Just as well, you might say. The BoJ has long had a reputation for footering around with monetary stimulus. As commitment and communication have both been lacking, they are wise to study the Fed, an organisation that leads in both categories.

Our portfolios have had a meaningful commitment to Japanese equities, currency hedged, over the past six months. These and US equities (in their case not currency hedged) have been the stand out performers over the period. Now that the *neko* is out of the *baggu*, we should consider what may foil Mr. Abe’s and Mr. Kuroda’s cunning plan.

The bit that can’t be easily known is to what extent corporate decision makers and consumers’ attitudes toward inflation and the value of cash savings will change or how compliant Japanese banks are willing or able to be.

Theory relates that part of the effect comes from driving down government bond yields and therefore forcing investors to shift to corporate securities. This theory was re-stated by Gavyn Davies in the Financial Times of 5th April. But when the curve, pre-launch, starts at 0.05% for 2 year paper and gets no higher than 1.8% for 30 years, compression is harder to achieve. Preventing rates from rising, rather than compressing them, is the name of the game. This can only be done if you are the biggest player in town, as the Fed is, as the BoE is and as the BoJ has become.

Longer term, our analysis of Japan is that its problems are increasingly demographic rather than monetary and curable only by a revolution in attitudes towards immigration. We see no sign of this and therefore our commitment is conditional on stocks being cheap and the BoJ pumping funny money.

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