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Investment Letter: 6th June 2013

May slipped through the statisticians' grasp and gains were eked out, against the run of weak Mays of the past three years. May's delay may be June's swoon.

Investing in the new normal can be compared to butterfly catching on the island of Flores. For all the varied, bright and sparkling things that can be netted, the canny lepidopterist knows that Komodo dragons lurk beyond the tree-line. In our world, the dragons are represented by the bond markets. They can snap your leg off.

Longer US rates are beginning to respond to the manifest recovery of the US economy. A change in price reflecting a change in prospects makes sense, even whilst QE operations are being conducted. That makes the exhaustive debate about tapering somewhat moot. A few letters ago, we speculated on the possible consequences of QE not having the desired effects in Japan. Changes to long interred policies, and to the expectations that have sprung thence, have disquieted the Japanese Government Bond market. At the risk of introducing too many animals, the horses have been scared.

If somebody would write one, the derivative instrument of choice must surely be a volatility contract on Japanese inflation linked bonds.

As we re-assess things Japanese, we recognise that the pay-off has changed somewhat. In the autumn of 2012, the Tokyo stock market was languishing at book value, perhaps even below, expectations were mute and an interesting election was coming up. In the summer of 2013, expectations have become vibrant, valuations have risen to 1.3x book and Abe is promulgating policy not just petitioning. The eastern dragon may yet bite, but we surmise that the reflationary option is still in play and the balance of probabilities keeps us involved. It has made sense to rebalance on the way up. The fall in the value of the yen re-activates memories of the 1990s when a parallel phenomenon foreshadowed the Asian crisis. The main spur of the Asian crisis was a sudden reversal of the strengthening trend of local currencies. Within Asia, China's loss of relative competitiveness will likely have bearing on its future exchange rate policy.

At the other end of the valuation and performance spectrum lie Emerging Market bond markets, panting from the exertions of a multiple year bull market. Our view has been that, in the inevitable dulling and then probable reversal of the trend, it would be cracks in certain key currencies that could act as earlier signifiers. The Turkish lira, Korean won, South African rand, Indonesian rupiah and Brazilian real were identified as possibles. The rand has been the one to break, falling from 8.48 to the dollar at the beginning of the year to 9.93 at the time of writing.

These moves are in themselves noteworthy. They presage a more difficult time in these far flung bond markets; for, when the sun moves away, the night will as be as long as that on Venus. We should expect greater country dispersion in Emerging Market returns – bond yield tightening will be more jagged and distinctive than its obverse: bond yield suppression.

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Queen Elizabeth reportedly asked of the 2008 world financial crisis "if it was so big, why did nobody spot it?" Quite, ma'am. Some phenomena are recognisably consequential, even as they unfold. Shale gas is one such development and the attached report is our thruppence on the matter.

The economic consequences of shale gas for the US are clear enough: it is both a deficit tamer and a dollar stengthener. America is a place of wide open spaces and (capitalistically at least) wide open minds. It is more difficult to attest to its prospect elsewhere. The environmental aspects can hardly be glossed over. For all Mr Cameron's keenness to see the back of Mr Salmond and his claims over the North Sea, he will not be allowed to blow up cathedral towns to do so. France is, geographically speaking, a more open country than the UK. The reflex of public opinion will likely be as here, though. Exploitation in Poland is possible; China too, although China's deposits lie deeper in the earth's crust and pose a greater engineering challenge.

In terms of companies, whilst the majors all have development in mind the equity value of an energy major will remain dependant on the oil and natural gas price. It is the ranks of consultants, engineers and equipment companies that will see the greatest lift in values. We have identified 46 companies worldwide that stand to benefit.

EF Pacific & Emerging Portfolio – Note from the manager

With his assumption of responsibilities for a new fund later this summer – TM Cerno Select –the lead manager position for EF Pacific & Emerging will pass from James Spence to Nicholas Hornby.

The Pacific & Emerging portfolio was established so that investors could benefit from the long established links that exist between the founders of Cerno Capital, the Asian region and the Emerging Market asset class. When we started the portfolio in 2009, we knew of no multi-manager, multi-asset structure dedicated to Pacific and Emerging markets. The strategy, then as now, is to invest in some of the most talented managers working in those regions. We reason that it is possible to obtain outperformance whilst shedding volatility by adjusting asset class exposures, in tune with the larger capital inflows and outflows. This downside protection and reduction of timing risk makes long term allocation more palatable. We continue to hold the bulk of the positions we established at inception. The managers that we have invested with have experienced all the EM cycles that have taken place since the Russian crisis of 1994. We have been able to add some value through currency overlays. More recently, we have begun to benefit from the strengthening of the US dollar.

Some performance analysis follows this letter.

Since inception in November 2009, the portfolio has returned +37.2% after fees during a period of, by historical comparison, poor returns for the asset class. A notional portfolio allocated 50% to local currency EM debt and 50% to Emerging Market equities would have returned +16.4% over the same period. The portfolio also outperformed both the EM and Asian equity indices over the period (by 22.1% and 20.1% respectively), although that was not an express objective. We properly regard its three and a half year track record as no more than a start. EF Pacific & Emerging is open for investment at month end dealing dates.

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