CERNO CAPITAL

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The markets had the early measure of the US election. True or not - and we'll never know now - a Romney victory was equated with a harder dollar, less funny money and therefore gold negative. Obama the reverse. By New York breakfast-time on November 6th gold was rising, the dollar weakening and the markets just knew.

At the end of that American day, the more fluent man spoke in Chicago and fretting began to set in shortly after.

Staying with the greatest nation on earth, its "fiscal cliff" beckons with the same portent as "Y2K", a phenomenon that similarly spooked the corporate world, back in 1999. But whereas Y2K was a boon to burgeoning IT departments, the fiscal cliff is acting as a passion killer to corporate expansion.

Indeed, so well ingrained is the belief that recession lies in wait if the cliff is not bestraddled, that it may prove to be self-fulfilling.

Positioned behind the cliff, in this Hieronymus Bosch-like landscape, is the cavernous hole created by mounting fiscal liabilities, threatening to swallow up the US dollar and the US Treasury market.

Bill Gross of PIMCO, who possesses the gift of describing epochal macro developments with great simplicity, lays out the problem in very big, round numbers. Were we to head off the fiscal cliff, the net budget improvement amounts to US$200bn. However what America needs, to correct its budget profligacy, is a per annum budgetary improvement of more than US$1.6tn for about five years in a row.

Averting the cliff, as business is imploring government to do, is therefore only a short term palliative. Between the short term fix and the longer term threat lies a time-constrained middle, in which federal obligations must fall as the tax take rises. Hence the febrile tone to markets since the election.

In the US, as elsewhere, our inclination is more to trust the underlying forces of recovery, however slow and turgid they may appear. Better consumption, a bottoming of the residential property market and willingness of banks to lend are all necessary conditions for this and are now in place. What is not yet in place is any appetite from corporate treasurers for additional investment. We are told that US boardrooms are stuffed with disgruntled Republicans. That may just be the case in a country where business votes different from the rest, old from the young, Latinos from the whites, and so on.

In our opinion, the greatest opportunity in world markets lies in cyclicals, including financials, which are not priced for a cycle. We are expressing this by a new investment in a basket of large-cap US financials and a renewed interest in Emerging Markets, where we have been underweight for several years, as the Developed Market outperformance versus Emerging Market took hold.

We look for the word “cycle” to slowly gain sway over the word “crisis” in the world’s press.

The underlying momentum in US corporate earnings is slowing, but still positive. In Europe, it is negative. Therefore, for equity returns from developed markets to beat their rate of income distribution of 3.3% (a number which includes Japan), the earnings multiple needs to rise, as it has been doing in the US.

The Fed model, which describes a mythical relationship between bond yields and the equity earnings yield, is largely but perhaps not wholly broken. We are beginning to witness the first migration flows from fixed income, where real yields have now reached zero. The hoof prints of this migration can been seen in commercial building yields, in infrastructure stocks and in the flows into highly reliable, low volatility income equities.

Provided markets can retain their faith in the Bernanke-Draghi backstop, the PEs on equities can rise by a greater quantum than earnings. Bond yields are going nowhere, short of a recovery. UBS Investment Bank research point out that these *regimes*, as they term them, can last for many years and bear no relation to economic growth rates.

There are no absolutes in multiple analysis but the relatives clearly now favour Europe and Japan over the US, cyclicals over defensives, North Asia over South East Asia.

Like turning out of bed on a cold November morning, it is hard to extract oneself from the comfort of highly successful, highly profitable, albeit highly rated, companies in favour of more economically variable ones. But there are plausible proxies: UK mid cap shares rather than Iberian financials, US financials as opposed to Chinese shipbuilders, and the like. While the beta on a share portfolio can more approach 1, it does not need to be 1.5.

If we can locate good intrinsic value in financial shares, supported by an income yield and a low price to book multiple – the case for investment can be made as long as new banking business is profitable. Many people think of banks these days as a necessary evil. As they got us into this mess, they can damn well get us out.

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