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Investment Letter: 12th September 2013

Until very recently, despair was the stock-in-trade of the Financial Times and their compatriots in the financial press. The UK was a place of lame government, sub-par companies, depressed consumers and a hobbled economy. How wrong could you be? The worms have turned: recent mornings read like the scribes took the happy pill.

The background mood has become conducive: spurred by the fact we have not had to live through a summer crisis, of a financial nature, for the first summer in several. “We are all data dependent now” is an entirely empty phrase but the data is helpful and suggestive of life beyond QE.

The proximate concern (out there, that is, not one we share) is about interest rates as investors commute the rise in longer term interest rates into expectations about what will happen to short term interest rates. Take comfort from the fact that market expectations regarding future interest rates are a traditionally poor guide for actual developments.

The summer of '13 has been a process of discovery in relation to the key Central Banks and their control over the bond curve. Few are the number of macro strategists who predicted that the mesmeric influence of the Fed, the BoE and ECB would partially erode before their eyes. Returning to our snakes in baskets analogy, we questioned what would happen if the charmers hit a bum note. We observed that all the other snakes seemed to watch the US viper. Were it to drop back in its basket, might the others follow? Indeed they did. Despite this, we have yet to receive the desk notes from economists that begin “I didn’t see it, but this is what I think it means....”

This is what we think it means. The tandem rise and steepening of the curve is logical given the improvement in conditions and the reassertion of cyclical developments. We are witnessing “normalisation”, a seemingly hazardous but likely profitable process for multi-asset class investors. When the SS Normalisation hove into view, we anticipated that the mill-pond calm of bond markets might well ruffle. The flip-side of smooth repression of interest rates could be jagged and peremptory. The raft of unintended consequences on retreat of extraordinary policy are maybe as large, or larger than that on entry.

Like bilge waters in the hull of a ship, the world’s capital flows are readdressing the prospects at the crises epicenters. This raising of prospects in developed economies has been akin to the quartermaster banging shut the larder doors and cutting rations to developing nations. No more rum for Asia and a stale biscuit for the Latins.

This creates a temporary problem in developing nations where there is a strong relationship between currency value and inflation (e.g. India) and others where policy is quixotic (e.g. Turkey). We see the full scroll of EM confusion: whether to intervene, whether to raise rates, would capital controls be effective?

The consequences have been pronounced. The YTD total return on the S&P500 is +17.8% whilst the JP Morgan Emerging Market rates index is down -11.8% over the same period.

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If asset allocation was always a tick-the-box, two-by-two process then top left is Equity, Developed where maximum happiness has lain. Bottom right is Debt, Emerging. At the time of writing a representative basket of well known EM debt investors have returned -12% for the year. So much for duration choice, so much for bottom-up analysis, so much for country selection.

That all said, we deem these to be temporary issues, not enduring ones for Emerging Markets. It would be a mistake to become preternaturally negative on these countries unless they have home grown problems already under gestation. There are better ways to make money than speculating on the rupee or rupiah.

We are not just witnessing normalisation, as stated above, we are investing through it. The uncertainty of it gives us access to investment premia.

The stamp of our investments is that they have a positive real return. Everything else is eschewed. Our clients' portfolios contain well thought out strategies in which we believe we can demonstrate good sense. Investment returns will remain fine for now.

Some readers of this letter have become seed class investors in TM Cerno Select. Thank you. This new fund, which represents our core investment management offering, invests globally across multiple asset classes. The Select Fund began trading on 4th September at an opening NAV of £10.00 with £21mn of assets at open and firm commitments for a further £9mn. The fund has accepted subscriptions ranging from £5,000 to £5mn and is suitable for ISAs and SIPPS. The seed class, at reduced fees, remains open to new investment for a limited period of time. Should you wish to know more about this fund, please email select@cernocapital.com to obtain the key fund documents.



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