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The authors of the Barclays Equity Gilt Study (2013) characterise the last investment era as The Great Moderation. During that period, which lasted from 1982 to 2008, US Treasury 10 year yields fell from above 15% to below 4% as a consequence of disinflation that began with the quelling of inflation and was extended by the opening of China.

The Great Moderation ended, as we know, with a Great Crisis. As to what era will come next, we cannot say with any certainty. It is hard to imagine the next world when surrounded by the remnants of the last. The bright young things of the 1920s had no foresight of the soup kitchens of the '30s; who would have dreamt up the 1980s in the midst of the scummy and hard-bitten 70s?

What we do believe is happening now is a process termed *normalisation*. We define normalisation as the ante room we must pass through, post-disinflation, post-crisis, before the foundations of the next investment era are built.

Normalisation, to our minds, is a powerful enough process to determine asset price behaviour *irrespective* of what you believe, or fear, may come next.

For that reason, whilst our core expectations are based around an economic middle way where neither deflation nor high inflation ensue, we would never entirely dismiss the dark forebodings of both deflationists or inflationists. Neither are they unrelated concepts. The germ of inflation can be found in deflation, and vice versa. One can become the other, akin to the socialists and the fascists of the 1930s.

Normalisation is not a process to be feared and it should be a profitable one for investors prepared to make decisive allocations in recognition of the manifest distortions at work in the world.

We have completed some interesting work on correlations within financial markets, referred to in a previous letter. Whereas most financial commentators reach for a correlation when they wish to demonstrate a relationship (often to sell an idea or a security) we approach them in a more agnostic frame of mind.

In financial markets, relationships need not be stable nor persistent. They are descriptive but do not represent an established state of affairs.

Everywhere we look, correlations are falling, following a period where they had been rising to unprecedented levels. They are falling between asset class returns, within asset classes, between global sectors and inter-regions. This applies at the broad asset class level and reaches down to the security level.

We understand these deviating lines as the slug trails of normalisation at work. Falling correlations are helpful to managers who rely on security selection as their primary means of delivering returns. In a very general sense it is a boost to active management.

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Practitioners of active management deserve a boost. We agree with the sentiment expressed by Capital Group chairman James Rothenberg when he said "The only voice that's been out there is the passive voice. We don't entirely agree that the answer for all people is indexing".

This is not to deny the utility of indexing: it is a comfortable substitute for benchmark hugging strategies, it is often a pragmatic option to eliminate security or sector considerations in favour of the broad gesture in asset allocation. It is also a secure redoubt for the multitudes of poorly advised investors. All that said, it is faulty analysis to suggest that, just because the average asset manager will be behind index, after fees, active management should be dismissed. Not often in life do we search for the average: whether picking our romantic partners or our motor vehicle, average is not in mind, so why should it be for asset managers?

Four studies under the umbrella heading of *What Normalisation Means for Investors* are included by attachment. The following link leads to both the report and a presentation on the subject of normalisation and asset allocation.

http://cernocapital.com/investment-view/

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