CERNO CAPITAL

Investment Letter: 16th July 2014

Last month, we considered aspects of China's residential property market, an asset group whose prognosis will have wider consequences.

Our view, depicted herein [click here to access last month's letter] is that the irresistible and irremediable forces of financial gravity are already at work and that Chinese property has already entered its first significant down cycle in its neo-capitalist age.

Testament to this is the ramp of simulative measures enacted to offset collateral effects of a slowdown. The general psychology in China supports the notion that property is an unavowedly good thing. This is well entrenched but likely to undergo change.

Another tempering force is the acceleration of global recovery outside key Emerging economies. This gives birth to the argument that a bout of weakness from China can be counterbalanced.

This is a dangerous argument, for when the manifest recovery is accompanied by a more suitable interest rate curve, the flow of capital out of developed and toward Emerging economies will be stemmed.

Recent financial market returns speak nothing of this credo: bonds have flattened, EM growth equities have picked up. But, as early as this autumn, the Federal Reserve may well have ceased QE purchases of its home bond market. We should expect, from that point at least if not before, that bonds will track in search of a new equilibrium level and this will entail higher levels.

This despite the doctrinal interventions of Bill Gross, who, under the gospel of the New Normal, prophesies that interest rates will be in a lower range for the foreseeable future.

The road map we have been referencing has long pointed to a zone of discomfort and it is our view that the border into this zone is now being crossed.

This discomfort can be chiefly understood with reference to asset class valuations which range from moderately overvalued to alarming. The last redoubt of relative value has been the equity class where a cognitive battle has been fought on economic terms. Whether or not residual scepticism toward economic recovery has been extinguished or not, valuations point toward the successful resolution of this issue.

We try to think of these matters in a probabilistic sense as timings can rarely be known. Valuations in the US have reached a point where the risks of mean-reversion are higher than at any time since 2007. Most other global equity markets have performed in a sympathetic if unsynchronised fashion. Catch-up has been achieved in the UK and also, more recently in Europe and Japan.

Europe has been an interesting case. We maintained a meaningful allocation here, even during the period when a euro break down was being widely discussed. European equities offered an interesting set of pay-offs whereby, if some form of recovery could be traced out, equities, which had lagged, would respond and perhaps even offer some outperformance over the US. If recovery was in abeyance, the disinflationary boom in European sovereign credit would continue and provide an adequate floor to equity prices.

Take your pick as to what happened next. A bit of both perhaps and Europe did outperform, if not by much and not for long.

Updating to current attributes, the disinflationary boom has run full course: Greek yields have come in from 21% to below 6%, Spanish yields are inside US yields. A believer in this asset class would need to actively wish for deflation to eke a return from this point. The topical chat is about the prospect for QE in Europe, but we tend to side with Stewart Cowley, Fixed Income manager at Old Mutual, when he questions whether the ECB is a central bank at all.

The particular set of pay-offs described above no longer exist and European equities no longer possess valuation characteristics that suggest any margin of safety. During June and early July, we substantially exited our European equity allocation, on valuation grounds and have trimmed back on equity weightings elsewhere.

The proceeds have found their way into cash, where they will remain for the time being. Cash levels will stand at 20% in the very near future. This is a meaningful allocation, although it is strange to speak of an allocation that has no plausible return.

Cash has no income, presently, but it does have a value. The value can be defined as the option to buy other assets, at a later date and at lower price. Some patience will be required now.

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