CERNO CAPITAL

Investment Letter: 12th September 2014

Over lunch this week with the editor of a charity publication, this writer was asked what important dates were coming up that merited attention. The 18th of September more leapt than sprung to mind: a vote that it is difficult for many of us, self included, to be objective about. Once blood pressures had settled back to more normal ranges, we discussed the investment trends that have run this year.

Last year, investment performance trends were quite distinct: a meaningful outperformance of equities versus bonds and, within equities, developed markets versus emerging. We, and others, conflated these developments with the phenomenon termed ‘normalisation’, an umbrella term that spans measureable facets such as the price of money and environmental factors such as investor and business psychology.

Normalisation has been the unifying theme of our allocations for the past two years.

It would have been logical to believe, as we did, that normalisation would have continued to run its course, perhaps not smoothly, but at least with that current. Notwithstanding the fact that the tenor of communications from the new Fed governor was even more dovish than the outgoing, the wind down of QE seemed a cert.

But these entangled phenomena have not, until very recently, kept to the musical score. The defining aspect of asset market performance, year to date, has been the disinflationary chill that has emanated from Europe: a chill that itself has numerous factors in the making: the *dolour* of the French economy, the slowdown of Germany and an ECB policy suite that has as its key measurement of success the very low bond yields that are also a symptom of disinflation.

More recently, there have been some signs that the US recovery pattern is being met with rising bond yields and a stronger dollar. This has been anticipated for quite some time so provides some succour to the ranks of dollar bulls who have been long frustrated. It also delivers pain alleviating medication to the European patient and re-energises Japan’s mission to escape its deflationary funk.

This looks like a virtuous circle but, buried within the good news, through the mechanism of a stronger dollar, is an incipient threat to emerging market flows and we remain alert to the tick, tick, tick of the bomb in those bond markets. Work collated by Robin Parbrook who heads Schroders Asian equity team reveals, in a very startling fashion, how much of the last few years of growth in Asia, China in particular, has been underpinned by credit expansion. Moreover the credit intensity of growth has increased year-on-year. This does not bode well in the longer run.

Whilst we are currently lightweight in non-Japan Asia we are over weight Japan.

In a way, the foreign investor view of Japan is very much conditioned by the headline Topix index which has operated as an approval gauge. The gauge went on the blink this year and sceptics have made mileage out of the temporary depressant effects of the new consumption tax. Closer watchers of the three-arrow phenomenon find plenty of evidence of continued vigour in the domestic sector. Hugh Sloane points out that this is the first economic upswing in Japan since the 1950s that has not been led by the external sector. This fact alone is testament to the success of the plan. He also references the Ministry of Trade and Industry's recommendation that Japanese companies should aim for a minimum return on equity of 8%. Currently only 43% of Topix companies do so but 78% of S&P500 and 70% of Euro Stoxx 600 companies do so. What matters is not the spot numbers *per se* but the direction of travel. Japanese companies are, slowly for sure, getting their act together.

It makes sense to anchor investments around positive change and Japan is one such example.

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