CERNO CAPITAL

Investment Letter: 22nd October 2014

A warm and humid September was the very definition of an Indian summer and when it ended the rains broke and a chill descended.

Something similar has happened within financial markets.

There have been a number of key reversals, as evidenced in the table below:

Asset Class	Index	1 Jan – 29 Aug	1 Sept – 17 Oct
US equities	S&P 500 Index	+8.4%	-5.8%
Oil	WTI Crude	-2.5%	-13.8%
Gold	Gold Spot	+6.8%	-3.8%
Commodities	Reuters/DJ Commodity Index	+4.5%	-6.9%
Nominal bonds			
- Global	Barclays Global Govt Agg	+4.5%	-1.8%
- US	Barclays US Government	+3.5%	+1.0%
Index linked bonds			
- Global	Barclays Global Infl-Linked	+7.2%	-2.1%
- US	Barclays US Treasury TIPS	+6.3%	-0.8%
GBP	GBP/USD X-rate	+0.2%	-3.0%
High yield debt	Barclays Global HY	+5.3%	-2.4%
Emerging market debt	JPM EMBI Global	+9.9%	-1.7%
Emerging market currencies	MSCI EM Currencies Index	+2.9%	-2.8%

Source: Morningstar/Bloomberg

The turbulence in financial markets, in particular the mid-October swoon in US Treasury yields, has elicited assurances from Central Bankers. They will have blanched with shock - for the implicit signal from such a decline in yields (the 10Y dropping a 35bps in an afternoon) is doubly alarming, first in its suddenness and second in what it implies. The immediate connotation is toward deflation, an outcome that was, at the beginning of the month seen as a growing possibility in Europe. By mid-October, deflationary concerns assumed a global bearing.

The other threat that has this global bearing is of course Ebola. Its relevance to financial markets is not yet known but was cited as a proximate factor by news channels. The merely regional - Ukraine, Hong Kong - have been demoted to inside pages.

The threat to normalisation is emanating from the parties who should be prosecuting it: the Central Banks themselves. It has long been our view that normalisation (of interest rates, of investment psychology, of business investment) would convey benefits that outweigh any consequent risks. The repeat reflex of the authorities to head off financial market volatility is regrettable.

It’s a Barnum and Bailey world.

Europe is the obvious weak link in the Maginot Line of inflation expectations.

European equities foreshadowed this and cracked first. A façade was dropped in the late summer, forcing investors to confront the adverse trend in inflation and the absence of top line growth within European companies. At that point, valuations of European bonds and equities possessed little in margin of safety.

The last major monetary authority to activate QE, the ECB, will find its effect somewhat dulled as the pricing of bonds already reflects low growth/low inflation expectations. If they follow the manual (which we doubt they will) they will end up buying private sector bonds and equities and injecting money directly into companies. The concomitant moral hazard is not likely be tempting to the German palate.

Augmenting the European malaise is growing evidence that Chinese activity is feeling more than just the effects of the austerity drive in official circles.

Up to now, US trends, especially employment trends, pointed to a hastening of normalisation, supporting the idea that the US remains at the vanguard of growth.

Hitherto, we have been able to cast two faces in either direction across the Atlantic. A Janus when we think about the world.

(Cool it Bill, not you).

When we think about what current valuations are telling us about future returns, we also need to accept that both equity and bond yields are suggestive of lower returns in the years to come: still positive in nominal terms (provided you look ahead more than, say, five years) but markedly lower than have been achieved in the past five.

Our economic and financial lives will remain disfigured by debt, this is true even for the flush. For it will determine how governments and their treasuries behave.

High levels of government indebtedness lends a bias to lower rates along the curve but investors have already pocketed the dividend in terms of asset price performance. The residual benefit is in the form of cash-flow relief for the indebted.

Even if we accept that rates, generally speaking, will have a low bias in the future, that is not the same as saying that conditions will be entirely loose. Various events can spur tightening. One of these is dollar strength.

Dollar strength is a quasi form of tightening, it reduces cash flows into corporate America and acts as a garrotte around the neck of the Emerging Market complex.

In our opinion, the greatest crash risk in the world resides in Emerging Markets and dollar strength has a causal relevance here. We are also somewhat closer to these possible events than market opinion currently suggests.

We have taken some defensive measures over the summer: shedding European equity exposure and instituting some positions that profit as China slows.

However, some structural exposures do not fare well when volatility spikes. Japanese equities, for instance, being dependant for the time being on foreign investor inflows are sudden orphans during market draw downs when allocation activity is halted. Specific exposure to merger arbitrage strategies is normalisation personified. In a low growth but normalising world companies will seek growth through acquisition. Sudden attacks of fear lead managements and advisers to cancel or postpone their plans, creating losses for those who structure investments around bid situations.

Defensive actions taken over the summer have added value during the third quarter. We have been investing in specific target equities during recent turbulence, using some of the cash that we built in the earlier part of the summer. We would have tolerated steeper falls to allow value a chance to show itself once more. Auntie has not permitted this.

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