CERNO CAPITAL

December 2014

Cerno IQ

The Cerno Capital Investment Quarterly — *Issue number 1*

Allocation view: **Positive** ▲ **Negative** ▼ **Neutral** ◇

Equities

US	◇	The US has the least controversial recovery path but the most obviously overpriced equity market. Although the valuation indicators we favour only work in the long term, we judge the level of overvaluation to now be at a level where broad market exposure should be eschewed. We remain invested in US listed Cerno Global Leaders and hold niche exposures to US banks and merger specialists.
Europe ex UK	▼	Sovereign credit issues may well re-emerge in 2015, Greece being a particular source of concern. Draghi gave the continent room to reform but the opportunity has been squandered. Market expectations of euro distress will likely build from here. As for QE, the ECB is playing from behind the 8-ball as inflation expectations are already damaged. Given all this, European financial assets need to offer value, which they do not.
UK	◇	The domestic section of the UK market has been on an improving path since 2011. General Election apart, this has every chance to continue. However, the political overhang is undeniably large: the public is resentful and the parties are riven. If the area of debate cannot be shifted off immigration and onto the economy we have every chance of a non-result in May 2015. To foreign investors, the UK screens as a political risk and this has obvious consequences for sterling.
Asia ex Japan	▼	History relates that the best time to enter Asian equity markets is when the price to book value rating is below 1.5x and the US dollar is weakening. Neither is the case now and the strengthening USD acts as a garrotte around the neck of many of these economies. Cheaper oil may provide a lift but we would prefer to be patient and await a better entry point.
GEM ex Asia	▼	The BRICs are troubled, each with its own issues, none quickly resolvable. The most pronounced trend of the 1990s and early noughties was the outperformance of LATAM, a process that is now decisively in reverse. We continue to be concerned about the deleterious effects of a strengthening dollar and the prospect of higher US rates on most of these financial markets.
Japan	▲	Although Abenomics and macro factors dominate reporting on Japan, our conviction is that Japan is a micro story and the key variable to watch is the domestic profit cycle. In truth, Japanese corporate prospects have been on an improving path for several years with a new found focus on economic value add, dividends and buy-backs. Japan being a consensus culture, we have probably reached a tipping point and the promulgation of the JPX Nikkei 400 supports this.

Fixed Income, FX & Macro

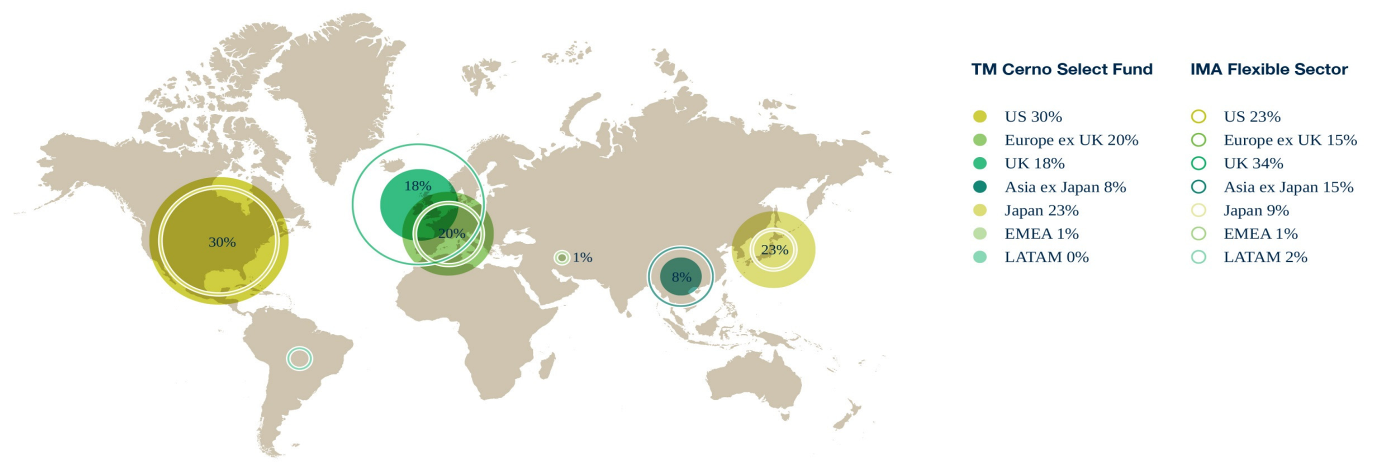
G10 Sovereign Credit incl. Inflation Linked	▼	Yields to maturity are tempting only to ardent deflationist. And although deflation is the topic du jour, nominal yields are very poorly placed for any change in expectations. As their proponents are loath to admit, inflation linked bonds perform best in a disinflationary environment.
EM Bonds (Sovereign & Corporate)	▼	The last 10 years issuance has been very strong and EM bond markets have very poor liquidity attributes. The open ended nature of funds in this sector suggests that they are at risk from a turnaround in sentiment. This could come about from further strengthening of the USD and/or a rise in US rates.
High Yield	▼	The high yield asset class is the caboose bolted onto the back of the income train. With continued bouts of QE, measures of credit risk have faded from consciousness. Distress in the energy sector as the oil price breaks down will rudely reassert risk in a sector that is moving on vapours.
FX and FI Macro	▲	QE has not been kind to global macro practitioners. The flattening of interest rate curves was fine enough until they became pancake flat. From that point, most strategies' pay-offs tend to zero. 2015 is likely to herald a loosely interlocking set of macro risks that present a set of opportunities and swings in volatility.
Equity & Thematic Macro	▲	We define equity and thematic macro managers as managers whose portfolios make widen use of equity as an asset class but have an avowedly macro viewpoint and the flexibility to invest in other asset classes. We continue to be of the view that fault lines between the developed and emerging worlds as well as distinctions between markets will provide an opportunity rich environment.

Alternatives, Commodities, Currency Overlays & Cash

Industrial Metals	▼	As per our below comments on commodity currencies, further weakness in China's economy would tend to continue the downward bias in industrial commodities.
Event Driven	◇	The process of normalisation as well as topping out of profit margins will, we think, accelerate corporate activity. This plays to the strategies of merger, arbitrage and event driven managers. We also believe that as the deal count rises against a backdrop of gently rising interest rates, bid premia will widen. This increases the inherent profitability of such strategies.
USD	▲	The run down of QE, broad strength of the US economy and the prospect of being first mover on rates are conspiring to provide impetus behind the upward move in the dollar. Our pragmatic response to this is not to stand in its way, so we hold a pronounced USD position in both cash and as an overlay. The greatest risk to this is crowding.
Gold	▼	Gold is struggling. This owes to its thematic irrelevance in the dash for yield, its previous popularity and the rising US dollar which makes gold more expensive in other currencies. To add to these travails, rising US rates will further expose gold's lack of yield. That all said, 2015 presents a cornucopia of macro risks and some of these may translate into demand for gold. Gold has perhaps better deflation protection attributes than inflation protection.
Commodity Currencies	▼	We believe that the property sector downturn in China will continue and this ties in with China's demand for commodities. Although we think the immediate risk of financial distress in China can be contained, the effects of a slowdown will be transmitted internationally via the commodity complex. All other things being equal, this entails weakness in key commodity related currencies.
Cash	▲	Cash is an underappreciated, if not undervalued, asset class at this juncture. The challenge of accessing properly underwritten returns in frontline asset classes will conspire to improve the case for cash.

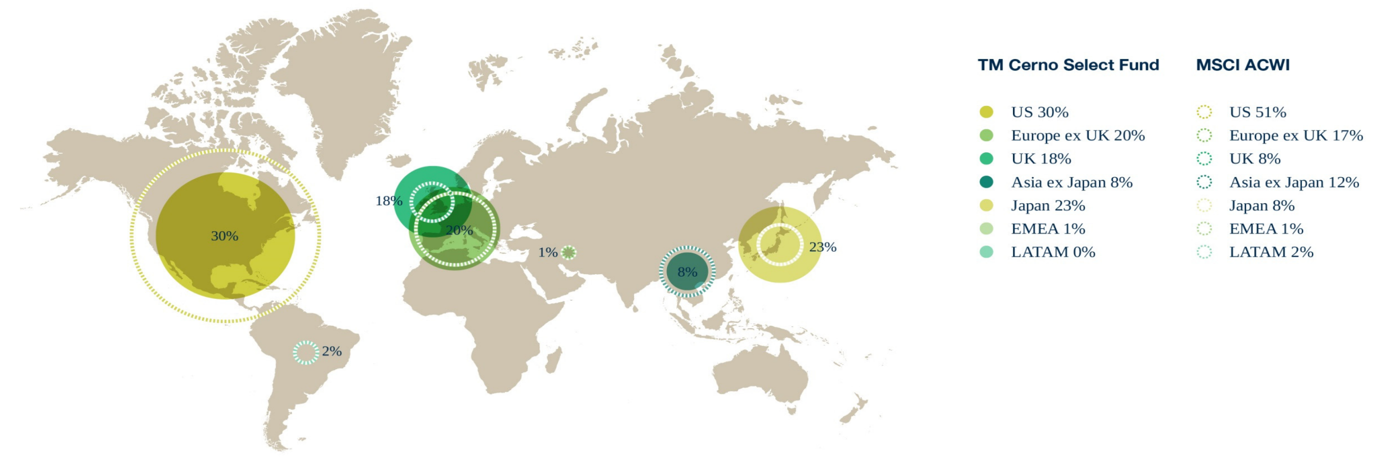
Explanation of the below: *the charts below depict the geographic allocations of the equity portion of the TM Cerno Select Fund. Where the disks are wider than the circles, we are overweight and vice versa. Equity allocations accounted for 63% of the fund's net assets at the time of production. The percentages below will add to 100% as they are calculated as a percentage of the equity allocation. Therefore, for example, an equity weight of 30% in the below graphic would correspond to 18.9% of net asset value of the fund (63% x 30% = 18.9%) . Select weights are compared with MSCI All Country World Index and the IMA Flexible Sector. Data is correct as at 3rd December 2014.*

Chart 1: Select versus IMA Flexible Sector Averages



Source: Cerno Capital, Morningstar

Chart 2: Select versus MSCI ACWI



Source: Cerno Capital, MSCI

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