CERNO CAPITAL

Investment Letter: 17th December 2014

Last month, we expressed views toward the Russian dictatorship. That dictator's poison is oil. Oil has it in for Vlad.

Had the fall been less precipitous, markets would be able to gurgitate the very obvious benefits of a lower oil price. Whilst not as important a cost input into businesses as it once was, it still remains significant. For the consumer, there is a direct relationship between the price of oil and disposable income.

The European perspective on these matters is somewhat different. A close reading of the ECB President's prepared comments and answers in Q&A following the ECB Governing Council's December meeting reveal much. He referenced the relationship between inflation expectations and the oil price several times and in a manner that suggested that, rogue January data apart, his mind is made up as to the case for deploying QE.

He also said: *"We have to keep in mind, however, that the initial conditions matter a lot. And in this sense, the initial conditions of the US and UK, when they decided QE, were different from the initial conditions of the euro area"*.

At first glance, this appears anodyne, however this writer's understanding of this comment is a reference both to the market impact of QE and its ultimate efficacy being subject to conditions prevailing at the time of deployment. Assessing the full scope of his address and answers, the subtext reads "we have no consensus, we are not ready, we need to work out what to buy as we don't know what yet". It is a testament to the communication skills of Signore Draghi that he retained the trust of the markets on such poor prep.

The conditions at time of deployment are 10Y Bund yields of 0.56%. Undoubtedly this can be pushed further down, but perhaps to questionable effect.

Energy markets have been effectively shorn of any presumption. Presumption matters because investment commitments are based off long lead times to cash-flows and long pay back periods. Each one of the US$1 trillion of investments that the FT reported as being at threat has behind it an Excel spreadsheet with one key input that nobody believes they can now forecast. A philosopher would interject at this point with the suggestion that the error was to believe that any analyst could forecast forward prices with any degree of reliability.

Looking way beyond the proximate effects of oil at US$60/bbl or indeed US$50/bbl, the seeds of an oil price rise lie in its fall. For we are not rid of the black stuff and should these projects be cancelled, the market will eventually tighten. A set of opportunities hove into view: the greatest being to invest in the equity of the most marginal frontier explorer to survive the crash and thence through a spectrum of oil-related plays. Emergent value will be shrouded by the smokescreen of distress as oil backed loans and bonds go sour. This won't be easy.

If oil is nothing less than a crash, other issues in the world have begun to fester, making for an unusual December.

Some of the cabling between Russia, Greece, oil, High Yield Debt markets, the wider EMs and beyond them, the Frontier, wire back to the same control room. A toxic mix of impaired cash-flows and heightened perceptions of credit risk already spell trouble for sections of High Yield bond markets and the spectre of contagion within EMs now looms. Our view is that the lack of inventory and inadequate market making within bond markets spells trouble.

Therefore it is not the time to be "balanced" nor passive, nor to maintain a generic set of risks as might be implied by benchmarks. Flexibility remains our hallmark.

There are a number of possible ways to install protection against these risks and some of the contagion effect is mitigated by marinating portfolios in US dollars. This we have done.

A summary of our asset class views can be found in Cerno IQ, a new report:

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

Finally, in the articles linked to below, Fay Ren refreshes our understanding of the applicability of the Cyclically Adjusted Price Earnings (CAPE) ratio and, with CAPE in mind, Russell Napier issues one of his customary cautionary warnings. The CAPE ratio has become somewhat of a favoured fetish of a wide range of commentators and practitioners including James Montier, Andrew Smithers and John Authers. It has the great virtue of being a mean reverting series that gives reliable signals on US equity valuation, but only in the long term. Here we define long term as periods of 7 years or more.

http://cernocapital.com/cape-ratio-revisited/

http://cernocapital.com/elephant-stands-head-cape-ratio-can-tell-us-future-us-equity-returns/

A favoured pre-Christmas and New Year farewell is "see you on the other side". It has rarely been more apposite.

James Spence
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