CERNO CAPITAL

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Last year's winners could be described as a near equal assemblage of deflationary and reflationary themes. The six best performing mainstream financial assets were as follows:

China Shanghai 'A' shares
Spanish government bonds
Italian government bonds
German bunds
S&P 500
Nasdaq Composite

Excluding Chinese shares, whose rise was boosted margin, margin that is now being clamped down on by the authorities there, yesteryear's five winning strategies were made up of two measures of the US growth story and three measures of the European disinflation story.

Like the Vesper Martini which puts gin and vodka in the same glass: it shouldn't work, but it did.

To say so though, is to flatter the US. Earnings expectations, other than pockets of Technology and Healthcare, have not held up to expectations. The aggregate earnings out-turn has been modest. Modest earnings in a strongly rising market spells one thing: multiple expansion. And for US equities, rising PEs are more of an explanatory factor for the market's rise than earnings and dividends together.

"The carry trade is still on", cries Ewen Cameron Watt from the top of the Rock.

That argument, though perhaps reductive, has worked for the last five years. However, two things need to be borne in mind of rising Price Earnings ratios: they cannot be predicted and they don't last forever. That makes top-down forward expectations difficult to formulate and should therefore render us suspicious of optimistic fulminations if they are not clamped to security-level investment theses.

The general line held by most commentators is that European sovereigns yields fell in anticipation of the €1.1tn European QE that was announced on January 22nd.. Whilst it has been hard to fault the logic of this observation, there is other corroborating evidence of deflationary impetus.

We should guard against viewing falling Chinese growth, the halving of the oil price, negative European cash rates, the capitulation of the Swiss National Bank as isolated events. Crispin Odey has warned of this and he is right to do so.

We wager that not too many portfolios are braced for a real taste of the business cycle.

Currencies matter. As Odey puts it, "Currencies are where the tires meet the road”.

Notwithstanding the biffing that the Macro Trading community has been dealt due to having got big into the CHF as a funding currency, currencies need to be dealt with on an active basis as their attribution will remain significant. As any manager who reports to their investors in USD will attest, they certainly proved so in 2015.

Losses in the CHF reflect a pattern of behaviour where progressively bigger risks are being taken in an endemically low return world. Walking thirsty in a desert, you eventually begin to imagine things that do not exist.

To our minds, the SNB's lifting of the yoke on the euro, also reflects the limitation of Central Banks. These limitations are of consequence in the next business cycle as they will have very little to bring to bear.

Mr Draghi looked exhausted on January 22nd, and his reluctant exegesis on what constitutes unanimity, consensus and a significant majority in board decisions would have further drained him. Demonstrations of power, as QE is in a financial sense, require an aura of invincibility to be maintained. From 2008 to his retirement in 2014, Ben Bernanke corralled his power behind a theory that had the helicopter money approach as its ultimate bazooka. Draghi, by contrast, could not attest to a plan B.

For the time being, a great deal hangs on the concept of fungibility. This is the notion that irrespective of which NCB (National Central Bank) is doing the bond buying, the money creation circulates through the European payments system.

The UK is an obvious beneficiary of this, as a consequence of any European upswing; in the absence of that, it's a beneficiary of capital flight. This is a good year to have an exogenous boost. May’s UK General Election may well not deliver a clear result. If it does, the combination of redistributive Labour administration hooked up with a vengeful and tactical SNP would be a chill prospect for business and the economy.

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