CERNO CAPITAL

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In an environment where asset markets lack the depth of opportunity, opinion has become shrill, sustainable advances more elusive, investment potholes ever deeper.

Currency attribution has begun to loom large in portfolios. This can be perceived in a number of guises: dollar strength, euro weakness, EM weakness, yen stability. Like beans on a drum, there is so much activity that it is not easy to discern the prime mover. In this regard we think it is the proximate change (euro rates falling) rather than the prospective change (US short term rates rising) that is acting as prime mover. Viewed this way round, the landscape is more defined - for the time being - by euro weakness than dollar strength.

If so, this can been cited as a convenient reason why dollar strength has not yet tipped EMs into crisis. Bond values are down but they are down on account of changing currency rates, not yet amplified by rising rates. Looking through the range of large EM debt funds, mid month returns were beginning to stretch down to double digit losses. They have since recovered to much more modest drawdowns.

Does Fed Governor Janet Yellen peruse the listings of EM debt managers as a matter of course? We think not, but the very hint of a reference to the value of the dollar has been enough to draw air from the dollar rally.

It is tempting to see global asset allocations through the filter of the dollar. There is something in it for most committed participants, not least those that argue that dollar strength leads to EM recession, consequently leading to global recession. The gloomy ones add a marinade of deflation to that dish and conjure up the asset crunch that QE was meant to avert.

Some of these moves look frenetic. In the world of macro investors, currency divergence has acted like a deep draft of water to a thirsty band of nomads. Their commitment to the dollar is avaricious. So much so that we speculate that every macro hedge and every quant fund in the world has flocked to this water hole.

Say it ain't so.

It is though.

The question therefore becomes more behavioural than anything else. It is never comfortable to invest in such an imbalanced market, prone to reversals. Quant fund interest is pendant on further rises in the value of the dollar and is based on what is termed single factor modelling, the factor in question being price. They are, metaphorically, “Mexican policemen” - a reference to exigent enquiry and speed to the draw.

The proximate reason for the hiatus in the dollar’s rise was a release of updated, tempered forecasts on growth and inflation from the Federal Reserve. This information was freighted via an updated dot plot chart. Plotting dots sounds like a plausible activity for a morning’s play at a Montessori school.

Whilst we can rue the fact that investment markets remain in the thrall of entirely mortal and human forecasters who have no special claim on data, we must accept it. It is a matter of regret that wise counsellors such as James B. Bullard of the St. Louis Fed, who urges his employer to get on with normalisation, represents the minority view.

So much so that his most recent presentation is sub-titled “Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.”

https://www.stlouisfed.org/~/media/Files/PDFs/Bullard/remarks/Bullard-OMFIF-City-Lecture-Frankfurt-26-March-2015.pdf

What makes this observation threatening to wealth is the pedestrian but unavoidable fact that financial assets are quite expensive. Berkshire Hathaway is 50 years old and this birthday caused a further torrent of hagiography to spill forth. Whilst the Sage is held up to be a value investor par excellence, his current actions have deviated a long way from Benjamin Graham’s guiding light. Heinz plus Kraft is a neat bit of corp fin for sure, but it isn’t value as we know it, captain.

To conclude, the challenge, as we see it, is not to guess the future actions of the authorities but to invest sensibly in a world where opportunity is clearly lessened. This, for our investors, means a flexible commitment to equity markets, a portion allocated to strategies that prosper when all else is being beaten up, a primarily defensive position on currencies and a healthy dose of cash.

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