CERNO CAPITAL

Investment Letter dated 15th December 2015

The best performing global equity sectors in 2015 have been Consumer Discretionary and Technology (both +4.6%), hardly a bonanza. The worst two have been Energy (-23.7%) and Materials (-15.9%), deflation in two nutshells.

Whilst the positive side of the coin has not been very positive at all, the dispersion in sector returns has been high. When full year numbers are in, we will see that the top quartile of active global equity managers will have done well, relative to the pack. Active investors favour dispersion in returns as it conveys a rich set of opportunities. Indiscriminate bull markets are less joyful than would appear, as good companies do not necessarily outperform: most asset managers having a bias to good companies.

My colleague, Fergus Shaw, points out that the poor performance of the latter two sectors has scuppered the fund managers who have chosen to play what traditionally are referred to as late cycle themes. They have also conspired to keep value strategies in the dog house.

Connecting observations about where we reside on the business cycle and stocks and sectors is a popular way of thinking about investment. In a casual way, it is a topical way of framing ideas. It has also, by some, been expanded into a methodology: termed “business cycle investing”. In business cycle investing, there are stocks and sectors for the early phase of expansion, different ones for the middle phase and others again for the mature phase.

This practice may not be of much use, though, in the current decade.

For the cycle has been elongated, largely as a consequence of the operation of successive waves of Quantitative Easing and the zero interest rate policy that more or less persists in the US, UK, Europe and Japan.

Policy interventions may well have headed off the big bust that was in the offing in 2008, their continued application in the wake of that rescue have shut down the normal forces of creative destruction.

One may rail at the global financial monopolists and be drawn to “end-of-money” theories or, alternatively, one may accept that the environment is that of an unusually long and somewhat underpowered economic cycle.

This letter has been written just ahead of the Fed’s apparently epic decision to raise interest rates by a modest amount. Epic on account of it being 9 years since the last hike (2006). Had the letter been written earlier in the month, we might well have commented on how well markets were adapting: dollar gains having been front end loaded, equities happy enough, bond yields fully backed up. As the decision date approached, that apparent calm has been disturbed.

For whilst the decision to increase interest rates and commence normalisation appears well enough grounded in US economic data, China's commencement of a steady, marginal but deliberate weakening of its currency coupled with further weakness in energy prices reminds us of the strong counter forces at work in the world.

Here is the rub.

Weak oil has its well appreciated positives: by putting cash in consumers' pockets, akin to a tax cut, it aids more than it harms.

Strong dollar is a more toxic phenomenon: it undermines the cash flows of giant US companies, it has a tightening monetary effect, it inhibits capital flows to Emerging nations and it jeopardises the solvency of hard currency borrowers.

But has the dollar not just peaked, at least for now?

The dollar index (DXY) had another run up as interest rate expectations changed in the early part of the quarter. It got above 100, as it had done in March, but did not last long above 100. EURUSD (the value of one euro in dollar terms) did touch 1.05 in March before backing up to 1.15. This month it failed to breach 1.05 and currently trades north of 1.10. These moves have played havoc with many FX and macro traders' books.

In a companion piece, Fay Ren explains that the shorthand, market way of speaking about the dollar, the dollar index, offers little more information than the EURUSD rate alone.

http://cernocapital.com/us-dollar-index-fit-purpose/

Apart from demonstrating just how concentrated macro players have tended to get, the broad phenomena we are observing (dollar having peaked plus cheap oil) are, of themselves, quite stimulative and supportive of risk assets at a time in the calendar when risk assets tend to do well.

So, should the seasonal rally find heart, in the words of the Ayrshire balladeer: we'll tak a cup o'kindess yet.

James Spence.

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