CERNO CAPITAL

January 2016 Update

For the past six post-crisis years, equities have been at the vanguard of financial risk asset performance. We believe they have now entered a bear market[1]. The economic recovery that took place post the crisis was unusual and perhaps we should expect this bear market to be different, too. For although it is sometimes possible to identify the epicentre of the problem, the challenges facing the world today have several facets.

US equities account for 52% of the global benchmark[2]. The bull market there has looked tired for some time and, last year, was predicated on a group of earnings light, concept heavy technology stocks to support the index. An equally weighted index of stocks described the topping out of US equities more clearly[3]. The proximate issue in the US is the earnings cycle which has been cajoled to a degree of efficiency where further gains are much more marginal[4]. The strength of the dollar[5], driven by higher short term rates, is sinking international earnings on translation. Demand for US equities is greatest from the companies themselves as executives have diverted the savings from weak labour and low oil into buying back and cancelling their own shares, to boost earnings per share[6]. US equities are expensive by historical measures[7] and the cracking of the earnings series will be enough to feed a bear market there.

The outlook for Japan and Europe, where monetary accommodation remains the prevailing macro input, is qualifiedly better, but perhaps only on a relative basis. We have long been supporters of Japanese reflation and remain invested here but at a much more constrained level. The Japanese stock market has few friends when other major indices are under pressure. Our Japanese asset of choice is now the yen and we have unhedged investments. The yen, like the dollar, has historically proven credentials as a flight currency[8].

Europe's particular sadness is that, having come to the reflation party late; it may find the main dishes of the buffet are being removed. Whilst it remains possible for certain domestic sectors in certain countries to progress, the broad swathe of larger European concerns is prey to a common set of global forces.

Market disruption and currency volatility comes at a bad time for most emerging market economies where demand drivers are weakening and indebtedness is at all-time highs[9]. Both equities and bonds have already been weak for some time but our expectations point to a deepening of these adverse trends with no immediate sign of alleviation. It remains too early to invest in these assets and we harbour serious concerns about the liquidity and solvency characteristics of many emerging credits.

Overall, it is our view that the cooling of the global earnings cycle, pushed along by deflationary drafts emanating from China and the global energy sector[10], calls for much more defensive settings in portfolios.

With this is mind, we reset TM Cerno Select earlier this month and have cut equity weights from the high 60s in percentage terms to the 30s[11]. It would be our broad expectation that we will run an equity weight of between 20% and 40% for much of the year. The non-equity portion of the portfolio[12] will be held in macro managers who are not related to the equity market and neither are they long credit risk. Cash and, plausibly, some longer term G3 government bonds will also have a role in portfolios. We have long sought diversification from pound sterling which has been notably weak and hold over half the portfolio in dollars and yen.

It should be noted that bear markets record many more up days than down days, so shorter range opportunities will arise. These, though, need to be assessed and executed in a bear market context which is different from a bull market where "buy on the dips" will suffice. The argument for a structural return to the equity class will need to be mounted on stronger valuation grounds and a redrawn road map.

At times like these, we are thankful that a multi-asset class approach to investment allows us the flexibility to adapt settings and that our insistence on super liquidity in what we invest in permits us to do so speedily, efficiently and cheaply.

James Spence

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[1] **Footnotes 1-12:** Please see associated presentation for related charts and tables.