CERNO CAPITAL

Investment Letter dated 30th March 2016

The particular combination of a supported Chinese currency, stronger oil prices and dovish Central Banks has been helpful to markets, at least in the near term, with benchmark equity indices striving to erase January's precipitous falls. We have also seen a counter-trend recovery, although uneven, in Emerging Markets, part helped by a recovery in the value of their currencies against the dollar.

This reversal in fortunes has posed more than a few difficulties for some managers who have explored the wilder shores of bear territory. No love has been shown to those shorting commodity currencies or taking bets against mining companies as both these asset groups have recovered strongly.

Does it make us killjoys that we do not welcome the cloying attentions of the BoJ, ECB and the Fed? Each has offered highly market sensitive prognoses and policy tilts in the past month but, in our minds, their actions may add to the risk of larger reversals at some stage in the future.

For, when the post Financial Crisis landscape is assessed from a greater distance by financial market historians, their conclusions will be highly bifurcated. They will, we think, offer plenty of support for the initial policy responses, as a deflationary bust was indeed on the cards in 2008. However, the follow-on set of policies - successive waves of QE, dollops of liquidity provision, zero or even negative interest rates will be written of in less sunny terms. The secondary consequences of these: weak growth, subdued inflationary expectations, uneconomic lending, denuded risk free returns, elimination of depositors interest, are upon us and come with their own challenging cargo.

One of the stronger cross currents to be negotiated in global portfolios is the relative fortunes of two currencies: the US dollar and the Chinese renminbi (RMB).

Recent official commentary from the US and China have tended to add softness to the dollar and support for the RMB. This, we believe, is working against economic forces which call for the reverse and we would be reluctant to support investment hypotheses that require either a weak dollar or a stable RMB or a combination of the two. This explains, for instance, a reluctance to make all encompassing judgements about Emerging Market recovery.

On currencies, we continue, to work to a moderately strong dollar hypothesis. The possibility of Brexit helps that argument along even though its central plank rests on US rather than UK factors.

The recent shift in interest rate expectations in the US was first enacted by markets themselves and subsequently endorsed by formal comments from the Fed governor. However, the formerly worshipped *data*, specifically data on inflation, suggests that inflation in the US is ticking up, just as the vaunted models for these things says it should. Add to that oil, whose price has been a disinflationary influence in the past year, will now work as an inflation augmenter. Now may be the time for inflation linked securities to do what it says on their cans, rather than behave inline with their nominal cousins. We also like gold for its potential to increase in value during either an upward or downward reset in inflationary expectations.

It is hard to escape the conclusion that the longer the Fed stays its hand, the steeper the ultimate adjustment will be, the higher the consequent volatility, the greater the potential economic shock.

So, we remain somewhat cautious and patient in front of these risks. In sailing terms, we are running close hauled.

Sailing metaphors keep cropping up: more than warranted from somebody who can only sport a dinghy certificate from the RHKYC to his name. Unlike the writer, others are out on the waves. We would like to wish the very best to our own sailor Hannah White with her multiple record attempts for 2016.

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