CERNO CAPITAL

Investment Letter dated 6th May 2016

There have been a fair number of reversals already this year: a retracement in oil prices, the cooling of the dollar, the rise of gold, recovery in commodity currencies….the list continues.

The great immovable force is the backdrop of high indebtedness, now a pervasive global phenomenon. The Debt Supercycle describes the defining economic development of this and the previous generation during which general indebtedness, measured as a percentage of economic output, has increased by a quantum degree.

Debt accelerated markedly in the 1990s with a great explosion of US debt and then further in the noughties and this decade in both direct and indirect consequence of QE policies. During the QE years, the Emerging Markets finally lost the great thing that stood them apart from Developed Markets: their relative low leverage at the state, company and consumer levels. The latest augment to the trend has emanated from China whose leaders have plainly decided to throw bad money after bad in their latest efforts to reflate aggregate growth back to the desired mark.

The present economic cycle's distinguishing factors reside in its very length and lowish growth, commensurate with what one might expect when debt begins to constrain growth rather than facilitate it. The longer term risks are manifest, especially when you consider the likely consequences of the other side of China's debt bubble. Even so, in the absence of the stimuli that conspire to create outright recessions, it remains a very difficult environment to be an outright bear as the recent track records of bears attest.

We have been in - and remain in - policy driven markets. This point has to be conceded by the guardians of financial assets. To resist is akin to howling at the moon. Allocations therefore need to be made in cognisance of policy trends. We have now arrived at an interesting point in this regard.

On monetary policy, it is becoming clearer - and it would be a good thing to obtain more fulsome confessions from the principal suspects, the central bankers themselves - that the raft of extraordinary monetary policies currently extant is unlikely to be able to deliver more than it has done so already. This has led to speculation as to where policy will head to next and the introduction of measures under the name "Helicopter Money".

Regional differences persist. The US has extracted a decent cycle, and fabulous stock market returns, from the 2008-2015 policy driven period. Europe has held onto its periphery which is, after all, a political prerogative. Japan has stimulated the sense of change without quite convincing anybody that it will stick. In between these, the UK has also enjoyed a good cycle, most notably on employment and has therefore enjoyed more US-type outcomes than European ones. *Salut!*

There is, therefore, no urgency to promulgate new policies in the US. The Federal Reserve craves the normalisation of interest rates, whilst remaining appropriately anxious about “foreign” risks. Recently reported 0.6% growth for the Eurozone in the first quarter hardly justifies the lighting of a celebratory pipe, a toot on an e-ciggy would be more proportionate. Europe evidently needs more pro-growth policies but Germany places a line across what is possible and what is not. As Japan has no plan B, it is to Japan that we must look for the next iteration of policy.

New action in Japan will bring them closer to what is called debt monetisation. The creation of reserves on a more permanent footing (rather than QE which eventually runs-off as bonds held by the Central Bank mature and is therefore temporary) to fund fiscal spending will, if done properly, actually create the much sought after inflation and will drive the yen down sharply. That being the case, foreign investors into Japan need to be good readers of the odds and timing of action and accurate predictors of the currency – a game that owes nobody a living. These policies have long been talked about by Japan watchers, often accompanying dire predictions for the Japanese government bond market. The looniest asset in the world must surely be Japanese government bonds, where a single day’s price change can eliminate 10 years of coupon flow.

We are not heartened by these developments and as our commitment in Japan (which was pared back in January) was predicated on the bottom up corporate earnings cycle, an equity market that becomes so definitively macro discourages us.

The yen strength that we have witnessed this year may not last. The other side of that has been US dollar weakness which likewise may be temporary. The recent weakness of the dollar (with the dollar index down 5.5% year to date) has allowed the extension of several of the countertrends referred to at the start of this letter.

We have little faith in most of these countertrends and the dollar may well rise again. This view is predicated on a simple reading of the data that the Fed itself deems to be important: employment and wages and their widely attested view that they would like to escape the Zero Lower Bound on interest rates as that will secure policy makers two way flexibility on rates for future events.

So, we stay with the US dollar and, within that context, have built a meaningful weight in US inflation linked securities. We observe breadth in the pick up US inflation readings, entirely appropriate, we think, for where we are in the cycle and the condition of the US labour market as it tends towards technically full employment.

The Global Leaders Programme, under which we identify, screen and then research sustainable growth models to create a concentrated portfolio of listed companies has held its way since the year’s beginning. The core, equity growth element of the portfolio is made up of these, a position in Indian mid caps and a complimentary longer term allocation to a specialist manager who selects innovative and technologically savvy disruptors.

Against these, we bulwark the portfolio with more defensive allocations to the US dollar, the Japanese yen, inflation linked bonds and some gold.

The aim is to be all-weather, all-year and address opportunities as they arise.

James Spence
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