

2H Strategic Outlook

A very useful way of approaching investing is to first assess the underlying prospects for a particular company and then to find the best value and risk reward in its capital structure to buy. Often, however, we tend to assess macro conditions, then market implications and asset allocate between equities or bonds before we look at companies. This approach often fails to discriminate between the diverse geographical sources or revenues and costs. Unfortunately, the force of habit is so entrenched that mainstream investment strategies will find it hard to adjust to the more targeted approach, and so we march on with the old tools. One has to be cognizant of the existing methodology since it will drive current capital allocations and fund flows which move the market.

It has now become consensus that the US economy is in a sustained recovery, so much so that the Fed is considering slowing down the pace of unconventional policy. I think this is correct. The market expects Europe to also recover but has failed to provide any causal explanation. I see the Eurozone in continued and regular weakness due to its common currency. The emerging markets are now feeling the strain of mercantilist developed markets withholding demand, credit, free transfers of technology and other charitable acts on account of their own weakness. With an innovation deficit, China, India, Brazil et al will face a hard time growing, while facing inflationary speed limits. I hope the Japanese economy makes it sufficiently far as to ignite a self sustaining recovery but the prognosis for the longer term is poor.

I like US equities. A recovering economy, low interest rates, strong balance sheets, high operating leverage, a shrinking float on account of share buybacks bode well for US companies. They also remain the most innovative, the most important owners and generators of intellectual property and innovation. And between debt and equity, there is no question that the value lies in the equity of US companies relative to their bonds.

I like European companies. The weak European economy will delay any risk of monetary

tightening by the ECB, labour costs will remain suppressed for a long time as employment switches out of the mainstream to contract hire, and material costs remain muted. European companies deriving revenues from emerging markets have a goldilocks operating environment of low costs and high growth. The underperformance of European markets has also resulted in attractive valuations. Whereas in the US over exuberant credit markets have made bonds expensive, European high yield is an attractive prospect paying higher yields and providing stronger covenants. In Europe therefore, the better approach is to assess a company then its capital structure for the optimal trade expression. For allocators who are unable to do so, **buy a balanced exposure to Europe; buy equities and buy high yield.**

I like Japanese equities. Tactically, the prime minister and the BoJ will need to ramp the market higher towards the elections. There, depending on the result, one should make a binary choice to double up or cut. My bet is that the elections will be positive, even if the majority is insufficient to gain unilateral control, and that the three prongs of policy will buy sufficient time for animal spirits to take hold in Japan. In the longer term, **I believe that the demographic will be unable to fund the fiscal deficit and default or unconventional reorganization is inevitable.** That, however, is too far down the road for our purposes and I would buy Japanese equities.

I like equity long short in Asia. Asia will see lots of winners and losers. Asia ex Japan is not as resilient as investors believe. Lack of innovation and a weakening Chinese economy will hamper the region. Much depends on China. Asia ex Japan remains a supply of resources to China or an entrepôt or a satellite to China's hub. The lack of world class brands or technologies is a serious gap in Asia ex Japan. Pockets of innovation in Korea and Taiwan may emerge but so far the norm has been repackaging or contract manufacturing. **Stock picking will be crucial in Asia.** Particularly in China, where the economy is clearly evolving towards a more balanced one between consumption and investment, the differential fortunes between industries and companies will emerge. I don't recommend a macro blanket approach to Asia. Certainly on a macro blanket basis, I am very cautious about China's prospects. The US is re-shoring manufacturing capacity and withholding the transfer or sharing of intellectual property and until China is able to invent, produce and market its own innovations, I think it will struggle. The same argument holds to any country which cannot innovate.

I have a definite view of inflation. **Indeed it is a case of Fire and Ice.** Massive balance sheet expansion in the developed markets in a world of open capital accounts has led to inflation flowing to where capacity is constrained by productivity and growth is relatively strong, in other words, the emerging markets. I therefore expect the **US, UK and German term structures to outperform** (steepen slower or less) than emerging market term structures. In the US, UK and Europe, rates are likely to rise, but this rise will likely come from strengthening economies. In the emerging markets rising rates are likely to be the result of rising inflation. As a result, in developed markets, bond yields will likely see negatively correlated duration and credit spreads whereas in emerging markets they will see positively correlated credit spreads. **This leads me to prefer developed market high yield over emerging market high yield.**

I like European senior loans. I liked US senior loans. Generally, the floating rate features of loans make them attractive if one believes that interest rates have bottomed. With 3M USD LIBOR at 27 basis points there isn't much room to fall. While I do not expect short rates to rise in the next 12 months, floating rates provide important diversification. The structural seniority of the claims, the maintenance covenants, all make senior bank debt a good asset to be in when in times of stress. The US loan market, however, has become pretty tight with the revival of the CLO market

and the return of some covenant light issues. In Europe, however, the CLO market is only just coming back to life and one could argue that the timing is ripe to invest in bank loans in anticipation of demand from a structural buyer.

I like the USD. As the US becomes more export led it will import more USD creating a shortage of USD which will likely support the USD. Otherwise, the continuing phoney currency wars make FX forecasting a very difficult game indeed.