

Investment Strategy: The New Macro

Investing has become more fraught with danger as policy attempts to do what policy has never done before. New ways of thinking about asset allocation need to be developed. We begin with prospects for a few economies and how they should be expressed under these new regimes.

Prospects for the US economy:

GDP is comprised of consumption, investment, government expenditures, and trade. The US economy has been in big trouble and continues to be in big trouble.

Consumption levels pre 2008 were sustained not out of cash flows from investment or employment but from credit. Supporting this credit was a rising housing market providing good collateral. With the collapse in the housing market this collateral is no longer available. With a sluggish labour market, cash flow lending is likely to remain muted. Also, recent experience is likely to increase savings rates further dampening consumption. Bottom line, consumption is likely to be very sluggish.

Investment pre 2008 was supported by a number of things not least construction encouraged by rising housing prices. With unsold inventory, land bank and inventory from foreclosures, housing construction is likely to remain depressed. Private infrastructure investment is likely to remain depressed as well as expectations for growth remain depressed. Inventory accumulation is a volatile series which is highly cyclical and subject to complex autocorrelations.

The government is quite simply broke. It is not tenable to continue to run deficit budgets with the existing level of borrowing. This puts a damper on infrastructure build and

investment in the technology set of the economy. Financing the government has become a serious problem, solved only under the guise of quantitative easing.

This leaves exports. Yet not every country can be a net exporter at a given point in time. There is a risk that globalization is reversed for a time as economies become more protectionist and insular. This is unlikely though as the march of globalization has created some hard to reverse relationships and interdependencies. What is likely, however, is the repatriation of productive capacity (read manufacturing) to the US. The macro outlook does not provide, however, clear implications at the micro level. As the US economy evolves into an export driven one, quite which industries will emerge at the forefront is unclear but bears close monitoring.

A likely consequence of the repatriation of productive capacity will be a higher NAIRU compared with previous decades. In past decades, the NAIRU was kept artificially low as the US exported productive capacity abroad thus taking advantage of economies of scale and cheap foreign labour to keep inflation low facilitating the 'goldilocks' condition of having high growth and low inflation and interest rates. Expect higher inflation at each level of GDP growth going forward.

In the shorter term, in the next 12 months, however, expect interest rates and yields to be depressed across the curve. With GDP growth running some 3 – 4% below potential, the Fed is likely to maintain zero to negative real rates at the short end, and encourage the same at longer maturities. There remains the motivation to create sufficient inflation to debase the debt and to manage the interest burden for the US treasury as well as to try to buoy the still moribund housing market.

Europe:

Much has been written about Greece, with prospects ranging from dire to disastrous. They are all true. Sovereign debt is a strange animal. The creditor has an ill defined claim, and yet the sovereign stands above its corporate credits. Yet for all the problems that Greece faces, these are symptoms of a greater structural fault, that of the Euro and the differential pressures it exerts on different parts of the union. Greece should have been allowed to default on its own in Drachmas. But it hasn't and its debt will now have to be aggregated into the same pool as all the other dodgy assets, transferred into default protected vehicles and eroded via inflation and cheap funding via unconventional means... A policy of transfer, hold and erode is the likely outcome. The question is transfer where and to whom? A more rational way, but one which involves too much up front pain is a restructuring. Governments and peoples prefer to defer pain.

Europe is a region still haunted by memories of war, for which economic and monetary union are seen as a glue to bind the various countries whether it makes economic sense or not. It has, however, a long history of crises and colonization and it is likely to weather the current malaise through evolution. Already European businesses are some of the most global in the world. The tiny country of Switzerland is home to some of the world's largest companies who clearly cannot be sustained by Switzerland's domestic economy. There are good companies in Europe which will see their stock prices decline in times of stress. The Greek situation is unlikely to be resolved quickly and is likely to plague the region for some time. There is even risk of contagion to Ireland, Portugal and Spain. These would represent buying opportunities of business whose links to Europe are largely legacy, but who derive most of their economic value from healthier parts of the global economy.

China:

The evolution of China into a more balanced economy with less export reliance and more domestic consumption has been slow.

As Western economies fell into recession and are recovering only slowly, China's economic growth has been driven more by investment than consumption. Construction and infrastructure still dominate marginal economic growth. The consumption has been localized in higher income household's demand for luxuries both domestic and foreign. Inflation pressures in agricultural and food products erode purchasing power and encourage saving while discouraging discretionary spending. Headline inflation including shelter is rising fast despite hawkish policy. A wage price spiral may already be underway, ironically triggered by central government's policy of wage increases to encourage domestic consumption. On the other hand the government seeks to manage overheating by maintaining high reserve ratios for the banks and raising interest rates. Perhaps it is hoped that this will encourage consumption out of cash flows without the creation of excessive credit, while discouraging excessive credit supported capacity overbuilding.

As the West repatriates productive capacity and rebuilds its manufacturing sectors China's industry must also evolve. It must evolve to supply goods and services to satisfy domestic demand instead of export markets.

China's infrastructure and investment binge has been criticized as unsustainable and likely to create overcapacity and lead to a deflationary recession. China's infrastructure and development plans span decades instead of years and often appear to Western observers as irrational. It is difficult to opine on the future implications of the current build out. In any case policy has turned against unfettered infrastructure investment. What complicates the analysis of the Chinese economy is that as a centrally planned economy the number and complexity of levers available to the central planner are myriad.

The long term view is a bit clearer. China is in the ascendancy and the central planner has displayed considerable astuteness of policy despite an often elastic chain of

command. The future is China's to lose and the wildcard is the Party and the pact that it has with the people. In order to maintain growth and control inflation, at some stage, China will need to outsource to cheaper producers as well. While Africa has been merely a source of resources to China, there is scope for it becoming the factory of the next few decades producing on behalf of Chinese businesses. Otherwise, it is merely a matter of time before China bumps against its long term potential GDP growth limitations and chronic inflation sets in.

Conclusions:

The macro view is no clearer or less clear than it has ever been. That said, even with a high conviction macro outlook, the trade expression for monetizing that view has changed. This is a result of a more globalized economy, more complex relationships resulting from the said globalization, and more globalized capital markets. Whereas in the past a view on a country's or region's economy translated into an opinion on that region's or country's equities or equity indices, the current structure of the economy and markets requires a more targeted trade expression. It requires an opinion on individual stocks, not so much based on the idiosyncratic fundamentals of each stock but based on an understanding of the macro environment's impact on each business.

The future belongs to economies like China, India, Africa. Seek targeted exposure to growth potential within each of these countries or regions but seek these wherever they can be found whether in companies located locally or in the developed economies.

Asset allocation remains the most important investment decision, however, its expression needs a more sophisticated and targeted approach.

That equities will continue to be impacted by local events

while being driven in the longer term by their financial fundamentals provides the astute investor with an interesting strategy of buying developed market companies deriving a significant part of their revenues or profits from emerging markets when negative events and news depress their stock prices.