

Random Thoughts for Random Markets

Strong commodity markets create winners and losers. For example, cotton prices remain 100% higher than a year ago even after a 30% correction. Companies like Carters which make baby clothes and ladies underwear and sell mostly through Walmart will struggle to pass on costs. Abercrombie and Fitch and Ralph Lauren will find it easier to pass on costs. Moreover, materials are a smaller proportion of costs at higher price points.

High precious metals prices also create winners and losers. Swatch and Richemont will see costs rise. The retailers in China such as LukFook, Chow Sang Sang and Emperor are gatekeepers to Chinese demand and will command stronger bargaining power.

High food prices also create opportunities. Retail prices of food are sticky upwards. When agri prices are weak, food retailers like supermarkets find it hard to improve margins. Price hikes are politically unpopular and the oligopolistic markets they operate in punish the outliers. When agricultural commodity prices rise, food retailers stock prices get punished. However, this is one of their few opportunities to increase pricing. When agri prices soften, margins are improved.

I remain very skeptical about US and European banks. Stress tests that are self marked do not inspire confidence. For all the efforts of the central banks to liquefy the banks, for all the efforts of the banks themselves to recapitalize themselves, bank lending has recovered only slowly. Why? With a fragile housing market, Western banks have seen their mortgage businesses languish. With Basel 3 capital requirements banks are motivated to get behind the Fed and put

on yield curve carry trades lending long and borrowing short. This leaves them vulnerable to a flattening out of the curve. I think there are more interesting opportunities in banks and credit institutions in Asia. Shriram Transport Finance for example is an excellent business with low delinquencies, strong margins, a wide network and high barriers to entry.

Elsewhere in emerging markets, telephone companies are encroaching into banking products with SMS payments and funds transfers. Vodacom, 65% part owned by Vodafone, is a mobile telco active in Sub-Saharan Africa. The upside gap risk is that the cellphone becomes a de facto 'debit card' or 'cash card'.

On the macro front, a market neutral stance is preferred until we figure out what the central banks want to do. The US government still requires a bulk buyer of its debt. It remains to be seen if and how the Fed will be able to engineer a program of buying without calling it QE3, a move that would shake confidence in the sovereign's credit quality. The European's by having an independent central bank, or at least a variously conflicted one, will struggle to monetize its debt. The Bank of England is already an off-taker of Gilts, yet there, the English are biting the bullet and going through austerity. The emerging market central banks are girded for the inflation battle. It seems that no central bank is currently in printing mode and this is likely to create volatility first in the fixed income markets then in credit, equity and commodity markets.

FX markets I know nothing about except to say that nothing goes in a straight line and whenever there is an extreme of consensus, the market is likely to confound.