10 Secs Into The Future. Investment Strategy For a Broken World 2012

Its one of those periods again when markets are falling and people are feeling down. And when they feel down, they sell assets and markets fall, and they feel even more down.

The US economy’s tepid recovery is real. In Aug 2011, the US economy began showing signs of life, and that spark caught on, albeit at a slow rate. Its main driver was emerging market demand for capital goods, driven by final demand for resources in China. The recovery is therefore highly sensitive to the Chinese economy.

Today, that demand is waning and at serious risk of faltering further, because China is slowing faster than anyone has guessed. Fortunately, on the back of some momentum in the US manufacturing numbers, and inventories being unusually low on account of acutely pessimistic managers, consumption has picked up in the US. This despite weak labour and wages numbers, has put the savings rate back on the decline. Its not healthy.

The picture in Germany is slightly brighter. Germany too has been dependent on exports of capital goods and intellectual property to the developing world and it has profited handsomely from the voracious demand from countries like China who are desperately building to fill the void left by cratering exports. With the recent downturn in China, even Germany is vulnerable.

There are cycles within cycles. Long term growth will always be positive due to the ingenuity and efforts of the species. That’s very long term growth. In the meantime, a shorter cycle exists driven by the lags and expectations of people in the economy.

Long term growth will slowdown. The world has accumulated too much debt which it must now repay. GDP counts debt fuelled growth, and now must count the cost of paying down that debt. Its just accounting. Thus, at each level of inflation, the potential growth rate will fall.

Be that as it may, in the long term, one must invest in growth and US companies are an excellent source of it since they are the owners of brands, strong reputations and intellectual property. As countries retrench, it pays to own these attributes. Europe too is attractive if not for an inefficient and dangerous currency regime. A global retrenchment, for example the US becoming a net exporter, will create a shortage of international USD pushing up the USD and USD interest rates across the term structure. Central bank policy of debasing currency and engineering as much unmeasured inflation will also support long term interest rates. Short duration fixed income is the efficient trade expression. In the long run. The problem with a long term investment strategy is that it requires more tolerance of volatility and patience than most investors can bear. Absolute return hedge funds are a better investment but search costs and fees are high. And most investors don’t understand hedge fund strategies anyway and prefer to stay away.
How about the shorter cycle? Europe, the US and China have managed to bolster growth in the past 2 years by creating more debt. It is a temporary fix and will now go away. No country in the world is in a position to create more credit, not without their borrowing cost rising out of hand anyway. Those who can, don’t need to. In any case the world has seen too much credit creation already. To boost output through the creation of more debt is a bit like putting out a fire with gasoline. With China’s shadow banking system (LGFVs) and banks at the limits of leverage and accounting creativity, output should slow quite significantly. This will have knock on effects to the resource producing nations and then on the major capital goods exporters like the US and Germany. The logical conclusion, based on the weakness in the Chinese economy in the past 6 months, is that the US economy must now slow down, likely into another recession.

Today the risk of Greece defaulting and or falling out of the Euro monetary union loom large. The impact of such an event is not well understood and markets have fallen as risk aversion has taken grip. There are countries and companies which are not viable. Today the public's gaze is directed at Greece. Tomorrow it will be something else. In all crises there are opportunities. In Europe, performing assets misunderstood in the panic can be bought at distressed valuations. Distressed assets, however, remain expensive with few sellers.

In the meantime, as always, the market mistakes damage for risk. The risk in Europe is mostly over. The Greek drama is damage. Risk prefers a mask of calm and collected doom.

Worry about scenarios that are unlikely to happen and that others do not envisage, like the Germans throwing in the towel on the Euro and leaving. Now that would be a risk.