

Investment Outlook for 4Q2012

Note that the US economy had begun its recovery in October 2011. Stage 1 of the recovery came from exports. Countries that benefited were not the natural exporters like China and Japan but rather anyone exporting to emerging markets, since they were the only importers with any ability to pay. Now even this game appears to have run its course as every country on earth seeks to export amid the current synchronized slump. Exacerbating this is a dearth of trade finance whose natural source has been the European banks who now find themselves a little bit short on capital.

Thus the global synchronized economic slowdown rolls on, and it took the announcement of unlimited quantitative easing by both the Fed and the ECB to stop the rally in risk assets. All other central banks have already got with the program and are minting empty promises at best speed.

In June, the market wrote off India as a lost cause, mired in political deadlock and stagnation. This seemed to be the catalyst for some maneuvering by the Prime Minister to push forward a slew of reforms, which have yet to be ratified, but have boosted expectations and the Sensex into a 20% rally. Whatever happens, the fiscal deficit is bound to widen on the back of more pork barrel politics.

On this basis, the weakness in data from the UK and the acutely poor sentiment for the UK economy suggests that the UK economy has probably troughed. Unfortunately, there is a corollary to Murphy's Law that says that you cannot make it rain by washing your car.

We have already noted in the past that QE limited on unlimited is only half of the equation, that it represents the financial part of a reorganization but not the operational side of it. As a business reorganization, QE is therefore incomplete and requires in addition, a new business plan to demonstrate a viable path to recovery. We have not seen such a plan on the fiscal or budgetary side. Austerity seems to be the only tool in policymakers' toolkit; however, this is to be expected since in most debt negotiations, creditors drive the discussion, that is, until default or liquidation.

So extremely inflated is the monetary base and so great the expansion of the banking system's balance sheet that one should consider the current strategy of the central banks highly non-robust to errors in policy. It has become difficult if not impossible to predict the consequences of policy, because all predictions are probabilistic and subject to envelopes of uncertainty, so high has this uncertainty become that it must encompass all manner of 'tail' possibilities.

Macro strategy based on expectations for economic variables and their impact on liquid assets pricing is therefore extremely prone to error. The only safe alternatives are direct lending and arbitrage.

There is a shortage of bank capital and thus bank lending. As a result private capital is finding less competition. On the other side, excess demand for funding allows lenders to be pickier and for underwriting standards to be higher. Trade finance, factoring, payroll finance, mezzanine finance, venture capital, private equity, real estate sale and leasebacks, equipment leasing, are lucrative investments. Even leveraged loans, particularly in Europe are looking interesting as European regulations drive capital away from the securitization markets. If the economic cycle proves less rosy than expectations, exchange offers and debtor in possession financings will not be far behind.

Arbitrage or quasi arbitrage opportunities are also usually available in abundance when markets dislocate. Bank regulatory capital relief trades, capital structure arbitrage, convertible arbitrage, all involve a mispricing of different claims, either for regulatory reasons, or adverse selection reasons. Either way, in credit, when demand and supply are driven by psychology and differing claims imply differing default probabilities or recoveries, arbitrage becomes possible. In equities, the trade is more one of relative value than arbitrage, a far less robust strategy prone to being confounded by persistently irrational markets. Only in event driven hard catalyst strategies can equities be more robustly applied to arbitrage. In the absence of an announced event, price convergence is subject to excessive extraneous factors.

If I was a macro strategist, in other words a betting man, I would say that the UK

economy will outperform, so will the US, while Germany slips into recession taking the rest of Europe deeper into the abyss, and India slips back as fiscal constraints strangle pork barrel policies and China continues to slump taking the commodity countries with it. The trade expression is even more unclear; shorting German (and other developed countries') exporters to China is top of the list, shorting high yield (still an expensive trade to maintain), buying non-agency mortgages and US homebuilders (to capitalize on the housing recovery, and even that is pretty uncertain), selling Italy CDS protection and buying German protection is a convergence "the Euro will hold together trade (which incidentally is a short Brent trade in disguise), US 5 10 flatteners through the cash or through payers and receivers (the other wings are too expensive),