Investment Review 2012. Investment Outlook 2013.

Model Portfolio and Strategy Review:

It’s time to review our investment outlook and strategy for 2013. It is remarkable how have arbitrary time intervals when we review and make our plans but that is how we humans have chosen to behave and so any study in human behavior or endeavor should reasonably respect these arbitrary wavelengths. We begin with a review of the investment strategy for 2012.

2012:

We were of the view, and remain of the view, that the world economy remains badly wounded, that the plots and purposes of regulators and governments remain misguided, and that the main ailments remain undiagnosed and unrecognized. However, we recognized that markets are the confluence of popular psychology, driven by the collective decisions of the masses, which provides no guarantee that fundamentals would be heeded, or that rationality would prevail.

In equities, we were risk on into the beginning of the year on two events, one was the recovery of the US economy which was already 3 months old, and the ECBs LTRO. Our trade expression was to overweight a clutch of European banks, likely insolvent but one cannot be dogmatic about these things. We were also selectively long US banks. We were chronically overweight luxury brands, a longer term theme which we think will persist beyond a couple more short term cycles.

We had been very negative on the prospects for China’s economic growth since Nov 2010 where we anticipated a hard landing. This did not stop us from being overweight exporters to China’s infrastructure building efforts as we saw a need for China to shore up growth at all costs, even further debt accumulation, in a changeover of management year. European and US industrials and selected consumer goods companies represented the bulk of our trade expression. We were short Chinese banks, exporters and consumer cyclicals.

The second half of 2012 saw a similar positioning. The arbitrary wavelengths hide an active tactical trading strategy that saw us long, then short, then long European banks purely on news flow of ECB policy action. We reiterate our view that the majority of European banks are fundamentally insolvent, even the blue chip names. The only chronic exposure we maintained was an overweight long position in luxuries, a theme that has served us well despite a few bumps along the way from the likes of Burberry.

Our shorts in Chinese banks generated losses as we were more wedded to fundamentals in this sector than we should have been, so compelling were the balance sheet issues. These positions were cut, even as we maintain our view that the accounting standard, or lack thereof, allow China’s banks to print their own numbers with impunity. This has now become an issue for the SEC more generally regarding the accounting standards governing Chinese companies.

Generally, the first half saw better returns on the back of more event driven trading, such as our interpretation of the first LTRO (to go significantly long), and the second LTRO (to trade short). The second half was disappointing as we were too slow to react to the change of psychology in Asia, which eroded the gains made in Europe and the US.

2013:

Macro is a guide and sometimes a poor one. The post crisis world we live in confounds macro in so many ways as policy collides with fear and relief. Fundamentals are always important as they provide the trend around which the noise ebbs and flows. We continue to believe that we are in a trading market and that psychology remains overwhelmingly important. Be that as it may, investors always want to hear the macro story so we shall not disappoint, although our story might, as might our accuracy ex post.

At a very high level we continue to exist in a post crisis world. Global economic growth will now be on a slower long term potential trend due to the repayment of accumulated debt. Policy will be focused on the short term (within the electoral cycle) pain management of that debt rather than seeking long term solutions. This will create trading opportunities in the form of local trends. Tail risks remain since the fundamental flaws of our economic system have not been addressed. A fundamental principal agent divide has emerged which has manifested at the country level as well as the company level. Hung parliaments, revolutions, conflicts, shareholder revolts, board mutinies, all the manifestations of principals trying to realign their agents, will intensify. In an age of lower growth, expect protectionism, trade war and perhaps the odd spat here and there. Tail risks remain high, except where protection is proffered.

Europe will try to muddle through as they believe that is the best they can do. There is little risk at least in the near future of a Euro break up simply because of the political resolve to keep the Eurozone together. Any small economy threatening to fall out of the Euro will be rescued. The Germans have already lost in the game of Chicken. It would take a country the size of Italy or France to break the Euro, which could happen, but not in the next 2 years. It is the consensus view that Draghi has removed the tail risk from the Eurozone but the definition of tail risk is that it is unenvisaged. Technically therefore, Draghi has addressed one major and evident risk. Given that all solutions thus far have been analgesic, one might suspect that the best that has been achieved is the transmission of risk from one area to another, usually less apparent area. While the politicians fiddle, and I mean no allusion to a smoldering Rome, private enterprise has picked up and moved on. So have private investors. European companies are some of the most global. Centuries of conquest and colonization have given Europe cultural access to Latin America, Asia, the Middle East and Africa. (While Vodafone struggles in Europe, Vodacom (65% owned by Vodafone) thrives in Africa.)

The US economy is a resilient one, yet it is plagued with high debt and even higher unfunded liabilities once welfare and healthcare is factored in. This will cap growth. The fiscal cliff is likely to be a nonevent given its scale. 800 billion USD of injections did little to lift the economy, 600 billion USD of withdrawals will not sink it. Never bet against the US consumer, however. Even in an environment of slow growth, the US consumer has dipped into their savings, lowering the savings rate further, in order to spend. The Fed is bent on facilitating this. In QE3 it is buying MBS in an effort to support the housing market, a gambit that appears to have worked, in expectation that US households will be able to refinance (which requires positive equity), or obtain new HELOCs (which also requires positive equity), so they can go shopping. Employment has been slow to recover as the economy evolves. It takes time for labor supply to adjust to the new face of demand. The slow economy will periodically spook the markets providing some useful tradable volatility. US corporates remain the largest repository of brands and intellectual property and their export capabilities should not be underestimated. It is not clear how a more protectionist world will impact US companies. Significant repatriation of productive capacity has already begun and will continue. The identification of winners and losers will have to take place at the company level.

It has been our view since Nov 2010 that China's economy was slowing aggressively and that it was headed for a hard landing. While the macro data has suggested otherwise, domestic stock prices have supported our view. We are now of the view that China's economy is bottoming or has bottomed. This is not a forward looking or particularly clever view, but a naïve inspection of current, coincident data. We are also of the view that the Chinese economy is already significantly consumer driven, and that it is the general weakness of the consumer economy, and not a slowdown in the evolution that has been responsible for the weakness all this year. China has engineered a deft strategy of rebalancing its economy while maintaining economic growth through investment and government spending. The cost has been an accumulation of long term debt in its shadow banking system which currently resembles the SIVs of post crisis Western capital markets. The most accurate characterization of China is that it has good continuous risk characteristics with substantial tail risk.

Trade expression:

Now for the hard part. We certainly sound more sure of our macro views than we actually are. In truth, our macro view directs our search for ideas, it does not dictate it. Very often our macro views are either wrong, in which case our trade expressions are negated, or our macro views are right but our trade expressions are wrong in which case we adjust them. This means that our trade expressions may be good one quarter out, but are otherwise very much subject to change.

Rates:

It is safe to say that all central banks will keep rates as low as they can for as long as they can until they are unable to do so. Unfortunately, low interest rates create an unhealthy dependence that is difficult to wean off, hence our view. The consequences of higher interest rates are just too painful for most economies to absorb in the near future.

The USD yield curve has flattened from 2010 and is likely to continue to do so. The same can be said of the Bund and Gilt curves. The JPY yield curve is ominously flat and is indicative of recession. The risk to central bank policy is where they are no longer able keep rates low. There is therefore tail risk from inflation which could cause long rates to gap.

FX:

We do not understand currencies. For correlated exposure we tend to allocate a portion of money to be fully expensed and hit the tables in Macau.

Fixed Income:

While we do not expect interest rates to rise, it pays to diversify some significant portion of the portfolio into leveraged loans which offer floating rate coupons and a senior claim in the capital structure. This is perhaps our strongest theme for

2013. We have previously highlighted a relative value argument, and a potential arbitrage pricing anomaly between loans and bonds arising from the thirst for yield among retail investors and their unfamiliarity with the loan asset class.

We like European corporate credit. There are a number of trade expressions depending on the investors’ liquidity tolerance. We see exceptional value in European CLO equity, however, the leverage and illiquidity may not suit many investors’ liquidity profiles. European loans are the liquid expression of our view on European corporate credit. One has to be selective of course but Europe is a good place to be hunting. Even in high yield which we generally feel is overvalued, European pricing and covenants make them relatively more attractive. We do not expect a sell off in US high yield but we don’t see a lot of value after the protracted and robust rally. High yield is expected to keep on paying with risk of defaults deferred, perversely, by the ongoing volume and ease of issuance. This game of chicken continues to be viable but one has to be prepared to exit quickly when rates rise. By extension we think that investment grade credits are expensive. Yield hungry investors have been overenthusiastic in this asset class. An interesting trade expression is to be long equities and loans and short senior unsecured bonds in the middle of the capital structure. This is a relative value way of investing in a company through the cheaper parts of the capital structure while shorting the overvalued portions which have been bid up by over zealous investors.

Emerging market debt is a hard one to call. We are cautious. There is considerable momentum in the asset class as investors diversify from developed market debt. Fundamentals are strong but yields have fallen to within less than a percent of the 2007 summer lows. Inflation is a risk as is the risk on risk off cycle which has a greater influence than fundamentals. Fundamentally, LatAm economic growth is slowing and likely to disappoint as their consumption cycles peak. Debt levels and the DM experience will moderate the likelihood of a significant pick up in investment. Russia continues to live off oil and agriculture with little in way of economic reform to balance its economy. Asia too is quite patchy. India’s experience is instructive where attempts at reform are expensive and face significant internal frictions. As a group EM fixed income has rallied hard and 2013 will likely see more dispersion and require more country specific analysis. We like Russia, Venezuela and Mexico and are underweight Indonesia, Philippines, Brazil, Turkey, South Africa and

Ukraine. On the whole, however, EM debt is at that point where investors are more willing to lend than EM borrowers are willing to borrow. This is usually a tipping point much like in 2007 when demand for mortgage debt outstripped demand for houses.

Equities:

The current environment favors equities over bonds. Companies have rushed to raise debt capital to replace equity financing through share buy backs and to pay dividends. This is evidence that insiders regard equity finance as expensive and debt finance as cheap. For investors this is a signal that equities are undervalued relative to corporate bonds. The problem with this thesis is that it makes equity valuations particularly sensitive to US treasuries since equities are cheap on a yield gap basis as well as on a discounted cash flow basis. A sell off in treasuries could create a correlation-1 sell off across corporate credit and equities.

We continue the emerging market/ developed market relative value theme where we previously sought long ideas among European and US companies deriving revenues from Asia and in particular China’s investment binge, and short ideas among expensively valued Asian companies facing a difficult export environment in Western developed markets, this time by taking the reverse of this theme by seeking long ideas in European and US consumer stocks with Asian and China exposure and short ideas in Asian and Chinese exporters of consumer goods. The specificity of this theme makes it not very robust so expect us to trade around the theme. The general principle remains true, we would rather track the source of revenues of a company than its domicile or country of listing. We expect China and Asia to become more consumption led and less investment led. The global wealth inequality theme remains intact and we continue to favor luxury stocks and continue to rotate between the high price point cyclicals like Coach and Tiffany and the ultra high price point defensives like Hermes and Richemont. Thematic ideas will also likely feature such as grain / grape alcohol substitution or rotation trades, commodity themed trades where we may short downstream companies unable to pass on higher raw material costs against longs in upstream producers. Kellogg’s high sugar and corn costs are a case in point.

We expect most of the stock ideas to be idiosyncratic bottom up situations where macro factors merely tells us where to look. There are few broad brush themes although we do see Europe improving faster than expected and showing good value. China’s economy may be recovering but we are wary of expressing our ideas in the

domestic A Share listings as the companies are mostly SOEs with a record of poor stewardship pf capital and dividend payment. Moreover, the high retail participation makes that market particularly sentiment driven and most investors both retail and institutional have only know a bear market (since volumes only picked up in 2007) and the market remains a
net destroyer of value. We are long China, just not through China listings.

Summary:

Arbitrage opportunities will continue to present themselves to investors with sufficient patience and a tolerance for less liquidity. The inefficiencies will present in credit capital structure arbitrage and in event driven strategies. In liquid strategies such as macro and equities, dogmatic reliance on fundamentals is likely to be confounded by the exogenous interference of regulation and policy with all their unintended consequences. For these markets we recommend ‘guerrilla’ trading based on opportunistic forays, tactical trades and event driven trading.