

Thoughts about General Investing Conditions. Why We Should Invest in Managed Products.

Economic Growth

In the decades prior to 2008, rising credit allowed most economies, even inefficient or unstable ones, to grow and prosper. 2008 marked a turning point in the long term credit cycle. With global deleveraging, weak and strong economies have been revealed for what they are.

Countries hardened by previous crises which have learnt from their past mistakes have emerged stronger. Most of the emerging markets fall into this category. North America, in particular the **US** with its flexible economy has recovered with renewed vigor. The innovativeness and entrepreneurial nature of the American people, coupled with a free and open market, have allowed prices to adjust and resources to be reallocated more quickly than elsewhere. The result is a self sustaining and stable recovery, even if a modest one. **Europe's** experiment with a common currency has been less successful. The rising tide pre 2008 hid the serious inefficiencies introduced by the common currency, the EUR. With sticky wages and over-regulated labour markets, the Eurozone structural unemployment is currently acutely high. Witness the Swiss and **UK** economies which unfettered by a common currency have been relatively robust compared with the Eurozone. Asia like **Latin America**, has had the benefit of severe crises in the 1990s which taught hard lessons about fiscal prudence and balance sheet management both in the private and public sectors. The relative strengths and weaknesses of the North American, European and Asian economies are now revealed by the withdrawal or reduction of credit on a global scale.

Inflation and Interest Rates

Inflation expectations can be similarly extrapolated from the different underlying efficiencies of each country. Massive money printing by the world's central banks have surprised by not producing the expected levels of inflation. Globalization is an important factor. Open capital accounts allow capital to flow to where it is most welcome or where it obtains the best returns. As a result, capital has flowed to relatively robust emerging markets, creating inflation there, while in the developed markets, capital has gone into asset markets most notably into the equity stock of global companies. If long term interest rates reflect inflation expectations, steeper yield curves are likely to follow. In the meantime, while vast QE irrevocably implies rising interest rates, developed markets long term rates can be expected to rise relatively more slowly compared with inflationary emerging markets. Globally, rising interest rates are almost inevitable. The question is which countries will outperform and which will underperform. The factors driving relative performance will include inflation expectations, public finances, and the current account. With lower inflation expectations and improving terms of trade and trade balances, it is likely that developed markets will outperform, this despite much worse public finances. Fiscal austerity has been deployed to address this issue and is likely to bear fruit down the road. The **UK** is a case in point where the early application of austerity is currently paying off.

Equities

What are the prospects for equity returns? As companies become more global, national aspects become less important. Is GE a **US** company or a Chinese one? Is Caterpillar a **US** company or a Central / Latin American one? Esprit sells more in Europe than it does in **Asia**. **Santander** has more balance sheet deployed in Latin America than it does in continental **Europe**. From 2007-2008 equity markets were correlated as they fell sharply, driven by fear. From 2009-2012 equities remained highly correlated as they recovered, driven by liquidity and relief. Correlations have fallen sharply since late 2012 as equities began to price in the relative and idiosyncratic fortunes of companies. This has created a stock picker market. This is likely to persist. The potential alpha, and it is potential since ex post alpha can be negative as well as positive, is high. The analysis of a company is complicated by their global reach and exposure, by their disparate geographical as well as priority of funding. Interest rates not only represent a cost of business, they are important in valuations as well. The coming rise of interest rates will create different

winners and losers.

Besides fundamentals, equity investing requires an understanding of the demand and supply of equities. The supply side is impacted by IPOs, secondary offerings and even share buy backs. The demand side is driven by the nature of the investor base, by psychology, by cultural and historical behavior and by taxation.

For these and other reasons, self directed investment portfolios will be disadvantaged versus the professional investor. Investors are well advised to rely on professional fund managers to invest on their behalf.

Credit and Fixed Income

Interest rates have spent the last 30 years falling. This is unlikely to continue; in fact rates are very likely to rise. In some countries the rise of interest rates will be precipitated by improving economic growth and moderate inflation. In others, rates may rise on inflation expectations. In yet others, rates may need to rise to defend a weak currency. The **US** is most likely to see rates rise as growth consolidates and QE is gently withdrawn. Initially rate volatility will be high, as when any sort of analgesic is withdrawn. The outlook for the Eurozone is complicated. Emerging markets with high inflation are likely to see higher rates in a less benign light.

Higher interest rates will impact equity risk premia in the respective markets. Where higher rates are the consequence of higher growth and profits, the equity risk premium and thus valuations can be preserved. The **US** is most likely in this camp. **Europe** is not only complicated but interesting. European companies are very much global. If disinflation or deflation takes hold in the Eurozone, companies may find their cost of debt remaining low while profits improve. Of course this would require and might imply some sort of mismatch in funding currency. The prospects for emerging markets are similarly complicated. The reader is invited to extrapolate the above line of argument.

Corporate bonds are mostly fixed rate securities and will find it hard to escape the effects of rising interest rates. Even high yield, where the yield is a composite of duration and spread will be affected to some extent. If we think of the spread as being correlated to the equity risk premium, interesting inferences can be made as

to the relative fortunes of different issuers' bonds depending on their currency and country of issue. Where rates rise due to a stronger economy, the spread is likely to compensate for the duration. Again the **US** is likely to be in this camp. Where rates rise due to inflation the impact of duration may be exacerbated. Readers are left to make their own inferences regarding the regional relative prospects for corporate credit.