

Wait Worry

Complacency

We began 2012 utterly dejected. Apart from the **US**, most regions from Europe to Asia to **Latin America** faced slowing growth. That said central bank pump priming managed to sustain global equity markets and 2012 turned out to be a good year for risk assets despite some mid year volatility. We began 2013 optimistic on the back of momentum in risk assets. As 2013 unfolded it became clear that the **US** real economy was actually improving and this helped to dampen volatility as the **US** equity market climbed steadily. In the latter half of 2013, the European economy began to show signs of recovery driving their equity markets higher. Emerging markets fared less well with slowing growth and rising inflation. Signs that the US Fed might slow down its large scale asset purchases added fuel to the fire and drove volatility there. **Japan** continued to confound the skeptics adding real economic progress to the improved sentiment. And even **China** appeared to recover from its apparent risk of a hard landing. Taken together, there is little to fear in the world of investing today. This is a thing to fear.

The risk of QE and its gradual withdrawal are significant. So far investors are pretty sanguine and some even interpret QE tapering as a sign of strength in the **US** economy and thus a positive development for equities, albeit less positive for fixed income. Depending on why **US** equities were bought up, there is a risk that the taper could be more damaging than expected. If for example, equities were bought as a claim on future production to hedge against future inflation, then higher discount rates further along the term structure could reprice equities making them more expensive than previously thought.

The other risk of QE is that we really don't know what asset prices look like without it. Short rates are artificially low, but the arbitrary nature of the setting of short rates is something we have come to live with. That QE has been extended across the term structure means that the shape of the yield curve absent QE is also unknown, and the shape of the curve is a somewhat important factor in signaling economic growth and shaping asset pricing. Quite worryingly, we have come to rely on QE and embrace it as a reality in our investment strategy.

Like the consensus, we expect the world to be less globalized and that trade growth while positive will slow in the wake of the underground trade war that has been waged invisibly these last 5 years. However, there will be an impact on the leveraged shipping finance industry which is supported primarily by European banks. This could be another source of volatility in store for markets in the near future. A lot depends not only on the asset side of balance sheets but also on the liabilities. Some investments are simply not robust against rising interest rates.

The heavy issuance of debt in 2013 is also disturbing, almost like a last hurrah. As a rule of thumb, it is always good to be a reluctant lender, and thus to prefer securities companies are less willing to issue and to not prefer securities companies are more willing to issue. Overzealous lending is leading to a resurgence of covenant-lite issuance, now some 60% versus a mere 30% in 2007. Some companies have become, to an extent, passthru's whereby their senior unsecured issuance is being used to fund dividends and payouts to other parts of the capital structure.

Pooling vehicles generally increase systemic risk. The rise of mutual funds and the return of CDOs and CLOs in the US add to instability in markets. The state of the art in risk management is backward looking. Any risk metric that aims to provide not only amplitude but timing of risk events must fail at one, or both. We believe that the estimation of timing of risk events is futile and advocate estimating the amplitude of risk events. We advocate a Gini Coefficient methodology for dealing with liability based risk.

A related risk is the large scale adoption of a small number of standardized risk models. Blackrock's Alladin system stands out as an example. As more small, independent, boutique investment managers and traders outsource risk measurement to more standardized risk systems such as Alladin, investor behavior becomes more correlated and less independent. This violates the necessary conditions for convergence in many central limit theorems used in the same risk systems and could lead to highly leptokurtic markets.