Investment Outlook 2010 and Post Mortem 2009

Post Mortem:

At the beginning of 2009 I wrote down my investment expectations and outlook. Why I do that at the beginning of the year I don't know. It's just an arbitrary point in time. Be that as it may, I am hereby repeating that irrationality by coming up with my expectations for 2010.

2009 was a lot of fun to analyse because of the carnage in 2008. For 2009 I expected the global recession born in 2008 to worsen significantly, and I expected monetary and fiscal policy to be highly accommodative. I expected interest rates to stay low, which they did, that was a no brainer. I expected the fiscal deficit spending and the quantitative easing to be highly inflationary. Wrong! Inflation has been moderate and well under control. Accept in pockets. Where was the inflation? Food prices, gold, commodities, asset prices, emerging markets, emerging market assets, anything vaguely capacity constrained. Where did it not materialize? Every market in which there was access capacity, which annoyingly is most things in the CPI basket.

Oil. There fear had always been high energy prices and I had envisaged oil in a range of 60-70 USD and thus creating inflation some. Right on the oil price, wrong on the impact on inflation. Why? Oil enters the CPI only in motor fuel which is 3% of CPI. Transportation is mostly capital values of private new and used cars. And here there was plenty of access capacity and thus no pricing power.

So, what were my specific calls and where was I right and where was I wrong?

<u>Equities:</u>

I liked Asia and Lat Am relative to developed markets. That worked.

I thought macro policies would trigger a relief rally unsupported by fundamentals.

I thought volatility would remain high. Together with a rising market, this would require short term volatility to rise exponentially. I got that wrong. Vol did not rise enough to offset the rising market. I had no allocation to vol trading funds.

I expected merger activity to pick up on consolidations and divestitures. This did not happen. I am still waiting. LBO's clearly are a long way away.

Fixed Income:

I expected issuance to rise, a no brainer given how broke governments became while bailing out the financial system and spending on behalf of the private sector.

It was easy to extrapolate that yield curves were likely to steepen, which they did.

I had expected fixed income arbitrageurs to do well given the expected volume of issuance and the relative dearth of market participants and intermediaries. The complexity of the cash, swap and derivative markets were also likely to present ample arbitrage and relative value opportunities. The HFRI Fixed Income Arbitrage index has outperformed most other strategies with the exception of Convertible Arb, Relative Value, and Emerging Market funds.

Credit:

With the transfer of risk from private to public balance sheets I expected corporates to outperform sovereigns.

I also expected a general spread tightening based on macro

policies and reversal of risk aversion.

Credit for SME’s to remain tight. I liked that call. It wasn’t intuitively compatible with the rest of the credit view.

I envisaged a longer distressed cycle based on recent lending standards. The returns generated by credit managers have thus far come from spread tightening and not from restructurings.

I expected a general spread tightening purely based on a reversal of risk aversion and based on macroeconomic policy. I had expected a short and sharp recovery followed by significant volatility. What I did not expect was the scale and sustainability of the rally in credit.

Commodities:

Oil in the range 60 – 70 USD.

Cyclical recovery in industrial commodities.

I expected gold to be capped or weaker. What a disastrous call. Anyway, you can’t win them all. Why did I make a call on gold, a commodity I have no feel or fundamental view on? Boredom. Completeness. Had to say something. If I stretch it, you could say I was making a general risk aversion call. So why was I wrong? Over 2009, you would have done better in industrial metals like copper. So why did gold rise? Governments printed money and when they do that anything that is capacity constrained or supply constrained rises.

FX:

Weak USD, EUR, GBP.

Strong JPY, CNY, SGD, AUD

I didn’t really get my FX calls right or wrong. I was generally right in terms of general direction for the year but there was a lot of volatility and not a lot of drift. The

result was that over 12 months, currencies didn’t really move very far from where they began.

But what now? For every correct call, there is an “I told you so” and a glib explanation. For every wrong call there is a lengthy explanation technically known as an excuse. In a sense, the aftermath of 2008 was easier to predict than less turbulent times. 2010 will see the ripples from 2008 attenuating with time.

2010:

It is natural that economies should recover from recessions. In 2008 staring into the abyss, it’s hard to imagine a future. In 2009, on the back of the first leg of a recovery, it’s hard to envisage another recession.

Economies, developing and developed do not decouple unless things are really bad. Under conditions of stable and robust growth and globalization, economies of all types have to engage. The decoupling between developed and emerging markets sought by investors was instead a continuous evolution. What the financial crisis of 2008 did was to precipitate and to highlight this evolution. The dislocation in credit markets led to a sudden loss of trade finance which stalled world trade exposing or precipitating (depending on your interpretation), a turning point; namely that developed markets balance of trade was about to mean revert. This mean reversion is underway and has implications for economic development, growth, currencies, rates and markets.

The picture for inflation is no less complicated. So much is dependent on economic policy and whether central banks tighten, governments roll back spending, raise taxes, how the public reacts and how capacity evolves in reaction to sentiment and the real economy. For the real impact on the economy, on real people’s lives, one needs to look beyond the CPI which reacts to owner’s equivalent rent and all sorts of

non cash flow items. A recovery in the housing market will raise inflation through that term which carries over a quarter weight in the index. One needs to focus on subsistence, on food, shelter and transport. Food represents over 8% in the US household but carries a higher weight in poorer nations. Household energy can be as high as 4 to 5% in colder climes. Transport accounts for 15% in the US with 7% coming from new and used cars. Developing nations will have a different make up of transport costs with a higher weight in public transportation (a mere 1.1% in the US) and motor fuel. Inflation is most concerning in staples such as food and energy, which for reasons of their high volatility are excluded from core inflation metrics. How convenient.

Equities:

I have no idea where equities will go this year. I can make a guess but it is nothing more than a guess. Much of the directional drift in equities will continue to be dependent on macroeconomic policy. While developed economies recovery remains muted, rates will be kept low and fiscal deficit spending maintained. Developed markets will then be pushed and pulled by weak fundamentals and loose policy. The impact then on developing markets will be more interesting since most will have some de facto dirty float against the USD, which transmits and sometimes leverages US monetary policy into a domestic economy that does not need it. This would further inflate already over-valued or fairly valued assets. If on the other hand the developed world recovers, policy makers will likely tighten monetary and fiscal policy precipitating a correction in equity markets. This I would consider a very early stage bull market correction since it pre-empts improving fundamentals. Given the scale of fiscal and monetary stimulus I lean towards policy overshooting and necessitating a reversal of policy.

In terms of valuations, the US is not cheap on price to earnings, to book or on dividend yield. Europe offers better

value. Asia, however, is a more mixed bag. On earnings, China, Australia, India, Singapore and Taiwan are all expensive. Indonesia and Korea are better value. Japan is terrible on earnings but not on book, so it depends on your perspective.

2008 and 2009 saw idiosyncratic risk fall as a proportion of total risk, market direction notwithstanding as investors traded equities based on systemic risk. We saw dispersion of equity returns crash from 2H 2008 all the way through 3Q 2009 even after equity markets had bottomed and rallied hard. The environment for stock picking was simply not ideal. This is evidenced by the performance of equity market neutral funds returning -1.45% for 12 months to Nov 2009. In the same period their beta drunk counterparts in equity long short returned 22.44%. Short biased funds averaged -21.74% in the same period.

Equity dispersion is on the rise once again but only just reaching pre crisis levels. This will bode well for stock pickers. Equity long short funds will have the opportunity to make (or lose) more money.

The risk of another deep bear market is not trivial. Equity markets have rebounded further than can be supported by economic fundamentals. In many cases, financial valuation ratios have been maintained by cost cutting and not top line growth. The risk of another near systemic failure is lower as regulators and investors are still vigilant as they usually are after a recent bruising. As long as markets remain open and liquid and free from arbitrary government intervention, stock pickers in the equity long short space should do well. Indices mask a multitude of virtues. The beta of the HFR equity long short index relative to the MSCI World has in recent times averaged between 0.60 to 0.80. Many equity long short funds have a chronic long bias. If equities see a sharp correction, there will be no escape for the broad equity long short indices and their long biased constituents.

Fixed Income:

Developed countries are mostly running high budget deficits. Europe, US and Japan have accumulated substantial public sector funding requirements. Sovereign issuance will be forced to remain high. Depending on demand for sovereign debt, this could lift the long end. While sovereign default is still a low probability event a weak recovery is likely to further burden sovereign balance sheets and put further pressure on sovereign debt. This year, as it was last year, the inflation debate will create mispricings and volatility which are tradable or open to arbitrage.

Credit:

Credit markets rallied hard in 2009 across the range of credit quality. At current levels, it is hard to see value in credit relative to equities. However, the same argument for equities applies to credit where it concerns macroeconomic policy. Credit markets are likely to be sensitive to macro policy for the foreseeable future. Any tightening of policy will likely hurt sovereign debt with a leveraged knock on impact on credit, that is spreads are likely to widen. If, however, the recovery is weak or muted, policy will likely stay loose to the benefit of credit. As in equities, I favour emerging market credit, in particular Asia. The argument is harder to make in equities. In credit, however, there are strong fundamental reasons to prefer Asia. Asian economic growth is relatively stronger. The Asian banks are healthy and Asian debt markets have always found support from the banking industry. Asian corporates having been through the 1997 crisis have run more robust balance sheets and liquidity positions and have entered the 2008 crisis in better shape.

Last year I expected the mid market and SME’s to struggle in terms of availability of credit. I expect this to continue in 2010. With larger corporates happy to accept higher spreads for their funding, banks have no incentive to service the

small to mid caps.

Last year I expected passive strategies to do poorly relative to stock selection. It turned out that spread compression was systemic as result of macro policy and a reversal in risk aversion. I believe that this year, stock selection will become important and that long short strategies will be necessary to generate returns. Idiosyncratic risk has already begun to rise relative to systemic risk as manifested in spread dispersions.

Commodities:

I find it hard to think of commodities in isolation. In particular the pricing of commodities in USD or EUR or JPY. An inflation neutral yardstick is always useful and here I like to use gold. Since you can’t eat it or burn it, its relatively useless enough that I can use it as an inert metric.

The industrial metals outperformed gold going into 2008 then collapsed. They have since recovered and on a 12 month basis have outperformed gold. Purely on the back of a policy inflated recovery, I would expect silver to trade up to a higher range (+17 to +30%) quanto gold. Copper looks like it has found its market clearing price and platinum looks like it has considerable upside, perhaps 20 – 50%, again in gold terms. Commodities in recovery are highly correlated to industrial production in real terms, hence my expectations, and hence my correction for inflation using a gold numeraire.

While industrial metals have recovered, agricultural commodities have stagnated (with the exception of sugar which rallied on India’s poor harvest). Everything from wheat, barley, corn, cattle to lean hogs have seen driftless volatility in 2009 leaving them close to their end 2008 levels. This is despite the expectations of the doomsayers that the world stands on the brink of mass famine and drought. I am no expert by far in agricultural commodities and shall

remain silent.

Now gold. I have no idea how to think about gold. It must be the most expensive substance to be as useless as it is. Gold bugs will claim that it is a store of value. Stores of value value as stores of value varies over time. Gold was a great store of value in the 1970's when the USD came off the gold standard and inflation expectations were turbocharged by rising oil prices. Gold averaged an annual return of 35% for the 10 years from 1972 to 1982. From 1982 to 2000, gold was a poor store of value. Since then it has been a great store of value again rising an average annual 19% from 2001 to 2009. My instinct is that the USD is oversold relative to gold and that gold should correct. A rational scenario based on logic I do not have.

FX:

Predicting the direction of currencies is a losing proposition. At least for me. At the start of 2009 I predicted USD weakness, surprise surprise. I also expected a strong SGD, AUD and CNY. On the other hand, I expected a weak INR and MYR. And how wrong were those calls. Never mind the internal inconsistency since currencies are priced against one another.

I shall make another stab at predicting the direction of currencies. The vast majority of transaction volumes in FX are speculation. In JPY/USD for example, less than 25% of transactions reflect asset liability management. Yet it is, I believe, asset liability management demand and supply that provides the drift in currencies, whereas speculative transactions add drift free volatility.

Based on the above assumption, I expect the US and Europe to move towards a net exporter status with China and India moving towards the net importer position. Countries like Brazil, Indonesia and Australia have overwhelming natural resource exports which should keep their currencies supported as long

as the Chinese are buying.

Investment Strategies:

I have not the time to directly invest and trade in the strategies I peddle above. Thus, my modus operandi is to outsource investment management to other investment managers who operate specific strategies. I won’t always be able to get the specific trade I want, but then again I’m not always right and this way I have someone else to blame if things don’t work out. What are the underlying managers for anyway?

It was easy to make money in 2009. It will be harder in 2010. It is always easiest to make money in markets which are the most dislocated and mispriced, whether they are overvalued or undervalued. Markets were undervalued in 2009. They are no longer undervalued in 2010. I will go into more detail in a subsequent post but for now, the broad principles I want to address are:

Focus on alpha generation. This was not the case in 2009 when it paid to be long into the relief rally. For 2010, idiosyncratic risk is rising and will provide opportunities on the long and short side. Tactical trading should be for risk management and not for taking bets. We have a new casino in Singapore for that sort of thing. Macro policy is becoming too important and is building up stresses that are likely to snap at some point.

Be hedged. Arbitrage opportunities still exist in capital structure arbitrage. If you have the staying power and the fund you are investing in has the appropriate lock ups, this is still the place to be. The ability to invest across the capital structure of a single issuer is a powerful advantage. Different securities are traded by different constituents who often do not police efficient pricing across the entire structure. The systemic recovery in 2009 has not corrected the mispricings that occurred in 2008 when again the deleveraging

occurred on a systemic level.

Be hedged. Market direction is highly uncertain and highly dependent on macro policy. Whether it is equities, credit or fixed income, being hedged is important this year.

Lend money to SMEs. Asset based lending and mezzanine finance address a market inefficiency, namely the dearth of credit to small and mid sized companies. Credit standards always improve following a financial crisis, particularly one centred on credit. Spreads are usually wider as well. This improves the overall risk reward of ABL strategies.

Lend money to banks. Banks would love to lend money but they can’t do it in a politically acceptable way with public funds for example. Structured finance and regulatory capital relief transactions can provide secure investments with high yield.

Distressed investing. The investors who got in in late 2007 were too early and lost their shirts, some their pants. Those who got in early 2009 did well but they simply got lucky. Default rates were not nearly high enough nor the pace of workouts sufficient to support the strategy. They made money because of spread compression from a general improvement in macroeconomic conditions. Luck. 2010 will be a good time to position to invest in distressed debt, provided one doesn’t overpay for the assets.

Managers I like:

In event driven equities, Fund A has a long track record of producing alpha, is run with a PE approach to public equities, runs a hedged book and often takes an activist role in realizing value. The fund dropped 24% in 2008 and made 24% in 2009 and is thus still below high watermark. The consistency of returns and the attention to risk management sets them apart. I expect equities to be more fundamentally driven and thus present this manager with fertile ground for generating returns.

In fundamental equity long short, Fund B is a smaller sized fund taking a very fundamentals driven, supply chain analysis approach to investing with the ability to invest in small and mid caps. The fund lost 24% in 2008 and has underperformed the market in 2009 with a paltry 3.7% gain. Their performance is explained by their strategy and portfolio and I expect the environment to favour their approach going forward. For the same reason as above, that fundamentals will dominate equity variation, this manager is expected to do well.

In multi strategy arbitrage, Fund C has a long track record in convertible arbitrage which spawned various sub strategies from capital structure arbitrage to mortgage backed securities and SPAC arbitrage. The fund's strategy requires stable capital and patience on the part of the investor. The team is highly innovative and constantly researches and implements cutting edge strategies. The fund lost 27% in 2008 but has since made 90% in 2009. While markets have recovered, capital structures remain dislocated and many securities mispriced presenting this manager with excellent profit opportunities.

In Asian multi strategy arbitrage, Fund D is managed by the same manager as Fund C but is focused in Asia. The Fund lost 36% in 2008 but has made 49% in 2009.

In Asian multi strategy directional, Fund E is a thematic trading fund trading across the capital structure and using fundamental analysis to identify the optimal trade expressions in the appropriate vehicles for executing the thematic view. The manager of the fund has a significant investment in the fund and represents a significant proportion of assets under management. The fund lost 40% in 2008 and has made 65% in 2009.

In the area of merger arbitrage, Fund F stands out. A veteran of 2 established multi billion hedge funds, the portfolio manager established his own management company in 2007. The strategy is backed up by in depth valuation and deal analysis

and structured with option buy write strategies for optimal trade expression. He lost 37% in 2008 on the back of serial deal breaks but has registered a 98% increase in 2009.

Fund G is a classic fixed income arbitrageur with a small inflation book. The manager has a track record dating to late 2001. The fund has some short term volatility but has generated very consistent annual returns. The fund made 22% in 2008 and followed this with a 9% return in 2009.

Fund H is a credit long short fund with a tactical trading approach. The fund is quite small which may limit the size of allocations but the manager is very experienced and has a very pragmatic view to investment management. The fund has been going since mid 2004 and has had periods of low but positive returns and periods of high outperformance, as expected from a tactical trader.

Fund I is a prop desk spin out that replicates a prop desk trading fixed income relative value, arbitrage and macro. The fund was founded about 5 years ago and has generated very consistent results which have helped it grow its assets under management. There is some overlap with Fund G, however, this fund has less of an arbitrage and more of a relative value and macro approach to trading.

Fund J is an Asian credit fund which was newly launched in mid 2009. The investment team is very strong and brings together fundamental credit work, technical expertise and a macro thematic overview. The Asian credit space is not crowded and arbitrageurs are in the minority with long term holders and real money investors forming the bulk of the market participants. The environment is ideal for this manager.

Fund K is a global multi strategy credit fund founded by a pioneer in structured credit who has built up a team and an infrastructure of outstanding quality necessary to excel in the arena of multi strategy credit extending from single names

to structured and tranched credit. The fund dropped a little over 6% in 2008 but has since made over 30% in 2009. The strategy is very much uncorrelated and captures returns from idiosyncratic risk and security selection and trade construction. The systemic nature of the rebound in credit markets in 2009 has not diminished the opportunity set for this manager as mispricing persists in the credit market.