Risk On Risk Off

1st May 2012

Investing on fundamentals in the last three years has been extremely expensive at times as seemingly obvious signs of asymmetry have been supported by enormous sums of money. Movements of liquidity have shifted markets counter intuitively in line with central bank attempts to manipulate outcomes.

The market has adapted by building a set of behaviours around central bank actions or their likely actions, this is generally alluded to as "Risk On Risk Off". The approach of waiting for a mini crisis, riding the momentum down, then anticipating central bank action and riding the wave up has been a reasonably effective approach over the last two years. This can be observed through the stellar performance in momentum-based strategies in certain periods.

However, we believe the use of any trend as a constant given that the status quo is never more than temporary in markets is dangerous. The importance of a process which focuses on the longer term and challenges, avoids short termism and extrapolation, and is perhaps more important in this type of environment than any other. The key has to be to look beyond the Risk on Risk Off dynamic.

The current posture of a number of the larger investment banks is a case in point, while their economists are totally aware of the status quo within Europe and the US, their market outlook almost presumes what comes next. In the world of centralized action, the focus remains on what it takes to make the Fed, ECB, BOJ, PBOC, IMF and sundry to come off the sidelines. If Spanish 10-year bonds rise to 6.5%? LTRO 3! If US economic growth stalls? QE3! How do you address the European calamity? All of these assumptions may indeed be correct; however, they are anything but certain, and the projected outcomes less so.

The Risk On switch continues to be driven by central bank action or the threat thereof. This has fundamentally driven markets, (US RMBS, Peripheral spread tightening to name but a few examples). Action is concerted globally with an open line of communication between all of the key central banks. The key is to understand that this money is seeking to limit or reverse asset price deflation which naturally occurs during a severe deleveraging cycle. However, the real danger here is for one to work on the assumption that this can happen again and again without a point of clear resolution (proper provisioning, credible deficit reduction).

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