Realm Market Review – The Behavioural effect of the Central Bank Put 12th Nov. 2012

Motivating any type of investor to walk into the current valley of shadows and deal with a plethora of un-quantifiable outcomes is no mean feat. In an environment where the prevailing pre-disposition is fear, one can only raise their eyebrows at the recent rally in everything risk. After all, there are no shortage of reasons to worry- be it a fragmenting/insolvent Europe, the Japanese demographic cliff or the American trillion-dollar budgetary cash flow shortfall, not to mention a significant regional conflict and a Chinese power transition. When we look a little below the surface at the behaviour of the return seeking participants, what can be observed is a fight for relevance and survival by the plethora of hedge funds, bond funds and equity managers who oversee trillions of dollars all over the world.

Each manager is hostage to the investment environment in each sub sector, but ultimately the business driver is peer performance, this focus on relative performance is simply another adaptation of survivorship bias and self-interest. The Hedge Funds or Macro managers have been painted as unscrupulous opportunists since the great recession began, and the blame has been placed squarely at their feet for testing or seeking to “break” the system. To be sure, many managers are compelled to invest in such a manner that reflects their constituent investors own fears. But the treatment of symptoms by regulators has seen them look to redress price weakness within specific asset classes and take measures, which in turn has seen hedge fund managers take losses and force them to rotate to the next likely financial or economic vulnerability. For example, this year we saw managers rotate their bearish positions away from Europe into Asia, a trade that probably suited the European policymakers and has led to some complacency on their part.

The context for money managers is the here and now, and the reality is that there has actually been less ambiguity about the ‘right’ thing to do over the last few months. That is, to believe the policymakers will do “whatever it takes.”

Looking at the value-based fundamentals has been costly. It’s apparently not important that the European ESM designed to bail out the Continent is underpinned by $80billion which has been pledged by among others the same countries it is seeking to help; or that the Greek coalition is fragmenting and if there were an election today the result would be very different; or for that matter that the biggest European Banks often operate balance sheets that are bigger than the parent country’s GDP; or that the arrears of Spain’s biggest banks are still unbelievably reported to be in the single digits and these same banks will apparently bail out the “bad banks” ; or that Italian austerity hasn’t even started; or that Draghi’s put was conditional on the recipient capitulating and leaving their sovereignty at the door. Yes- despite all of that, being short risk over the last couple of months has been the wrong thing to do.

Investment markets have pushed central bankers and governments to go from implicit guarantees (through the European Target 2 mechanism) and explicit threats (the withdrawal of support for Greece), to explicit guarantees (whatever it takes) and implicit consequences (inflation down the road?). The markets have figured out that much like a shark, a large industrialized economy cannot stop swimming for any length of time. The leverage in the system just will not allow it, it’s a perverse catch 22. The consequences of the Shark stopping for a spell are observable anecdotally in nations like Greece or Spain, where the austerity/negative growth /insolvency spiral that has been engaged will test the limits and subservience of any modern society.

And so it goes on; the enormous European and global Bank balance sheets cannot and will not take a slide in global GDP particularly well given that weak GDP leads to weak revenue, which leads to rising defaults and asset impairment. In a system where the safety nets are frayed and the consequences dire, the system will continue to be protected by the Central planners, who will continue to prime the market with the liquidity, which allows the treasury functions of Government to deliver some measure of austerity. In the current context fiscal policy has now become cyclical (cutting budgets when the economy desperately needs stimulus), which is exactly the reason central banks have little to no choice but to continue to prime asset markets and hope that it trickles through to the real economy. The point is there will be a continued divergence between assets prices and asset value. The task for the long only managers and hedge funds is therefore getting tougher.

In this kind of environment, a fixed income manager must have their wits about them. The emphasis should be on credit discovery and plugging the funding fissures that are functions of liquidity and in-accessibility rather than riding the risk wave. It has never been more important to get back to looking at bonds as loans and promises of repayment rather than faceless securities.

Our view is that research and a ground level awareness of a market will drive a superior outcome. Investment markets are unforgiving at times like this. Debt, purchased with due diligence and value in mind, provides a finite set of outcomes and parameters which makes the question of price less ambiguous than is the case in other asset classes where blue sky can solve for a shortfall between market realities and individual expectations, such as equities.

In fixed income, hope forms no part of the strategy, the emphasis has to be on buying the facts.

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