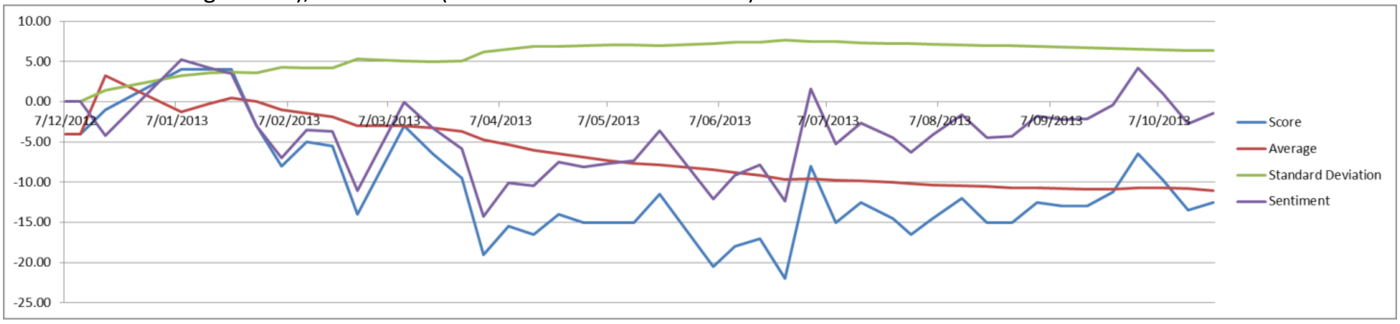
Investment Committee (Resilience or Complacency) 28th Oct. 2013

Over the period of the last year and a half the formal operation and scoring of our macro view has acted to provide us with an active barometer.

The discipline of maintaining a record of thought has assisted us in not only monitoring our own effectiveness but has also helped us better understand broader behavioural trends.

The chart below tracks our macro score from week to week. What it illustrates is that our view of the broader economy has progressively deteriorated as the year has progressed.

Legend: Blue line (Investment Committee Score), Red line (Moving average investment committee score), Purple line (Weekly Score minus Average Score), Green Line (Standard Deviation of score).



However, what has become just as apparent is that the more accustomed the market becomes to generally weaker conditions the harsher news needs to be to have an effect. This is described by many as being a sign of ever increasing resilience, meaning that bad news is suffering from the law of diminishing returns.

In the years following the crisis the market suffered from an almost seasonal sell off, as the resolve of central planners was tested. What investors seemed to take away is that ultimately central banks and regulators have no choice but to acquiesce to the needs of the broader economy and financial market.

This has seen us shrug off Beppe Grillo, Cypriot depositor run-downs, Tapering and the EM crash, debt ceiling, a government shut-down, a potential Chinese shadow banking crisis/hard landing, the occasional cough and splutter in Abenomics and the continuation of the Euro crisis.

What we have found is that a bad number at an investment committee level doesn't necessarily provide informational content on market behaviour, however we have observed that the differential to the mean does. In short, bad news now needs to be worse and good news just needs to be not that bad to have an impact.

This is a definite change and speaks volumes of the markets confidence in the explicit support provided by central banks and governments.

Following this train of thought, to what is for us its logical conclusion, it stands to reason that at present what separates the market from significant volatility is the belief that ongoing support has become a self-evident truth.

How would this truth respond to the Chinese hardening their line on shadow banking, or to the Japanese needing to accelerate budget cuts to reign in their deficit, or to renewed talk of tapering as a way to manage asset bubbles, or if God forbid the ECB stress tests on their banks are actually true to label?

If the answer is poorly, perhaps what we are faced with is a market that suffers from complacency rather than one that is evolving greater resilience. Which by extension means that the best way to describe our markets currently is complacent and vulnerable.

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