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The going gets tougher

"There are times when the burden of taking other people's money forces you to be active when you don't really have conviction. It gives you a sense of pressure and expectation. When it's your own money you don't have to do anything."

- Tony James, President of Blackstone, commenting on Stanley Druckenmiller's decision to wind up his hedge fund. As reported in The Financial Times.

The Investment Commentary will shortly be taking its summer holiday.
It will return, on Monday 20th September.

As capsule summaries of 'agency risk' go, the one above takes some beating. As any honest trader will confirm, being forced to be active without conviction is a licence to lose money. Doubly so in such a convictionless market as the one in which investors are now becalmed. Henny Sender's article ("The letter that shook hedge funds") for last Thursday's FT cites a hedge fund executive similarly bemoaning the apparent lack of alpha male assuredness in alternative asset management:

"Nobody is sending out definitive 'this is my view' letters these days. Nobody has any conviction. We go through rallies and we go through sell-offs and nothing is well sustained."

Well, ***tough***. Above the noise of the world's smallest violin playing on behalf of the hedge fund community, nobody ever promised them, or anyone else, a rose garden. If the author of the anonymous quote above had been a traditional banker, we could at least have gone onto an extended rant about moral hazard, moral bankruptcy, and the sad triumph of a parasitic underclass that has gone on to devour its host and much of the rest of the economy. As it is, all we can suggest is that in such an apparently challenging market, those who can manage risk should now thrive at the expense of the hordes of overpaid chancers who pollute the ranks of the supposedly homogeneous hedge fund sector. The problem is most acute in the world of so-called global macro funds. In more tightly defined strategies, say credit arbitrage, you make the best – and the worst – from the asset universe available. But in global macro the investible universe is pretty much infinite; there is arguably too much choice, if there can be said to be such a thing. And if a lack of conviction were really warranted, each of those choices today essentially represents an opportunity for the active manager to hang himself.

Individual investors may lack conviction, but as we pointed out last week, the markets themselves have no such reservations. Stock markets admittedly seem caught in a state of funk. But bond markets are screaming it from the rooftops: ***deflation is coming.*** How else to explain 30 year German government bonds at all-time record yields below 3% ? Or 2 year Treasury notes hovering at 0.5% ? The investment media, of course, have an answer: it's a bond bubble. But it's difficult to feel the same way about lending money to 'AAA'-rated governments as most people did about piling into profitless internet businesses 10 years ago selling online petfood. (Interesting, in passing, to recall that Mr. Druckenmiller by all accounts lost a huge amount punting internet stocks. It's not enough to say it was just a matter of market timing, and mistaking the ninth inning for the eighth. Being late and being wrong can be the same thing.) Yes, it could be a bubble, but "bubble" seems an odd way to describe an asset that most people pursue to preserve rather than expand their wealth. A bit like talking about a "bubble" in saving. Which doesn't stop the likes of Jeremy Siegel, author of one of the most notorious examples of equity cult fetishism ("Stocks for the long run"), whining about "The Great American Bond Bubble" in the Wall Street Journal. To take one admittedly extreme example, from the one economy that has endured outright deflation recently, one of the surest ways of losing money throughout the 1990s was by shorting, as opposed to buying, Japanese government bonds as their yields sank, and sank, and sank further.

10 year Japanese government bond yields, 1990-1998

(Source: Bloomberg LLP)

It seems plausible to conclude that there are at least two types of institutional investor – aside from central banks – buying government bonds and who are largely price insensitive. One is pension funds, who have actuarial and liability-driven reasons for doing so. The second is, ironically enough, the banks who were, alongside governments, most complicit in causing the crisis in the

first place: as recipients of essentially free, government-sponsored money, parking those proceeds in the government bond market allows them to earn what they would call "riskless" profits – though we know enough about banks by now, and ratings agencies, to treat their definition of "riskless" with a pinch of salt.

Japan gets something of a bad press when it comes to its deflationary lost decade. As Richard Koo points out in "The Holy Grail of MacroEconomics: lessons from Japan's Great Recession" (John Wiley, 2008), the damage incurred after its property and equity bubble burst in 1989 was worse than that suffered by the US during the Great Depression. Japanese commercial real estate prices fell by 87% from their peak. (As Koo suggests, imagine the effect on the US economy if urban real estate values fell that far.) The loss of wealth from the value of land and shares in Japan came to 1500 trillion Yen. That is three years' worth of Japan's GDP:

"about the largest loss of wealth in human history during peacetime."

By comparison, the loss of wealth in the US during the Depression summed to "just" one year's worth of US GDP. Japan ***really*** had it bad. And yet, while the US unemployment rate soared to 25% during the Depression, during Japan's contraction its own unemployment rate never rose above 5.5%. Cultural hostility to lay-offs no doubt played some role, but a larger role was played by the Japanese government, which stepped in to replace private sector spending, albeit by issuing enormous amounts of government bonds. And yet despite this issuance, Japanese government bond prices never fell. Individuals and banks, rebuilding their shattered balance sheets, bought them. Despite suffering the financial equivalent of an atomic blast, Japanese GDP didn't fall during the 1990s. But more to the point, after a colossal collapse in both property and the banking sector, ***government bond prices can act in somewhat counter-intuitive fashion***.

The problem facing Western governments is that the policy cupboard is almost bare. Conventional monetary policy is spent: interest rates, particularly policy rates, simply can't go any lower. Nor is there ammunition in the fiscal armoury: most governments have now belatedly rediscovered austerity, so there is no realistic prospect of tax cuts, quite the opposite. The only tool left is the unorthodox and last ditch one known as quantitative easing. As Koo points out, this was staggeringly ineffectual in Japan: he calls it "the twenty-first century's greatest monetary non-event". The BoJ implementation of QE at a time of ZIRP (Zero Interest Rate Policy) was

"similar to a shopkeeper who, unable to sell more than 100 apples a day at Y100 each, tries stocking his shelves with 1,000 apples and, when that has no effect, adds another 1,000. As long as the price remains the same, there is no reason consumer behaviour should change – sales will remain stuck at about 100 even if the shopkeeper puts 3,000 apples on display. This is essentially the story of quantitative easing, which not only failed to bring about economic recovery [in Japan], but also failed to stop asset prices from falling well into 2003."

In an unnecessary but valiant attempt to placate our earlier anonymous hedge fund executive, here are ***our*** views. QE2 looks like a done deal across Western administrations, and we expect it to be comparably as futile as the Japanese found it to be. But it may well sow a sufficiently critical mass of inflationary and currency-destructive seeds to justify, ultimately, inflation protection. In the meantime, government bond markets will remain well bid since deflationary pressures trump any other. We prefer, however, to invest in true quality rather than perceived high quality, and are therefore focused on the most creditworthy sovereign borrowers in the world which happen also to provide excellent yields by comparison to the overcrowded conventional yields available in usual suspect markets like the US, the UK, Germany.. Investment vehicles such as the New Capital Wealthy Nations Bond Fund (investment grade sovereign debt, which yields c. 7%) and Stratton

Street's Renminbi Bond Fund (Asian investment grade sovereign debt with a structural exposure that is long Renminbi and short US Dollar; current yield c. 6%) strike us as significantly more attractive on a risk-adjusted basis than the conventionally "riskless" government markets of heavily indebted countries like the US and the UK. In equity terms we have favoured for some time the most defensive blue chips. In other respects we see little by way of compelling wealth insurance except for absolute return funds with a demonstrable track record of capital preservation and growth, and gold. Happily for us, we are not managing a global macro hedge fund: in those areas outside our zones of highest conviction, we will be doing precisely nothing.

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