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Continental Drift

"I'm counterfeiting euros. If I'm caught I'll plead insanity."

- Matt cartoon, The Sunday Telegraph.

The latest Greek bail-out changes nothing, other than accelerating the pace at which euro zone tax payers have their funds flushed down the toilet, redirected to the banks, or both. (They may be the same thing.) European politicians appear to be struggling to accept the underlying reality: Greece is insolvent, so simply throwing €180 billion more of other people's money at the problem doesn't improve matters, in the same way that violently injecting ever greater doses of adrenaline into a corpse doesn't change the outlook for the corpse. The package announced last week was admittedly more dramatic than the markets had anticipated, but its confidence-boosting impact will probably have evaporated by the middle of this week, not least because other sovereign insolvencies are quietly biding their time on the sidelines, oozing poison into the markets. €180 billion doesn't buy you much of a rally these days. Bullishness is terrifically expensive.

Sometimes, amid the Sturm und Drang of the market, it's possible to have a blinding moment of clarity. In one such moment, Nomura's Bob Janjuah we think clearly identifies the problem facing Europe, in just three little words: weak trend growth.

"Most policymakers and many in the market are still desperately hanging on to the view that trend growth rates in developed markets (and emerging markets too) have not been impacted materially as a result of the financial crisis. To me the evidence is clearly 'in'. **The only way developed market (and emerging market) policymakers have been able to deliver even barely acceptable trend growth has been through the use of unsustainable policies which put short term gains first but which clearly create huge long term risks to sovereign credit quality and which leave a deeply negative scar in the minds of the private sector, which is attempting to de-lever and which knows it is facing the mother of all tax liabilities going forward. The reality is that absent a private sector debt binge (the private sector is not that stupid) and assuming we are coming to or are at the end of the line with respect to policy, then developed market trend growth over the next 3 – 5 years will be in the 1% to 1.5% range.. Once the market is able to see the limits of policy, and once the market is able to see through the excuses (of 'soft patches'), then it is inevitable that we see a significant re-price lower** of earnings expectations, of incomes, of asset values, and a genuine (rather than hypothetical) acceptance that living standards, especially in the developed market economies, are going to be materially lower over the next 5 – 10 years than current consensus expectations / forecasts."

Bob Janjuah is surely almost certainly correct when he concludes that emerging market economies, as a whole, are likely to outperform over the medium term, on account of their "strong balance sheets, huge flexibility in taxation and labour markets, and very low levels of entitlement expectations".

Or to put it another way: Europe has – with the possible exception of Germany – gone ex-growth, and faces a future that looks rather similar to the last two decades in Japan. This point is not lost on Merryn Somerset Webb writing for the weekend FT and citing some holiday reading for investors still clinging to a sense of realism. Among her selection is Alex Kerr's 'Dogs and Demons', which covers Japan;

"..for a real insight into how the odd banking crisis can turn into a disaster for public finances, turn to [ironically enough] chapter 11. Here you will learn about how "the ministry of finance's support for banks and industry through the manipulation of financial markets has had high costs. Interest rates of 1% or lower have dried up the pools of capital that make up the wealth of ordinary citizens; insurance companies; pension funds; the national health system; savings accounts; universities; and endowed foundations. The prognosis is for skyrocketing taxes and declining social services." That should have a familiar ring to it – it is a glimpse into our own futures."

And while Europe drifts slowly towards further genteel decline, American politicians wrangle over their own debt burden, showing, in the process, an alarming complacency at the prospect of sovereign default, and obvious unfamiliarity with the principle of 'risk-free assets' and the capital asset pricing model. Orwell suggested how language would be deployed as the last refuge of the political scoundrel, so we have been treated in recent weeks to concepts such as 'restructuring' and 'selective default', as if investors were unaware that huge parts of the sovereign debt structure were buckling under the weight. We take a hugely simplistic view of the global debt landscape: if the (sovereign) borrower is a deadbeat, we don't lend to it. In the words of John Badham's film 'War Games', sometimes the smartest move is not to play.

If it makes sense to be highly selective about bonds, given the risks, it surely makes sense to behave in the same way when assessing equity opportunities. Europe's slow decline doesn't automatically invalidate the shares of European or UK-based companies, for example, but it does suggest that we should be thinking about those businesses with meaningful exposure to faster growing places in the world, and about those businesses whose shares represent deep defensive value. The problem here is nicely expressed by JP Morgan's Michael Cembalest. Large cap, blue chip stocks in the UK and Europe trading at single digit price / earnings multiples, with 30% to 50% of their revenues in faster growing economies, and offering 3% to 4% dividend yields, or higher, are surely relatively attractive. But "we don't expect to get paid in full until (and unless) the world's largest debtor economies find a way out, which is going to require more leadership than we have seen so far, and perhaps a crisis to bring it about." We disagree only on one point: where Michael Cembalest uses the word 'perhaps', we would use the word 'certainly'.

Given that the ability to anticipate the macro environment involves a more than ordinary ability to assess just how selfish and stupid politicians are going to be, we feel more uncomfortable than normal allocating capital to macro managers. We favour purely systematic, mechanistic trend-following strategies for our 'absolute return' exposure, and we acknowledge that the sector is currently struggling with market headwinds that may be influenced by the extent of political asset price manipulation.

Our fourth asset class commitment in these extraordinary times is to real assets. Observers often complain that we seem to write about little more than gold. Which is wholly unfair. We have often discussed the investment merits of silver.

So we peer into an investment landscape more than usually obscured by uncertainty and with huge prospective tail risks. We draw huge comfort from an investment process that we feel is more genuinely diversified by asset type than those of many of our peers, and that simultaneously benefits, we believe, from a concentration of investments where we have particularly high conviction – the monetary metals being a special example. There is admittedly not much fun in anticipating what might be years of structural decline in our home markets. But it most certainly takes the edge off when one has a plan.

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