Innealta
CAPITAL

COMMENTARY: JULY 31, 2013

AN UPDATE ON OUR GLOBAL OUTLOOK

As summer is in full swing, we pause to reflect on the state of the economy and discuss our outlook, both domestically, and internationally.

I. THE DOMESTIC OUTLOOK

The World According to Bernanke

Recent events provide concrete evidence that global financial markets are still glued to the unprecedented monetary stimulus efforts of our Federal Reserve. Following the revelation of growing support among policymakers to begin tapering, global financial markets reacted violently. Commodity prices dropped. Previous asset flows to emerging market countries reversed course in dramatic fashion, driving down valuations across the board as the U.S. dollar rallied. Apparently not liking the result, Bernanke dispatched the henchmen to begin reversing the damage by providing “clarification” and “assurance” to calm the markets. Sadly, the additional rhetoric further suggests the Fed is in fact walking the proverbial tight rope with no clear path to unwinding this unprecedented monetary expansion. Or, more likely, they have absolutely no clue what they are doing. They have unnecessarily cornered themselves into a position where the capital markets now dictate policy like a spoiled child dictating parental discipline.

It is important to consider carefully the language and context of the feared tapering of asset purchases, as well as the timeline laid out. Here, it is helpful to think about the levels of stimulus, not simply the monthly “flows,” which truly are additional stimulus on top of the accumulated previous asset purchases. On the current course, the Fed pours an additional $85 billion into the monetary system through asset purchases. This means that over the span of every 10 months, the Fed pours more money into the system than was ever allocated for bailouts during the financial crisis. That is a staggering figure. And each month of asset purchases is on top of the previous purchases, which have resulted in an extraordinarily bloated balance sheet at the Federal Reserve. Our question is simply: To what effect?

But what is perhaps most disturbing about the language used by the Fed is its inconsistency. They first used specific timelines, followed by targets associated with their dual mandate. Now, their language has almost come full circle by returning to innocuous rhetoric. To us this strongly implies an internal recognition within the Fed that they fully understand the ineffectiveness of QE on the real economy. It also reinforces our hypothesis that they have produced their own paradox. They realize the ineffectiveness of the current policies and the need to reduce their bloated and highly leveraged balance sheet. However, the only beneficiaries of these policies don’t much care about the real economy only that the commitment to cheap money be retained. If that commitment is even reduced microscopically the potential backlash is deemed too disruptive. At this point it will take years for the current policies to be unwound and the side effects will be non-trivial. With that there will be an increase in tactical investment opportunities.

Where are we now, and what do we have to show for the unprecedented monetary stimulus?

The recent Financial Crisis saw many large, systemically important financial institutions over-leveraged and invested in assets that subsequently incurred large, if not total, losses. But what about the Federal Reserve? Multiple rounds of asset purchases have increased the Fed’s balance sheet to nearly $3.6 trillion. As a point of reference, in July of 2008 the size was just over $900 billion. Relative to a rough estimate of the Fed’s reserves, this corresponds to leverage of approximately 30 times—by some estimates as large as 50 times. Further, should interest rates rise meaningfully, the Fed is not far from the point of insolvency. In fact, some pundits have presented back-of-the-envelope calculations to suggest that, based on reasonable duration estimates of their asset holdings and the rise in benchmark interest rates over the last two months, the Fed is already insolvent were they to mark their assets to market. It gives us great concern to realize that a relatively small rise in benchmark Treasury rates, which are still low when viewed in the context of historical rates, has already pushed the Fed across this threshold. What is even more staggering is that capital markets' sole focus appears to be on how long this habit may be able to last, not whether the current levels pose systemic risk.

Much attention has been placed on unemployment. Certainly headline unemployment numbers suggest the aggregate unemployment rate has been on a steady downward decline, to the extent that the Fed's bogey natural unemployment rate is in sight. But there are other factors to consider when interpreting this number. Specifically, the statistics are influenced by work force participation and the "quality of employment."

First, to work force participation, this number is at an all-time low domestically. Demographics play a role, since retirees and students are fit and able to work, but chose not to do so. Since the Financial Crisis of 2008-9, the domestic labor market participation rate has dropped precipitously. This is why, although the economy has barely created more net jobs than lost during the crisis, the unemployment rate has declined (i.e the numerator effect). In some cases, workers become frustrated and give up. In other cases, workers return to school for new training and hope to re-enter the work force on better terms. Regardless, it is important to recognize that low participation in the labor market means the burden of providing public goods falls increasingly on the working population, which is a non-trivial headwind to economic growth.

Second, to the quality of employment, we note many workers have taken part-time jobs in order to make ends meet and avoid large unemployment gaps. Thus, a significant fraction of employed workers are in fact under-employed. Taken in the context of economic behavior, where consumer spending has been an important driver of domestic economic growth over the previous expansion, this is not a positive statistic. Under-employed workers have less discretionary income for spending, and likely have lower propensity to spend or borrow given their employment status.

Current consensus forecasts show slow expected annual domestic GDP growth in the range of 2%. This is despite fiscal stimulus efforts and unprecedented monetary measures. Most troubling is that we are experiencing the weakest GDP growth and net job creations following any recession in our nation's history.

The U.S. economy continues to be weighed down by various headwinds, none of which show any sign of easing. Numerous structural problems exist, one of which is the labor market. Globalization has opened manufacturing to the *billions* of workers in emerging market economies demanding wages far below those of U.S. workers. By legislating minimum wages in excess of the wages demanded by these minions of workers, it is no wonder domestic job creation has been slow. To truly bring manufacturing back to the United States, we must erase the wage gap by either paying workers less or improving production technology to the point that it is vastly superior to that of international competitors. Thus, it is reasonable to believe that unemployment will remain a structural problem. This is all significantly impacted by the upside-down incentives produced by ever increasing unemployment benefits.

With much attention focused on current deficits, attention has shifted from a very large pink elephant in the room: the enormous unfunded future liabilities faced by the federal government and municipalities across the land. These include pensions, Social Security and Medicare. Upside down demographics result in many more retirees and too few workers paying into the system, leading us towards a breaking point where one of two things will be forced to happen. Absent intervention, either constituents will be forced to take large cuts in promised benefits or the younger generation will bear the tremendous burden imposed by the costs of these plans and the past decisions to raid the coffers for temporal spending purposes.

Additionally, as we approach mid-term elections, partisan politics and a continuing political divide have resulted in businesses facing prolonged uncertainty. Business leaders, not the least of which include the CEOs of Fortune 500 firms, state they are intentionally holding back on capital spending and investment projects until certainty emerges. Uncertainty ranges from the effects of Obamacare, the extent of sequestration cuts, tax increases, and the aforementioned actions of the Federal Reserve. Quietly, the Treasury continues to approach the debt ceiling with no political initiative in Congress existing to address this, or any, matter. We should point out that were the Federal Reserve not returning the interest they earn on their asset purchases to the Treasury, the debt level already would have exceeded the existing ceiling. In an increasingly interconnected world economy, where resources and capital flow across borders like water, we cannot help but lament the lost economic opportunities from this political stalemate and just the extraordinary absence of executive leadership.

Shooting the moon

After years of misdirected policies that do more to hinder than encourage economic growth, scandals, and deepening the partisan divide, the executive branch has turned its focus back to the economy. Apparently there has been a sudden recollection that job creation matters to the electorate. Perhaps the upcoming midterm elections forced this change of focus. To roll out this new initiative, the president has encouraged publicly the American entrepreneur to "think big." Entrepreneurs have been tasked with creating innovations significant enough to support economic grow so robust that we simply grow our way out of our current problems. Of course, if such innovations were squarely within our grasp as to need only the encouragement of a cheerleader, one might think some of the trillions of dollars stock piled by U.S. corporations would be allocated towards R&D and capital investment. Instead, we see the exact opposite phenomenon as corporations hoard cash in direct response to their concerns about policy uncertainty, tax uncertainty and the overall state of the economy. Corporate cash hoarding is consistent with the interpretation that, despite low interest rates, the economy is plagued by a dearth of profitable investment projects.

At some point, capital markets will recognize the unsustainability of the current system. We believe that this will be precisely the mechanism that will set the wheels of change in motion. Such events will present tremendous opportunity for investors and we are excited for the opportunity to manage our way through the ensuing volatility.

II. THE OUTLOOK FOR EUROPE

The current Environment

European financial markets have calmed since the beginning of the year. In fact, one could be forgiven for believing the rhetoric of some EU politicians that the Eurozone crisis is now under control. However, even now, few of the real issues have been addressed, while more and more public funds have been pumped into the troubled Eurozone periphery with little noticeable effect. The total amount of loans that has been provided by the European Central Bank (ECB), other EU institutions as well as the EU member states themselves to the crisis countries, namely Greece, Cyprus, Italy, Spain and Portugal, has surpassed 1.5 trillion Euros (around 2 trillion dollars).

Moreover, in addition to all the public Eurozone bailouts that have received headline treatment in the press, the financial assistance provided to weaker Eurozone nations has been far greater than previously understood. A relatively little-known fact that has only been brought to the surface recently by several prominent economists such as Sinn and Wollmershaeuser (2012) is that beside the well-publicized bailouts that we have become accustomed to, there has been another financing mechanism in place between EU central banks, largely out of the public eye. This mechanism is called target loans. Target loans are a way of providing financial assistance between central banks that had been used even before the main bailouts had been structured. While, in principle, there is nothing wrong with such loans, the problem lies in the fact that these loans have been provided on very favorable terms to the weaker nations, terms that those nations would never have obtained through the financial markets. As a result, target loans add to the burden that the stronger Eurozone members have chosen to bear to “save” the periphery.

The Problem is Worse than Expected

Target loans originate once current account deficits cannot be financed through the financial markets any more but need to be financed through national central banks. National central banks provide financing to the public that they themselves obtain through the European Central Bank (ECB) system’s foreign central bank deposits provided by stronger Eurozone nations on more favorable terms than through financial markets. Although this mechanism works through the ECB system, the central banks of stronger Eurozone countries actually provide a public loan to weaker countries’ central banks. Any excess liquidity of surplus countries that is deposited with their central banks de facto constitutes accounts receivable of a national central bank towards the ECB. Around a trillion Euros of these “inter-central bank” loans have been made available to weaker Eurozone members largely out of the public’s eye. As any loan to a weak debtor, these target loans may or may not be recovered by the stronger Eurozone members’ central banks. The German Bundesbank alone has more than 700 billion Euros of this type of loan outstanding that potentially cannot be recovered. This amount is additive to all the other financial commitments that have been made to various Eurozone institutions and mechanisms designed to assist the weaker members of the union. Moreover if the Euro were to break down, it is currently unknown whether there would be a legal mechanism to recover these loans. This is, indeed, a house of cards.

This system of loans on preferential terms between central banks in Europe is in contrast to the U.S. system in place between different regional Federal Reserve banks. In the U.S., these loans are made at market rates rather than rates that are more favorable to debtors. Moreover, collateral for those loans is exchanged and adjusted on an annual basis thereby ensuring the interest rate paid on a loan reflects the creditworthiness of the borrower and corresponds to market rates. In this way, incentives to abuse the system and to take advantage of artificially cheap financing are eliminated.

It is important to emphasize that in Europe target loans have been used to help weaker member nations by the ECB without any involvement of elected politicians. As a result, fiscal decisions have in effect been made circumventing the democratic decision making process within the Eurozone. A de facto bailout was decided by the ECB when it gradually watered down the collateral required of debtor nations to receive these target loans without any political discussion or involvement. Until recently almost all Eurozone politicians had not even been aware of this matter.

As a result, the total amount of bailouts to the Eurozone periphery is considerably higher than previously computed. However, all these measures, like U.S. Fed policy, have proven to be almost completely ineffective. The reason is that the rationale behind these measures is itself flawed. The widely held premise is that the Eurozone simply has to demonstrate financial strength to calm capital markets without necessarily having to use their financial strength to bail out countries. In that spirit almost unlimited guarantees have been made by the ECB as well as various protection vehicles such as the ESM (the European Stability Mechanism) and the EFSF (the European Financial Stability Facility). The Eurozone institutions have been trying to make us believe that these aid promises by themselves will cause interest rates to fall permanently and sustainably and that the countries in crisis become solvent again and would therefore be able to service their debt. Their belief is that they are only required to pledge these guarantees without ever needing to draw upon these guarantees. It seems that prestidigitation has become the best approach for policy makers on both sides of the Atlantic.

Now that these enormous amounts have been allocated to the countries in crisis, the question is whether any of the underlying problems have been solved. While the affected countries have been able to roll over their maturing debt and have therefore been rescued from immediate default, their economic situation has barely improved. Unemployment continues to be at record levels, youth unemployment in particular, which is above 50% in some countries, such as Spain. While financial markets seem to have been calmed for now, the situation of the real economy in the affected countries reminds one of a seemingly bottomless pit, despite all the financial help that has been received.

Flashback – How the Crisis Started

Before the credit crunch, cheap credit was easily available to the (mostly southern) Eurozone countries that are in crisis now as financial markets did not distinguish between weak and strong debtor nations within the Eurozone. In other words German debt was treated mostly the same as Greek or Italian debt in terms of default risk and financing could be obtained cheaply regardless of credit quality. This cheap financing caused a massive inflationary trend in the weaker countries and thereby destroyed their competitiveness because their goods, services and labor costs simply became too expensive. Estimates by various economic think tanks and international organizations confirm that price levels in some of the affected countries would need to fall between 20% and 40% for these countries to regain competitiveness in the global marketplace. At some point financial markets became unwilling to continue financing the resulting current account deficits of the weaker Eurozone nations, which is the catalyst that forced the community of Eurozone states to intervene.

The main problem is that, just like pain killers, the financial assistance that has been granted only relieves the symptoms rather than treating the underlying cause of the illness. Despite this temporary reprieve from the crisis symptoms, reality will reappear in a more severe form once “the painkiller”, i.e. financial assistance, is discontinued. Such reprieve, granted through financial assistance, allows nations to side-step the imminent need to address the underlying causes of the crisis. As evidence, rather than falling, price levels in the affected countries have barely changed, and if they have, they have actually increased further. This is a direct result of the financial assistance that has been granted and that has undermined markets’ self-healing ability.

Crowding out the Private Sector

The private sector refrains from making investments into the affected countries because prices and labor costs remain high, rendering any new investment opportunities uncompetitive. Moreover, investors in the real economy (such as wealthy Greek business people) know that the current price levels in the affected countries will only be sustainable until the creditor nations run out money or willingness to provide more loans, thereby leaving them with heavy capital losses at some point. In general, any private capital has stayed away from these nations because it is unable to compete with loans by the ECB that have been provided at interest rate levels far below market levels in return for dubious collateral. ECB interest rates charged to crisis countries have often been as low as 1%. Given that these loans have similar default risk as junk bonds, the level of risk is clearly not reflected in the interest rate at all. Naturally, it makes no economic sense for private investors to compete with the ECB on these terms. However, the only way out of the crisis for the weaker Eurozone countries is to be able to access private sector capital again at reasonable cost levels and without continuous public support from the wider Eurozone. Does this sound familiar to U.S. domestic issues?

Current account deficits in the affected countries remain high as they continue to be financed by public Eurozone money. Labor costs have remained high, companies have not been forced to reduce their prices and governments have continued to be able to pay elevated salaries financed by EU loans, which has kept imports and current account deficits high.

All of these worrisome economic developments have been caused, or at have least been prolonged, by the financial assistance provided by the ECB , ESM, etc. Rather than solving problems, these measures actually have made the situation worse. The measures have prevented current account balances from adjusting and they have supplanted capital investments into the real economy by the private sector.

A similar situation prevailed in East Germany during the 1990s. As is now commonly acknowledged by economists, wages and salaries, and therefore price levels, were equalized between East and West Germany too quickly although East Germany's productivity continued to be low due to outdated machinery and the mental adjustment required to be able to compete in a free market economy. The result was that investors had very little incentive to invest in East Germany when they were able to produce much more cheaply in other Eastern European countries with similar productivity levels. Therefore, unemployment remained high for a sustained period of time with all the associated social and demographic problems. Some parts of East Germany still suffer from the flawed economic policies that were implemented at the time, even more than 20 years after the German reunification. This situation bears some similarity with the Eurozone crisis countries today. However, the problems today are much worse. East Germany was small and had a very strong partner, namely West Germany. The southern Eurozone periphery is much larger and the “saviors” are less strong (and perhaps less willing to help) today.

In this context an interesting contrast should be pointed out to the situation in Ireland. Initially, Ireland got into financial troubles in 2006. At that time, no other country or Eurozone institution was there to help. In fact, at the time, there existed no mechanism in place to provide financial assistance to troubled Eurozone members. As a result, Ireland had to go through a painful (but healthy!) reduction in labor costs and price levels of approximately 15% in real terms. Through such adjustments, Ireland at least partially regained competitiveness. As a result, while problems remain, the country is today in much better shape than the southern Eurozone periphery, despite all the financial assistance these countries received. Rather than adjusting price levels, these countries preferred a “political solution” as the seemingly less painful option, at least in the short run. Ireland, on the other hand, has been able to transform its current account deficit at the time into a current account surplus. The country went through a healthy readjustment by allowing the self-healing forces of markets to work in its favor.

The question is whether the EU financing of the Eurozone periphery can be sustained and whether one should even attempt to do so?

What to do Now

The longer the Eurozone credit crisis lingers below the surface without the fundamental issues being addressed the more the situation becomes overwhelming. This is true, even for the stronger Eurozone members acting collectively. Sooner or later countries like Germany, which has been the major creditor to the Eurozone, will exceed their financing capacity. Most likely before this point has been reached, the willingness to sustain a bottomless pit is going to stop. As a result, for this reason and all the above-mentioned arguments, we think that this endless vicious financing cycle needs to be stopped, at least partially. If this were to happen, what would be the consequences?

In our opinion, the world (or even Europe) would not go under, despite turbulences that would most likely erupt in financial markets, which have become accustomed to always expecting taxpayers to bail out investors if things go wrong. The credit crunch won't be resolved at that point since this problem has already grown too large to be resolved easily, even with the best intentions. The sooner investors are forced to realize heavy losses on their positions, which are inevitable, the faster Europe and the global economy can move on and address the underlying problems of the crisis rather than simply applying cosmetics to make the pig look pretty. There are numerous examples of sovereign defaults in the recent past that did not lead to ruin, such as Argentina and Russia. A sovereign default is not the end of the world. The risk of contagion of some of the weakest countries to default is overblown in our minds. These risks are obviously most strongly pronounced by parties that have a vested interest in the status quo, such as the many Eurozone politicians who originally advocated the common currency as well as a sustained increase in the number of Eurozone countries. These politicians have now been proven spectacularly wrong, but of course have not been held accountable for their severe miscalculations.

To this effect, as we have argued in previous commentaries on this topic, several of the weaker Eurozone members should leave the Eurozone and reintroduce their own currencies. This would leave a smaller core group of stronger and more disciplined countries within the Euro that are more homogeneous and therefore better suited for a currency union.

While we closely monitor European markets for valuation adjustments that might make short- to medium-term investments in the region attractive, our long-term outlook for the Eurozone remains negative as long as the fundamental problems haven't been addressed credibly. All of these issues will result in investment opportunities going forward.

III. OUTLOOK FOR ASIA

The investment team monitors carefully the Asia-Pacific region, which has become an increasingly important area of global growth. China certainly commands much of the headlines in this region. We continually monitor the news flow and latest developments in China, including political events, the liquidity crisis there, and economic indicators. While annual growth in the range of 7 to 7.5% would be great news to almost all economies, to China these numbers, which represent current annual growth projections, represent a slow-down. Concerning to the Investment Committee, more than a slow-down in the growth rate, are the drivers of that growth and concerns about its sustainability.

Unlike the U.S., where consumption has driven much of the growth over the past decades, in China much of the economic growth has been driven by investment, and ironically, by export growth that has been fuelled by U.S. and European consumption. For various reasons, including structural issues, China and other emerging markets have enjoyed a relative advantage in manufacturing costs. Intensive investment in domestic infrastructure has expanded that infrastructure to levels well beyond sufficient to support such activity. In fact, much of the GDP growth has been due to expanding infrastructure investment. Thus, the drivers of overall growth have largely been exports, predominantly to the U.S. and Western Europe, and investment in domestic infrastructure.

To support organic growth, China must stimulate domestic consumption. Despite huge increases in wealth resulting from the country's economic prosperity, domestic consumption has failed to take hold as a driver of economic growth, as had been hoped for by policy makers. In fact, this has led to huge demands for domestic property and financial assets as opposed to consumption, creating a host of other, undesirable systemic problems. It appears saving for the future is a trait more powerful than materialism across much of the Chinese populous.

Despite concerns over the sustainability of mainland China's growth, other countries, such as Hong Kong, are positioned more attractively, benefiting from their geographic proximity to China and their relatively free market economy. In fact, our quantitative framework suggests current valuations are attractive for Hong Kong.

Under Prime Minister Abe, Japan has embarked on large-scale monetary stimulus efforts aimed at depreciating the Yen and stimulating growth by making Japanese exports more attractive. While the net benefits of this strategy remain to be seen, there is no arguing that the short run effect has been to excite a slumbering Japanese work force and bring Japan to the forefront of capital markets attention. There are of course reasons to doubt the long run benefits of adding indebtedness to a country already burdened by heavy debt levels, more than twice the size of GDP.

Japan's actions, which have resulted in the devaluation of the Yen, have had negative externalities to other export-oriented economies such as South Korea. In fact, the nation competes heavily with Japan in export markets. Decreases in trade resulting from the Yen devaluation has resulted in a slew of bankruptcies as Korean construction, shipping and steel companies suffer. Ironically, the liquidity and open-ness of the South Korean economy have hurt it disproportionately during the Fed-induced emerging market sell-off this past June. Noting that the Bank of Korea has room to cut rates, and has done so in the recent past, provides room to relieve upward pressure on the currency to boost exports, the Committee interpreted the model framework as positive on Korea and added this exposure to the portfolios. This decision has played out well, having capitalized on the over-done valuation compression across emerging markets.

Overall, the investment committee and our quantitative framework look more favorably upon the opportunities in the Asia Pacific region. The emerging market economies here in many cases present compelling growth stories, benefiting from favorable demographics compared to other developed economies. This is an area we continue to monitor for opportunities, as illustrated by our recent trades to take advantage of valuation compressions caused by the across-the-board emerging markets sell off.

IV. OUTLOOK FOR LATIN AMERICA

Unlike the U.S. and Europe, the problems that exist in this region have at least been priced into equity markets at various times over the last few months and we have been able to profitably exploit some of these opportunities. Several of those opportunities, particularly in the larger economies of this region have now disappeared and as a result we have liquidated these positions, e.g. in Brazil. Here is an outlook on the countries within the region that are investable.

Brazil, the largest Latin American economy, faces a dual problem, namely slow economic growth and inflationary pressure. Growth in the first quarter this year was just 0.6% and significantly below most forecasts. Economists' forecasts for future growth continue to be repeatedly revised downward. In order to combat inflation Brazil's monetary policy committee has been forced to increase interest rates (such as the 0.5% interest rate hike around May this year). Needless to say, this is detrimental to economic growth.

For many years Brazil's center-left government has promoted growth through demand side economic policies designed to stimulate consumer spending through wage increases and cheap credit. But now consumer demand in Brazil is losing steam. At the same time corporate investment has been neglected, now resulting in slow growth, high inflation and low external competitiveness. While other economies in Latin America also have been weak and therefore have been adversely affecting Brazil, many of the current economic problems are home grown.

Mexico, the second largest Latin American economy, isn't in very good shape either. Industrial output has fallen several times this year, and on a year-on-year basis production growth, while positive, has been far below analyst expectations. Manufacturing, which provides most of Mexico's exports, has been particularly badly affected. From a model perspective, Mexico fares particularly poorly on our value metrics, particularly after the equity market run-up that happened last year. Even after the price correction that happened over the second quarter this year, Mexican equities remain relatively expensive.

Recent declines in commodities prices have not been kind to many economies in this region which depend heavily on the production and export of such commodities. The conjunction of the sell-off in emerging markets and the commodities price declines have been especially brutal among many of these markets, which presents opportunities. One such opportunity is Peru, a beta exposure currently held in our Country Rotation Portfolio. Peru has suffered as commodity prices, particularly gold, silver and copper, have fallen dramatically. While heavily dependent on mining, Peru also has a large (as a fraction of their small economy) banking sector. Unlike their counterparts across North America and Western Europe, Peru's financial sector is relatively healthy. The key monetary policy tool is the reserve requirement, which has been increased four times over the past 12 months to control the extension of credit. Despite increasing reserve requirements, new loan volume rose 18% over the last year. Overall, the Peruvian economy, despite heavy dependence on mining and natural resources, presents a compelling opportunity.

Along with Asia Pacific, Latin America presents opportunities that the Investment Committee continues to monitor and act upon opportunistically.

V. SUMMARY / CONCLUDING REMARKS

While we have taken advantage of the recent equity market corrections in the emerging markets space and Korea over the last few weeks and established short- to medium-term equity positions that have mostly paid off handsomely, we are returning to equity valuation levels in most countries that seem overoptimistic to us given the weaknesses in the global economy. We believe that further corrections are on the horizon and we are therefore ready to stand by and wait for new opportunities to arise. This is particularly true for the U.S. and Europe, where we have been observing a severe decoupling between the real economy and capital market valuations due to extremely loose monetary policy. This monetary policy bubble has continued to inflate to enormous proportions. At some point this bubble is going to burst as it will become unsustainable for even the richest country to finance. The experience over the last few months in the U.S. has demonstrated the market's extreme sensitivity to the possibility of reductions in monetary stimulus efforts, or their phasing out, over time. The argument that market valuations are almost entirely policy driven, rather than driven by the real economy, holds for both the U.S. and Europe. For these two regions to become attractive again, significant market corrections will be needed. Asia Pacific and Latin America present more immediate investment opportunities.

REFERENCES

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IMPORTANT INFORMATION

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