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Equity Commits Hara Kiri, The End of the Beginning of Europe, The Beginning of the End of Global Macro, and 'Active' Money Management

Guillotines are so 18th century. In order to 'spread the wealth around', to coin a phrase, Japan's mandarins, who are now theoretically responsible to elected officials, though in practice have been a power all their own for several centuries, allowed Japanese equity markets to commit *hara kiri*. By some recent measures, public company book values did not rise for two decades. The practice was intended for the nobility who launched unsuccessful wars to absorb the blame of the bloodshed, sparing society from broader fratricide. As a moral parallel, equity holders and managements might be expected to absorb the shock of economic disappointment and restructuring rather than laying off the working stiffs, but as a practical outcome measured by GDP growth, the desired result may have fallen a tad short. Japan is a very wealthy society, and there were no committees of *le sans culottes* selecting which ticker got whacked. But over time, the terminal systematic risk premium in our DCF's rose to 10%. The structural bias for larger tickers is even higher, as both management and technology of industrial conglomerates age along with customer saturation. So the average index stock trades at 6x normalized cash flow, which our Standard Value system now deems fair, leaning towards expensive.

http://www.rationalinvesting.com/ETFPortfolio.asp?etf=187&name=%20Japanese+Tickers

This is our second letter in a row which brings up Japan. When we began coverage, it modeled cheap across the board. Such a systematic outcome would usually have been merely irritating to a process focused on market neutral outcomes, since what matters is consistency rather than median accuracy, but the fact that the rest of the G7 faces similar macroeconomic troubles made the problem more urgent. We think of Japan as a template for what is the likely path of equities elsewhere, while societies debate their safety nets in a time of economic trouble. The Japanese decided to 'invest' their way out of the malaise, with the government spending twice its income, but the money has to come from somewhere, and the usual suspect is equity. Assuming our Harvard wonks do only half as much damage as the Waseda law graduates in the Ministry of Finance, the US should plan for a lost decade or so.

For those who think about such things, the terminal value[i] of a firm depends on two factors: 1) how the macro economy is doing 2) how the company is doing. In DCF modeling, both have to be extrapolated off current conditions. In Japan, the market assumes the macro economy will be repaired 2/3 back to 'normal' equity spread of 5.5-6% over 10 years, and so will specific companies, forced to restructure comparably, likely by competition. One could argue a democracy is capable of faster adjustment than that, but without a market for corporate control, i.e. hostile M&A, these assumptions are not pessimistic. In addition, a yield curve of 0.1% for the 1-year and 0.75% for the 10-year government bond makes the definition of democracy a

little suspect. Maybe someone who went to the University of Tokyo or, say MIT, to make a wild guess, has the power to decide the price of your currency. If they could only decide its value….

The biggest counterargument is the performance of the Dow over the last four years i.e. if cheap money is so bad, why is the market up? The answer lies in the initial impact vs. long term effect. As rates are falling, the market reacts positively. The implicit assumption is that when rates have to be raised, it would be in reaction to a rapidly strengthening economy. However, when the market realizes that rates have stabilized at low levels permanently, then the softness of the economy and the absence of final goods inflation finally sinks in. At that point, there is no floor to the outcome, as Japan has found out.[ii]

Onto Europe:

As the Nazis tore up the Molotov-Ribbentrop pact of 'non-aggression', Hitler reputedly said that treaties were just pieces of paper, and ordered tanks onto Russian oilfields. As the Europeans are finding out, currency unions are just like treaties. Eventually, to avoid becoming just pieces of paper, they have to be defended. A population with sufficient critical mass and industry has to be taxed, or worse, drafted to war, to support the geopolitical weakness or outright political error of another signatory, entering into a contract with whom seemed like a good idea at the time. Ironically, a time has arrived when it might be convenient for another German leader to tear up another piece of paper called the Euro, but she seems to be resisting the temptation. Angela Merkel may well prove to be the most significant politician to shape Europe since Churchill rose to the occasion when Norway was invaded in 1940.

Mrs. Merkel has decided there is no choice but to defend the Euro. While reigning Greek politicians (many now voted out) acted like junkies whose favorite dealer had just been shot - panic, melodrama, withdrawal - she convinced the German electorate to backstop the gradual political restructuring of southern Europe. Since no one is getting drafted, Germans voters are reacting to the series of bailouts the same way as my usually generous two-year-old does when asked to share ice cream: he would have you know he really likes you, but if you chose to get your own scoop, he really wouldn't mind. The German population's grudging assent to having its wealth spread around has the potential to help European equity markets outperform the rest of the world while southern Europe restructures.

No one is being drafted yet because, with the help of the German taxpayer, this argument is still about the pace of restructuring of government rather than scarcity of resources. But continued misallocation might yet lead to such scarcity. Given the growth in Asia, the price of food and energy is not about to go down. 'They gotta eat, and they wanna drive' is the best refrain I have heard. 600mm people in India do not eat enough, so the price of food is where 6% growth in GDP is likely to go. I have seen 3-wheelers stuffed with a dozen kids in school uniform in the morning along the Delhi-Agra road. For those who have experience a ride from the Taj Hotel in Delhi to the Taj Mahal in Agra, memory of that traffic should be sending a shiver down your spine. If those kids were all seat-belted to western standards over the next 10 years, Indian fuel

consumption will double, giving western central bankers the kind of inflation they are *not* looking for.

If inflation does not start wars, I am not sure what does. If it spikes and the Treasury market hits the wall, debilitating our ability to spend money to police Asian waters, an outright war between China vs. India + Japan would go from being a ludicrous idea to merely unlikely. Germany started two World Wars because it was always threatened by the potential, and occasionally real, stranglehold of Russia and France on the natural resources required to feed its industrial complex. In the twenties, France was occupying the Ruhr and Russia thought of Poland as its own scoop of ice cream. German strategy did not work out, but today China is in the same place, and its decisions will impact every country touching the Pacific and Indian Oceans. Thanks to the demand for raw materials, southern Europeans and northern Africans are going to find their service prices for tourism and textiles hacked by competition even as wheat / corn and oil remain in uptrend. The US, thanks to the Mississippi and Missouri, and a technology called fracking, finds itself immune for now, but the troubles of the world are rarely escaped for long.

Meanwhile, in Greenwich, Connecticut….

All this geopolitical volatility has had the effect of wrecking all the assumptions behind statistical global macro models. There was a time when, once you got into Chicago, the only thing standing between you and half a million a year doing God's Work on Broad Street was Eugene Fama's signature on your favorite statistical equation in Finance 432, the class used to weed out the mere stockbrokers from the true believers. In hindsight, it was quite obvious from presentations of investment banks that government interest rate and currency policy was the equivalent of The March of the Light Brigade; and one simply had to implement a basic statistical relationship between yields and exchange rates and hang on tight through the volatility as they allowed their coffers to be robbed.

That volatility eventually led all the brokers to go public, so that the partners enjoyed a cheap put from the public shareholders. The good old days were when inflation was trending in a single direction, and emerging countries were sufficiently mercantilist and inexperienced to 'manage' exchange rates and your last name did not even have to be Soros to make 30% a year - and then the bank levered you 30x.

Today, as assumptions change after every Fiscal Cliff meeting or Euro Summit or Middle East revolution, models have to be recalibrated in real time. Volatility has to be managed, and the technology to do so is rare, and so the work becomes labor intensive. This is leading the prior generation of the most successful fund managers to return outside capital and form 'family offices'. The next generation is still in a fight to ensure its models can outrun the new volatility and transaction costs.

These troubles will now show up in company operating margins, an event delayed by Comrade Bernanke for four solid years; no minor miracle, that. I remain a skeptic of so shortsighted a

monetary policy, but while America is still a functional addict, it is quite hard to hang on to one's convictions. Maybe we are the few who, like Gianni Versace, can wake up without a hangover at 5 am after partying on South Beach, morning after morning, and get to work. Otherwise, even as the Treasury curve is flattened, the credit curve is likely to reverse course and become impossibly steep[iii]. The present peak in junk prices may well be comparable to the 1984 peak in gold.

Input inflation also puts the well-established global supply chains of the S&P500 at risk. The rents will be squeezed out of their franchises for the multinational elite to avoid the guillotine, i.e. final prices might not keep up with costs. Witness India's resistance to $80k a year for cancer medicines, which is more money than made by 99% of Indians, vs. merely the bottom 47% in America. The likes of Roche's management need a lobotomy if they cannot come up with a pricing equilibrium for a new market of 1.2bn. The masses will demand that monopoly rents be constrained for the added volume of business. As history has taught, they are rarely content to eat cake.

To summarize, rising inputs and declining service prices cannot be positive for margins and company valuation or volatility.

Active Human Managers[iv]

This brings us to an interesting phenomenon we recently observed in the distribution of our own model's quarterly market neutral returns[v]. Per calendar quarter, average price returns are distributed as follows:

Month 1	Month 2	Month 3
35%	37%	29%

This is counterintuitive, because earnings season in the US starts in earnest in the middle of Month 1, so Month 2's strength is understandable, but Month 3's relative softness followed by next quarter Month 1's strength is a mystery given the value of information must fade steadily over time to some degree, even if we believe our technology takes several months to get fully reflected in the market.

This is until one thinks of window dressing and tax loss selling. While one's personal finances might be genuinely helped by selling in December, the idea that professional managers would go into a mild panic late every quarter and start dumping decliners and buying momentum in sufficient size to create a noticeable swing in returns over the course of a quarter says something about the state of 'active' money management. With the application of stops to get out of the way of this herd, and getting back in at the close of the month, the difference in actual returns between the two months amounts to at least 1% a year *in a very diverse portfolio of 1000 tickers*. Too small for the individual investor to notice, perhaps, in times of high inflation or market returns. But since intuition suggests Month 3 returns should be meaningfully higher than

Month 1, the real difference might be closer to 2% a year. These days, that is more than what some government bonds pay, even if you lend for 10+ years. And the phenomenon does not seem to be restricted to the United States. The global value of this exercise, whatever its cause, might be in the hundreds of billions of dollars a year. Enough to solve some budget crises.

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[i] The projected final value of the firm at the end of the investment horizon of a Discounted Cash Flow model, typically 10 years, when the cash flows of the firm are treated as a (hopefully) growing perpetuity.

[ii] For those statistically inclined, a test of equity returns vs. real Treasury yield levels and rate of change of those yields might offer some insights. I did a little work on rates vs. gold, and the results went along with my hypothesis. Please email for more details or if you are able to help me develop this idea a little further.

[iii] Treasury Curve is market lingo for difference between the cost of short term and long term borrowing by the government, typically the difference between interest rates for 1 year and 10 year government bonds. Credit curve is the difference in interest paid between low risk AAA and high risk B or C rated borrowers.

[iv] Thanks to Steven Zheng of SAC for suggesting an analysis that should have been done years ago.

[v] Based on a monthly ticker by ticker stop loss and reallocation at month-end closing prices.