What Lurks Beneath

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This week has seen the conviction of both bulls and bears tested. Job creation in the US exceeded expectations in June and so investors yesterday bid the S&P 500 to yet another high. Bulls probably took succor from Janet Yellen's mid-week promise not to use the blunt instrument of interest rate rises to prick any irrational exuberance. Yet, earlier in the week, bears must have looked approvingly at a Bank for International Settlements report which intoned gravely against the risk from "euphoric capital markets" and made a call for tighter monetary policy.

Let me address the key issues for investors raised in the BIS report.

1) **Are financial markets expensive?** At the very least, they are not cheap. Those assets for which I have a working model tend to be slightly above their average valuation level. Looking across the spectrum, markets vary between being on their fair value mean to being one standard deviation overvalued. The only asset which is "cheap" is the US dollar.

2) **Do bear markets always start from an overvalued level?** Not at all. The last two bear markets (defined as a decline of more than 10% over a six month period) which started in 2007 and 2010 occurred when prices were below an average valuation level. This is not uncommon.

So my first reaction to the BIS comments is that we could have a bear market, but it will not arise because of extreme valuations as was the case in 1962, 1987 or 2000.

Over valuation is not a pre-condition for a bear market

The bigger issue raised by the BIS was whether central banks' constant manipulation of interest rates creates false sense of security among market participants. Here, I am in full agreement. One problem is that more and more money is managed via indexation, which is just a form of momentum buying. And since index money is not allocated on the basis

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US nonfarm payrolls rose by 288K in Jun, from 224K; **avg hourly earnings rose 2% YoY**	Both are better than expected 215K and 1.9% respectively	We expect a much stronger 2H growth as the labor market is improving rapidly
Swedish Riksbank cut its refi rate by –50bp, to 0.25% from 0.75%	Bigger than –25bp cut expected; deposit rate cut to –0.5%	Riksbank initially slow to react to low CPI & high jobless; weaker SEK will help; will it be enough?
Irish GDP rose 2.7% QoQ in 1Q, from –0.1% in 4Q13	Much better than first estimate of 1.2% QoQ; 4Q13 also revised up from –2.3%	Irish recovery gaining traction driven by strong exports; austerity plans likely to be eased
Indonesia issued maiden euro bond worth €1bn with 7 year duration at sub 3% yield	N/a; record orders indicating strong appetite for yield; likely to see more EMs borrow in EUR	EM carries still attractive thanks to Yellen & Draghi, but we would go with shorter duration

of the marginal return on invested capital but rather according to market cap, the result is large-scale capital misallocation. As such, it is a form of socialism, and we all know how effective this system is at allocating capital. Since bear markets always result from either (i) excess valuation or, (ii) a corrective response to capital misallocation, it is clear to me that the next big market decline will be of the second cleansing variety.

The worry for investors is that markets correct a large scale capital misallocation

Adding fuel to the fire has been the Federal Reserve's zero interest rate policy. Back in 2011 I argued that sustained low rates would result not in growth, but capital misallocation (see The High Cost Of Free Money). I wrote that ZIRP would cause a rise in asset prices, but not an increase in the national inventory of capital. And the result would be a structural decline in productivity and a huge rise in the Gini coefficient (the rich getting richer, the poor getting poorer).

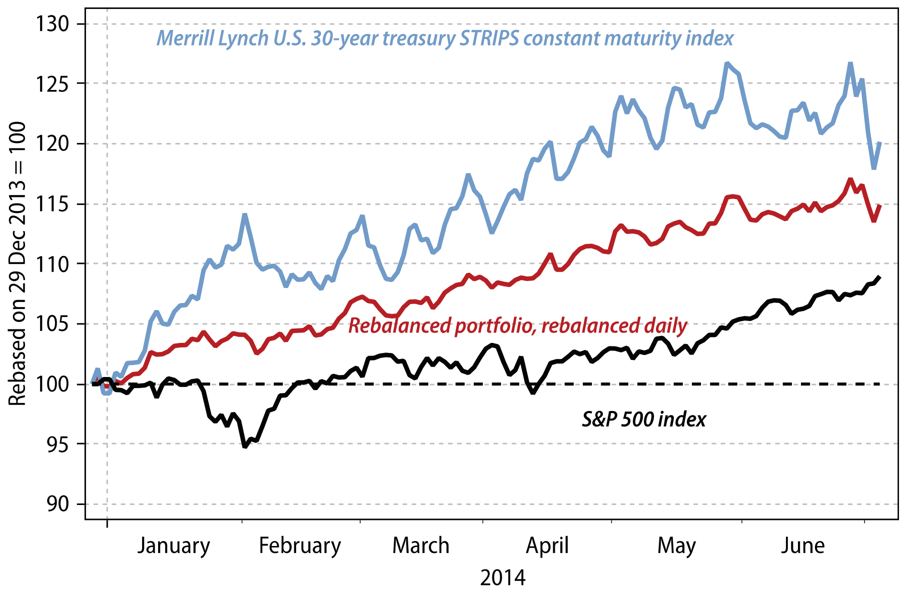
The point was that while high interest rates impede growth, low rates achieve exactly the same results. What is needed is a market determined cost of capital which is elemental to capitalism. Rent controls on property always end badly, and so does freezing the rent on money.

It is worrying that bonds have outperformed equities for six months

Markets are now engaged is a momentum game with investors convinced that central banks in the US and Europe can avert big asset price declines. That was not such a dangerous proposition for investors back in 2011 and 2012 when shares were cheap. Back then, I advised investors to be 100% invested in equities even though I hated the policies. The problem is that investors are now skating on much thinner ice, which is why since 2H13 I have advised an equity position hedged by a long dated zero coupon bond. Such a balanced portfolio has strongly outperformed so far this year, and I recommend to stick with it.

What worries me is that bonds have outperformed both equities and a balanced portfolio for six months and no one seems to care.

Skating on thinner ice: hold balanced portfolio



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