Still plenty to worry about

Contrary to what most would believe, the investment decision going into 2009 was far easier than what fund managers are facing for 2010.

In late 2008 and early 2009, the analysis seemed reasonable that policy maneuvres borne of desperation and panic would persist until the economic freefall had been stemmed. The sheer magnitude of reckless central bank balance-sheet expansion and government spending ensured good money after bad would be thrown in until a level of credit and financial functionality had been achieved, and recovery the likely outcome. And as history has often repeated, from the steepest plunges come the steepest reversals, albeit this one with a mighty helping hand.

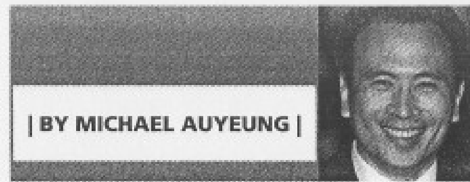
The decision to buy back into the equity markets was made easier as the more we talked about our strategy, the more pushback and general rebuffs we got from investors and peers. This consensus of fear and avoidance on such an ubiquitous scale is always a clear indicator that a contrarian strategy will yield supernormal returns. And so it has, but the fear of stepping into free falling markets is never an easy impediment to overcome.

The vacillations of markets at seemingly toppish levels now suggest an array of divergent possible outcomes going forward.

Some consensus views have largely been reflected in tremendous price upticks. These include holding gold, heavy overweights in emerging-market stocks, the focus on BRIC (Brazil, Russia, India and China) plays, and the short dollar positions.

Equally strong but diametrically opposing convictions see funds still very heavily imbedded in fixed-income and money markets, despite record low yields, data confirming economic recovery, and the prospects of inflation as commodities prices ascend on a weak dollar.

The picture beyond the next two quarters is questionable. After the push factors of monetary accommodation and stimulus spending are


| BY MICHAEL AUYEUNG |

withdrawn, will the economic revival be able to stand on its own? Or does it all go wobbly at the knees yet again?

This is why the messages from central banks and government regulators are taking centre stage. Any signs of early, or what the markets would deem as pre-mature, exit strategies could trigger an overwhelming flight response.

So, why is this juncture so different than so many other inflection points before?

Markets have always been swayed by policy decisions. The recent rebound is no exception.

But going forward, no one really knows what the new normal will look like other than markets and financial systems under heavy regulatory oversight. What is the fallout from such unprecedented policy aggression that would bankrupt (financially and morally) governments and central banks? How will unwinding these policies impact on currencies (especially the deficit-plagued developed-market currencies), funding costs from a squeezing out of private capital, shrinking government components of GDPs, and the ability to undertake further policy measures should economies falter yet again?

Such complex scenarios can generate the kind of outlier events that rock markets and push investment funds to extinction.

The hindsight analysis has evolved that the current crisis is a direct result of the overkill reaction by the governing powers post the dotcom bubble. In comparison, the measures taken then to reduce the economic stresses were far more conventional and far tamer than what has been put to work in the past 12 to 15 months. Even so, no one could foresee the repercussions from those more mundane decisions. What greater catastrophe then is in store given the very drastic measures taken in this crisis?

For the professional investor, the risk-reward parameters now teeter in either direction. Already this year, many funds have paid dearly for their passivity by missing out on the rebound that would have recouped their prior year's losses. One would imagine that yet another false step in the coming months could drive underperforming funds deep into the redemption void.

As the US Federal Reserve has warned, and attested to by record bank bankruptcies in the US, there are still plenty of balance-sheet issues in the finance sector to worry about. Sure, they have reported huge profit jumps, but much of that was related to risk taking and trading in the capital markets. Their core businesses are not going to normalise for a long time, and there is still the commercial real-estate fallout that is just starting to unfold. The trouble at Dubai World speaks volumes.

Meanwhile, a number of central banks are itching to move toward more normalised interest rate levels (and not necessarily for inflation fighting purposes), removing much of the accommodation and allowing the cost of funds to rise. Could this halt stock prices and, worse, stop economic buds and green shoots from moving towards maturity?

Adding fuel to the fire, there are camps proclaiming that the US is at risk of entering an entrenched double-dip recession a year or two out, fanned by deflation rather than inflation. The prospects of a Japanese-style lost decade, where government policies have zero impact on stimulating growth, suggests US equity markets may swoon to new lows and stay there for years and years.

More fodder for the bears is the need to cool a supercharged China economy that has been the spearhead not only of economic hope, but also of bolder and more independent decision-making among its smaller Asian brethren. A hard-landing scenario in China driven by bursting asset bubbles would certainly take the wind and bravado out of Asia's sails, and quash the decoupling argument of decreased reliance on its traditional Western customer base.

For the bulls, much rests on restoring confidence that will see businesses lead a new spending cycle and heal the employment markets. Global companies must commit to their roles in the catalyst chain and drive growth in recipient markets, leaving more time for laggards to recover.

With all things financial and economic, there is a tendency to revert to the mean. As US house prices level out and actually start rising, and hiring starts into the second or third quarters of next year, consumers are likely to take up the next leg of the charge (okay, brisk walk). Deleveraging has been aggressive with savings rates in the US having reverted from negative to about +4%. This will aid consumption as and when the cycle turns.

Meanwhile, Asia and other emerging markets have undertaken some decent reforms on their economic models. Many are finally adopting a more self-reliant domestic consumption model, accompanied by the type of infrastructure and know-how development that will prime the next stage of growth. This partly explains why governments have not been stricken by rising currency values.

The key to positioning investment portfolios for 2010 will be flexibility. The lack of clarity and absence of sustained conviction suggests that markets and asset classes can move all over the map. Staunch adherence to a pre-determined analysis could mean the final chapter for a lot of investment funds. In 2008-2009, that path was littered with the corpses of numerous single-strategy hedge funds. E

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