

# From Deflation to Inflation?

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*"We attribute a large portion of the rally over the past three months to the shift in market expectations from a 1930's deflationary scenario to a 1970's reflationary outcome" - Bank Credit Analyst*



**Nancy Curtin**

**Nancy Curtin** has over 20 years' experience encompassing senior roles in asset management, private equity and hedge fund investing. Having started her career as a Financial Analyst for Morgan Stanley in Mergers and Acquisitions, between 1979-1981 she became Vice President-Corporate Finance at Credit Suisse First Boston between 1983-1987. She subsequently became a senior portfolio manager at Rho Asset Management, where she managed the firm's assets across a range of strategies including global and European equity long/short, relative value, fixed income and macro. She also developed Rho's private equity businesses in Berlin, after the fall of the Berlin Wall. Between 1993-1999 Nancy held a number of positions at Baring Asset Management including Head of Emerging Markets, Member of European Investment and Asset Allocation Team as well as Member of the Board of Baring Asset Management and Baring Venture Partners. In 1999 Nancy was appointed as Managing Director of Schroders Investment Management NA and Head of Global Investments for its \$20bn Global Mutual Fund Businesses. She was also CEO of Internet Finance Partners, a venture capital business of Schroders Plc which invests in leading edge technologies for the financial services industry. Nancy holds a BA in political science, summa cum laude, from Princeton University and an MBA from Harvard Business School.

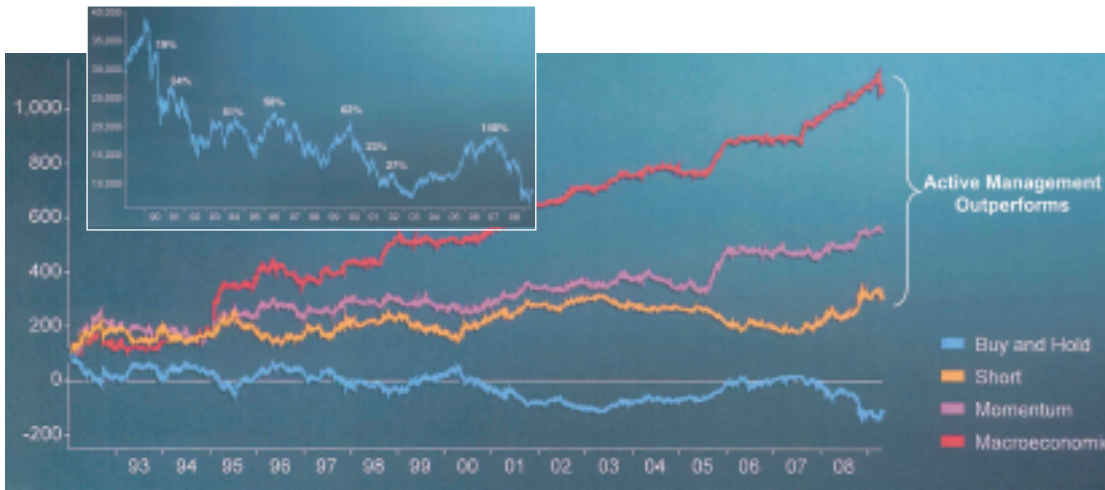
**M**arkets rose again in May, as the extension of green shoot ebullience continued to the relief of investors. Early signs of a reversal in the pace of economic decline, based on evidence that reflationary forces might be overtaking deflationary ones, were manifested via a series of positive indicators announced over the month:

- The Baltic Dry Index, though still less than half its value this time a year ago, continued climbing and is now more than 500% higher than its January 1st value
- US housing construction rose in May and June. Despite a persistent inventory overhang and spike in foreclosures, the rise brought new housing starts up from their worst level since 1960 to just over half the number from 12 months ago
- US Consumer sentiment rose to the highest level in 9 months and spending rose an estimated 0.3%, the first rise in 3 months
- The World Bank raised its estimate for 2009 Chinese GDP growth from 6.5% to 7.2%, due to a larger than expected bounce from the Chinese stimulus package and bank lending
- Two indicators which have predicted the end of every major recession since the 1960s – the rise of the manufacturing ISM above the level that indicates overall economic growth and the reversal of the ratio of coincident to lagging indicators – were both signalling that the end of the downturn could potentially be in sight

That the rate of economic decline has slowed, and that the global economy is no longer on the verge of a systemic meltdown, seems clear. What is less clear however, is whether recent signs of stabilization equate to a sustainable economic recovery. Previous bear markets have been characterized by substantial rallies followed by savage declines. And, although the current rally has gained a broader base than its original

'dash-to-trash' origins might have intimated, the magnitude and sustainability of this rally remains uncertain given the range of lurking negative forces, any one of which could sap confidence and drag markets lower. As we write, markets are increasingly fearful. Bloomberg reports that US CEOs and other executives recently have been selling their shares into the rally at the fastest pace since the credit markets began to seize up two years ago – an indication that insiders collectively may not believe their businesses will be able to support current stock price levels. News that Japanese exports slumped a greater than expected 40.9% year-on-year, partially due to declining demand from Asia, has further unsettled investors. And the continuing rise in unemployment statistics, with the unemployment rate in the US hitting 9.5%, its highest level for 26 years, continues to point to a fragile consumer at best.

In addition, beyond whether corporate earnings will recover enough to sustain current stock prices and whether the Western banks are really adequately capitalised to stimulate broad based lending again (a prerequisite most would agree to a sustainable economic recovery), perhaps one of the largest imponderables is the sheer cost of the various governmental stimulus programs themselves. Staggering rescue packages come with equally staggering price tags that must be either financed or monetised. Tax rates are likely to head higher, just as savings rates increase, a combination which is likely to generate further downward pressure on growth. As bond yields hover close to 4%, up from 2% earlier in the year, investors have increasingly taken fright over the cost of the government bailout and stimulus programs. Indeed, a further lurking threat to the resumption of growth could well be the 'green shoots' themselves. Should global economies gain sufficient traction such that bond yields are



driven up further or that Central Banks are forced to drain liquidity prematurely, this early removal of the proverbial 'punch bowl' may derail signs of nascent recovery and throw global economies back into a deflationary decline.

Recently, the World Bank has revised downward its estimated global growth forecast to -2.9%, a figure more than double the current IMF forecast of -1.3%. Many Fortune managers believe that early signs of reflation are premature and that further deleveraging into a slowing global economic world will again raise the spectre of deflation. Indeed, Fortune managers, irrespective of their near term bullish or bearish views, believe that the world is likely to swing between the forces of deflation and reflation in the same 'schizophrenic' pattern that has characterised markets this year. Such large swings in market price levels, though difficult for long-only and buy-and-hold managers, play to the strength of active hedge fund managers and are reminiscent of the volatility that characterised Japan's Lost Decade. As seen in the chart above, the violent swings in the Japanese market from 1992 to 2008 rendered all but active trading strategies largely loss-making for a decade.

## Market Themes and Investment Opportunities

Sifting through market noise to synthesize the view of Fortune's hedge fund managers and industry strategists, we find three themes reigning supreme.

**1** A deflationary world is likely to be broadly Dollar supportive. However, the flip side of successful reflation is not merely the debasement of developed market currencies but instability within the entire fiat currency system. The Dollar which has functioned as the world's reserve currency for nearly four decades could well come under increased pressure as creditors grow increasingly concerned over the rapid expansion of the Fed's balance sheet. Anticipated Dollar weakness and currency vulnerability elsewhere in the developed world imply that both commodities in general and gold in particular may well be viewed as the ultimate and only store of value.

**2** Whenever and in whatever form the recovery happens – U, W, upward sloping L – the low regulation, easy credit and abundant liquidity environment of 2002-2007 is consigned to the past. We agree with Pimco's characterisation of the post-2008 environment as the 'New Normal' in which increasing regulation, rising public sector and fiscal spending, increased sovereign risk (as well as likely increased bond yields) and higher taxation are coupled with decreasing productivity, high unemployment, increasing savings, and rising inflation. Fortune's managers anticipate that economic and earnings growth will likely be muted for years to come with markets characterised by rising equity risk premiums and increased volatility. Market participants and consumers will likely feel strapped for cash regardless of actual liquidity available.

**3** The so-called 'Developed Emerging Economies' (i.e. the BRIC economies led by Asia) may nonetheless offer some hope for resumption of growth and hence profit opportunity. China, with its increased governmental and regulatory flexibility, falling taxes and inflation, and rising productivity has not only the financial strength to grow, but also the resources to stimulate a low inflation consumer-driven demand recovery.

However these themes may play out, the investment landscape is uncertain and likely to be marked by significant swings in asset classes over the remainder of this year. Hence we believe that nimble hedge fund managers who can exploit a range of possible outcomes along the deflation-reflationary spectrum are most likely to deliver the strongest returns: managers who in essence can benefit from the optionality inherent in such a pattern of market volatility. Consequently, we seek to position our clients' portfolios to perform well irrespective of market directionality by combining the following types of hedge fund managers:

### Liquid Trading:

- Skilful hedge fund managers who excel in volatile environments and who can exploit macro trends while employing tight risk controls, whose funds offer low correlation and liquid investment terms, Fortune can offer

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investor access to these managers in a managed account or hedge fund format.

**Equity Hedge:**

- Some of the best and most nimble talent in the equity long short space, managers with proven hedging and exposure management skills, moderate correlation to equity markets, with strong stock picking skills often with domain expertise in particular sectors or industries.

**Distressed :**

- Fundamental credit managers with deep expertise of the previous credit cycles who can generate idiosyncratic outsized returns, exploiting the rise in defaulted and distressed assets with moderate correlation to credit indices.

In the Liquid Trading area, opportunities generated by volatile markets are plentiful. Decreased competition – due not only to the closure of weaker hedge funds but also to the near cessation of bank proprietary desk trading – has resulted in less crowded trades and wider spreads. Increased volatility means that adept managers can generate outsized returns with smaller positions and lower risk than previously and with minimal correlation to equity markets. Accordingly, we target investing with skilful trading, macro and, managed futures managers who can adroitly exploit market volatility and predict how and when to profit from swings in market volatility.

The carnage of the last 18-24 months has generated excellent opportunities for Equity Hedge managers to buy undervalued companies and sell overvalued or troubled companies. Effective management of cash versus exposure levels can generate excellent optionality in both rising and falling markets, allowing managers to capture much of any market upswing while preserving capital during periods of market decline. Volatile markets also offer strategic entry and exit points for the nimble equity hedge manager who can adjust his net and gross exposure to optimise returns. Accordingly, in this area, we seek managers who understand and deliver investment returns from both the long and short side of the market, who maintain a disciplined hedge and/or have a proven ability to adroitly adjust net and gross exposures to market conditions.

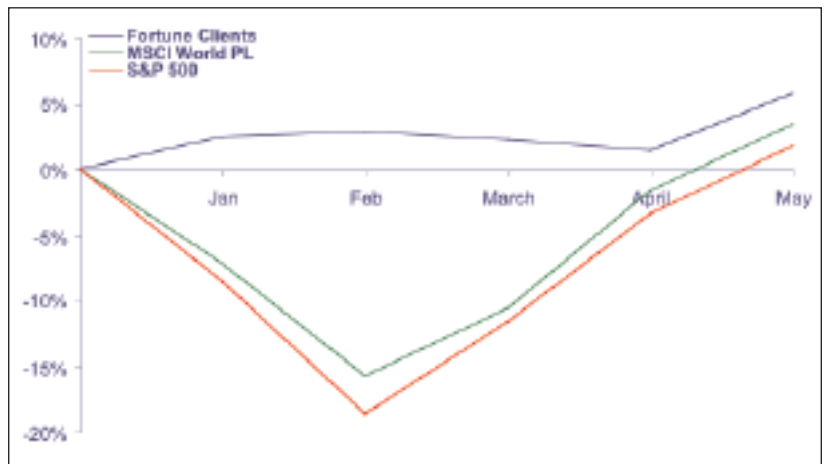
As default rates rise to 10%, Distressed strategies offer compelling entry points for an idiosyncratic return profile. The magnitude of this opportunity is cyclical in nature but given the deleveraging still to occur, the size and scale of the

economic downturn is likely to last longer than previous credit cycles. Fortune aims to invest with managers who display a deep knowledge of prior credit cycles, who do not have legacy investor or position issues from the illiquidity of 2008, who demonstrate the ability to build an event-like credit portfolio likely to manifest an idiosyncratic return profile.

**2009 Performance**

Fortune Client Accounts are up 5-7% on average year to date (estimate to end June), which compares favourably with long only indices, particularly on a risk adjusted basis. Although hedge funds generally lagged the March to May rally – due to large cash positions and low levels of net and gross exposure – they also avoided the January-February decline in markets. Year to date, hedge funds have delivered with a fraction of the volatility that has accompanied the long only ride, with lower levels of market/beta exposure and with a renewed emphasis on liquidity. This return profile can be seen in the chart below:

**Year-to-date, the hedge fund industry as a whole, and diversified portfolios of hedge funds in particular, have provided superior risk-adjusted-returns versus the long-only world.**



Year-to-date, the hedge fund industry as a whole, and diversified portfolios of hedge funds in particular, have provided superior risk-adjusted-returns versus the long-only world. If, as we suspect, markets weaken further from here, hedge fund managers should also continue to provide increased downside protection.