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## Looking Beyond the Abyss

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**As** we write this commentary in November, the negative feedback loop between the credit and economic crisis persists with continued savage declines in credit instruments; thereby causing further losses at financial institutions and undermining the effectiveness of the bailout. This results in a further freeze in lending and economic activity - which, in turn, leads to further credit losses, more poor economic announcements and further market declines... and so the negative spiral continues. Although governments and central banks are, for the most part (although perhaps too reactively, particularly in Europe) working together to restabilize the financial system, economic activity will continue to slow until market confidence is restored and bank lending resumes. The longer this process takes, the worse the recession will be. In the words of one noted US Economist, "the US has already slipped into a recession that could be the most serious since World War II."

In market terms, Fortune believes that we have already entered into a secular bear market. In past secular bears - such as the 1930s, 1970s, and the collapse of Japan and the NASDAQ in 2000/1 - major equity indices also lost at least -40% to -50% nominally from their peak values as economies experienced deep and prolonged recessions with "whiffs" of deflation. Savings rates rose and investors tended to flee to low risk assets for some time until market players could be convinced that the risk of deflation had passed. Typically, in most secular bear markets, the next economic boom and bull market in stocks does not emerge for many years. As BCA so aptly put: 'secular bear experiences feature despair and debt liquidation, and they invariably result in major alterations in the social, economic and financial landscape.' Such 'major alterations' are already evident in the vast changes in the financial sector; as Byron Wien points out, the year of 2008 will likely be remembered as the onset of the 'Age of Interventionism': "The idea that free market forces work over time to solve problems

seems quaint and obsolete because the belief is now, that without the government, the financial system would have failed."

Nonetheless, some hedge fund managers have fared well in this environment which has featured unprecedented levels of volatility, with the VIX index touching a high of 89% in mid October. Fortune's managers which have posted a positive return are:

- Managers experienced at short term trading in extreme volatility. Some of these managers are traditional hedge fund managers with trading skills, often in the macro or commodities spaces. Other of these managers are "liquid alpha" managers with systematic and short term trading skills and which often offer non- or low-correlated returns irrespective of market circumstances.
- Managers who, from a fundamental stance, were massively net short the market, e.g. one fundamentally oriented manager on Fortune's Approved Manager Platform entered October, 50% net short, a stance allowed by his significantly positive year to date performance.
- Managers who, again from a fundamental stance, were aggressively short the 'right' sectors of the market, i.e. those sectors which fell the most. This included managers in the financial sector whose short book gains offset their long book losses, managers in the credit space - in both developed and emerging markets - as well as managers who selectively shorted equities in the consumer discretionary and commodity producing sectors.

For all other types of managers, the combination of extreme, never-before-seen volatility with tight risk controls caused losses, ironically especially for most risk disciplined hedge fund managers. As one manager explained: "Assume that most investors find a 15 per-

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cent decline in a position's price unacceptable. For most of the period between 2003 and 2007, the VIX was below 15%, so most of the time, say 90%, stock fluctuations for random reasons would not force a sale of a security, and an investor could focus on fundamental drivers of valuation. With the recent VIX at over 70%, this assumption is obviously false, as most stocks move in 15% ranges on a daily basis as of late. Managers are constantly buying high and selling low. Volatility plus risk control equals guaranteed losses."

With price movements of nearly 5x their normal magnitude, more fundamental type managers found both longs and shorts moving against them in dramatically unpredictable ways, while some traders made or lost circa 8-10% on positions that, in normal markets, would net them plus or minus 2%.

However, even the most bearish of market participants believes that the 'major alterations' in the economic and financial landscape will generate enormous opportunities to profit and that a secular bear market does not mean that investors should hide forever in cash. In the secular bear of the 1970s, infrastructure stocks increased 230% between 1974-82, consumer services tripled in the same time period, and oil and gas stocks increased 360% between 1973-80. It should be noted that most industry forecasters believe that, while growth in the developed world is turning lower, EMs are likely to continue growing albeit at reduced rates, ergo EMs are experiencing contagion from the developed markets in a cyclical – and not a secular – manifestation. Or, as one EM manager commented, "in Chinese, the word 'crisis' is composed of two characters: one represents danger and the other represents opportunity."

As we piece together the vast commentary from our hedge fund managers, industry strategists and economists, it appears that three 'profit opportunity' sets are likely to emerge from each phase of this crisis, each of which can be exploited by particular hedge fund strategies:

- Deleveraging and Liquidation – Liquid trading managers offer the best opportunity
- Markets Normalize – Debt and equity long short emerge as significant opportunities

- Recovery and Reflation – Equity markets recover. Distressed and equity long short dominate returns.

A summary table of these three phases follows the conclusion of this piece.

## PHASE I: Deleveraging and Liquidation

Fortune managers believe that the degree of ongoing global deleveraging has led to an unprecedented correlation amongst all asset classes. For want of a better term, managers refer to the present phase as 'debt liquidation.' During this ongoing phase, markets remain in free fall, volatility remains high, economic and profit releases continue to disappoint and most rallies are short lived. Risk aversion is high and risk assets uniformly remain out of favour and under pressure. Until the economic situation is known and markets can begin to normalize, fear, unpredictability, and overreaction will continue to dominate investor psychology. **Only skilled traders, like the trading hedge fund managers and the systematic, short term non- or low-correlated "liquid alpha" managers who make a living profiting from intra day trades virtually irrespective of fundamentals, tend to generate positive returns. Fundamentally driven managers are generally better off remaining long on cash and with very limited exposure to markets.**

This period is also referred to by one of Fortune's macro managers as the 'strong Dollar deleveraging period', wherein liquidations of almost all assets support further rises in the world's reserve currency, which by dint of low velocity of global money (itself a function of a lack of credit) is likely to see the Dollar pushed even higher than expected by market participants. Thus far, efforts to stabilise the financial system have not been sufficient to 'get banks to start lending again' and no doubt more imaginative solutions will be required. Interestingly, Bernanke spoke in Japan some 5 years ago and argued for the use of quantitative easing to rejuvenate the forces of credit in their economy and ward off the onset of deflation. The announcement on November 26th that the Fed is once again expanding its balance sheet—by up to \$800bn on top of the current, massive \$2trn in its coffers is just such a step in the move

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towards full scale monetization. Unlike the expansions we have seen so far—where much of the cash came from the Treasury, which sold bonds (thus, in effect, sterilizing the expansion)—it now appears that the Fed is creating new money to finance its planned purchases of GSE mortgage bonds and other securitized assets. Recent tentative declines in the Dollar may be the first signal that the market realizes that the Fed will be flooding the system with new (rather than borrowed) dollars.

Direct Fed purchases of private sector assets, however, were perhaps necessary because it allows the Fed to inject cash directly into the economy, bypassing the banking system that has been a roadblock for monetary policy. Quantitative easing is likely in one of Fortune manager's opinion to be joined with a sequential flattening of yield curves around the world as developed market bond yields converge to Japanese levels. Indeed, BCA would argue that the only market which at this point has **not** begun to discount debt liquidation is the G7 Government bond market. Several of Fortune's managers argue that buying government bonds even at yields of 3-4% are an excellent hedge against deflation and further declines in equity values. Bond yields may have remained sticky on the downside, probably reflecting concerns over the large increase in public borrowing. However the concern may be misleading if private sector savings more than compensate for public sector borrowing. If Japan is any guide, bond yields across the curve could easily fall to 1%.

Note Greed and Fear points out that the case for equities clearly improves the more government bond yields fall below the dividend yield on equities. In deflationary environments however, it is quite possible for stocks to bottom with a dividend yield two or three times the long-term government bond yield. Indeed in the 1930s the S&P yielded about 13% in dividend terms in mid-1932 while the long-term Treasury bond yields were then around 3.5%.

It also remains to be seen if other central banks follow the Fed's course in pursuit of quantitative easing and implicit yield curve flattening. However, the deleveraging and liquidation phase cannot really end until the banking systems of the world begin once again to function.

## PHASE II: Markets Normalize - Debt as Significant Opportunity

Once markets realise that governmental policy is having a stabilizing effect on the credit crisis, we enter phase II, wherein fundamentals again will matter. This is not to say that traders should exit. **There will be opportunities for skilled traders, especially macro, systematic and short term "liquid alpha" managers, throughout all three phases as volatility is likely to be higher** in this economic cycle than it was in the past, with in one manager's view: "the age of 14% volatility now largely prehistoric." As markets renormalize and move from trading in response to one large macro theme, fundamental managers will again be able to rationally exploit the market inefficiencies on both the long and short side of the market. **This market renormalization will offer fundamental opportunities to not only equity long short, relative value, fundamentally driven global macro managers, but perhaps most importantly to managers in distressed and high yield** as well, where the opportunity set may be the most attractive on a risk to reward basis.

As BCA writes, economic recessions typically coincide with an equity bear market as corporate profits slump and investor risk aversion increases. Deteriorating corporate health also normally causes spreads to widen and defaults to rise. Given the severity of the expected downturn, John Paulson believes that default rates will likely rise to 12-15%, the highest since the Great Depression. Given current levels of 2% default rates and the sheer size of the likely distressed universe - over \$10 trillion - John warns against rushing in too early. "Prices across the credit spectrum are likely to fall far further as default rates rise and liquidity available to soak up 'bad debt' remains insufficient to meet the problem." Only in the AAA segment of the RMBS market (expected returns of 25% plus) and in some parts of the first lien bank debt market (expected returns of 15-20%) does Paulson and others believe that we may be near a buying opportunity.

However, the price collapse in all forms of credit (which is accelerating in the debt markets in November as we write) will likewise create one of the greatest distressed debt and credit opportunities of this century. Moreover, while equity long short managers will again be able to

work their fundamentally driven theses, **opportunities in debt as an asset class are likely to emerge significantly before a long-only stance in equity markets should be contemplated.** Indeed, industry research indicates that speculative and distressed debt outperforms equities during economic recessions and in the earliest stages of a recovery. Following the 1990-1991 recession, distressed and high yield credit total returns exceeded equities for more than three years. "Distressed debt tends to outperform until economic indicators are clearly in 'improving health' territory." Three other considerations may also favor debt as an asset class over equity in the early part of this cycle:

- There are clear advantages to investing higher up in the capital structure as default rates rise and economic problems escalate.
- Building deflationary pressures are likely to impair near terms earnings growth more than balance sheets, making equities acutely vulnerable to profit downgrades.
- Policy makers finally are more sensitive to disruptions in credit markets and thus are more likely to intervene to fix them (think about what a mortgage relief program under Obama could mean for values in RMBS).
- Investors are getting equity like returns without taking equity risk.

Opportunities in credit are not confined to the developed world. In emerging markets the high level of spreads on sovereign and corporate debt present a high hurdle to equity investment, such as Gazprom senior debt currently trading at a 25% yield to maturity or one year dollar denominated Russian risk at 14%.

### PHASE III: Recovery and Reflation

As one hedge fund manager commented: "the worse the financial crisis, the more that policy makers are likely to throw at the problem." The likely result of continued concerted global governmental fiscal and monetary stimulus is likely to be recovery at some point and perhaps even a significant rise in inflation. When assets begin to reflate, phase III has commenced and, if the past is any guide, this market recovery will presage the actual economic recovery by approximately 6-9 months (indeed, perversely, stocks almost always rally on weak-

ening growth and falling profit). When mired in a recession and investor panic, all that is really needed to turn around a falling stock market is the perception that the balance of the odds has begun to shift away from a further melt down and that most of the bad news is already discounted in share prices. Market bottoms also tend to occur when companies and corporate insiders step up and place bids for their own shares. **This environment would most favour equity long short, long biased, commodity and EM strategies.**

Early signs of phase III are likely to be a significant and sustained weakening of the Dollar combined with sharp equity index rebounds. Christopher Wood's 'Greed and Fear' refers to this period as the 'Dollar debasement' phase, when the world stops worrying about global depression and focuses on just how indebted the US has become, leading the Dollar to decline. As the central role of the US as safe haven reserve currency moves to 'reflating' economy, the "sweet spot" for gold is also likely to be reached. As one manager so aptly commented, "when policymakers, particularly in the U.S. move ahead of the deflation curve, gold is likely to experience the mother of all rallies, particularly as investors search the world for value in an inflationary world." Money in circulation may now be too high (a result of overstimulation in phase I) and may need to be further sterilized by central banks.

**In addition to a range of trades played perhaps most skillfully by macro managers (e.g. short Dollar/long gold), there are a number of regional and sector specific strategies likely to fare well.**

Again in Greed and Fear's view, "when the move from the strong Dollar to the Dollar debasement trade comes, Asia - which benefits from one of the soundest economic stances globally - will move from being a region of cyclical vulnerability to being the world's most attractive haven for assets given its high savings rates, low leverage and still existent levels of economic growth." Is Asia in one manager's view 'really worth a quarter less than it was valued at over 15 years ago'?

Whether deliberately Keynesian or not, fiscal stimulus in this economic crisis is also likely to result in vast amounts of infrastructure spend. Authorities around the world have no choice but to beef up public sector spending if they want to try to keep growth afloat. The

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most likely beneficiaries will be infrastructure and renewables, in which developed markets have remained chronically under-invested for years. BCA believes **that industrial commodities will be supported by this anticipated infrastructure investment boom** and could experience sharp rallies as projects and spending start to kick in.

Finally, **recovery plays in financial assets are likely to reap enormous returns for the skilled investor** who can correctly identify the winners and losers in this sector. The rules of the game have been virtually rewritten in this sector with some financial stocks likely to rebound 3-5x, others remain moribund utilities subject to ongoing government oversight and intervention while some others may perish entirely or cease to exist in their current form.

Reflationary or outright inflation hedges moreover – such as long energy, particularly oil – can be played profitably by both fundamental investors and traders in Phase III. In addition, riskier assets classes that generally benefit from economic and commodity recoveries and reflation, such as EMs more broadly and real estate, are also attractive investments at this point – though the sharpness with which EMs generally rebound argues for investing prior to when the full recovery effects are felt.

## Conclusion

It is not clear how and when these three phases might emerge and whether they will be largely sequential, overlapping or recurring in nature, (i.e. money may be made in assets of all three phases as the bear market is likely to be accompanied by massive cyclical bull market moves). The commentary above moreover is by no means an exhaustive list of assets and strategies likely to do well. Indeed, the secular bear market of the 1930's was chaotic and vicious, with periodic steep rallies and subsequent devastating declines. The 1970s bear market was essentially a flat market in nominal terms, but with enormous price gyrations. Most of Fortune's managers are unsure how the secular bear of 2008 will evolve but the following two thoughts should be considered:

- With authorities committing to taking whatever action is necessary to prevent a global meltdown, a downward spiral in debt deflation like the 1930s does not seem likely.
- With strong supply side expansion through fiscal stimulus policies, **the longer term inflationary consequences of today's vast liquidity injections may not be as inflationary as they were in the 1970s**.....however this remains a risk that needs to be carefully monitored.

What is certain is that the investment environment and ease of making money will challenge investors for years to come. However, given the severity and indiscriminate nature of the corrections across asset classes today, handsome rewards can still accrue to talented managers and astute asset allocation decisions. As mentioned, Fortune believes that there will be ample opportunities for skilled traders, especially macro, systematic, and short term "liquid alpha" managers, throughout all three phases, while more fundamentally oriented managers who can exploit dislocations in the debt and equity markets on both the long and short side will flourish in phases II and III.

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## Summary Chart of Phases

Phases	Phase I	Phase II	Phase III
Timing	Deleveraging and Liquidation  Now	Markets Renormalize: Debt as Significant Opportunity 2009	Recovery and Reflation 6-9 months before economic recovery...
<b>Characteristics</b>	Credit markets frozen One large macro market Global economies entering significant recession Markets in freefall with short lived rallies Excessive volatility (70%-80%)	Credit begins to work again Fundamentals matter  Economies in full-blown recession Markets in bottoming process, rallies more significant Significant volatility remains (30%-50%)	Credit working normally Fundamentals matter  World shows tepid signs of recovery or at least not getting worse Markets rally in anticipation of economic recovery Volatility present but normalizing (15%-30%)
Credit  Economy			
Micro outlook	Economic and profit releases disappoint Layoffs begin Default rates rising Valuation metrics don't apply Stocks good and bad fall together	Earnings reflect recession Companies aggressively cutting costs and shedding workers Default rates move towards peak levels Markets trade on assessments of growth and value (growth usually dominates) Winners and losers in all asset classes can actually be evaluated	Growth creates demand for commodities Credit transforms companies to going concerns Operational efficiencies kick into earnings Markets trade on assessments of growth and value (value usually dominates) Winners and losers in all asset classes can actually be evaluated
Currency  Policy	Dollar deleveraging period Low velocity of money supports reserve currency Concerted actions by CB-albeit reactive Quantitative easing Curve flattening, long and short ends converge to 1	Dollar begins to weaken  CBs let the medicine work  Curve slowly begins to steepen	Significant Dollar weakness: Dollar debasement period Inflation may pick up CBs do not yet drain liquidity  Upward shifts in the yield curve
Investor Sentiment	Risk aversion extreme Asset classes correlate to 1	Bear market still in force but cyclical rallies can be significant Assets classes show divergent behavior based on fundamentals	Markets begin to show early signs of recovery Rallies more sustainable; greed begins to take hold
<b>Favoured Strategies</b>	Long Dollar Long cash Long indices (play the rallies) Long government bonds  <b>Long trading and macro managers</b>	Long gold  <b>Long trading and macro managers</b>  <u>Corporate debt/RMBS as equity opportunity.</u> Higher up capital structure (bank debt and high yield) 20% plus returns Size of opportunity--prices likely to extremely attractive  <u>Equity long/short</u> Global Technology Financials  Convertible and merger arbitrage may return to favor	Long commodities Long infrastructure Long financials  <b>Long trading and macro managers</b>  <u>Distressed as equity opportunity.</u> Bankruptcy paper and equity stubs Lower down in capital structure Size of opportunity--prices likely to extremely attractive  <u>Equity long/short</u> Global EM  <u>Long EM</u> Asia-growth Russia-value
Hedge Funds			
<b>Ends when...</b>	<b>Banking system resumes functionality</b>	<b>News flows stops growing increasingly worse</b>	<b>Actual economic and financial market recovery commences (either tepid or bull)</b>

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