BEWARE THE INVESTMENT DESERT

It is not the assets that you think are risky that tend to damage your portfolio, warns David Bowers, but the ones you believe are safe

When a legendary hedge fund manager returns $2bn to investors, it is time to sit up and take notice. Louis Bacon – founder of the hedge fund Moore Capital – did just that back in August. Why he made such a move tells us a lot about the state of the world that we are in.

According to press reports, Bacon described market conditions as an 'investment desert'. He went on to say: "Disaster economics, where assets are valued based on their ability to withstand a lurking disaster as opposed to what they may yield or earn, is now the prism through which investors are pricing markets." The world he describes is a world where investors are increasingly obsessed not so much by the return on capital, but rather with the return of the capital. Investors – including some corporate treasurers – are now prepared to pay governments to keep their cash safe for the next two years. At the end of August, two-year government bond yields were negative in Germany, Denmark and Switzerland.

This assessment by Bacon goes straight to some of the concerns we have voiced in this column. We are in a world where large government budget deficits have their counterpart in unusually high corporate saving. 'Black swans' seem to lie around every corner and under every bush. The lack of policy visibility combined with lacklustre consumer spending means that companies are being increasingly run 'for cash' rather than 'for growth'. That unholy trinity of eurozone break-up, Chinese hard landing and American fiscal cliff is creating a deep-seated risk aversion that is keeping the lid on corporate spending. Policymaking remains highly politicised. Even if quantitative easing has supported economic growth – as US Federal Reserve chairman Ben Bernanke would have us believe – it has been at the cost of a massive distortion of financial markets.

Now it could be that this 'investment desert' is temporary. As I argued last month, the biggest surprise – certainly in the investment world and probably for corporates, too – would be that the global economy does not fall into recession next year, and instead an organic recovery gets under way. There could be some easing of the strains in the eurozone; China could ease monetary policy aggressively to head off a hard landing; and worries about the US fiscal cliff might be reduced in the event of a Romney-Ryan victory in November. Optimistic? Maybe. Impossible? No.

Paradoxically, this positive turn of events could cause some serious headaches for corporate treasurers. It would almost certainly be accompanied by an improvement in risk appetite and expose just how expensive some of the 'defensive' assets have become – particularly in the fixed-income space. It is not the assets that you think are risky that tend to damage your portfolio; rather it is the ones that you think are safe that cause the problems.

It is, of course, possible that the 'investment desert' is here to stay, confirming a fundamental change in the way the global economy operates. There is no going back to the business cycle as we have known it. Maybe we are at the start of a generational shift whereby the growth 'baton' is being passed on from the credit-sozzled baby boomers to something altogether different. Maybe the financial landscape is changing so radically that some of the fundamental tenets of finance are set to be challenged. In short, maybe we are at the start of what Richard Florida describes in his book as 'The Great Reset', where he argues that prolonged downturns are often periods of creative destruction, rich in technological innovation, that end up redrawing the world's 'economic geography'.

I think the challenge for corporate treasurers – and for investors – is to work out which of these two worlds we are in. Are we experiencing a temporary hiatus before the credit and capex cycles reassert themselves? Or are we embarking on a multi-year transition to a world whose economics become ever more unfamiliar? By the end of this year, we will have a much better idea of where we are more likely headed.

FACTS AND FIGURES

-0.04%
WAS GERMANY'S TWO-YEAR GOVERNMENT BOND YIELD AT THE END OF AUGUST 2012

-0.11%
WAS DENMARK'S TWO-YEAR GOVERNMENT BOND YIELD AT THE END OF AUGUST 2012

-0.21%
WAS SWITZERLAND'S TWO-YEAR GOVERNMENT BOND YIELD AT THE END OF AUGUST 2012

SOURCE: THOMSON REUTERS DATASTREAM

36%
THE PROPORTION OF US HOUSEHOLDS THAT THINK THAT EQUITIES HAVE A ROLE TO PLAY IN RETIREMENT SAVING (35% NOW THINK EQUITIES ARE UNSUITABLE)

SOURCE: ABSOLUTE STRATEGY SURVEY OF US HOUSEHOLD FINANCES, SEPTEMBER 2012

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