GaveKal Ad Hoc Comment

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Our Current Thoughts on Asset Allocation

One of the biggest advantages we have at GaveKal is our very diversified, and generous, client base. All around the world, our clients never shy away from presenting their views, confronting our beliefs, and simply expressing their opinions. Needless to say, this "network" is especially valuable at important turning points, when the visibility could otherwise appear dim. Unfortunately, in recent weeks, our "network" has not been as useful to us as it may have been at other important junctures; indeed, everywhere we turn, clients sound as thoroughly confused by recent events as we feel! After all, we have just witnessed a seizure of epic proportions in the credit markets. We have also seen a number of large financial institutions flirt with bankruptcy. And economists are falling over each other to downgrade their growth expectations for the OECD. Simultaneously, however, equity markets are making all-time highs, led by cyclicals. Commodities are making new highs. And yield curves are steepening. So what is happening? And what should it mean for our portfolios?

Because of the "credit crunch", it is safe to assume that money is going to be much less available. First and foremost, this simple reality should lead us to avoid any negative cash-flow investments (i.e., countries with current account deficits).

The paradox, however, is that there is still plenty of money around in the World: MZM in the US is still very high, sovereign funds (such as the new China Investment Corp.) are flush with cash, etc…. And we can't shake the feeling that a lot of this money will be invested more in equities than in government bonds. If nothing else, this should help provide a floor to the equity markets.

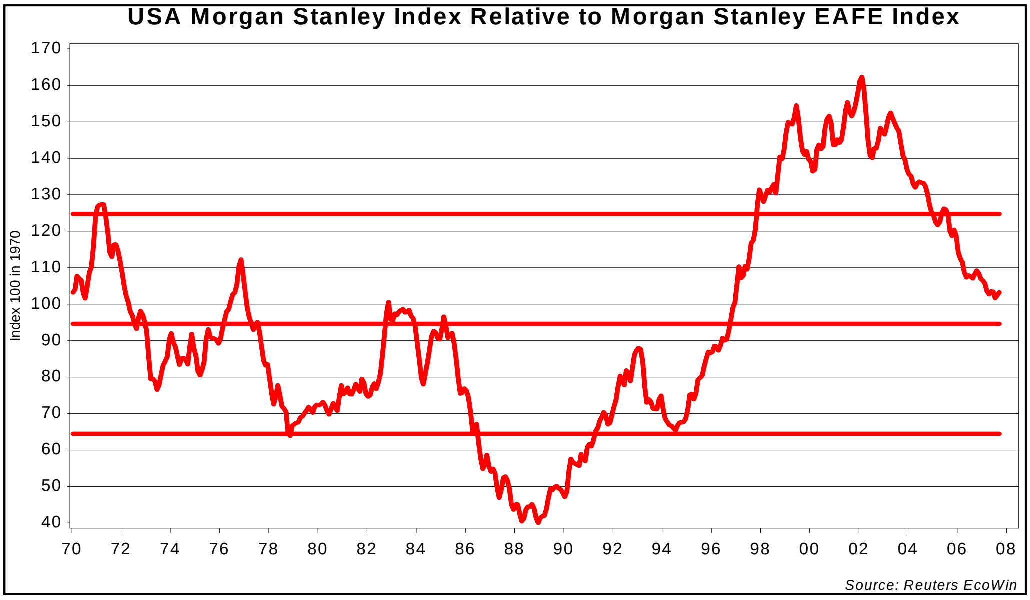
At the same time, the decline in the velocity of money (see *Don't Forget About Velocity*) should lead to the emergence of downward pressures on most prices, not just real estate. In turn, this should lead to a much lower inflation rate, which, of course, would be welcome news for bond markets that are currently coming under pressure.

On balance, we thus find it hard to expect significant downward movements in any of the two major asset classes. The long-term potential of equities is still intact, and there are reasons to think that bond yields will find it difficult to move very much higher from current levels.

In the US, the recent collapse in the US$ means that we are witnessing a massive transfer from the non-tradable goods sectors (real estate, finance, services...) to the tradable good sectors. As a result, exports are growing at 3x the growth rate of imports, and the trade balance is improving. More importantly, unlike in Japan, it is likely that the devaluation of the US currency will be monetized by a number of US companies. We thus see no reason to be bearish on the US tradable good sectors, or on US companies with production assets abroad. In fact, we would use any sell-off as an opportunity to accumulate positions.

In the past, whenever we witnessed an improvement in the US trade deficit, the S&P 500 would outperform the EAFA Index (Japan + Europe). This makes sense if one assumes that, instead of detracting from US GDP, trade actually acts as a net-positive on growth and that the earnings of US companies become supported by the undervaluation of the US$. Thus, in a World MSCI portfolio, it makes sense to rebalance away from EAFA and towards the US (with a bias in favor of the tradable goods, large-cap, multi-national companies, etc…).

With an undervalued US$, the earnings of US companies become supported by the undervaluation of the currency.



In recent years, through a painful but effective competitive deflation, Germany has managed to achieve a significant improvement in its competitive position within Europe. In turn, we witnessed a surge in Germany's trade numbers, and a marked improvement to Germany's tradable good sectors and the Dax. But we should not forget that Germany is still a cyclical producer of goods. We should also not forget that, elsewhere across Europe, the painful adjustments which took place in Germany have, by and large, been avoided; and most of the rise in the stock markets were linked more to the rise in currencies and the consequent surge in the non-tradable goods sectors (housing, finance, services...). And, at this stage, the interest rate levels and concurrent credit crunch are now powerful enough to slow real estate and finance almost everywhere. Meanwhile, tourism should also start to hurt because of the exchange rate. This, we believe, further argues against an overweight position in European stocks. Those who want to maintain positions in European equities should do so in the German tradable goods sectors, or among European companies that sell mostly to Asia (e.g., luxury goods).

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In Asia, meanwhile, we face almost the reverse situation: The terms of trade continue to move (albeit very slowly) in favor of non-tradable goods. In fact, we would argue that Asia is exactly where Europe was in 2004, at the beginning of a significant change in its trade-weighted currencies. Or, to put it differently, over the coming 18 months, we should reverse the massive currency collapses of 1997. Why? As we have repeated endlessly in recent months, the central banks across Asia are still controlling the rise of the exchange rate—which forces monetary aggregates to rise very fast and can only lead to rapidly rising asset prices (which is why we remain very overweight Asian equities and Asian real estate) or accelerating inflation. And of course, the faster prices rise, the sooner Asian central banks will have to make a choice: accelerating inflation or higher currencies? In Asia, it is thus important to remain overweight equities, real estate and currencies.

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The big question in most investors' minds remain of course the Euro-US$ exchange rate. And here, we should put our hands up and say that we messed up. Frankly, we simply do not understand the Euro at these levels. The purchasing parity of the US$ against the Euro is currently at two standard deviations away from fair value, a point which has been reached only three times since the beginning of floating exchange rates in 1972. Yet, nothing seems to dent the Euro's march forward! However, we still hold onto the hope that the Euro will come back to Earth, weighed down by one of the three factors below:

The big question in most investors' minds remain of course the Euro-US$ exchange rate.

1. So far, the Euro has probably benefited from the fact that it is one of the only major currencies in the world able and willing to take the brunt of the US adjustment. In other words, the Euro was rising because Asian currencies refused to. This, as discussed above, could very well changed in the coming months.

2. European growth should soon start to slow, weighed down by the high exchange rate and the high real rates.

3. Finally, the US$ could rise as the world realizes how cheap US assets are on a relative basis. Capital would then flow into the US and easily overwhelm trade flows.

Thus, at this juncture, buying EMU bonds seems very dangerous if one is measured in US$ or in Asian currencies. Buying them and hedging the currency risk makes, we believe, a lot more sense.

The other markets where, frankly, we have been wrong-footed are oil and gold. Both are making new highs for reasons that we have a hard time understanding. Indeed, with growth slowing across the OECD, and inflation rolling over, we would have expected gold and oil to roll over...not make new highs! We are thus tempted to link all three (gold, the Euro and oil) together, and explain that oil is the driving force of the other two: Could it be that as oil prices rise, oil producers—who tend to dislike the US—receive US$ and exchange them for gold or Euros?

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To summarize, we still have a serious bias in favor of equities, with internally consistent biases in favor of Asia, Asia-related companies anywhere, tradable good sectors in the US, Sweden and Germany, and multinationals and large caps in the US. We would be very cautious on the non-tradable good sectors in Europe and would argue that it is too late to sell those in the US. Nevertheless, we are still anxious on financials as the recession in OECD housing is probably only getting started. In fact, OECD housing is the asset class which should take the current liquidity squeeze right on the chin. We are thus broadly indifferent on bonds, though we do expect further credit spread widening. We are also bearish on inflation-indexed bonds.