Three Things I Think I Think

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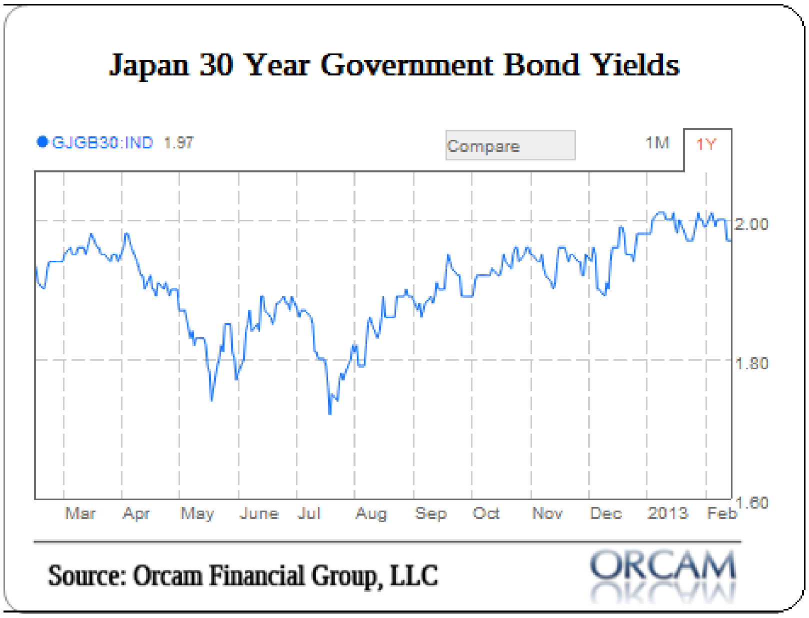
Some housekeeping first. The database is all set-up. You can access it by going to the front page of the Orcam website and clicking on the "Client Access" link at the top right of the page. Your user name is the email address you registered with and the password "orcam". This will give you access to all of the old notes. I encourage newer subscribers to go back and read some of the more educational pieces as they can help you better understand the methodology that is central to the research. Please let me know if you have any questions or troubles with the database.

"Risk comes from not knowing what you're doing. "
-Warren Buffett

1. The Yen, Mea Culpas and the Outlook

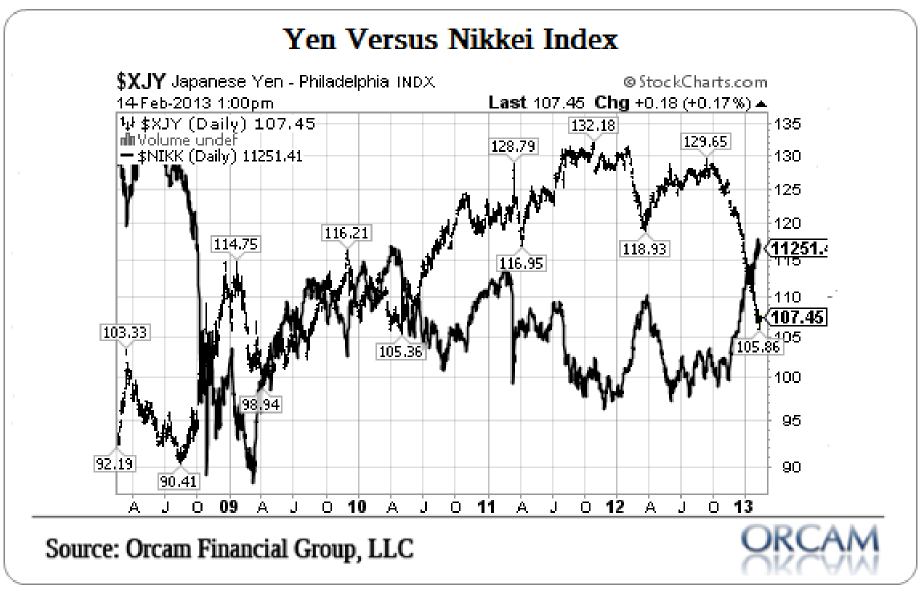
The current monetary policy occurrences in Japan are truly staggering. Shinzo Abe is throwing the kitchen sink at the economy by trying to drive down the Yen and bring the Japanese economy out of its long-time battle with deflation. The Yen is off over 20% from its highs last year as a result.

Devaluation is a lovely idea if you're the only one implementing it, but we're in a world where everyone is trying to devalue in the race to the bottom. I have to wonder how long the world is going to sit around and let Japan benefit from their improving balance of trade at the expense of other countries? My guess is not for long. Of course, my guess on this positioning has been wrong for several weeks now, but this is something I think we need to be patient with. These are massive and slowing moving parts of the global macroeconomy.



It's also interesting to note that the 30 year JGB has hardly budged during this epic move in the Yen. Stock prices have surged over 30% , but the JGB yields have rallied just 5 bps during Abe's declaration of war on the Yen. Are bond traders calling his bluff? Throughout the years the JGB has continually proven to be the best "tell" on the overall state of the Japanese economy. Is it different this time? I doubt it.

Also of importance is the inverse correlation between the Yen and the Nikkei index in Japan. A bet on the Yen at current levels is essentially a bet against the Japanese stock market. I don't want to short the Nikkei Index as Abe puts a 13,000 price target on it, but I do think the Yen is a reasonable synthetic equity short here. And considering our bullish equity *strategic* positioning, it's not an unreasonable hedge for our bigger picture.



2. What To Do With a Market That Doesn't Decline?

This is related to thought #1 though not entirely. How should we approach a market that seemingly refuses to decline? When the market is stretched and at levels that I would describe as being in an unusual disequilibrium, there is a tendency to chase assets for fear of "missing out". In my opinion, this is misguided as it leads us to take ever increasing risk as the market becomes increasingly more unstable.

Of course, part of our approach through overlapping timeframes through our strategic and tactical view is to remove a big part of the risk involved in betting on market short-term market moves. So, our core strategic piece is designed to give us exposure to pieces of the market regardless of potential disequilibrium (based on a macro view). But the tactical piece is designed to smooth out those disequilibriums by creating non-correlation in the overall portfolio. The current market environment is an example of such a period where we're long stocks in the strategic piece and bearish in the tactical piece.

This sort of approach is destined to create underperformance in soaring markets, but it is also designed to keep us out of the market when risk of a substantial decline is high (as was evidenced by our November sell call that sidestepped the ensuing -10% decline). So, what we're really trying to achieve here is stability of returns or what some might call higher risk adjusted returns. It's not always easy to see the market rise when you're not positioned for the entire move, but we have to remember that proper portfolio goals should not always adhere to beating the market, but rather beating the market on a risk adjusted basis.

Based on this thinking I believe it is prudent to remain a seller of the market at current levels from a tactical position as opposed to being enticed into buying stocks at ever increasingly risky levels thereby leading to a portfolio that is entirely unhedged during a *potential* disequilibrium.

3. Is the Sequestration a Bigger Deal Than the Market Presumes?

One of the reasons for the current complacency in the market is the lack of a fear catalyst. There is seemingly very little to be worried about. That leaves the market with a persistent bid. But that could change with the sequestration debates later this month. It's looking increasingly likely that the full sequestration cuts could take effect in an effort to compromise on the debt ceiling. That would mean a $85B cut in 2013 federal spending and the CBO estimates that it could cause a loss of 750,000

Q1 and Q2. Investors might find their reason to buckle up as soon as late February when this debate will be all over the front pages of financial newspapers. I doubt it will produce the kind of circus that ensued around the November election, but this is a meaningful risk to the economy and investors are simply ignoring it at present. As the risk of full sequestration cuts rises so too will the market risks.

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