Where is the Excessive Risk?

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Constructing an intelligently diversified portfolio isn't only about knowing where to place your bets. It's also about knowing when NOT to place a bet. Like a good gambler, you have to be able to decipher the odds of certain hands during the game and decide when It's best to sit out and when it's best to participate. In terms of portfolio management, we should take a similar approach. A good manager does not merely participate in every hand just because he/she can. He/she must pick and choose markets and environments where the odds most favor a beneficial outcome. That said, it is helpful to take a top-down view of markets to decipher where the tail risk exists. In other words, we want to eliminate the riskiest markets from the hands we potentially decide to play.

“If the global economy is a bad neighborhood then the peripheral European nations are cardboard boxes in alleyways.”

Deciphering Excessive Risk

Deciphering the riskiest markets requires a broad understanding of many moving pieces. We can't know precisely how the future will play out, but through understanding the pieces of the puzzle and how they come together, we can increase our odds that we'll be able to avoid those markets where the risk of substantial downside exists. I start primarily from a macro understanding of the monetary system and break-down the picture using an increasingly micro understanding.

If we look around the world we can begin to formulate a better understanding of this approach. For instance, if we look at Europe we see an unworkable currency system where the nations have all entered into a single currency without floating exchange rates. Anyone who understood this years ago knew that Europe's crisis could not be resolved without a substantial institutional redesign. In short, European countries are like the states in the USA. The problem is that the system has no rebalancing mechanism via floating exchange rates or fiscal transfers. So, when a trade imbalance occurs the only solution is a painful deflation. In the USA, this doesn't occur because the states tap the Federal government for fiscal aid. This virtually eliminates the risk of a solvency crisis and counters the missing floating exchange rate fix via the system of fiscal redistribution. Europe's periphery countries have structural trade imbalances that can't be fixed via floating exchange rates and won't be fixed via fiscal transfers (because there is no entity to provide such fiscal transfers). So the accounting is rather simple—it's deflation, deflation, deflation. This puts pressure on corporate profits and makes equity markets on the periphery substantially more risky than many other nations.

Conclusion: you can eliminate all of the peripheral nations from portfolio options since the Euro crisis remains unresolved and the tail risk remains extremely high. If the global economy is a bad neighborhood then the peripheral European nations are cardboard boxes in alley-ways.

Japan & Abenomics

The Japanese monetary system is currently undergoing one of the most extraordinary government interventions in the history of fiat money systems. They have pledged to fight deflation with "whatever it takes". One of the keys to this approach is the equivalent of the Greenspan or Bernanke Put with an influence on the "wealth effect".

In essence, the Bank of Japan will attempt to talk up equity prices with the hope that higher prices will lead to shareholders feeling wealthier, spending more, etc. The risk to such an approach is that it puts the cart before the horse. I am sure Apple Corp. would love to see their stock price double. And they could come out and say they're buying back stock and that they feel their share price is half of what it should be. But that doesn't necessarily justify an immediate doubling in the share price. No, Apple should stop wasting their time on buybacks and spend more time focusing on the next product that will drive revenue growth, profit growth and ultimately justify a doubling in the stock price.

The worry with the BOJ's approach is that they're doing the equivalent of talking up equity prices without creating a sustainable underlying fundamental impact. This creates the potential for a disequilibrium in the market where investors temporarily bid up prices only to later realize that the BOJ's wishes were never back by anything fundamentally driven.

Of course, the Japanese policymakers appear to believe that they're having a fundamental impact. And they very well could be. After all, they're running massive fiscal stimulus programs and these programs are likely to generate *some* growth. But there is a substantial risk of disequilibrium in Japan where equity prices have been bid up by FIFTY PERCENT since last November in anticipation of government intervention.

From an operational perspective, QE is clearly flawed in terms of generating a fundamental impact. At its most basic level, QE is a simple asset swap whereby the central bank purchases bonds from the private sector and replaces those bonds with bank reserves or bank deposits. The result is no change in the private sector's net financial assets. Since spending in the economy is a function of current income relative to future desired savings we should seriously question the validity of a program that alters none of the variables in the spending equation. The fiscal stimulus will alter income levels (because it increase the "flow" in the economy), but QE will alter neither incomes nor savings. Therefore, it's unlikely to generate high inflation and high growth. But the markets are extremely optimistic that this will pan out.

Further, the Japanese Yen has collapsed since QE was implemented. The decline has been astonishing in that QE has never been met with such a decline in a currency. On a relative basis, this appears largely irrational. QE has no mechanism through which it can influence foreign exchange rates and the forex markets are ultimately a zero sum game. This means that QE can only "work" through the FX markets by stealing revenue from elsewhere. If Japan's exchange rate falls versus the dollar they benefit from the USA's loss in competitiveness. This is sustainable only so long as a nation allows another nation to manipulate the exchange rate. And I am quite certain that Japanese officials are now manipulating the Yen lower versus the US Dollar. The US Treasury responded this past weekend for the first time since the intervention began so we have to wonder how much further the Yen can be depressed versus the USD.

Conclusion: Buying Japanese equities under the current policy approach involves substantial downside risk. The Japanese equity market is currently trading with extreme volatility and extraordinary uncertainty. The Japanese economy is not nearly as bad off as the peripheral European economies, but the Ponzi-like policy approach creates the risk of substantial downside. I would avoid both regions in favor of lower risk markets.

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