Eriswell Market Insights

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HOW TO OUTPERFORM WHEN UNCERTAINTY IS HIGH

THROUGH THE EYES OF A HEDGE FUND MANAGER

Eriswell
Capital Management

Financial ‘experts’ prefer to explain how things ‘should be’, rather than questioning the way they are.

Stocks and bonds ‘shouldn’t’ have fallen together. Yet they have, and even well-diversified retail portfolios are down 10% to 20% this year. The first half of 2022 has been the worst six-month period for a traditional 60-40 portfolio in 90 years!

“Stick with it and prices will recover”, is the oft repeated response.

But will they? By when? What if you need the money first? What is the risk of a continued downslide? Are some assets better placed than others?

Staying curious opens new possibilities.

In October 2021, it opened the door to a radically new low volatility stock portfolio which is currently up by almost as much as markets have fallen.

Staying curious opens our minds to new possibilities of what might be. But it can also be a vacuum that sucks us in.

To balance the two outcomes, we must first focus on what we feel certain about and then use this as a basis for making educated inferences about what should be.

While always considering how 'what we don't know' may affect the things we feel certain about. The American physicist John Wheeler compared the interdependent motion between a distant star and a nearby black hole to a dimly lit ballroom where women in white dresses are dancing with men in black tuxedos. You can only see the women but can infer the existence of their invisible male partners from the women's spinning and whirling motion.

Then, if your theory works out, great. And if it doesn't, you must consider why this might be.

There's no point in saying, "but that shouldn't be, I'd never have made the world that way". Unless you're God that is!

Then keep going round and round until you figure out what's going on.

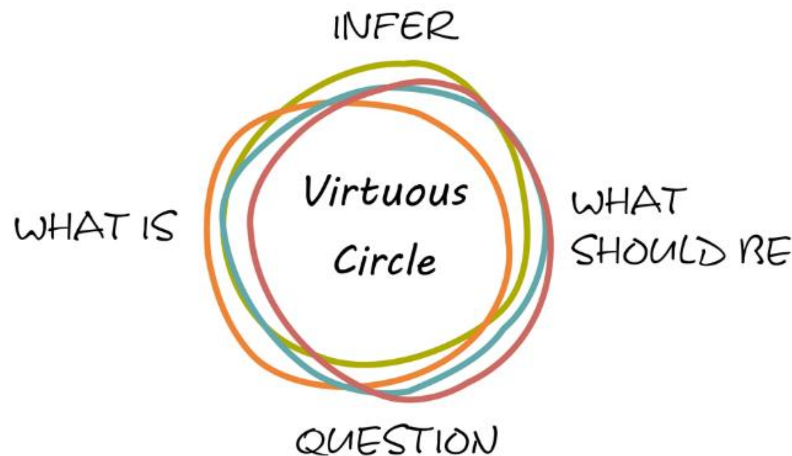

Image: Eriswell Capital Management

Back to investing

Over the past year, bonds have suffered the worst real returns – returns adjusted for inflation – since the early 1980s, when then Federal Reserve Chairman Paul Volcker was fighting a wage-price spiral. Volcker ultimately prevailed, which heralded a 40-year fall in bond yields (bond prices move in the opposite direction to yields).

Now, we know – or at least we think we know – that government bond yields are one of the most important axes around which almost all asset prices revolve: stocks, corporate debt, gold, real estate, fine art, etc. And over the past 40-years, falling bond yields have been one of the principal juices for both economic growth and rising asset prices.

In July 2020, this juice finally ran out as 10Yr US Treasury yields hit a low of around 0.5%. They had nowhere else to fall. Worse, like the women in white dresses, falling yields reflected other darker forces within our economies. Forces which are hard to measure and even harder to understand.

Consequently, to try and plug the gap as yields started to rise, governments were forced to start spending like Billy-O.

And with that, the rules of the game radically changed.

Isn't it at least worth considering what this means for asset prices in the longer term?

For your savings? For your, pension? For your life?

Now, you might ask if there is any precedent for what has changed in Western economies. It's by no means perfect but, yes, there is. Or at least something that has the same common denominator.

Enter stage, another 40-year period, this time in Japan. In January 1950, Japan's Nikkei 225 index traded at 92. Over the next 40-years it bounced around, but those following "buy and hold" strategies were handsomely rewarded. By the end of December 1989, the Nikkei 225 traded at 38,916.

Then 'something' dark but subtle changed in Japan.

By the end of March 2003, the Nikkei 225 had fallen to just 7,972, meaning investors in Japanese stocks had lost over 80% of their money! Almost 10-years later, in July 2012 the Nikkei 225 remained stuck at 8,696. Today, it is trading around 28,000, less than half its value in 1989. Now there's some maths we need to do here to make precise measurements, but you get the idea.

Unsurprisingly, Eriswell spent long nights searching for what exactly went wrong in late-1980s Japan?

What if I told you the same dark things are going wrong in Europe and the US today?

What if I told you the Federal Reserve is deeply concerned? Or that top hedge funds have been closely monitoring these developments for years? True, Western stock markets are nowhere near as overvalued as Japanese stocks were back then, but similarities nevertheless remain. And don't forget that bubbles are much easier to identify in the rear-view mirror.

We'll summarise the details of what is going wrong in a forthcoming series. So, let's get back to investing.

A Radically New Retail Portfolio

In August 2021, we were investigating the possibility that a "lower-risk" portfolio might be able to protect against the inflation storm we forecast at the time. And then, hopefully continue to outperform in the low inflation bust we forecast next.

By following the flow, in October 2021 a radically new portfolio was born (Figure 1).

We called this Eriswell's "NGDP1 Defensive", depicted in blue below.

Far from what conventional finance expected, "the NGDP1 Defensive" portfolio was chock full of stocks. Albeit stocks with some very special characteristics. In fact, this portfolio contained no bonds at all, and curiously – given Eriswell's inflation forecast – no index linked bonds. Which turned out to be a good thing as index-linked bonds have been hammered.

How has "NGDP1 Defensive" performed since its inception on 15 October 2021?

One might benchmark it against the standard retail 60:40 stock/bond portfolio. Or one might benchmark it against one of the main stock market indices. It doesn't really matter as all have performed poorly (Figure 1).

Either way, "NGDP1 Defensive" has outperformed assorted conventional benchmarks by around 23–30%. Even we were surprised!

To understand this strategy more fully, we need to understand more about this 'something' that has gone wrong. As it did in late-1980s Japan.

Then, to make useful predictions, we need to understand where this 'something' came from, how it works, the direction it's travelling and, of course, what might eventually cause it to go away.

It will then become apparent why tracking nominal-GDP (NGDP) is so important today. Hence our strategy's name.

The final step is to figure out which assets are likely to do that.

But that as they say is another story; it's the subject of a new Eriswell series which I'll link on here:

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Figure 1: **"NGDP1 Defensive" versus Different Benchmarks** (15 October 2021 – 27 July 2022, normalised)

For any enquiries or comments, you may have, please contact us at info@eriswell.com. We look forward to hearing from you.

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