The Burning Questions For 2015

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With two reports a day, and often more, readers sometimes complain that keeping tabs on the thoughts of the various Gavekal analysts can be a challenge. So as the year draws to a close, it may be helpful if we recap the main questions confronting investors and the themes we strongly believe in, region by region.

1. A Chinese Marshall Plan?

When we have conversations with clients about China—which typically we do between two and four times a day—the talk invariably revolves around how much Chinese growth is slowing (a good bit, and quite quickly); how undercapitalized Chinese banks are (a good bit, but fat net interest margins and preferred share issues are solving the problem over time); how much overcapacity there is in real estate (a good bit, but—like youth—this is a problem that time will fix); how much overcapacity there is in steel, shipping, university graduates and corrupt officials; how disruptive China's adoption of assembly line robots will be etc.

The consensus on China risks missing the real story

All of these questions are urgent, and the problems that prompted them undeniably real, which means that China's policymakers certainly have their plates full. But this is where things get interesting: in all our conversations with Western investors, their conclusion seems to be that Beijing will have little choice but to print money aggressively, devalue the renminbi, fiscally stimulate the economy, and basically follow the path trail-blazed (with such success?) by Western policymakers since 2008. However, we would argue that this conclusion represents a failure both to think outside the Western box and to read Beijing's signal flags.

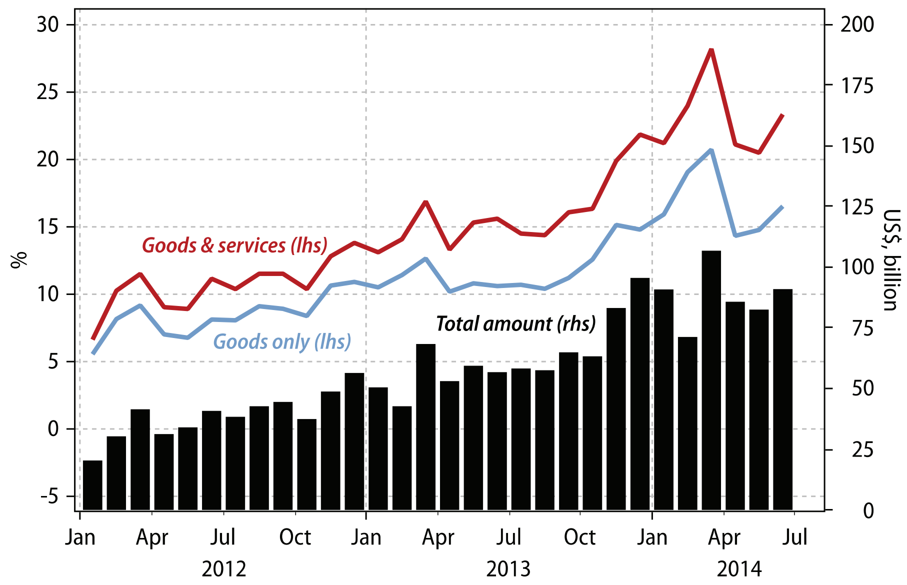
In numerous reports (and in Chapters 11 to 14 of [Too Different For Comfort]) we have argued that the internationalization of the renminbi has been one of the most significant macro events of recent years. This internationalization is continuing apace: from next to nothing in 2008, almost a quarter of Chinese trade will settle in renminbi in 2014 (see the chart overleaf).

Emerging market policymakers have two perennial worries

This is an important development which could have a very positive impact on a number of emerging markets. Indeed, a typical, non-oil exporting emerging market policymaker (whether in Turkey, the Philippines, Vietnam, South Korea, Argentina or India) usually has to worry about two things that are completely out of his control:

1) **A spike in the US dollar.** Whenever the US currency shoots up, it presents a hurdle for growth in most emerging markets. The first reason is that most trade takes place in US dollars, so a stronger US dollar means companies having to set aside more money for working capital needs. The second is that most emerging market investors tend to think in two currencies: their own and the US dollar. Catch a cab in

Trade settled in renminbi



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A strong US dollar has usually spelled trouble for emerging markets

Bangkok, Cairo, Cape Town or Jakarta and ask for that day's US dollar exchange rate and chances are that the driver will know it to within a decimal point. This sensitivity to exchange rates is important because it means that when the US dollar rises, local wealth tends to flow out of local currencies as investors sell domestic assets and into US dollar assets, typically treasuries (when the US dollar falls, the reverse is true).

2) **A rapid rise in oil or food prices.** Violent spikes in oil and food prices can be highly destabilizing for developing countries, where the median family spends so much more of their income on basic necessities than the typical Western family. Sudden spikes in the price of food or energy can quickly create social and political tensions. And that's not all; for oil-importing countries, a spike in oil prices can lead to a rapid deterioration in trade balances. These tend to scare foreign investors away, so pushing the local currency lower and domestic interest rates higher, which in turn leads to weaker growth etc…

Looking at these two concerns, it is hard to escape the conclusion that, as things stand, China is helping to mitigate both:

But renminbi internationalization is mitigating the risk

- China's policy of renminbi internationalization means that emerging markets are able gradually to reduce their dependence on the US dollar. As they do, spikes in the value of the US currency (such as we have seen in 2014) are becoming less painful.
- The slowdown in Chinese oil demand (see The Great Normalization of China's Oil Demand), as well as China's ability to capitalize on Putin's difficulties to transform itself from a price-taker to a price-setter (see A Changed Energy Dynamic), means that the impact of oil and commodities on trade balances is much more contained.

The renminbi's rise is likely to provide an economic and monetary boost

Beyond providing stability to emerging markets, the gradual acceptance of the renminbi as a secondary trading and reserve currency for emerging markets has further implications. The late French economist Jacques Rueff showed convincingly how, when global trade moved from a gold-based settlement system to a US dollar-based system, purchasing power was duplicated. As the authors of a recent Wall Street Journal article citing Reuff's work explained: "If the Banque de France counts among its reserves dollar claims (and not just gold and French francs)—for example a Banque de France deposit in a New York bank—this increases the money supply in France but without reducing the money supply of the US. So both countries can use these dollar assets to grant credit." Replace Banque de France with Bank Indonesia, and US dollar with renminbi and the same causes will lead to the same effects.

Consider British Columbia's recently issued AAA-rated two year renminbi dim sum bond. Yielding 2.85%, this bond was actively subscribed to by foreign central banks, which ended up receiving more than 50% of the initial allocation (ten times as much as in the first British Columbia dim sum issue two years ago). After the issue British Columbia takes the proceeds and deposits them in a Chinese bank, thereby capturing a nice spread. In turn, the Chinese bank can multiply this money five times over (so goes money creation in China). Meanwhile, the Indonesian, Korean or Kazakh central banks that bought the bonds now have an asset on their balance sheet which they can use to back an expansion of trade with China…

China is extending its regional trading and investment network...

Of course, for trade to flourish, countries need to be able to specialize in their respective comparative advantages, hence the importance of the kind of free trade deals discussed at the recent APEC meeting. But free trade deals are not enough; countries also need trade infrastructure (ports, airports, telecoms, trade finance banks etc…). This brings us to China's 'new silk road' strategy and the recent announcement by Beijing of a US$40bn fund to help finance road and rail infrastructure in the various 'stans' on its western borders in a development that promises to cut the travel time from China to Europe from the current 30 days by sea to ten days or less overland (see **Travels Along The New Silk Road: The Economics Of Power**, and **Blood And Bazaars On The New Silk Road**). Needless to say, such a dramatic reduction in transportation time could help prompt some heavy industry to relocate from Europe to Asia.

That's not all. At July's BRICS summit in Brazil, leaders of the five member nations signed a treaty launching the US$50bn New Development Bank, which Beijing hopes will be modeled on China Development Bank, and is likely to compete with the World Bank (see **A Chinese Bretton Woods**). This will be followed by the establishment of a China-dominated BRICS contingency fund (challenging the International Monetary Fund). Also on the cards is an Asian Infrastructure Investment Bank to rival the Asian Development Bank.

So what looks likely to take shape over the next few years is a network of railroads and motorways linking China's main production centers to Bangkok, Singapore, Karachi, Almaty, Moscow, Yangon, Kolkata (see **No Bridgehead Too Far In China's Expanding Empire**). We will see pipelines, dams, and power plants built in Siberia, Central Asia, Pakistan and Myanmar; as well as airports, hotels, business centers… and all of this financed with China's excess savings, and leverage. Given that China today has excess production capacity in all of these sectors, one does not need a fistful of university diplomas to figure out whose companies will get the pick of the construction contracts.

...which will boost Beijing's political influence...

But to finance all of this, and to transform herself into a capital exporter, China needs stable capital markets and a strong, convertible currency. This explains why, despite Hong Kong's pro-democracy demonstrations, Beijing is pressing ahead with the internationalization of the renminbi using the former British colony as its proving ground (witness the Shanghai-HK stock connect scheme and the removal of renminbi restrictions on Hong Kong residents). And it is why renminbi bonds have delivered better risk-adjusted returns over the past five years than almost any other fixed income market.

Of course, China's strategy of internationalizing the renminbi, and integrating its neighbors into its own economy might fall flat on its face. Some neighbors bitterly resent China's increasing assertiveness (see **Beijing Eyes the Bay of Bengal** and **Perilous Seas**). Nonetheless, the big story in China today is not 'ghost cities' (how long has that one been around?) or undercapitalized banks. The major story is China's reluctance to continue funneling its excess savings into US treasuries yielding less than 2%, and its willingness to use that capital instead to integrate its neighbors' economies with its own; using its own currency and its low funding costs as an 'appeal product' (and having its own companies pick up the contracts as a bonus). In essence, is this so different from what the US did in Europe in the 1940s and 1950s with the Marshall Plan?

...much as the US did in the 1940s with the Marshall Plan

2. Japan: Is Abenomics just a sideshow?

With Japan in the middle of a triple dip recession, and Japanese households suffering a significant contraction in real disposable income, it might seem that Prime Minister Shinzo Abe has chosen an odd time to call a snap election. Three big factors explain his decision:

1) **The Japanese opposition is in complete disarray**. So Abe's decision may primarily have been opportunistic.

2) We must remember that **Abe is the most nationalist prime minister Japan has produced in a generation**. The expansion of China's economic presence across Central and South East Asia will have left him feeling at least as uncomfortable as anyone who witnessed his Apec handshake with Xi Jinping three weeks ago. It is not hard to imagine that Abe returned from Beijing convinced that he needs to step up Japan's military development; a policy that requires him to command a greater parliamentary majority than he holds now.

Japan has its most nationalist prime minister in a generation

3) The final factor explaining Abe's decision to call an election may be that **in Japan the government's performance in opinion polls seems to mirror the performance of the local stock market** (wouldn't Barack Obama like to see such a correlation in the US?). With the Nikkei breaking out to new highs, Abe may feel that now is the best time to try and cement his party's dominant position in the Diet.

As he gets ready to face the voters, how should Abe attempt to portray himself? In our view, he could do worse than present himself as Japan Inc's biggest salesman. Since the start of his second mandate, Abe has visited 49 countries in 21 months, and taken hundreds of different Japanese CEOs along with him for the ride. The message these CEOs have been spreading is simple: Japan is a very different place from 20 years ago. Companies are doing different things, and investment patterns have changed. Many companies have morphed into completely different animals, and are delivering handsome returns as a result. The relative year to date outperformances of Toyo Tire (+117%), Minebea (+95%), Mabuchi (+57%), Renesas (+43%), Fuji Film (+33%), NGK Insulators (+33%) and Nachi-Fujikoshi (+19%) have been enormous. Or take Panasonic as an example: the old television maker has transformed itself into a car parts firm, piggy-backing on the growth of Tesla's model S.

Japanese companies have transformed themselves over the last 20 years

Yet even as these changes have occurred, most foreign investors have stopped visiting Japan, and most sell-side firms have stopped funding genuine and original research. For the alert investor this is good news. As the number of Japanese firms at the heart of the disruptions reshaping our global economy—robotics, electric and self-driving cars, alternative energy, healthcare, care for the elderly—continues to expand, and as the number of investors looking at these same firms continues to shrink, those investors willing to sift the gravel of corporate Japan should be able to find real gems.

Which brings us to the real question confronting investors today: the 'Kuroda put' has placed Japanese equities back on investor's maps. But is this just a short term phenomenon? After all, no nation has ever prospered by devaluing its currency. If Japan is set to attract, and retain, foreign investor flows, it will have to come up with a more compelling story than 'we print money faster than anyone else'.

Is the Kuroda put just a temporary phenomenon?

In our recent research, we have argued that this is exactly what is happening (see Hollywood Does It Again, Ring of Fire, Japan's Genki Grandparents, Japan's Hydrogen Game Changer). In fact, we believe so much in the opportunity that we have launched a dedicated Japan corporate research service (GK Plus Alpha) whose principals (Alicia Walker and Neil Newman) are burning shoe leather to identify the disruptive companies that will trigger Japan's next wave of growth.

3. Should we worry about capital misallocation in the US?

The US has now 'enjoyed' a free cost of money for some six years (see [The High Cost of Free Money]). The logic behind the zero-interest rate policy was simple enough: after the trauma of 2008, the animal spirits of entrepreneurs needed to be prodded back to life. Unfortunately, the last few years have reminded everyone that the average entrepreneur or investor typically borrows for one of two reasons:

• **Capital spending**: Business is expanding, so our entrepreneur borrows to open a new plant, or hire more people, etc.

• **Financial engineering**: The entrepreneur or investor borrows in order to purchase an existing cash flow, or stream of income. In this case, our borrower calculates the present value of a given income stream, and if this present value is higher than the cost of the debt required to own it, then the transaction makes sense.

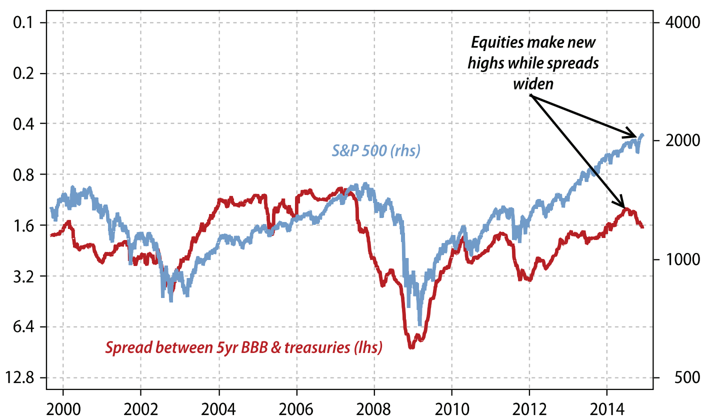
Financial engineering does nothing to deepen an economy's capital stock

Unfortunately, the second type of borrowing does not lead to an increase in the stock of capital. It simply leads to a change in the ownership of capital at higher and higher prices, with the ownership of an asset often moving away from entrepreneurs and towards financial middlemen or institutions. So instead of an increase in an economy's capital stock (as we would get with increased borrowing for capital spending), with financial engineering all we see is a net increase in the total amount of debt and a greater concentration of asset ownership. And the higher the debt levels and ownership concentration, the greater the system's fragility and its inability to weather shocks.

We are not arguing that financial engineering has reached its natural limits in the US. Who knows where those limits stand in a zero interest rate world? However, we would highlight that the recent new highs in US equities have not been accompanied by new lows in corporate spreads. Instead, the spread between 5-year BBB bonds and 5-year US treasuries has widened by more than 30 basis points since this summer.

Spreads have widened...

S&P 500, and corporate spread (5yr BBB - 5yr UST)



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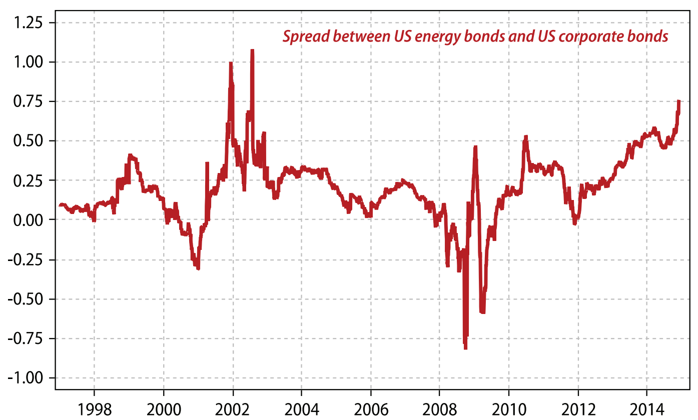
...largely because of the energy sector rout

Spread between ML index of US energy sector bonds and US corporates



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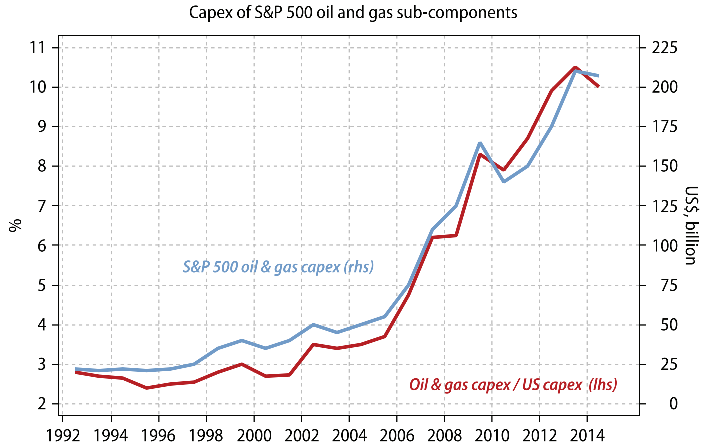
Behind these wider spreads lies a simple reality: corporate bonds issued by energy sector companies have lately been taken to the woodshed. In fact, the spread between the bonds of energy companies, and those of other US corporates are back at highs not seen since the recession of 2001-2002, when the oil price was at US$30 a barrel.

US oil and gas investment went into hyperdrive in recent years...

The market's behavior raises the question whether the energy industry has been the black hole of capital misallocation in the era of quantitative easing. As our friend Josh Ayers of Paradarch Advisors (Josh publishes a weekly entitled *The Right Tale*, which is a fount of interesting ideas. He can be reached at josh@paradarchadvisors.com) put it in a recent note: "After surviving the resource nadir of the late 1980s and 1990s, oil and gas firms started pumping up capex as the new millennium began. However, it wasn't until the purported end of the global financial crisis in 2009 that capital expenditure in the oil patch went into hyperdrive, at which point capex from the S&P 500's oil and gas subcomponents jumped from roughly 7% of total US fixed investment to over 10% today."

Oil and gas investment has boomed...



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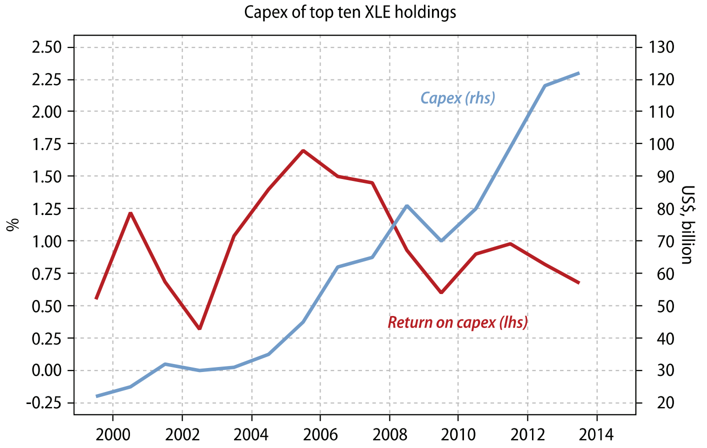
...even as the returns on that investment have declined



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"It's no secret that a decade's worth of higher global oil prices justified much of the early ramp-up in capex, but a more thoughtful look at the underlying data suggests we're now deep in the malinvestment phase of the oil and gas business cycle. The second chart (above) displays both the total annual capex and the return on that capex (net income/capex) for the ten largest holdings in the Energy Select Sector SPDR (XLE). The most troublesome aspect of this chart is that, since 2010, returns have been declining as capex outlays are increasing. Furthermore, this divergence is occurring despite WTI crude prices averaging nearly $96 per barrel during that period," Josh noted.

The energy sector may not be the only place where capital has been misallocated on a grand scale. The other industry with a fairly large target on its back is the financial sector. For a start, policymakers around the world have basically decided that, for all intents and purposes, whenever a 'decision maker' in the financial industry makes a decision, someone else should be looking over the decision maker's shoulder to ensure that the decision is appropriate. Take HSBC's latest results: HSBC added 1400 compliance staff in one quarter, and plans to add another 1000 over the next quarter. From this, we can draw one of two conclusions:

1) The financial firms that will win are the large firms, as they can afford the compliance costs.
2) The winners will be the firms that say: "Fine, let's get rid of the decision maker. Then we won't need to hire the compliance guy either".

Are the world's tech giants about to turn the banking sector on its head?

This brings us to a theme first explored by our friend Paul Jeffery (see **The Disruption That Could Change Banking**), who back in September wrote: "In 1994 Bill Gates observed: 'Banking is necessary, banks are not'. The primary function of a bank is to bring savers and users of capital together in order to facilitate an exchange. In return for their role as [trusted] intermediaries banks charge a generous net spread. To date, this hefty added cost has been accepted by the public due to the lack of a credible alternative, as well as the general oligopolistic structure of the banking industry. What Lending Club and other P2P lenders do is provide an online market-place that connects borrowers and lenders directly; think the eBay of loans and you have the right conceptual grasp. Moreover, the business model of online market-place lending breaks with a banking tradition, dating back to 14th century Florence, of operating on a "fractional reserve" basis. In the case of P2P intermediation, lending can be thought of as being "fully reserved" and entails no balance sheet risk on the part of the service facilitator. Instead, the intermediary receives a fee-based revenue stream rather than a spread-based income."

There is another way we can look at it: finance today is an abnormal industry in two important ways:

Banking is an abnormal industry, ripe for an internet revolution

1) The more the sector spends on information and communications technology, the bigger a proportion of the economic pie the industry captures. This is a complete anomaly. In all other industries (retail, energy, telecoms…), spending on ICT has delivered savings for the consumers. In finance, investment in ICT (think shaving seconds of trading times in order to front run customer orders legally) has not delivered savings for consumers, nor even bigger dividends for shareholders, but fatter bonuses and profits for bankers.
2) The second way finance is an abnormal industry (perhaps unsurprisingly given the first factor) lies in the banks' inability to pass on anything of value to their customers, at least as far as customer's perceptions are concerned. Indeed, in 'brand surveys' and 'consumer satisfaction reports', banks regularly bring up the rear. Who today loves their bank in a way that some people 'love' Walmart, Costco, IKEA, Amazon, Apple, Google, Uber, etc?

Most importantly, and as Paul highlights above, if the whole point of the internet is to:

a) measure more efficiently what each individual needs, and

b) eliminate unnecessary intermediaries,

Peer-to-peer lending and payments are poised to take off

then we should expect a lot of the financial industry's safe and steady margins to come under heavy pressure. This has already started in the broking and in the money management industries (where mediocre money managers and other closet indexers are being replaced by ETFs). But why shouldn't we start to see banks' high return consumer loan, SME loan and credit card loan businesses replaced, at a faster and faster pace, by peer-to-peer lending? Why should consumers continue to pay high fees for bank transfers, or credit cards when increasingly such services are offered at much lower costs by firms such as TransferWise, services like Alipay and Apple Pay, or simply by new currencies such as Bitcoin? On this point, we should note that in the 17 days that followed the launch of Apple Pay on the iPhone 6, almost 1% of Wholefoods' transactions were processed using the new payment system. The likes of Apple, Google, Facebook and Amazon have grown into behemoths by upending the media, advertising retail and entertainment industries. Such a rapid take-up rate for Apple Pay is a powerful indicator which sector is likely to be next in line. How else can these tech giants keep growing and avoid the fate that befell Sony, Microsoft and Nokia? On their past record, the technology companies will find margins, and growth, in upending our countries' financial infrastructure. As they do, a lot of capital (both human and monetary) deployed in the current infrastructure will find itself obsolete.

How will this disintermediation affect the nuts and bolts of investment?

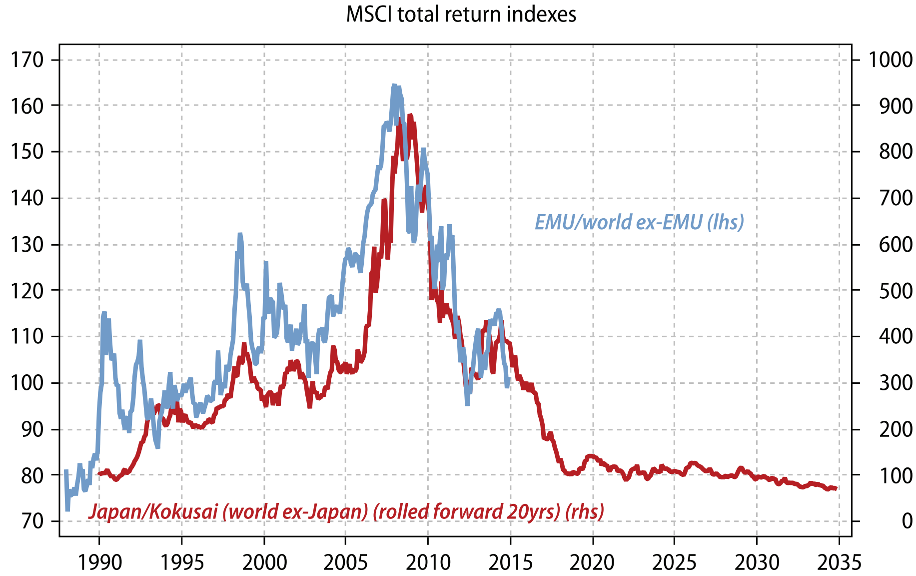
This possibility raises a number of questions—not least for Gavekal's own investment process, which relies heavily on changes in the velocity of money and in the willingness and ability of commercial banks to multiply money, to judge whether it makes sense to increase portfolio risk. What happens to a world that moves 'ex-bank' and where most new loans are extended peer-to-peer? In such a world, the banking multiplier disappears along with fractional reserve banking (and consequently the need for regulators? Dare to dream…). As bankers stop lending their clients umbrellas when it is sunny, and taking them away when it rains, will our economic cycles become much tamer? As central banks everywhere print money aggressively, could the market be in the process of creating currencies no longer based on the borders of nation states, but instead on the cross-border networks of large corporations (Alipay, Apple Pay...), or even on voluntary communities (Bitcoin). Does this mean we are approaching the Austrian dream of a world with many, non government-supported, currencies?

4. Should we care about Europe?

Europe today is reminiscent of Japan in the early 1990s...

In our September **Quarterly Strategy Chartbook**, we debated whether the eurozone was set for a revival (the point expounded by François) or a continued period stuck in the doldrums (Charles's view), or whether we should even care (my point). At the crux of this divergence in views is the question whether euroland is broadly following the Japanese deflationary bust path. Pointing to this possibility are the facts that 11 out of 15 eurozone countries are now registering annual year-on-year declines in CPI, that policy responses have so far been late, unclear and haphazard (as they were in Japan), and that the solutions mooted (e.g. European Commission president Jean-Claude Juncker's €315bn infrastructure spending plan) recall the solutions adopted in Japan (remember all those bridges to nowhere?). And that's before going into the structural parallels: ageing populations; dysfunctional, undercapitalized and overcrowded banking systems; influential segments of the population eager to maintain the status quo etc…

Is Europe turning Japanese?



...which prompts a clear conclusion

With the same causes at work, should we expect the same consequences? Does the continued underperformance of eurozone stocks simply reflect that managing companies in a deflationary environment is a very challenging task? If euroland has really entered a Japanese-style deflationary bust likely to extend years into the future, the conclusion almost draws itself.

The main lesson investors have learned from the Japanese experience of 1990-2013 is that the only time to buy stocks in an economy undergoing a deflationary bust is:

a) when stocks are massively undervalued relative both to their peers and to their own history, and

b) when a significant policy change is on the way.

This was the situation in Japan in 1999 (the first round of QE under PM Keizo Obuchi), 2005 (PM Junichiro Koizumi's bank recapitalization program) and of course in 2013-14 (Abenomics). Otherwise, in a deflationary environment with no or low growth, there is no real reason to pile into equities. One does much better in debt. So, if the Japan-Europe parallel runs true, it only makes sense to look at eurozone equities when they are both massively undervalued relative to their own histories and there are expectations of a big policy change. This was the case in the spring of 2012 when valuations were at extremes, and Mario Draghi replaced Jean-Claude Trichet as ECB president. In the absence of these two conditions, the marginal dollar looking for equity risk will head for sunnier climes.

Buy European equities only when heavily undervalued and when there is a big policy change in the offing...

With this in mind, there are two possible arguments for an exposure to eurozone equities:

1) The analogy of Japan is misleading as euroland will not experience a deflationary bust (or will soon emerge from deflation) (this was the argument presented by François in September's Quarterly and in **Bet On Reflation, Not Deflation**).
2) We are reaching the point when our two conditions—attractive valuations, combined with policy shock and awe—are about to be met. Thus we could be reaching the point when euroland equities start to deliver outsized returns (in essence, this is the argument Anatole presented in **The Great Policy Convergence**).

Proponents of the first argument will want to overweight euroland equities now, as this scenario should lead to a rebound in both the euro and European equities (so anyone underweight in their portfolios would struggle). However, it has to be said that the odds against this first outcome appear to get longer with almost every data release!

Proponents of the second scenario, however, can afford to sit back and wait, because it is likely any outperformance in eurozone equities would be accompanied by euro currency weakness. Hence, as a percentage of a total benchmark, European equities would not surge, because the rise in equities would be offset by the falling euro.

...or decide to ignore Europe altogether

Alternatively, investors who are skeptical about either of these two propositions can—like us—continue to use euroland as a source of, rather than as a destination for, capital. And they can afford safely to ignore events unfolding in euroland as they seek rewarding investment opportunities in the US or Asia. In short, over the coming years investors may adopt the same view towards the eurozone that they took towards Japan for the last decade: 'Neither loved, nor hated… simply ignored'.

Conclusion:

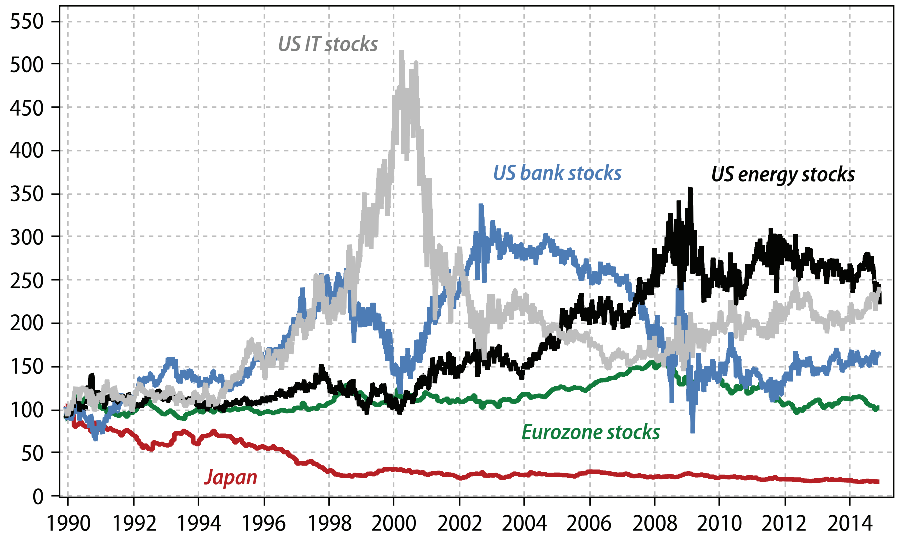
Most investors go about their job trying to identify 'winners'. But more often than not, investing is about avoiding losers. Like successful gamblers at the racing track, **an investor's starting point should be to eliminate the assets that do not stand a chance, and then spread the rest of one's capital amongst the remainder**.

To outperform, don't try to pick winners, just avoid losers

For example, if in 1981 an investor had decided to forego investing in commodities and simply to diversify his holdings across other asset classes, his decision would have been enough to earn himself a decade at the beach. If our investor had then returned to the office in 1990, and again made just one decision—to own nothing in Japan—he could once again have gone back to sipping margaritas for the next ten years. In 2000, the decision had to be not to own overvalued technology stocks. By 2006, our investor needed to start selling his holdings in financials around the world. And by 2008, the money-saving decision would have been to forego investing in euroland.

Picking winners or avoiding losers?

Performance relative to MSCI World index



Gavekal Data/Macrobond

To avoid future potholes, answer these questions

Of course hindsight is twenty-twenty, and any investor who managed to avoid all these potholes would have done extremely well. Nevertheless, the big question confronting investors today is how to avoid the potholes of tomorrow. To succeed, we believe that investors need to answer the following questions:

- Will Japan engineer a revival through its lead in exciting new technologies (robotics, hi-tech help for the elderly, electric and driverless cars etc…), or will Abenomics prove to be the last hurrah of a society unable to adjust to the 21st century? Our research is following these questions closely through our new **GK Plus Alpha** venture.

- Will China slowly sink under the weight of the past decade's malinvestment and the accompanying rise in debt (the consensus view) or will it successfully establish itself as Asia's new hegemon? Our Beijing based research team is very much on top of these questions, especially Tom Miller, who by next Christmas should have a book out charting the geopolitical impact of China's rise.

Can India finally punch its weight?

- Will Indian prime minister Narendra Modi succeed in plucking the low-hanging fruit so visible in India, building new infrastructure, deregulating services, cutting protectionism, etc? If so, will India start to pull its weight in the global economy and financial markets?
- How will the world deal with a US economy that may no longer run current account deficits, and may no longer be keen to finance large armies? Does such a combination not almost guarantee the success of China's strategy?
- If the US dollar is entering a long term structural bull market, who are the winners and losers? The knee-jerk reaction has been to say '*emerging markets will be the losers*' (simply because they were in the past. But the reality is that most emerging markets have large US dollar reserves and can withstand a strong US currency. Instead, will the big losers from the US dollar be the commodity producers?

Who will pay for misinvestment in oil?

- Have we reached 'peak demand' for oil? If so, does this mean that we have years ahead of us in which markets and investors will have to digest the past five years of capital misallocation into commodities?
- Talking of capital misallocation, does the continued trend of share buybacks render our financial system more fragile (through higher gearing) and so more likely to crack in the face of exogenous shocks? If it does, one key problem may be that although we may have made our banks safer through increased regulations (since banks are not allowed to take risks anymore), we may well have made our financial markets more volatile (since banks are no longer allowed to trade their balance sheets to benefit from spikes in volatility). This much appeared obvious from the behavior of US fixed income markets in the days following Bill Gross's departure from PIMCO. In turn, if banks are not allowed to take risks at volatile times, then central banks will always be called upon to act, which guarantees more capital misallocation, share buybacks and further fragilization of the system (expect more debates along this theme between Charles, and Anatole).

Are big banks about to become obsolete?

- Will the financial sector be next to undergo disintermediation by the internet (after advertising and the media). If so, what will the macro-consequences be? (Hint: not good for the pound or London property.)
- Is euroland following the Japanese deflationary-bust roadmap?

The answers to these questions will drive performance for years to come. In the meantime, we continue to believe that a portfolio which avoids a) euroland, b) banks, and c) commodities, will do well—perhaps well enough to continue funding Mediterranean beach holidays—especially as these are likely to go on getting cheaper for anyone not earning euros!