Weekly Perspectives

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A Weekly View of Global Economies

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Federal Reserve Chairman Ben Bernanke certainly got the attention of bond and foreign exchange markets, last week. He was speaking before a congressional committee, and unlike his predecessor, the master obfuscator Greenspan, his words weren't fudgy enough. Instead of leaving himself room for flexibility, he seemed to be a little too eager to be looking for an opportunity to call it quits on rate hikes.

Bernanke has a strong academic background and he would be prone to base his decisions on forecasts generated by complex models. In contrast, Greenspan wasn't a hot modeller and preferred to sniff the wind, which is why he didn't want to commit himself too early in case the wind changed direction.

For a complex system that is subject to feedback loops, such as an economy, model forecasts can be subject to a wide margin of error. Whatever his methods, it looks like Bernanke has surmised that a slowdown is around the corner, based on the lagged effect of earlier interest rate increases. Ergo, it may be time to relax.

If he's right, that'll make him look good. The economy settles into just enough moderation in growth to cause the inflation demon to pull in its horns. But if he's wrong and the economy has more punch in it than expected, then extra steam will raise inflationary pressures, forcing him to act more forcefully later in the year. Under this scenario the Fed will eventually have to take harder action to squash expectations of rising inflation, resulting in lower growth rates for 2007.

As we wrote last week (April 26) - - before Bernanke went before the congressional Joint Economic Committee - - it is wise to be less than trusting about central bank resolve, particularly if you are a fixed-income investor. So it shouldn't come as a surprise that the chimes sounded by big Ben made the bond and forex markets plenty edgy.

Naturally, currency markets are the first to react to data and events, and the dollar has been weakening against a number of currencies as investors assess the prospects of a softer Fed. Meanwhile, the Chairman caused further ripples in the markets by making remarks to a reporter at a White House dinner, and it inevitably became a hot news item. The tone of the comments appeared to be aimed at countering the view that he is overly dovish but ended up hurting his credibility. As for the data, they still point to an expanding economy and more inflationary pressure.

Hedge funds are back in favour among investors, following their improved performance - - and inflows appear to have picked up. This is in contrast with mediocre average returns that prompted outflows last year. It should be noted, though, that there is considerable diversity in terms of strategy and performance in the industry.

Looking past short-term flows, an ongoing trend is the desire by institutional investors, such as pension funds, to increase their exposure to hedge-fund investments. Some of these large investors would like to juice up overall returns by increasing the proportion allocated to alternative relative to traditional asset classes.

They like the prospect of higher returns but are wary about taking on excessive risk. So before giving money to hedge-fund managers they want to have a lot of oversight, as well as frequent reporting on what's being done with their funds. Traditionally, hedge-fund managers have not been at all keen about giving away details of their modelling and trading strategies, or spending time and effort on detailed reporting of their activities.

But when institutional investors come knocking on the door with billions to allocate, there are plenty of managers who will lick their chops and submit to the strictures. And the result is the institutionalisation of parts of the hedge-fund industry, resulting in managers who are increasingly risk averse.

In terms of compensation, instead of aiming to earn performance fees geared at greater risk taking and beating the market by a big margin, they opt for regular management fees that add up to a lot when money under management is substantial. Consequently, they lose their innovative edge and begin to resemble traditional funds.

It is well-known in the hedge-fund world that some of the best performers are relatively new small funds with novel strategies and good risk management. And, then again, a manager's staying power depends not only on his risk-management skills but also on his ability to adapt to a changing environment. Models and strategies that work successfully under one set of conditions will fail as circumstances change, so adaptability is a key consideration.

Finding the stars and avoiding the dogs is not an easy task. It requires a good deal of skill and judgement. In a universe of over eight thousand funds, entry and exit is high. But institutional investors with mega-dollar placing power won't be chasing after the small fry. As for high-net-worth individuals, they need good advice.

Digressing a little, it is reported that Stephen Roach of Morgan Stanley, who has been bearish for a number of years has recently turned bullish on the global economy. We can take this as a contrarian indicator.

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