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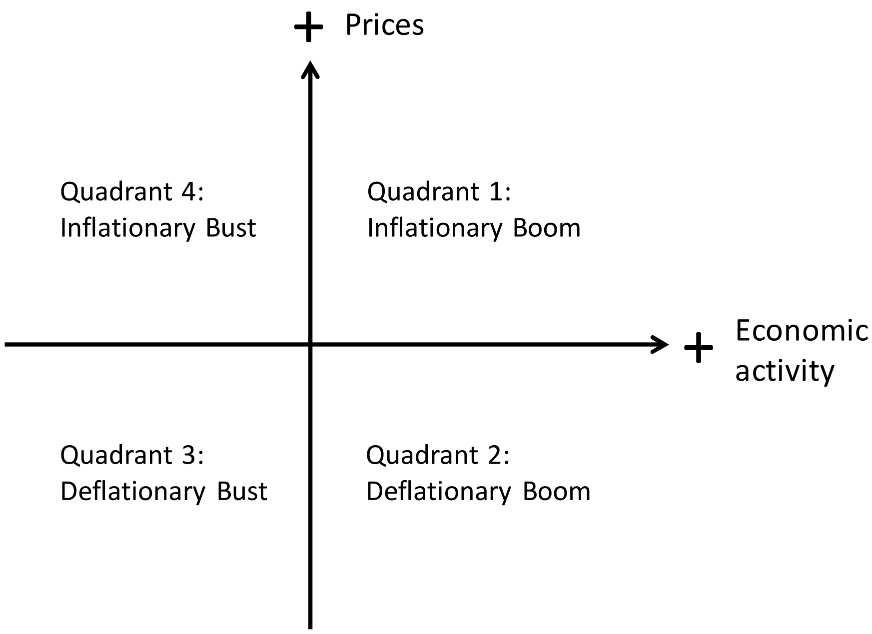
Just for rules-based investors

In some 25 years watching financial markets, my dominant decisions have resulted from a mixture of emotions such as amusement, curiosity or despair. There have been times when I thought that financial markets were invented to make people miserable for the greatest possible amount of time or make economists (and their forecasts) look even sillier than they actually are. For that reason, I decided long ago to become a rules-based investor working carefully and constantly on these rules, trying to follow them regardless of my mood. Among my long-standing decision rules there is one (learned from my mentors) that generally proved reliable in the past. The idea is that there are four basic investment environments depending if economic activity is expanding or contracting, and whether prices are accelerating or decelerating (see the picture below).

There are four basic investment environments



I have observed over the years (and identified) the assets and sectors that perform consistently better in each of the four quadrants, (and the ones that perform consistently worse). Therefore, the work to be done consists of two exercises. The first step is to determine in which quadrant we will move in the next quarters (or years). The second exercise consists in identifying the assets and sectors with better (or worse) track record throughout history when that quadrant has materialized.

Apparently (at least so people believe) we have entered the "Quadrant 1" …

Let's go with the first exercise. Apparently (at least so people believe) we have entered the "Quadrant 1", or an environment of price acceleration and increase in economic activity in Western economies. As long as people keep thinking this (and I do not know how long this could last) the most reasonable strategy is to invest in those sectors that outperformed in the past periods when quadrant 1 materialized:

- Buy equity shares in consumer discretionary, developers, universal banks, mining, cyclical producers, etc.
- Buy stores of value (gold, commodities, mining, etc.).
- Sell long term bonds.

… but I guess that this will prove to be temporary.

Needles to say, it is an obvious (and easy) exercise to determine what quadrant we have just left. Far harder is to judge which quadrant we are entering. I have suggested that we could be now entering the first quadrant (or at least, consensus thinks so), but I guess that this will prove to be temporary. Five years ago I warned this bank that we had entered the "Quadrant 2" (Deflationary Boom) and that we would remain for a long time in an environment of price deceleration and positive but low global economic activity. I must tell you that I suspect that we will continue in this scenario in a structural way for some more time. If true, and once consensus realized that Trump is not that "game changer" people think he actually is, all of us will have to re-focus on my long-held, structural strategy:

We will likely continue in "Quadrant 2" in structural way for some more time.

- Sell little pricing power equity sectors (Food and supermarkets).
- Sell low margin equities unable to fight in a low sale prices environment (utilities and telecommunications).
- Sell *price monetizers* (equity markets) such as Australia, New Zealand, Russia or Brazil.
- Buy *volume monetizers* (countries that buy protection through positive trade balance): Taiwan, China, India, South Korea or even Europe).
- Buy equities with higher demand elasticity to low prices: Fashion, automotive, media, leisure, technology.
- Buy those equities that most benefit from disinflation: Chemicals.
- Buy those companies that cause disinflation: Robotics, firms with high degree of automation (medical technology, logistics), Innovative companies.
- Buy Long term bonds.