WHEN MARKETS COLLIDE

INVESTMENT STRATEGIES FOR THE AGE OF GLOBAL ECONOMIC CHANGE

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INTRODUCTION: FINDING SIGNALS WITHIN THE NOISE

By the standards of the financial markets, I entered the investment world late. I was 39 years old when I left the relative predictability and stability of a career at the International Monetary Fund (IMF) at the end of 1997 for the rough and tumble world of Salomon Smith Barney in London. A fascinating journey followed during which I had the privilege of witnessing at close hand the slow but steady transformation of the global economic and financial landscape.

At first, the changes impacted relatively small areas of the investment and policy world—essentially, the specialized segment of emerging market investing and the even more specialized and arcane world of derivative instruments and risk transference. But the phenomena—and the related good, bad, and ugly that came with them—gathered momentum, and they are now critically relevant to a broad spectrum of investors, policy makers, and international institutions.

By discussing these phenomena in some depth, *When Markets Collide* seeks to shed light on how the ongoing economic and technical shifts, what I refer to throughout the book as "transformations," are impacting the world we live in—present and future. The book offers analytical anchors for identifying the key elements of what, for some, have become drivers in an unusually fluid environment. In so doing, I will uncover many of the understandable reasons that otherwise rational and well-informed investors can be late in recognizing important turning points and, subsequently, be prone to mistakes. In some cases, such mistakes have resulted in market turmoil, liquidity sudden stops,[1] institutional failures, and emergency policy responses—and they will continue to do so.

The information in this book has important practical implications for investment strategies, business approaches, and policy making. It provides readers with insights on how best to exploit new opportunities and minimize exposure to changing patterns of risks. Or in market jargon, the aim is to minimize the left (that is, unfavorable) tail of the distribution of outcomes while simultaneously exploiting the right (that is, favorable) tail.

In this new economic and financial age, both tails are fatter.

Transformations: Inherently Tricky

Transformations are not easy to recognize or navigate, especially when they are initially unanticipated and evolve rapidly. By challenging conventional wisdom and historic entitlements, transformations feed a dynamic that is inevitably uneven and, at times, unpredictable. Indeed, the phenomena accentuate in an important manner the difficulties that people face in the run-up to the more familiar long-term (i.e., secular) turns.

Here, the issues tend to revolve essentially around the timing and the orderliness of the turn as opposed to the secondary considerations that pertain to time and system consistency.

As transformations in individual markets are gathering momentum, it becomes evident that the market and policy infrastructures cannot yet adequately support the emerging realities—at either the national or international levels. Activities that have been newly enabled by the transformations tend to outrun the ability of the system to accommodate and sustain them. The result is a series of blockages and other "plumbing problems" whose prevalence gives rise to an initial bewilderment, turmoil, a blame game, and a subsequent realization that some type of change is needed.

Then when the needed refinements are being undertaken, market participants—investors and national and multilateral policy makers—face uncertainty and worry about the prospect of further turbulence. The market turmoil that started in the summer of 2007 illustrates the type of overshoots and dislocations that are likely to continue to occur. I would go so far as to say that the turmoil will shake the foundation of our global financial system. What started as a problem peculiar to the subprime segment of the U.S. mortgage market has morphed into a series of collapses whose impacts are being felt on both Wall Street and Main Street.

The responses of both the private and public sector market participants were initially undermined by their lack of understanding of the causes and consequences of the turmoil. Too many observers were quick to dismiss it as transitory and of limited impact. Investors, particularly in the equity markets, regarded it as an isolated event that would not prove contagious.

Policy makers initially remained on the sidelines, also influenced by the understandable desire to allow greedy borrowers and unscrupulous lenders to suffer the consequences of their actions.

However, it did not take long for all this to change as elements of the financial industry and the economy as a whole fell with a loud thud. Wider recognition triggered a catch-up process involving massive injections of emergency liquidity by central banks around the world. When such injections failed to halt the collapse, the U.S. government was forced to adopt a large fiscal stimulus package and directly support the housing sector. Meanwhile, senior executives of major western investment banks headed to Asia and the Middle East in a massive capital raising campaign—one that was described on the front pages of the financial media as involving "lifelines" (*Wall Street Journal*),[2] "bailouts" (*Financial Times*),[3] and the "invasion of the sovereign wealth funds" (*The Economist*).[4]

To some of us, the financial market turmoil that started in the summer of 2007 reflects the secular transformation of the global economy. There are now economic and financial forces in play whose impacts are of great consequence but that cannot as yet be adequately sustained by the world's current policy and market infrastructures. As such, the efficiency gains that they bring are associated with higher risks of short term disruptions. Indeed, one of the important messages of this book is that *the present turmoil is neither the beginning nor the end of the transformation phase*.

A series of inconsistencies and anomalies, which will be detailed throughout the book, acted as early *signals* of the growing tension between what participants or actors on the global finance stage were pressing for and what could be reasonably and safely accommodated by the existing systems in order to minimize the risk of turmoil. The signals also indicated the extent to which cross-border wealth hand-offs were empowering a new set of actors and products when it came to global influence.

As you read this book, it is important to realize that the forces behind the recent financial crises have not gone away. Instead, underlying global transformations will play a major role in defining and influencing the investment and policy landscape for years to come.

When Noise Matters

This bumpy process is nothing less than a collision of markets, in which *the markets of yesterday collide with those of tomorrow*. The underlying dynamic is one of hand-offs being made between actors, instruments, products, and institutions. In this environment, the basic challenge is to understand the inevitable bumpiness of such hand-offs and to manage them appropriately without losing sight of the nature and implications of the new destinations.

Market participants first become aware of transformations through what is commonly known as "noise." This noise comes initially from the sudden emergence of anomalies to long-standing relationships that participants take for granted. The typical human inclination is to treat the anomalies as both temporary and reversible. People tend to dismiss the noise as containing no meaningful information. Consequently, they believe there is little point in thinking about the longer-term implications for investment strategies, business models, or national and multilateral policies. But a careful reading of history and theory suggests otherwise. Noise can matter in so far as it contains signals of fundamental changes that, as yet, are not captured by conventional monitoring tools.

During my first year as an analyst on the Salomon Smith Barney trade floor in London in the late 1990s, I learned through observations a simple but powerful lesson about how to approach market noise. Rather than automatically dismissing it, one should ask whether there are *signals within the noise*. This lesson came from observing a smart colleague—a trader in his early twenties—who was working on the emerging markets bond desk. His name was Edward Cowen. I remember Edward as a talented trader and a diehard supporter of Arsenal in the English football league.

Edward was particularly well versed in one of the three qualities that Bill Gross, PIMCO's founder and widely respected "Bond King," argues are essential for an ideal portfolio manager or, more realistically, an ideal portfolio management team: street smarts. And to the outsider, Edward seemed to know it and be proud of it—so much so, I am told, that at one stage early in his career, he preferred to be seen walking to his desk in the morning with a tabloid under his arm as opposed to the *Financial Times* or the *Wall Street Journal*.

Edward's market instincts were so sharp that they more than complemented the other two qualities that Bill Gross had identified: a rigorous training in economics and a command of finance mathematics. These qualities made Edward a moneymaker for the firm at a young age. Indeed, he illustrated back then what work, particularly in behavioral finance and neuroscience, has confirmed: The importance of instincts, especially during periods of market stress. This was most visible in the manner he would treat analysts like me. On some occasions, he would step back from the markets to listen to our views—in fact, he aggressively sought them. In the process, he would push us hard on whether the turmoil reflected a potential realignment of fundamentals. On other occasions, he would ask us (mostly politely, but not always) to stay away from his desk lest we confuse him with some fundamental analysis that bore no relationship whatsoever to the realities of that day's market action.

This lesson—and specifically the discipline to think about potentially different interpretations of market noise—stayed with me as I moved from analyzing markets at Salomon to directly investing in them at PIMCO and at the Harvard Management Company (HMC). And over the years, I have found validation for this approach from thoughtful academic work on imperfect and asymmetrical information, market failures, and behavioral finance.

Most of the time, I have applied the lesson to specific strategies and trades. Early in my investing career, I was lucky to be involved in an asset class (emerging market bonds) inherently prone to noise and investor overreaction. After all, it was still in its early maturation phases. The challenge was to identify the causes of the noise and derive their implications. And the outcome was often good—not only through the calls that PIMCO made on Argentina's bond price collapse in 2000 to 2001 and on Brazil's sharp bond price recovery after the summer of 2002 but also in the contrarian positions taken vis-à-vis smaller market events (for example, the manner in which the markets was extrapolating in early 2002 the impact of Argentina's default on Mexico and the impact of Zimbabwe's unstable political situation on South Africa).[5]

The methodology was a simple one: Observe and analyze the underlying causes of the noise; see how those causes relate to a separate and distinct analysis of valuations based on economics and financial fundamentals and market technicals; test the initial findings against the views of experts in the markets; and derive short- and long-term implications for the impacted financial asset valuations and those that are connected through common ownership or other drivers of correlation.

In many instances, the right answer was to "fade" the noise—that is, treat it as a temporary and reversible deviation. But in some important cases, the correct response was to interpret the noise as containing signals—that is, pointing to meaningful changes in parameters governing both absolute and relative prices in certain market segments. Always, the right approach was to resist the initial temptation to simply dismiss, and therefore ignore, the noise.

With time, I inadvertently documented the process through a regular publication that I wrote for PIMCO and in op-ed pieces for the *Financial Times* and *Newsweek*.[6] The articles had a simple objective: to explain recent market developments and trends, including how they impacted investment strategies and policies going forward. In the process, I ended up compiling a body of evidence suggesting that the noise was signaling the emergence of deep and, as yet, little-understood changes impacting the global economic and financial landscape.

A shift in the nature of the noise coming out of the markets supported this evidence. Starting in 2004 and 2005, we moved from a world where noise was generally associated with *sequential* inconsistencies in markets to a world where *simultaneous* inconsistencies were notable. In other words, rather than just being inconsistent *over time*, the progressively louder signals coming from various market segments also became increasingly inconsistent *at the same time*.