FOOD FOR THOUGHTS

by Andrew Capon

Le Cercle

with Stephen Jen, partner and co-founder, SLJ Macro Partners

This column serves two main purposes: the pleasure of the company of some of the most interesting people in the investment world and the licence to dine in good and occasionally great restaurants. A fringe benefit is that once in a while the seed of an investment idea is planted. Stephen Jen did rather better than that. He offered the full-grown tree and the ripest low hanging fruit, sliced on a plate, sprinkled with sugar and served with dollops of cream.

We met one day before the Bank of Japan meeting last month. Having grown inured to "momentous" moments that pass without moment, I cynically asked if we were about to witness another such non-event. Jen put me right. "I have just been in Tokyo. The Bank of Japan is about to join the 'whatever it takes' club and more. [Governor] Kuroda isn't stepping into the ring in the first round of a championship-boxing match with the intention of meeting expectations. The aim will be to stun the market."

Of course, I should have listened. Jen is impeccably well connected in Asian policy circles having spent many years, including the 1997 crisis, as Morgan Stanley's currency strategist in the region. But, the menu was inducing recurrent bouts of hunger and it is rude to telephone a broker over lunch.

For me, yen calls had to wait. But for macro traders such as Jen, trends such as the 35% move in JPY/USD, and the volatility induced by central bank activism, are very welcome.

Making money in currencies has been difficult in recent years. Once trusted friends, such as carry and the forward rate bias (funding in low yielding currencies to buy higher yielding and generally better performing ones) have proved fickle, in the new ultra-low interest rate world.

The yield on the Australian 10 year bond is currently a meagre 3.26%, making punting AUD, once a darling of carry traders, a dangerous game. If anyone is still brave enough to dabble in leverage, it could prove existential.

Carried out

"When interest rates are so low, carry can backfire horribly. FX markets can move by 2% in a day, which will wipe out the gains from interest rate differentials. Also, many systematic traders were combining carry and momentum. When trades did not work out, they would add to the short position.

The trouble with that is that you end up with a pay-off that is similar to an option. The [return] distribution is very skewed. Sudden policy intervention can be very damaging," says Jen.

Stephen Jen: "Fixed exchange rate regimes create a false impression of stability but end dramatically and violently, like autocratic political systems

In place of quant wizardry, policy wonkery and people watching are now to the fore. "In macro trading you need to get three things right," says Jen. "You need to have a grasp of the trajectories of economies, an understanding of market dynamics and a sense for the direction of policy. That final piece of the jigsaw has become by far the most important. Without a policy compass, and an understanding of policymakers, you are trying to understand markets blindfolded."

Given high levels of indebtedness in the developed world, the policy baton has been passed from governments to the monetary authorities. With interest rates set at zero and the transmission mechanism for policy hobbled by a *hors de combat* financial system, Jen argues that unprecedented monetary experimentation was inevitable. However, he also believes that missteps by central bankers helped create the crisis.

In particular, he points to inflation targeting. After the successes of the Bundesbank in the 1970s and Paul Volcker's tenure at the US Federal Reserve, this policy became a new global orthodoxy. However, it failed to take account of the deflationary forces unleashed by globalisation.

Says Jen: "When eastern Europe, India, China and other emerging markets joined the global economy, they exported disinflation at the same time policymakers were adopting inflation targeting. Globally, inflation was massively undershooting relative to economic activity. Central banks kept monetary policy far too loose and that is what nurtured asset price bubbles. The interaction between globalisation and the institutional framework for policy setting became dangerous."

Jen worries that policymakers too often fight the last war. His experience trying to explain the Asian financial crisis taught him that. One way of viewing that debacle was as a failed attempt to defend fixed exchange rate regimes. "Fixed exchange rate regimes create a false impression of stability but end dramatically and violently, like autocratic political systems. Floating exchange rate regimes may be sub-optimal, but they do not tend to dramatically blow up," says Jen.

Part of the problem for the eurozone is that a fixed exchange rate regime is coupled with an inflation-targeting central bank. Jen believes this will continue to be a source of instability. The new policy goals that will emerge from the financial crisis and great recession are still to be fully formed. But, as Jen says: "It is a fascinating time to run a macro fund. Policymakers have very different ideas on how to kick-start growth."

Stephen was an engaging lunch companion. Even if I failed to get leveraged short JPY, long any risk, that afternoon he and Le Cercle made up for imaginary trading losses.

For the quality of food on offer it was extraordinarily good value. For all you City boys reading this, my tip is to spend a tenner on a taxi and head to points west. The spread between the price and value of high-end restaurant food in the City versus the West End is getting silly.

Exploit it while you can. It should be arbed away. Wise people like yours truly and Jen are already all over this trade. But having missed out on short yen, long Nikkei for starter, main and dessert, I forgot Soros and communed with my inner Billy Bunter.

Stephen also purred through two of his three courses and said he would definitely take his wife to Le Cercle soon. Review over. Recommendation enough.

Le Cercle:

1-5 Wilbraham Street, London, SW1X 9AE
Starters: Watercress velouté; Foie gras, lemon pearls, cardamom crust
Mains: Truffled baby Royans ravioles and braised chicory; Suckling pig variation, kohlrabi "Anna" and glazed onion
Desserts: Chocolate fondant and ginger ice cream; Crème brûlée, raspberry sorbet
Drinks: 2 X bottles sparkling mineral water; 1 X glass Château Coucheroy, Pessac-Leognan
Total (including service @ 12.5%): £78.47
Rating: AA