Investment Report: Q4, 2010

Market Summary

The final quarter of 2010 saw risk assets extend the recovery of Q3 (Figure 1). Fiscal difficulties within Europe were quickly forgotten once the Irish banks were '’fixed’ and confirmation of the ongoing recovery in real economic activity lightened investor mood. The announcement of further quantitative easing by the US Federal Reserve combined with the explicit pursuit – in the US – of higher inflation added ‘fuel to the flames’. The move higher was, largely, in a straight line as the ‘Market Postcards’ later in this note illustrate.

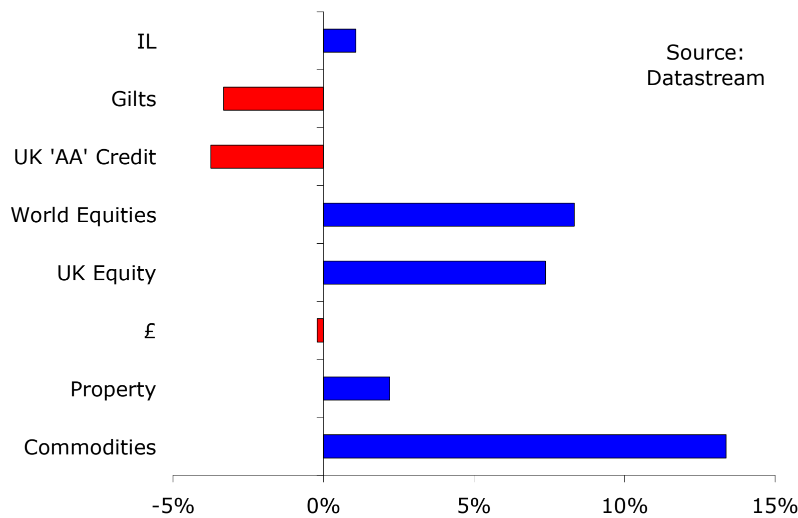


Figure 1: Market Performance – Q4, 2010 (total return)

It has taken a while but the money markets are beginning to adjust to the notion that official interest rates might move away from the emergency settings of the crisis years. That adjustment has picked up pace through January and consistent with actual inflation data is most pronounced in the UK and Europe; there remains minimal core inflation in the US so those money markets have yet to move. The challenge for policymakers in the UK is that the headline inflation data points to a situation almost out of control yet the Q4 GDP estimates suggest the economy is contracting. Take away the impact of sharp increases in indirect taxation as well as the variable and ‘made in Asia’ surge in commodity prices and core UK inflation is barely 2%. Equally, it is worth noting that the strongest inflation in Europe is in Spain and they hardly need a tighter monetary policy. Who would be a Central Banker?

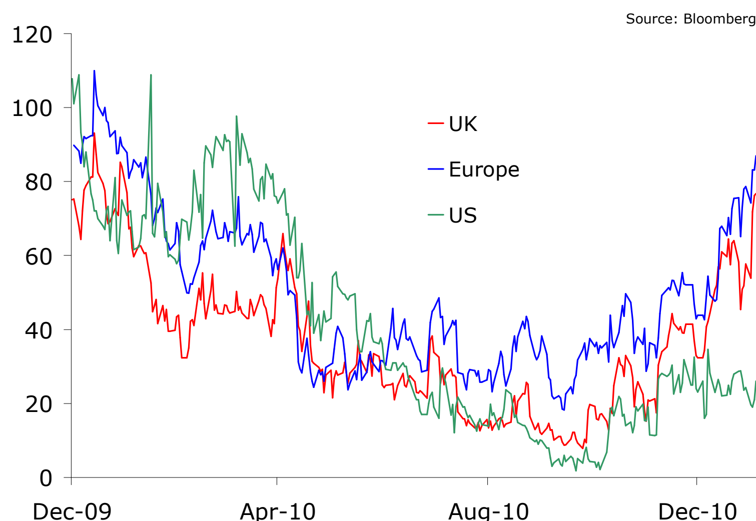
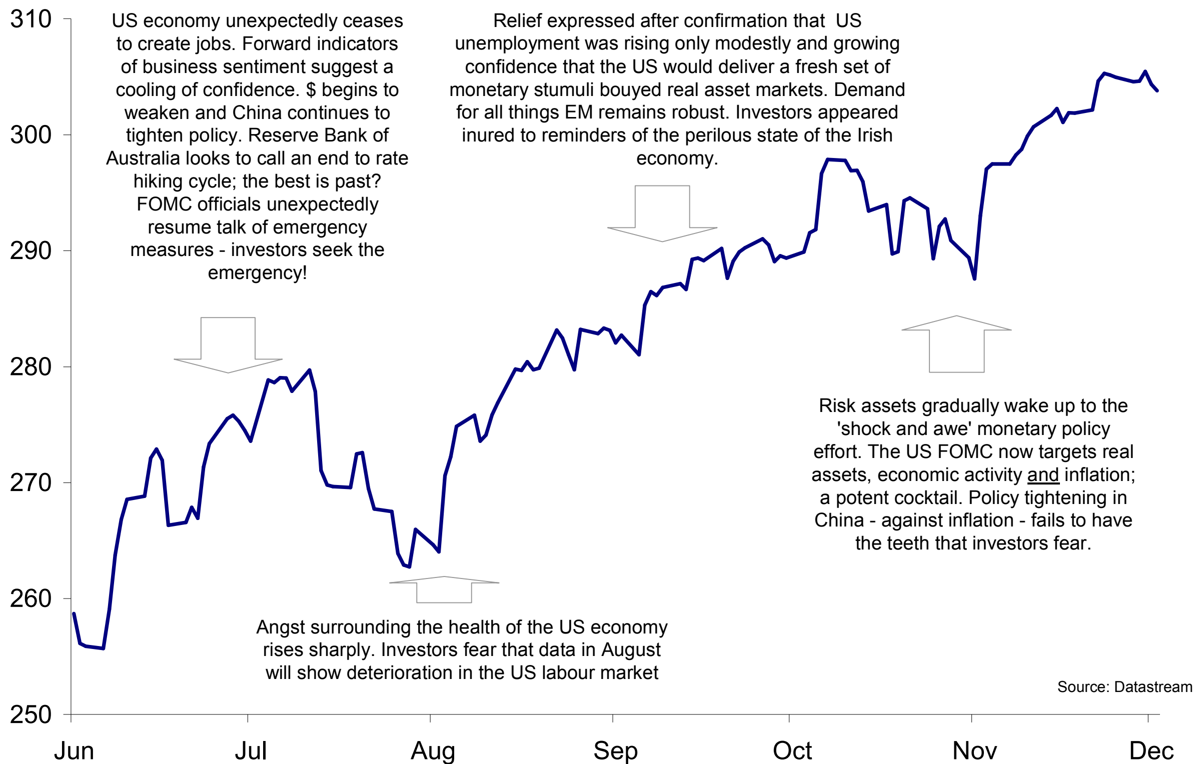


Figure 2: Expected Change in Official Rates – 1 year hence

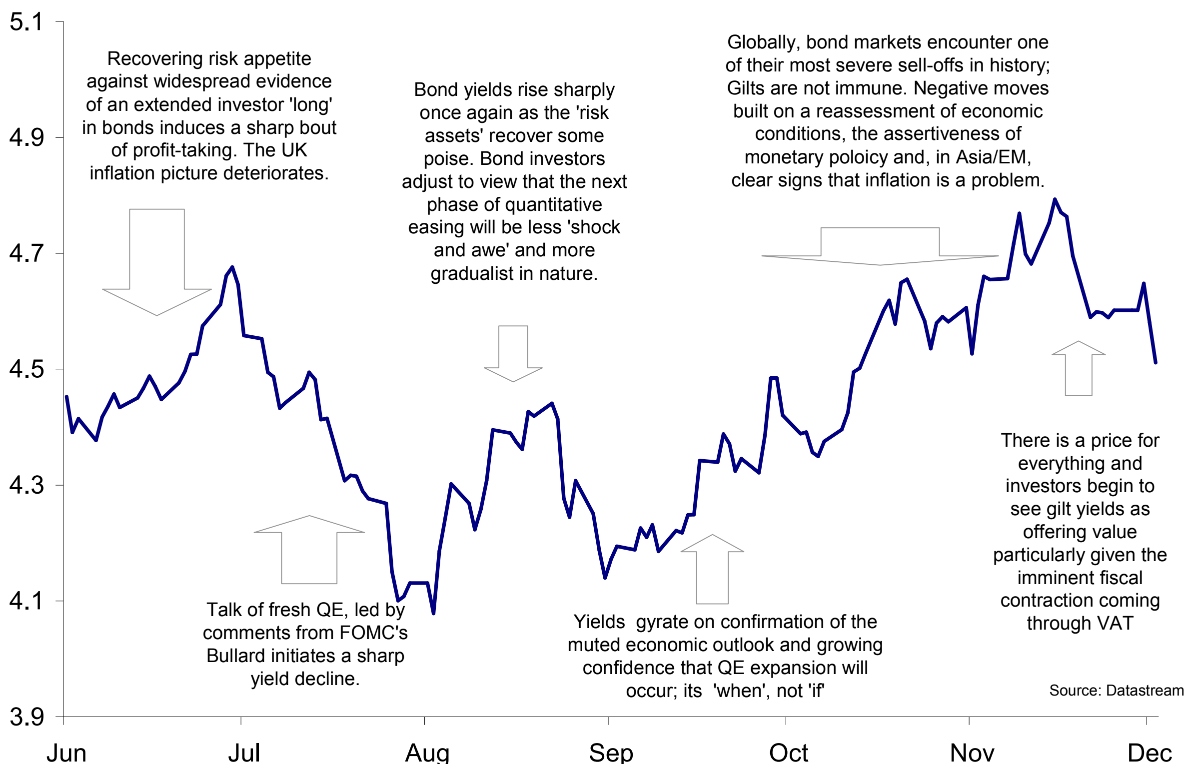
Market 'Postcards'

The next four charts provide an annotated, pictorial summary of moves over past six months.

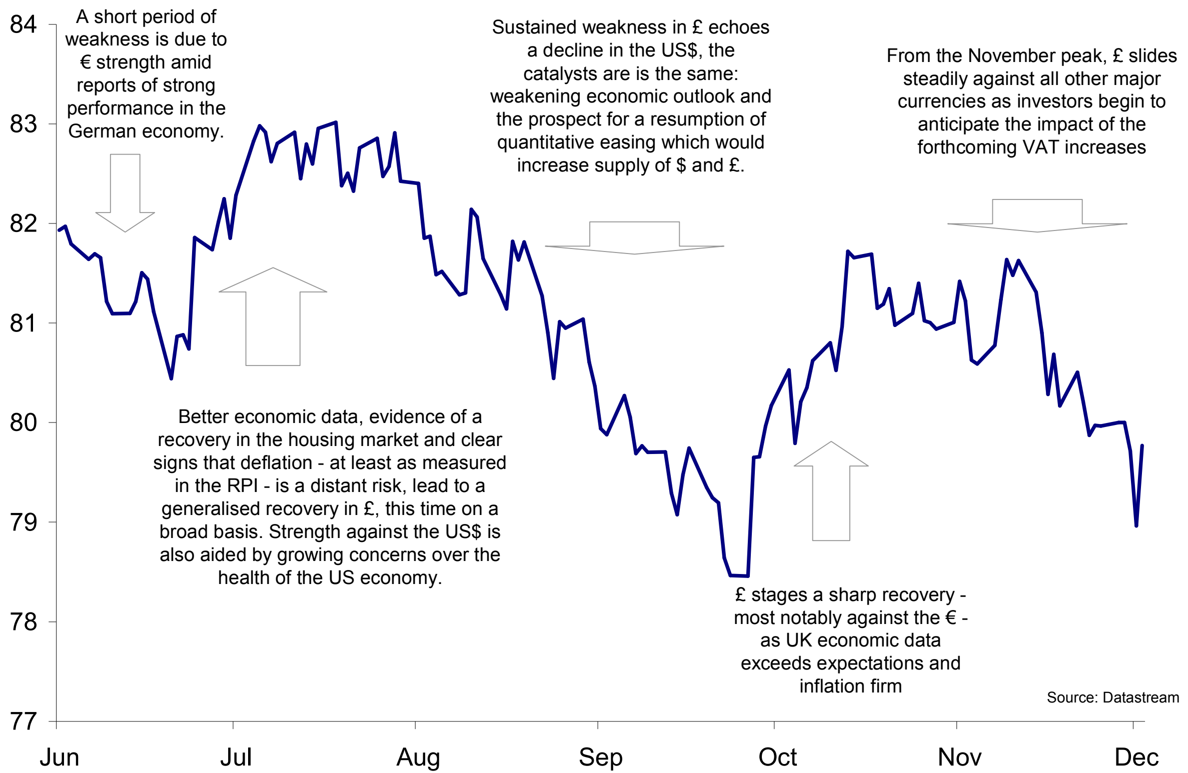
Global Equities:



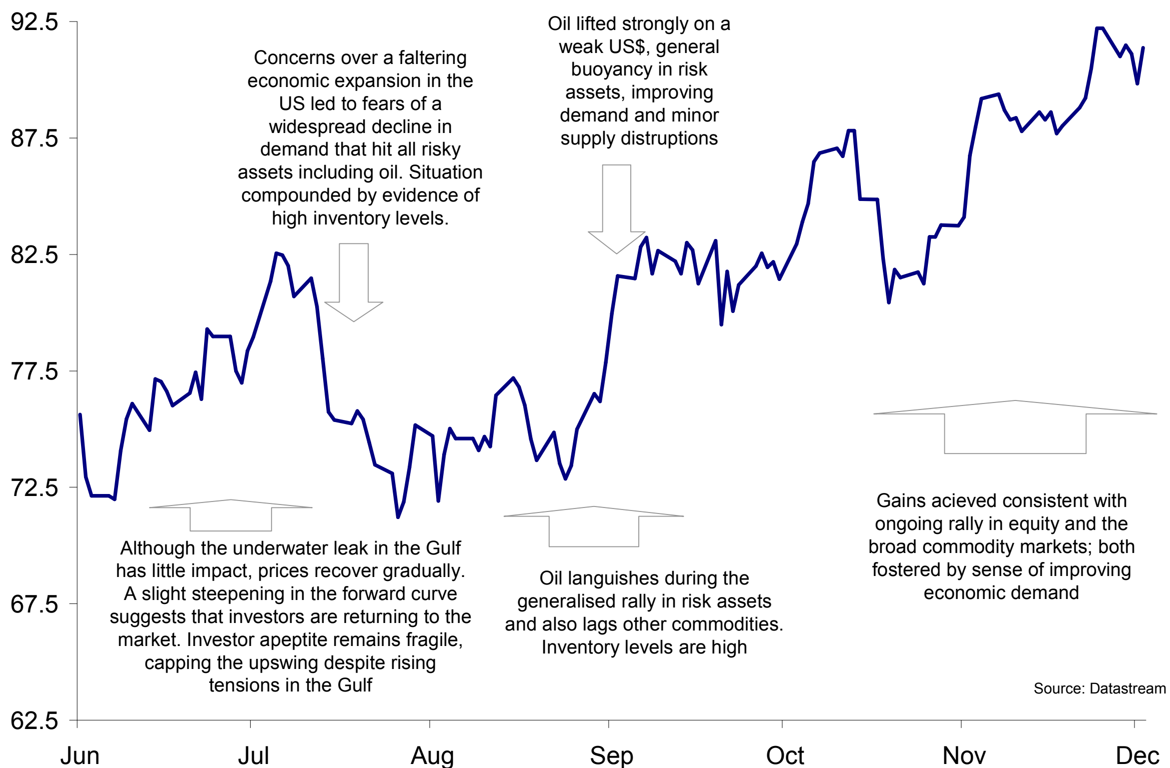
Long Gilts:



£ (Trade Weighted Index):



Oil:



Commentary

The broad backdrop for 2011 is very familiar. Cyclically, the bottom-up and top-down dataflow is supportive for corporate earnings, with positive implications for both equities and, to a lesser extent, given ratings, corporate credit. However, the structural backdrop remains challenging and there will likely be at least hiccups, and possibly worse, from the political and economic aftermath of the Great Recession.

The cyclical positives are clear. The major economies (US, Germany, UK) are growing at rates (measured by nominal GDP) which should be sufficient to lower unemployment levels more quickly than currently expected and bolster tax receipts (thus cut fiscal deficits). Corporate earnings will be robust and will encourage capital investment, hiring and M&A activity. Real interest rates are historically very low and boosting real asset prices (equities, property, commodities), while yield curves are steep enough to boost banking sector profitability. There is upward pressure on Chinese and other emerging market currencies. A stronger Renminbi in particular would assist in the long-term process of re-balancing, which is needed between surplus (generally emerging markets) and deficit countries (US, UK and southern Europe).

Meanwhile the structural challenges also stand out. Economic growth has been boosted by extraordinary policy support; but support is going to be less visible in 2011. Indeed away from the US, that fiscal support is being removed. Perhaps more significantly and as the year progresses, markets may begin to discount the end of zero interest rate monetary policies. Higher interest rates will not help the still very weak housing sector. Global imbalances are worsening, with northern Europe profiting as southern Europe sinks deeper into recession. Also, emerging market (EM) surpluses are expanding even as profligate fiscal policy encourages more deficit spending in the US. The Euro area's problems have received most publicity but inflows into emerging market local currency debt markets could be the true flashpoint in 2011. Capital controls are already evident across the EM complex - more of the same could be destabilising. Inflation is a problem in a number of EM markets already (including China). This is all inherently unstable. The banking sector remains impaired by yet unrecognised loan losses, a continued capital shortage, repercussions from any Euro area debt restructuring and regulatory hostility ("regulatory uncertainty" to be polite). Bank lending is a lagging indicator but in this cycle it could be even more so, thus impeding how self-sustaining the recovery can be. Some of these structural threats to the outlook in 2011 have a greater probability of being destabilising than others.

The thing about PIIGS

Take the peripheral European sovereign/banking crisis. Yes, it seems highly likely that the market may well challenge policymakers over Spain. Unless there is a pre-emptive policy announced to strengthen the existing mechanisms in place to provide funding to distressed countries, the market will wonder whether the ECB and stronger euro zone countries have the political will to provide enough support to Spain via, for example, lines of credit sufficient to recapitalise the Spanish banking system. Therefore, it's quite possible that spreads between Spanish and German government bonds will at some point widen from current levels. It's also possible that Greece and/or Ireland embark on some form of debt restructuring, perhaps involving lengthening the duration of existing debt.

However, how much of a shock would that be to broader financial markets? A review of the 2010 performance of 95 equity, bond, commodity and alternative assets shows that just fifteen of them had negative returns (in local currency) in 2010. Ten of those fifteen were the equity and government bond markets of Portugal, Ireland, Italy, Greece and Spain. It's quite possible that the PIIGS will deliver another year of negative returns. But one wonders whether quite a lot of their problems have already been reflected in the performance of their markets last year. And some sense of history is, as ever, useful when considering things European. For example, in the 17th century the Netherlands was able to borrow money at 3.75% while the Kingdom of Spain, at the time also a major world power, was borrowing short-term money at 40%. Plus ça change? Rather than thinking about the destabilising effect

of countries where bond yields are already in the range of 4.5% to 12.5%, and widely expected to go higher, perhaps the market needs to think about the effect of interest rates rising in markets where they are 0-3% and widely expected not to move.

From East to West – the bright light or shadow of inflation

Since December 2008, the Fed Funds rate has been 0.25% and the UK Bank rate has been 0.5% since March 2009; neither rate has ever been this low (back to 1694 in the UK). Yet two years into a recovery and the consensus is forecasting minimal changes over the year ahead.

These extraordinarily low interest rates are part of the legacy of the battle aimed at preventing a recurrence of the Great Depression and a breakdown of the banking sector. Central bank balance sheet expansion has also been extraordinary via not only quantitative easing (QE) but also via the acceptance of a remarkable array of securities in return for which the central banks have provided government bills and notes. There have been other examples of banks accepting exceptional collateral. In the 1825 banking crisis the Bank of England "…lent money by every possible means and in modes we have never adopted before. We took in stock on security…" according to Bank Director Jeremiah Harman. In the 12th century, King Baldwin II of Jerusalem secured a loan using his beard as security. But these are all extraordinary things and it is dangerous to extrapolate the extraordinary too far into the future.

The combination of the December agreement to loosen fiscal policy and the ongoing commitment to QE is leading forecasters to raise real GDP growth rates for the US economy by 1% or more. Real growth of 3.5% and nominal growth of over 5% appears eminently achievable in 2011. This should lead to a decline in the level of unemployment. If the cyclical tailwinds continue, a look at where a variety of economic indicators tend to be when Fed policy changes suggests that each will be consistent with a rate hike by October 2011.

In a normal cycle, the first moves to tighten monetary policy tend to be supportive for equities as the policy change is seen as a validation that the cycle has momentum. Normally the market moves to discount some tightening, with shorter duration bond yields rising and the yield curve flattening as those rates move up more than longer duration yields. Now clearly there is substantial evidence that this is not a normal cycle. Given that many commentators argue that the recovery has been rather muted by some measures despite extraordinary policy support, it's quite possible that if the market begins to think extraordinarily loose monetary policy is ending there will be a wobble in "risk assets".

That will certainly be the case if there are any signs that inflationary pressures are spreading beyond that already factored into forecasts. One of the risks to a positive investment slant for 2011 is that food, energy and other commodity price inflation begins to creep further up the value chain. Should there be signs of inflationary expectations rising, there is a risk that western central banks are perceived to be losing their anti-inflation discipline and that could lead investors move to discount more rapid rate rises. It also remains the case that inflationary pressures are already high in many emerging markets and any more aggressive policy response to that in, for example China, could be destabilising to markets more broadly.

For the moment, cyclical tailwinds will continue to be supportive. Nevertheless, the implication of another couple of quarters of reasonably strong growth could be the market beginning to discount higher interest rates in the US and UK (as has started to happen in January – see figure 2). Moreover, that could, at some point in 2011, pose more of a challenge to the broad financial markets than another year when only in the PIIGS are interest rates rising.

Strategy Guidance

The global economy remains highly challenged by global imbalances that see the 'west' smothered by a debt mountain and the Chinese economy defined by a 53% (of GDP) savings rate; this is unsustainable. Policymakers continue to believe that there is an outcome that doesn't involve an element of debt destruction through default; rather they seem inclined to (quietly) favour debt destruction through inflation. Bond investors are starting to sense the epithet of 'patsy'.

The Japanese were able to inflict upon themselves 'lost' decades largely because they were a creditor nation; the 'West' are, largely, debtors, and their creditors simply won't allow such an outcome. Eventually the West will need to sign up to a grand version of an IVA (Individual Voluntary Agreement). Only then will free capital be able to be durably deployed to risk, in the meantime, while all the evidence suggests that (scarce) free assets are being targeted (impossibly) at liability reduction/hedging.

As a result, the multi-year outlook remains for a broad, but ultimately trend-less, trading range for equity markets. 'Contingency' cover will be important.

The Fund is inherently 'long' risk assets. As such, the Fund is exposed to underperformance of these risk assets and to a strengthening (decline) in bond yields.

Specific points

1. The preceding Commentary highlights the 'tug of war' between the cyclical and structural forces. The current uneasy truce is seeing risk assets find favour as, generally, economies are expanding and no imminent hostile policy move is threatened. Inflation is largely an issue for EM and the UK; bond investors have, thus far, been prepared to dismiss these as special situations. If core inflation in the US were to rise materially from the current level of 0.8% per annum, there will be an end to the complacency. If bond investors take fright, the impact is likely to be felt across all markets.

2. March/April sees the Spanish banking system requiring to re-finance around €70bn of borrowing. Market appetite to renew these lines of credit is unclear; hence the activity in recent weeks by the ECB *et al* to establish a fallback. This period is likely to prove a focal point for market angst and, perhaps a watershed. A successful outcome without a crisis-induced solution could herald a period of policy tightening as policymakers seek to restore credibility.

3. Emerging markets are being challenged by stubbornly high inflation and relentless inflows of foreign capital. Monetary policy is attempting to deal with the inflation pressures but too credible a stance, driven by higher interest rates, risks enhancing – for FX at least – the external attractiveness. The 1997/8 emerging market collapse occurred when investor optimism proved mis-placed. This time, the strategic arguments for emerging economies are clearly well supported. EM central banks have a difficult path to tread and an error could easily occur.

4. The upshot of the points above is that markets are likely to deliver more volatility than most investors would welcome. Shocks are likely to enhance bond prices albeit that, in some situations, episodes might be characterised by rising bond yields.

5. The potential for marked currency volatility remains high. FX rates remain the principal means by which national contrasts might be expressed, indeed, for some, currency imbalances, are a significant issue. Overall exposure to programmes – such as CTAs – remains appropriate.

6. All the while, the theme of investing for a persistent higher level of inflation than the consensus expects is likely to persist. Perhaps a UK-only phenomenon, the process of orienting portfolios to a pro-inflation stance will likely drive market ratings. Markets are

vulnerable to any resumption of a deflationary outlook.

7. Pressure for protectionist policies – from within EM at least – will persist. This market period would be highly unusual were it not to be characterised by some mis-placed, politically inspired, policy error.

8. As a general rule, it's better to be wary of the impact of things that are not widely expected, than to be too focused on those that are.