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## **DEBT, CURRENCIES, AUSTERITY AND OPPORTUNITIES**

For most investors who remember previous recoveries, recent economic data describes a rather unfamiliar, almost “upside down” world. Accelerating industrial production, improving trade balances and very low inflation, coupled with soaring productivity, feels like the sort of “Tiger Economics” of Emerging Asia, rather than an enfeebled G7. By contrast, rising inflation, spiralling labour costs and central banks reluctant to tighten policy or allow currency appreciation, reminds one of the problems and dilemmas faced by Western economies in a rebound. The astonishing rebound in industrial production across the globe is beginning, not unsurprisingly, to expose pockets of inflation across the emerging world. This has led to marked improvements in minimum wages to Chinese workers to counter rising living costs and increasing labour shortages. Meanwhile, in India, industrial production is growing at an extraordinary 17.6%, pushing headline inflation to over 16% in May. Vietnam has also seen inflation more than double in just four months to 9.5%. (source: Ned Davis Research Inc.)

By contrast, the picture in the West could hardly be more different, driven lower by a collapse in home owner and rental costs, US core inflation fell on a monthly basis in January, for the first time in twenty years. This supports the decision by the US Federal Reserve to leave interest rates at between zero and 0.25% for a still “extended period”. Even more extreme anti-deflation measures have now been introduced in Japan, with the Bank of Japan’s new 222 billion Dollar bank credit program and the unexpected announcement by the Swiss National Bank that currency intervention may again be used to avoid excessive appreciation of their currency. In other words, despite the extraordinary economic rebound of the last six months, super-loose money policy and special liquidity measures appear to remain with us – the comparison with Asia and the Emerging World could hardly be more extreme. Even as the global economy recovers and broadens, the world economy remains distorted by rigid currency structures that continue to drive trade and capital flows. The largest of these remains China’s undervalued Dollar peg that generates vast trade surpluses and is resulting in a war chest of reserves of 2.5 trillion Dollars. Ordinarily, such excessive surpluses would cry out for a revaluation of the Chinese currency. However, heated politics and a nervous export lobby ostensibly remain in the way. China’s behaviour distorts not only the US/China bilateral trade, but has wide-ranging repercussions across the broader emerging market world that is terrified of losing competitiveness to it.

Although most emerging markets have more flexible currency regimes that allow them to “normalise” interest rates, they have delayed their moves for fear of attracting more capital that will put upward pressure on their currencies. In essence, roughly 58% of the world is stuck in direct or indirect Dollar pegs that drive, in an increasingly distorted manner, trade and capital flows. A further 14% of the world is tied into the Eurozone where a similar rigid currency arrangement drives the disparate economic region. Whilst we have finally seen a 45 billion Euro package for Greece, the resurgence of political turmoil in Latvia (which just a year ago, faced a Greece-like choice of devaluation or austerity) shows the danger of longer-term political instability which comes from remaining in a rigid currency arrangement.

Unpopular austerity measures have bred public discontent, exacerbating splits in the governing coalition and threatening to derail the IMF-led loan agreement. The issue for Greece is not today’s funding crisis, but the longer-term political instability that will accompany the austerity measures that are now being implemented.

### **So what does this mean for global liquidity?**

For the moment, it means that global liquidity (the lubricant for financial markets) will remain exceptionally generous. In order for interest rates in the US to rise, a substantial checklist remains to be met. The list is even longer for Central Bankers in the Eurozone (including resolving real estate and funding crises in peripheral Europe) and in Japan (reversing headline deflation across the economy). The US checklist can be broadly summarised as follows:

1. *Stop buying securities*
2. *Closedown special lending facilities*
3. *Get unemployment down*
4. *Restore health of regional banking system*
5. *Drain excess reserves*
6. *Raise Federal Funds rate*

Only points 1 and 2 have been met so far!

Indeed, the US Federal Reserve's Vice Chairman Janet Yellen has more recently argued that the US economy still needs the support of "extraordinary low" interest rates to achieve employment and growth targets. Fiscal and monetary policy should firstly be tightened in the emerging world and in particular, in Brazil, China and India – but only the latter has done so, and perhaps they simply had to act in the face of colossal inflation. In China and perhaps Brazil, politics, fear of acting first and almost two decades of export lead growth make it difficult to encourage the currency appreciation and tighter money which comes from a necessary responsibility of being the locomotive at the front of the world economic train.

Despite lots of tough talk about re-establishing fiscal credibility with Europe, it is unlikely that Germany will pour petrol onto the Greek fires or the smouldering problems in Spain and Portugal by arguing for tightening monetary policy in the Eurozone. **Fixed interest markets are now beginning to notice this and income yields are now beginning to fall, with further capital growth opportunities ahead to look forward to.**

**Supranational bonds denominated in emerging market currencies offer a sound alternative. This allows investors to access appreciating and high-yielding currencies, but with limited sovereign risk.** Core strategies within investment portfolios should be based upon the following:

1. *Further currency and interest rate rises across the emerging world*
2. *Further equity market increases in the developed markets, lead by a new "Nifty Fifty" selection of global, large cap growth stocks with superior cash flow and dividend growth potential.*
3. *Under-performance of emerging world equities, driven by tighter local credit conditions, rising real wages and lower international fund flows.*
4. *Further "blow ups" in structurally distorted regions (peripheral Eurozone) as they struggle to implement radical restructuring without currency or interest rate flexibility.*
5. *Japanese deflation is now an absolute political priority, regardless of the longer term economic outlook which implies a materially weaker yen and rising asset prices.*
6. *Corporate cash flow continues to be extraordinarily strong (US corporate cash balances last quarter were a record 13.8% of non-financial company net worth). (source: Ned Davis Research Inc.)*

**In Summary**, pent up pressures in the inflexible and outdated currency structures across the global economy will continue for the foreseeable future. Change will eventually come in the form of Chinese currency revaluation (happening as I write), tighter money and stronger currencies for much of the emerging world together with enhanced fiscal union across the Eurozone, the latter being inevitable. The timing is hard to predict, as domestic and international politics are the real drivers of the reform. When the change comes, it will be disorderly or chaotic and extreme currency volatility will lift overall market volatility. While we wait for this change, it is inevitable we will continue to see active use of special liquidity instruments (possible reintroduction of quantitative easing within Japan and the UK), currency intervention (Switzerland) and currency pegs, that contribute to what we see as **abnormal liquidity conditions which will remain very generous, with the downside risk to asset markets being limited.**

Against this backdrop, **high quality global growth equities with strong cash flow and accompanying dividend growth continue to perform well. Global and emerging market bonds will also remain well supported.**

As always, diversification across portfolios is critical in controlling risk, albeit investors are being forced to take an element of capital risk due to the poor returns on cash. In view of my earlier comments, I do not see any marked improvement to cash based returns in the foreseeable future.



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(NB: Past performance provides no guarantee of future returns and any views expressed by us do not constitute advice as each client's circumstances differ)