

5 October 2009

“Marry in Haste, Repent at Leisure”

It is pleasing to see marked improvements across portfolio valuations since my last communication in July, so we could say that finally, **“the patient is starting to respond.”**

Whilst a **marriage of convenience between Central Bankers and politicians** is certainly good for economic recovery, equity markets and other “real assets” – the long term risks to inflation may appear rather sooner than expected and with it, renewed volatility in world bond markets.

For the first time in recorded economic history, June saw all 33 countries in the OECD’s leading indicators index, record monthly gains. As the global economy continues to exit the economic tailspin of a few months ago, there is (dare I say it) just the possibility of today’s “green shoots” turning into something closer to a V-shaped recovery, with simultaneous economic decline turning to simultaneous economic recovery. As the extraordinary aggressive monetary policy and Quantitative Easing “QE” has been part of the cure, the same question always emerges – **“If growth does continue to accelerate, should we be preparing for higher inflation, or is deflation (from massive surplus capacity and credit starvation worldwide) still the greater risk?”**

The deflationists can certainly point to some very low inflation rates across the Western World, although much of that reflects a 39% drop in oil year-on-year and a 15% fall in the price of a basket of other commodities. They can also well argue that over-indebted consumers, over-borrowed businesses and undercapitalised banks are all simultaneously trying to repair their balance sheets and bring down debt loads to more sustainable levels. Such co-ordinated deleveraging (paying down debt) has suppressed private sector demand and would, under normal conditions, certainly send a powerful deflationary impulse throughout the world economy.

In “normal” times, hefty increases in public spending could be used to offset private sector retrenchment but years of fiscal profligacy in the developed world have exhausted the politicians’ purse. The “debt to GDP ratio” (Gross Domestic Profit – a measure of economic output) of advanced economies are already a sky-high 70% and further counter cyclical employment programs, increased social spending and unemployment payments will only worsen this. By 2014 the “debt to GDP” ratio of advanced economies is expected to rise to 115%. In other words, if governments were to pay an interest rate of 4% on debt outstanding, they would spend 4.5% of GDP in servicing their debt every year – effectively, the public sector’s debt burden and the interest accruing on it, then becomes the primary constraint on the nation’s growth. (source: Net Davis Research, Aug 09).

A Shotgun Marriage – The combination of private sector deleveraging and public sector debt has enormously exacerbated the deflationary risks inherent in this economic cycle, but the extraordinary response of politicians and Central Bankers may have tipped the balance the other way. With few options available, Central Bankers (cheered on by politicians) have put greater and greater emphasis on monetary policy as the inevitable antidote. Under the wide banner of QE (the most ambitious of these programmes), Central Banks have agreed to purchase Treasury Bonds, Mortgage-Backed Securities, Corporate Bonds and in the Swiss case, foreign currency through money creation. Investors might have expected these programmes to be curtailed in recent weeks as economic indicators improve, but Central Bankers have done the reverse!!!

In other words to back-stop their fiscal policies and bank rescue programmes, Central Bankers have temporarily bequeathed their printing presses to the politicians, as the ultimate monetary guarantee of this extraordinary intervention. The result is clear – in the race to create a powerful enough deflationary antidote, we have forced a shotgun-marriage of necessity on our politicians and their Central Bankers that may prove abnormally painful to unwind.

There are risks associated with exit strategies from massive monetary and fiscal easing – politicians are “damned if they do and dammed if they don’t”. In other words, **there is now an inbuilt bias in favour of a more reflationary strategy and it will take abnormally determined political will to reverse this.** Initially, the impact will be felt in asset price inflation globally (hence our expectation of further rises in equities, quoted real estate and commodities) but by next year, there will be more meaningful risks for the wider price index. All of these risks are probably greatest in the UK where the Bank of England’s authorised Gilt purchase programme is already larger than the record-breaking net government issuance of £185bn, a quite extraordinary state of affairs leaving the Bank with a staggering 18.5% of all outstanding treasury issues. At any other time and in any other country, such a vast and unprecedented “peacetime” sponsorship of government borrowing by the Central Bank would be known as “debt monetisation” – the UK, the economic laboratory of these processes is clearly most at risk.

The recent rally in world equity markets supported by these trends has also been driven by company earnings data that now seems to be somewhat “less awful” than expected. This broad theme has been repeated across world markets rather as we had hoped, with better earnings than expected, meeting generous liquidity conditions and improvement economic fundamentals.

Politicians and bankers alike caught a glimpse back in March of a financial catastrophe that might have unravelled into global depression, so they stepped back and forged a hasty and pragmatic union to do something about it. While this averted disaster, it set in train a series of new economic issues, imbalances and conflicts, the consequences of which investors and markets are grappling with and will certainly take some time to resolve. Given the current competing threats of inflation and deflation, each with its own quite different implication for asset types, it remains that diversification within portfolios continues to be very important in controlling risk.

I have taken the opportunity to enclose our Financial Bulletin which I hope you will find of interest, along with our 2010 diary.

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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)