Any volunteers?

2015 has started much as 2014 left off which should come as no surprise as markets care little for arbitrary changes in dates after all; so no predictions! Oil is one of many unknown variables including the fate of Greece the strength of the dollar the flight of Abe's third arrow relations with Russia and the greater Chinese slow down. Then of course we have elections in the UK which will be interesting in the debate but almost certainly inconclusive in the outcome. It has been suggested a coalition government might be formed between Labour, the Scottish Nationals and UKIP; if so I'll be catching the first flight to somewhere a long way off.

The central banks still appear to be in control; well they seem to think so. Now he is no longer in that particular club Alan Greenspan thinks things look a bit "risky". Well risk is what investing is all about after all, but what is this elusive "particle" orbiting our portfolios?

Some would have you believe that it's all about volatility. If it goes up and down a lot the ride will be bumpy but you stand to make a lot more money than in something that gives you a smoother ride. Looking back over the last 30 years or so that smooth ride would have been government bonds and for most of that period returns would have been better than equities. So a low risk portfolio should be stuffed full of them right? Yes indeed if your risk model looks purely at long term historical data and ignores where we are in the journey.

But markets have an enormous propensity to make us look like fools. This time last year the predictors were saying, to a man, that sovereign debt was hugely expensive and due a very significant correction as rates were bound to rise weren't they? If there is one data series that is consistently called incorrectly this is it - perhaps a reason why the largest component of the derivatives mountain is in interest rate futures!

So in the UK a gilt tracker would have made you nearly 15% against a pretty much flat equity market and the 10 year gilt now resides at a scanty yield of 1.6%. Over in Europe the 10'year Bund is at 0.4% and everything under 5 years duration pays a negative yield. Yes investors are willing to pay a premium just to get their money back!

As the chart of the 10 year Treasury yield shows, we have come a long way in the interest rate journey and whilst further gains are possible can yields go much lower. If we are going Japanese, and the Germans already are, then of course they can. Ten years ago, having 50% in investment grade bonds in a portfolio for a cautious investor would have been eminently sensible especially with one's attention in the rear view mirror, but today?

The major unintended consequence of government and central bank intervention since Volcker's stand against inflation has been to generate its nemesis; deflation. With interest rates near zero in the major economies, there is nowhere for rates intervention to go to provide a stimulus. Strangely the answer must be higher interest rates. We will then see some "creative destruction" which is what the financial system needs to reset and start a proper economic cycle, but with the investment banks, who stand to lose the most, controlling the strings (just how do you think the US Budget bill got changed to allow banks' derivative positions to be included in subsidiaries covered by FDIC insurance? ie the taxpayer covers their losses) we need stronger hands at the tiller than a coalition of "politicians" or a lame duck president. We need somebody with balls and I don't mean the second fiddle in the Ed Miller band…any volunteers?

Clive Hale – January 12th 2015

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