PFP
Wealth Management

3 Windsor Court
Clarence Drive
Harrogate, HG1 2PE
01423 523311

Lion House
72-75 Red Lion Street
London, WC1R 4FP
020 7400 1860

www.pfpg.co.uk

4th January 2010

Happy New Fear

"Tradition is what you resort to when you don't have the time or the money to do it right."

- Kurt Herbert Alder.

Public sector strikes. Growing union militancy. Increasingly vicious and intractable terrorism. Governments losing their grip, both upon the economy and upon social stability. Currency crisis. Food shortages. Readers with an interest in time travel can revisit the turbulent decade of the 1970s via the BBC's excellent 'Rock'n'Roll Years' documentaries (1974, for example, is here). Alternatively, simply stick around: history seems destined to repeat itself. As an enfeebled Labour administration lurches toward what seems likely to be electoral liquidation, there appears to be a disconcerting ignorance – or perhaps a simple refusal to believe – by much of the British public of the inevitable retrenchment in social services and welfare provision that lies ahead during 2010. The UK government has done itself few favours. While the MPs' expenses scandal was largely an equal opportunities blunder, Iraq War II was a partisan and cynical exercise on the part of New Labour under Tony Blair that has done much to extinguish faith in the political process. What faith remains in British politicians will be sorely tested by the tough choices that lie ahead, for whoever is unlucky enough to have to take them. Chancellor Darling was allegedly prevented in his Pre-Budget Review by Gordon Brown from taking the pruning shears to Labour's unruly spending projects; that merely forces the emergency Budget likely to follow this year's general election to be even more draconian.

Economically speaking, the UK Treasury will be forced to tackle three comparably threatening Furies this year: Taxation is sure to rise (as Shadow Business Secretary Ken Clarke suggested yesterday); Government Spending needs to fall; Borrowing absolutely needs to be reined in. This last challenge could prove the most exacting, since it is almost universally accepted that 2010 will also see the first reversal of the great Quantitative Easing experiment. One thing is certain: it is going to be an interesting year for Gilts. Deflationists still see value in UK government bonds, but if they are right, 2010 is going to be a profoundly depressing year. Objectively looking at the fundamentals, from a perspective of either underlying credit quality (deteriorating) or scarcity (hardly), Gilts look unattractive. And they are also denominated in the wrong currency. It is difficult to foresee Sterling performing well on the foreign exchange markets during 2010 – though it is perhaps just as difficult to make a ringing endorsement for any of its major rivals, aside from non-fiat gold, still widely presumed (by those not actually long the metal, one supposes) to be in something of a bubble.

Speaking of bubbles, The Economist magazine in its New Year edition rather ominously features the two lost decades that have afflicted Japan in the aftermath of its property, equities and banking busts of the late 80s and early 90s. A colossal debt deflation / balance sheet recession is a terrifying thing to behold; it may just be that the western economies will have time to reflect on Japan's woes with a renewed sense of empathy in the years ahead.

It is traditional to start the New Year with some resolutions. One of this author's preferences in 2010 will be to spend less time consuming the output of traditional media. As an example of fatuous recent analysis, look no further than Time magazine's list of "People who mattered" during 2009. Seeing US President Barack Obama mysteriously relegated to 12th place – behind the likes of Jay Leno and David Letterman – can perhaps be accounted for by traditional media's time-honoured insular self-obsession. But having Mr. Obama followed shortly afterwards by Sarah Palin at No. 14, and by the stars of the film series 'Twilight' at No. 15, suggests a sense of complete redundancy.

It is also traditional at this time of year for financial commentators to proffer forecasts for the major indices and asset classes. We will politely decline, if for no other reason than it is an exercise in utter futility.

What we will do is indicate our current preferences across the investment landscape. They are, in truth, little changed from 2009 – but then novelty simply to accommodate the human fetish for discrete calendar years is also a wholly dispensable trait. In **bond markets**, we continue to favour only the highest quality sovereign issuers – those entities that actually have least requirement for borrowing in the first place. That naturally excludes the likes of massive state borrowers such as the US and the UK. Note, for example, that as Daniel Kruger of Bloomberg points out, US Treasuries were the worst performing sovereign debt market of 2009, suffering their biggest annual decline since at least 1978; 10 year Treasury yields ended the year at their highest levels for six months. Corporate bonds are also starting to feel tired, while emerging market bonds are starting to enter nosebleed territory. In **equity markets**, we continue to see the greatest attraction in classic value stocks and defensives with superior yields to Gilts and US Treasuries yet with greater potential to generate meaningful longer term returns. Given the extent of last year's rally and the possible dependence of the equity market upon indefinitely extended quantitative easing and ultra-low interest rates, focusing on defensive-type stocks, ideally with single digit price / earnings multiples, is likely to offer some protection in the event of further market falls. There seem to be few commentators who now expect the March 2009 equity market lows to be retested. For that reason alone, continued caution seems warranted. In the realm of **absolute return** funds, we maintain our preference for systematic trend-followers, and also to multi-asset funds more generally. Which leaves **real assets**. It still feels too soon for collective (i.e. somewhat indiscriminate) investment into property funds, but we retain a lingering respect for the monetary metals, gold and silver, where we intend to build exposure on more dramatic price weakness.

Readers may detect a degree of foreboding in this analysis. This sits uneasily with the spirit of optimism which has become a traditional part of New Year financial commentary. But given the many serious challenges still facing banks, businesses, economies and governments throughout the world, it would seem churlish to embrace mechanical positivity. In the cause of and aspiration to generating low risk, absolute returns, how could one realistically be positioned any other way ?

Tim Price
Director of Investment
PFP Wealth Management
4th January 2010.

Email: tim.price@pfpg.co.uk Weblog: http://thepriceofeverything.typepad.com

Bloomberg homepage: PFPG <GO>

Important Note:

PFP has made this document available for your general information. You are encouraged to seek advice before acting on the information, either from your usual adviser or ourselves. We have taken all reasonable steps to ensure the content is correct at the time of publication, but may have condensed the source material. Any views expressed or interpretations given are those of the author. Please note that PFP is not responsible for the contents or reliability of any websites or blogs and linking to them should not be considered as an endorsement of any kind. We have no control over the availability of linked pages. © PFP Group - no part of this document may be reproduced without the express permission of PFP. PFP Wealth Management is authorised and regulated by the Financial Services Authority, registered number 473710.

Ref 1001/10/SB