

Back to School

September, end of the summer holidays and back to school for many. Parents are sorting out uniforms and children are sharpening their pencils. Whilst our children may have new subjects to study, students of the financial markets continue to study the same old topic they have studied all year – Deflation or Inflation? In our School students are divided by their views, and the bond and equity teachers seem to be telling us different stories.

Bond markets see growth in the global economy stalling, deflation and the possibility of a “double dip” recession. As a result ten year government bond yields in the US, UK and Germany have fallen sharply from their peaks earlier this year. At the beginning of April this year, ten year US treasuries were yielding nearly 4%, more recently the yield has been below 2.5%. Despite the falling yield, recent US data shows that for the second year in a row, investors have been putting record amounts of cash into bond rather than equity funds. It would seem at these record low yields that investors are more concerned about return ‘of’ their capital rather than return ‘on’ their capital.

The UK Gilt story is much the same, the yield on ten year paper was standing at 4.23% on 22nd February this year, today it is nearer to 2.8%. In their recent Inflation Report, the Bank of England reported that UK inflation stood at 3.2% in June, well above their 2% target. The Report explained the higher level of inflation was due to rising oil prices, the restoration of standard rate VAT back to 17.5% and sterling depreciation. They also stated that they felt inflation would stay higher than expected in the medium term, particularly with VAT rising to 20% in 2011. So whilst gilts have outperformed UK equities year to date, there seems to be little attraction in investing at these levels. Yes, you will get your money back in ten years and an annual income of 2.8% but it is more than likely that inflation will erode your original investment.

So the lesson here for bond students: ***Trees don't grow to the skies!***

In the equity class, you will find the students in a more optimistic mood. Equities are now much cheaper compared to bonds following the second quarter sovereign debt crisis in Europe. Companies remain in fairly good shape with stronger balance sheets, improved profitability and a more confident outlook. These students are well aware of the different shapes of economic recovery that we are witnessing around the World. Countries such as China, Brazil, India and other parts of Asia are booming to the extent that most of these countries are beginning to tighten monetary policy in order to fight inflation. At the other end of the spectrum most of the Western economies have experienced a fairly lacklustre economic rebound since hitting lows in 2009, despite record levels of monetary and fiscal stimulus. For these economies a further round of Quantitative Easing is now expected. When money printing was introduced last time, in March 2009, equities rallied sharply on a wave of optimism.

So the theory followed by equity students: ***Fight fire with fire!***

So where do I sit in class? I suppose the answer is to sit close to Ben Bernanke, the Chairman of the US Federal Reserve and one of the leading scholars of financial crises, especially the Great Depression. The committee he chairs has the mandate to maximise employment and control inflation. This is the committee that at the height of the financial crisis last year cut interest rates to zero and urged the US Congress to act quickly by injecting masses of capital into financial markets after one of the worse recessions since the Great Depression of 1930's. Despite this massive stimulus, there has been no real improvement in US unemployment nor in the US housing market. Many students point to aging population and the structural issues which weigh upon economic growth. However Bernanke has an unwavering belief that deflation is reversible and recently testified in front of a Congress committee that the Fed is prepared to intervene once more. He stated "We are ready and we will act if the economy does not continue to improve, if we do not see the kind of improvements in the labor market that we are hoping for and expecting." I suspect that they will act again soon and we should see a significant market rally. The size and extent of that stimulus and the strength of the subsequent rally will be determined to a great extent by the unemployment data, as US inflation is not a concern at this time.

For now I continue to see deflation short term, inflation long term. This is a view shared by William Littlewood, manager of Artemis Strategic Assets Fund, in his recent Fund commentary. He sees the threat of inflation from developing markets being offset initially by developed markets such as Japan. However he also believes that the effects of the first round of Quantitative Easing and further rounds will tilt the balance towards inflation. His response to this is to be long equities and short government bonds stating, “these are levels (ten year government bond yields) which will only make a proper return for investors if inflation is eradicated for the next ten years, a scenario I view as extremely unlikely. They are also yields which show scant regard to the history of fiat money and governments’ abilities to generate inflation.”

My own view at the beginning of the year was that this would be a “tricky” market but that it was still possible to make money. It has indeed been tricky and the “risk on, risk off” market has continued throughout the year unsurprisingly given the environment of continual political, economic and market volatility that we have experienced. When risk is removed the US dollar rises whilst equities and commodities fall, and vice versa. At North we have balanced our client portfolios between risk and defensive assets, although we have been light on bonds preferring gold and absolute return funds as an alternative. We also invest in UK Equity Income funds as I find it difficult to believe that low yielding gilts can continue to deliver better returns than high quality UK companies offering a competitive yield and with a track record of dividend growth. This, for me, is a very good story but one where patience may be required for things to play out so don’t expect overnight success.

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