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

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Nothing as it seems

"**1.40. The Mouse That Roared.**
*** Wry comedy. A tiny country faces bankruptcy."

- Film listing in The Radio Times, Sunday 10 January 2009.

Whatever the dynamics of markets or current events, we tend to view the world through a prism of discrete annual cycles. So, simplistically, if 2008 was the year of crisis; and 2009 was the year of policy-driven recovery, what will 2010 bring for investors ?

Political uncertainty, for one, in the UK and elsewhere. The Labour administration shambles wearily on, unloved by much of the electorate and with the leadership unrespected if not discredited by its own senior figures. The government finances are sufficiently wrecked that the next election will be a poll that nobody sane would want to win. The threat of a hung parliament hangs over the year like a Damocles sword, but it may be that fears for a new government with no outright majority are overdone; an uneasy coalition recognising the gravity of the UK's fiscal situation could still be a better outcome than another Labour administration in complete denial about the scale of the debt burden and the draconian spending cuts required.

Another grave problem surrounds the timing for the anticipated withdrawal of quantitative easing by the Bank of England – and others. Central bank Gilt purchases may be the last dike separating a flood of new issuance from the disinterested private sector vacuum awaiting it. And this is a problem with international dimensions. Having supposedly saved the markets and banking system through extraordinary levels of stimulus and monetary intervention, western governments now face the unenviable task of reversing it.

And this is what makes the business of rational investing in 2010 more than usually difficult. Investors will be broadly aware of the Keynesian 'beauty contest' metaphor: suppliers of capital voting not out of personal conviction but from their assessment of the personal convictions of the crowd. That is not the environment we are in. The markets of 2010, boosted by state-sanctioned liquidity and taxpayer guarantees for the banking system, more closely resemble a blind-fold game of musical chairs. The investment choices can still be made, but watch out for when the music stops. Competing with other investors with different preferences, objectives and biases is difficult enough, but it's an inevitable characteristic of free markets. Competing to invest with bureaucrats and politicians, with seemingly inexhaustible capital, is an altogether different ball-game, and one that fundamentally distorts the price signals emanating from the market. We have suggested before that when faced with huge uncertainty about the outcome of a game, perhaps the best course of action is simply not to play. That seems an appropriate metaphor for Gilt and Treasury investing in 2010. The likes of bond house Pimco would seem to agree; as manager Bill Gross suggested last week, it's unlikely that even the US economy is robust enough for the government to "gracefully exit" from its stimulus programme, or that private demand will be there to pick up the deficit funding slack. The same problem faces the UK. So Pimco is voting with its feet, and cutting its exposure to UK and US government bonds. And as Bill Gross makes clear, investors have a choice: rather than continue to support the Anglo-Saxon government bond markets in the face of deteriorating fundamentals, they can commit to more fiscally responsible government bond markets. They are simply unlikely to find those markets within the G7, so will have to look somewhat further afield. To fundamentally more creditworthy government bond markets like, for example, those of Qatar, the UAE, Hong Kong, Singapore and Taiwan, and other countries with the greatest ability to repay their debts. As regular readers will be aware, the debt of such countries forms a core component of the New Capital Wealthy Nations Bond Fund, an institutional bond fund that currently yields above 8% in Sterling, compared with a sub-5% yield from lower quality corporate bonds, or less than 3% in the case of shorter dated UK government paper. This is what is known in the markets as an ***unsustainable anomaly***. Its resolution can be expected to come about through a compression in the yields of safer country debt (i.e. a rally in bond prices there), or a rise in the yields of UK Gilts (i.e. a fall in Gilt prices), or a combination of the two. High quality corporate bonds are probably a little safer, but they still look expensive in relative and absolute terms.

The recovery in asset prices from their March 2009 lows has the smack of psychological as much as fundamental support. Having seen world equity markets fall by roughly 60% between October 2007 and March 2009, investors evidently decided they could only tolerate so much grief. And as if coping from a financial bereavement, investors seem to have rotated through the initial Kubler-Ross stages of grief, from denial, through anger – at bankers and politicians – to a crude form of bargaining ("I'll accept these losses if the market rallies from here"). But if asset prices and notably equities turn back down and re-test their March 2009 trough, the next stage to come for investors could be ***depression***, in which they confront the reality and inevitability of their losses and their own inability to affect them. More benignly, we may already have transcended this stage and reached the final resolution of ***acceptance***. Another, albeit imprecise, psychological rule of thumb that reinforces March 2009 as the definitive market low is the Coppock indicator, which compares the stress of a bear market to bereavement in terms of duration, at between 11 and 14 months. (This argument, unfortunately, fails catastrophically to account for the drawn-out bear market that has afflicted Japan since its 1989 market peak.)

To return to the question: what lies ahead in 2010 ? With political risk rising in the general environment, it makes sense to try and minimise it within portfolios. The supposedly riskless characteristics of UK (and US) government bonds will be sorely tested in the months ahead. We see the prospect of better returns over the medium term, with reduced risk, in high quality non-G7 sovereign debt. It seems likely that with markets anticipating the slowdown or reversal of quantitative easing, downside volatility could return with a vengeance to equity markets this year – another argument, if any were needed, in favour of defensive and higher yielding equities. This would also be consistent with any fears of a double-dip recession as the economy is nudged back toward self-reliance having been sustained by overmuch government spending during 2008/9. While diversification across multiple asset classes did investors few favours during the brutal downwave of 2008, its implementation will surely – if selectively – do better to protect portfolios during 2010. A final message from the banking and financial crisis: we are now in an investment climate within which literally anything can happen. As investors that would seem to put a premium on being highly imaginative, and with few or no preconceptions about either time-honoured economic principles, or the extremes between which investor psychology can swing.

Tim Price
Director of Investment
PFP Wealth Management
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Email: tim.price@pfpg.co.uk Weblog: http://thepriceofeverything.typepad.com

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