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

8th March 2010

Don't shoot the messenger

Marty: "You know in Greece they cut off the head of the messenger who brought bad news."

Visser: "Now that don't make much sense."

Marty: "No. It just made them feel better."

- From the screenplay to 'Blood Simple' by Joel and Ethan Coen.

The commentary will be taking a short break next week and will return on Monday 22nd March.

When you are a government and your finances are shot, pinning the blame on speculators as opposed to your own fiscal incompetence is always an option. Even that term 'speculators' may be overly contentious, though after the banking crisis set in, it's now fashionable for governments to point the finger at all financiers since that helpfully distracts the electorate from the loathsome venality and brazen inadequacy of elected officialdom. (UK voters may wish to recall and give thanks for how the Usual Suspect inevitably rounded up whenever currency markets gyrate, George Soros, saved the UK from a fate worse than Sterling, namely the Euro. Masahiro Sakane, chairman of Japanese construction and mining equipment-maker Komatsu, conceded as much on Friday when he expressed relief in an interview with the FT that Britain had decided not to join the Euro bloc.)

So it has been sad but probably inevitable to see market regulators – you know, the bodies tasked with the mission of ensuring banks were prudently run; oh, never mind – examining what are likely to be ***perfectly legal*** trades in both the (Euro) foreign currency market and (Greek) credit default swaps. The US Department of Justice has separately rounded up some of the higher profile usual suspects, i.e. hedge funds, in the form of SAC Capital Advisors, Greenlight Capital, Paulson & Co and Soros Fund Management, darkly hinting at the existence of something that used to be called a concert party, though that phrase now seems like more of a throwback to the days of HMS Titanic. But it is banks and latterly politicians, and not hedge fund managers, that have been at the helm as the iceberg approached.

The larger hedge funds are big enough, successful enough and rich enough not to need us to defend them, but it is extraordinary how gullible the regulators believe electorates to be. The last time we checked, not a single hedge fund had sought or been given a penny of taxpayers' money to see it through a sector-wide crisis not even of its causing. Hedge funds do serve as a welcome distraction, however, whenever the markets start to highlight things that are fast becoming untenable, such as a lingering belief in Greece's ability to put its own fiscal house in order, or in the Euro fulfilling the function of a global reserve currency when half of its members are approaching technical insolvency, having performed accounting contortions that in the private sector would be classified as illegal. Perhaps banks' prop. desks also have some positions in the Euro and in Greek CDS not to the taste of the European regulators. But having shelled out so many millions of other people's money to support them, it would be churlish to criticise the sort of trading helping them return to profit. Much better to punish hedge funds, especially since you need to be rich just to know about them.

Ronald Reagan once said that Government's view of the economy could be summed up in a few short phrases. If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it. We can now add a further codicil: if it reveals fundamental inconsistencies at the heart of your economic policy, pretend it's illegal. Perhaps this is only what we should expect from administrations that, faced with an imploding, deleveraging and deflating credit bubble of monstrous proportions, now have two years' experience of policy-making on the hoof. What should concern all investors, and not just hedge fund managers, is that law-makers are in the distressing position of being able to change the law. You thought foreign exchange markets were free and open ? They are, so long as your position-taking squares with the stability of our pet currencies and political projects. The only question now is whether what passes for a free market in investments, overseen by today's politicians and regulatory functionaries, is closer to an Orwellian dystopia or to a Lewis Carroll-style Looking Glass asylum.

"Just arrest everyone in St. James'"

(Source: Warner Bros.)

A good definition of investment management is capturing the arbitrage available between perception and reality. A growing number of market professionals now believe that that gap has never been greater (think the crisis is over ? Think again). And the range of theoretical outcomes has arguably never been wider. On the one hand, deflationary forces are massing in the form of monumental credit contraction and wholesale bank sector and consumer deleveraging. On the other, inflationary forces are gathering in the form of unparalleled fiat money printing, post-crisis stimulus packages and competitive currency devaluations. In this sense, a "muddle through" outcome – both for economic growth and inflation – may ultimately be a ***low*** probability outcome versus a fat tail of ***either*** inflationary fire ***or*** deflationary ice.

A general principle of Darwinian evolution, commonly expressed as “survival of the fittest”, is perhaps better expressed as “survival of those organisms most adaptive to change”. Our central argument would be that the global financial environment has, in just two short years, already experienced something akin to massive climate change. For the time being, the blundering and heavy-booted forces of bureaucracy hold sway, busily distorting asset markets and making up for past regulatory failings by inadvertently impoverishing the innocent through punitively low interest rates and inadvertently (?) supporting failed malinvestments in commercial banking through an obsequious and Pavlovian obedience to the banking lobby. Immoral hazard, if you will. One possible outcome: until the unavoidable currency cataclysm, interest rates will stay lower for longer than almost anybody previously thought. We have advocated the benefits of genuinely high quality sovereign debt for some time, albeit those issuers amount to the road less travelled, being the likes of genuinely wealthy Gulf states and emerging Asian economies, many of them rich in natural resources. From an equity perspective, an environment of lower (interest rates) for longer would also be consistent with a gradual rerating of high quality largely defensive stocks offering sustainable dividend yields hugely more attractive than the pitiful yields being offered from fundamentally discredited and generally deteriorating government bond markets. Whether in a bond or equity environment, we think quality will absolutely win out. The tortoise versus the hare, if you will. It’s an ill wind that blows nobody any good.

Tim Price
Director of Investment
PFP Wealth Management
8th March 2010.

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

Bloomberg homepage: PFPG <GO>

Ref 1022/10/SB