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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Woe, to be in England

"There cannot be a crisis next week. My schedule is already full."

- Henry Kissinger.

All these bank runs are getting exhausting. Two and a half years after the failure of Northern Rock and a year and a half after the failure of Lehman Brothers and most of the rest of Wall Street, Greek investors are finally joining the party. μπράβο! In this case, better never than late. On the one hand, you can believe that some kind of political settlement to Greece's seemingly intractable fiscal problems is possible. On the other hand, just follow the money. Depositors in Greek banks are weighing up the options and seem to have decided in favour of branches of HSBC, Société Générale – despite its awkward serial habit of employing massively ~~fraudulent~~ anomaly-causing staff – and sundry Swiss banks. According to the FT, Greek savers took €10 billion of deposits (or 4.5% of the total) out of the country's financial system during January and February. UK bank depositors should not be feeling *too* smug at this point. No matter how carefully you check your bank statements this year, the post May 6th new government will be on the prowl for any spare cash. Cynicism or realism might suggest that anyone luxuriating with surplus money in the bank will have at least some of it forcibly removed. For those on higher pay, the forcible money removal process has already begun, at source. Oh, to be in England, now that April's there. This is probably *not* what Robert Browning was thinking about.

There was once a time when government bonds were viewed as safe investments. Safe as houses, you might say, if you weren't keeping up with events. But that was then, and this is now. Something rather ominous has started to happen in the government bond markets of the west. Under normal market conditions (remember them ?) corporate bond yields trade above the yields on government debt. This is logical insofar as corporate bonds carry higher risk than governments, which can print money and levy taxes to make good any shortfall in their requirements for income. But higher quality companies are now in the unusual position of seeing their debt offering *lower* yields than those on government bonds with the same maturity. Bloomberg points out that bonds issued by Berkshire Hathaway, Procter & Gamble, Johnson & Johnson and Lowe's have all recently traded with yields lower than those of equivalent duration US Treasuries. If you want to see a mismatch between theory and reality, look no further than the bond market convention that the return from US Treasuries represents the so-called "risk free rate". There can only be two conclusions, and they are mutually exclusive. Either the bond market is wrong, and the corporate bonds of these companies are mispriced (and by extension the price of US Treasuries is comparably mispriced but in the opposite direction). Or the bond market is right, and the

perceived "riskiness" of US Treasuries (and certainly UK Gilts) has risen sharply. As Gillian Tett for the FT points out, 10 year US Treasury yields at the end of March also started trading above 10 year swaps (which represents interbank risk). Both the US and the UK enjoy 'AAA' credit ratings from the major ratings agencies. This would be some comfort were it not for the fact that the financial crisis has revealed the ratings agencies to be a bunch of clueless and conflicted monkeys.

Wise financial counsel suggests that if you're at the poker table and haven't spotted the patsy yet, it's probably you. On a similar basis, if a given investment looks terrible, sounds terrible, smells terrible, has terrible fundamentals, and is rushing through the markets screaming "I'm terrible," then discretion might have to be the better part of valour in the interests of preserving both capital and sanity. This argument is even more clearly articulated when the one buyer of last resort – namely the central bank of the country (or countries) in question – stops buying government bonds, as the Bank of England has already done, albeit with the caveat that it might be back at the poker table if required, hurling more of the nation's capital into the toilet. Meanwhile, having troughed at 3% during the financial panic of 2008, 10 year Gilt yields now yield 4%. It is not beyond the realms of plausibility that they rise further. This would equate to holders of conventional Gilts losing money. Relative to (increasingly risky) western market government bonds, why not consider high quality dividend-paying stocks which in some cases offer higher yields and the prospect of growth in real terms over the medium term, which in the case of government bonds looks practically impossible ?

Kenneth Rogoff, co-author of the magisterial if not necessarily sexy study 'This Time is Different: Eight Centuries of Financial Crises', suggested last week for the FT that the bubble du jour is in (western market) government debt:

"..when debt markets collapse, there inevitably follows a long, drawn-out conversation about who should bear the losses. Unfortunately, all too often the size of the debts, especially government debts, is hidden from investors until it comes jumping out of the woodwork after a crisis."

Unfortunately for all current investors, the markets are awkwardly polarised between fears of profound debt deflation and between fears of uncomfortable monetary inflation. On the basis that generals are invariably transfixed by the last war, it might be fair to suggest that Americans are determined never again to experience the debt deflation of the 1930s. In any event, given the role and extent of government indebtedness throughout the modern world, a debt deflation is a practically unthinkable outcome. But in their eagerness to pump money into the system to make up for the credit contraction caused by an ailing banking system, the politicians of today may be setting themselves up for the last financial war painfully recalled by German monetary officials, namely the Weimer hyperinflation. And if officials don't deliberately design or ignite an inflation, it may come about in any case via the foreign exchange markets (or a surge in government bond yields). As Jens Parsson indicates in his superb but sadly difficult-to-obtain study 'Dying of Money',

"The spectre that waits in the wings of any inflation, including the American, is the general exodus of the people from the currency when they lose faith in it at last. When this spectre steps in from the wings, the government's games are over and the final curtain is not far away."

Here in the UK, we have a month to wait before we learn who inherits the Brown whirlwind. (A polite term for a rather unpleasant meteorological condition.) Over that period and beyond, both the Gilt market and the foreign exchange market will make for interesting watching. By the side of each of them sits gold, quietly appreciating in value.

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

Bloomberg homepage: PFPG <GO>

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