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

15th November 2010

Viene la tormenta, part II

"The thought that you can create a prosperous economy by inflating is an illusion."

- Paul Volcker, former chairman of the US Federal Reserve.

For our **latest webcast**, which features an economic overview by my colleague Killian Connolly and an interview with credit specialist fund manager Andy Seaman of Stratton Street Capital, advisers to the Wealthy Nations Bond Fund, please visit our website.

The FT's Alphaville carries a nice parody of the sort of communication with which anyone with an email account will be familiar:

"Dear Sir,

Good day and compliments. I am Dr (Mr) Benjamin Bernanke, Chairman of Federal Reserve of United States of America. This mail will surely come to you as a great surprise, since we never had any previous correspondence. My aim of contacting you is to crave your indulgence to assist us in securing some funds abroad to prosecute a transaction of great magnitude.

Due to poor banking system in America, many subprime borrowers are not paying back mortgages and banks have lost ONE TRILLION TWO HUNDRED BILLION UNITED STATES DOLLARS ($1,200bn) so far. This calamity has caused much suffering in my country. To help remedy this situation, our president, Mr Barack Obama, has authorised to be spent a sum of EIGHT HUNDRED NINETY SEVEN BILLION DOLLARS ($897bn) on stimulus plus many other good deeds like cash for clunkers. Unfortunately, since that time, we are being molested and constantly harassed by bond vigilantes who do not care that their reckless and vicious behaviour could ruin our hopes and plans.

To this effect, last year I authorised the printing of ONE TRILLION TWO HUNDRED AND FIFTY BILLION ($1,250bn) of United States currency to purchase government securities. To my great shock, this was not enough so I am now buying another SIX HUNDRED BILLION DOLLARS ($600bn).

If you forward a modest sum to purchase Treasury notes then I can buy many more of them with my unlimited printing press and their price will rise. I am absolutely positive that this arrangement will be of mutual benefit to both of us. I can offer you generous interest rate of EIGHT TENTHS OF A PERCENT after taxes.

I want you to immediately inform me of your willingness in assisting and co-operating with us, so that I can send you full details of this transaction and let us make arrangement for a meeting and discuss at length on how to transfer this funds.

Yours Faithfully,

Dr (Mr) Benjamin Bernanke

N/B: Please contact Mr Timothy Geithner on this e-mail address for further briefing and modalities."

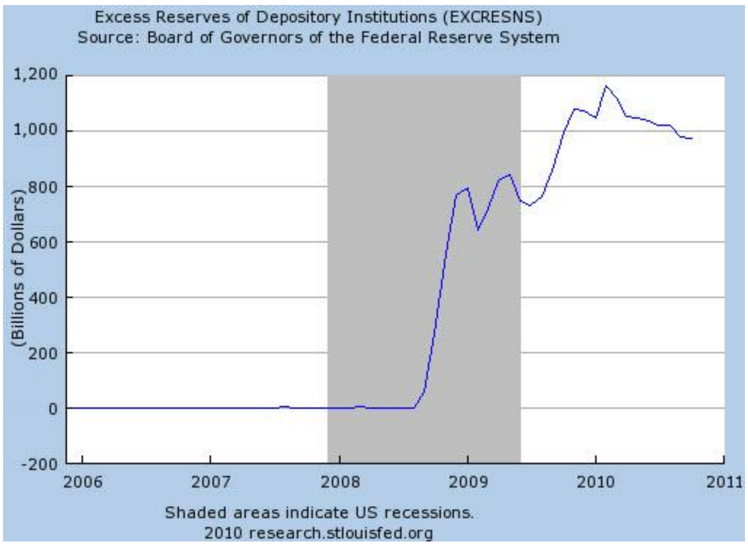
Or is it really a parody ?

Meanwhile, the markets are behaving as if they have finally become unhinged. Irish and Portuguese government bond yields have exploded higher again, bringing the prospective spectre of a Euro zone sovereign default back to the feast, and temporarily interrupting the dollar's long fall. The common characteristic between Dr (Mr) Bernanke's unsolicited begging letter and Europe's (so far peripheral) crisis is a longstanding inability on the part of politicians to take decisive action when faced with terrible fiscal and monetary problems; instead, those problems have merely been kicked further down the road. We have now run out of road.

Chris Martenson uses a different metaphor but the conclusion is largely the same: in initiating QE2, Bernanke has lit the fuse. To what distance you can safely retreat and watch the fireworks will be a function of what preventative action you have taken thus far. Martenson asks what the difference has been between the two QE programmes launched in the US. The first QE effort

"had the specific aim of **repairing damaged bank balance sheets**. That is, banks and other financial institutions had made some colossally poor and risky financial moves that didn't work out for them. They needed some help, and the Fed was more than happy to oblige by handing them free money to patch up their losses."

The extent of the essentially free money parked by banks at the Fed can be seen below:



QE1, then, had the explicit aim of bailing out bad banks. But just as peripheral Europe is discovering, in the process of saving the banks, governments demolished their own finances. So QE2 is about getting money conjured out of thin air to the government. Unlike QE1, there is very little consensus about the urgency or validity of this exercise. Martenson cites Richard Fisher, head of the Dallas Federal Reserve:

"The Federal Reserve will buy $110 billion a month in Treasuries, an amount that, annualized, represents the projected deficit of the federal government for next year. **For the next eight months, the nation's central bank will be monetizing the federal debt.**

This is risky business. We know that history is littered with the economic carcasses of nations that incorporated this as a regular central bank practice."

In passing, Martenson also references a speech made by the Federal Reserve chairman, Ben Bernanke, to the House Budget Committee on June 3, 2009:

"Either cuts in spending or increases in taxes will be necessary to stabilize the fiscal situation…**The Federal Reserve will not monetize the debt**."

As Martenson points out, QE2 has been met by a global chorus of disapproval. Greek Finance Minister George Papaconstantinou warned that quantitative easing only serves to fuel an ultimately inflationary fire:

"You get inflation. You get a situation that's out of control. People lose their purchasing power. It doesn't get you very far."

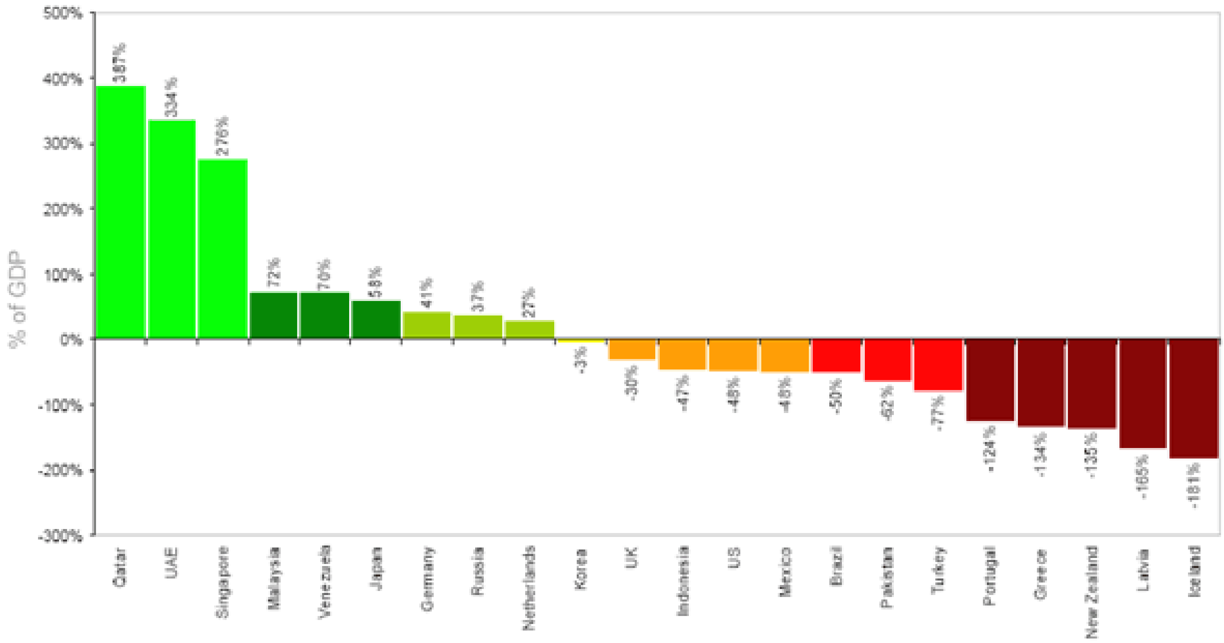
Major trading partners with the US have referred to QE2 as "clueless", "abusive" and "absurd". But as Martenson wonderfully observes,

"By the time you are getting lectured by Greece on monetary actions, it might be time for a bit of self-reflection."

Given the current pace of events, some form of reset of the global monetary order may be approaching more quickly than we might otherwise have thought. Three investment policy responses – or wealth insurance, if you will – seem particularly justified given the circumstances and broader uncertainties. Exposure to gold and silver, the monetary metals, is one. Exposure to more fundamentally valuable sovereign debt is another. Exposure to more fundamentally valuable currency (fiat, that is; gold and silver apart) is the third.

Happily, there is a relevant metric that we can use to assess objectively those countries and by extension those currencies that are, all things being equal, best placed to ride out a corrosive storm in the credit markets. It is a metric used extensively by Stratton Street in the composition of their Wealthy Nations Bond Fund, namely 'net foreign assets as a percentage of GDP'. Those countries that score particularly highly by this metric (the likes of Qatar, the UAE and Singapore) are likely to be altogether better credit risks than those that have dreadful scores (the likes of Portugal, Greece, Latvia, Iceland, as the chart below indicates). All things equal, it is a plausible thesis that what holds in sovereign debt terms also holds in foreign currency terms, so no prizes for thinking which are our preferred foreign currency holdings.

Net foreign assets of selected countries as % of GDP



Net foreign assets of selected countries (Source: IMF data, Stratton Street Capital LLP).
Data as at August 2009.

So in trying to navigate these treacherous waters we deploy our assets across four asset 'classes': high quality sovereign bonds using the rationale above (a rationale which also points to what we consider are the more attractive foreign currencies outside the Sterling arena); high quality defensive stocks; funds actively managed to an 'absolute return' objective; and real assets, notably gold and silver. At which point, I hope readers will indulge me as I repeat words that I last expressed in November 2007:

"We have consistently advised investors over recent months to rein in their animal (and particularly equity-related) spirits in the face of an increasingly obvious approaching squall. At the conclusion of James Cameron's 'The Terminator', Sarah Connor vanquishes one foe only to drive unwittingly toward an even deadlier threat. As the film's last lines attest: viene la tormenta. ***There's a storm coming in***."

Tim Price
Director of Investment
PFP Wealth Management
15th November 2010.

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

Group homepage: http://www.pfpg.co.uk

Bloomberg homepage: PFPG <GO>