GlobeTrot
— FROM DELMORE ASSET MANAGEMENT —

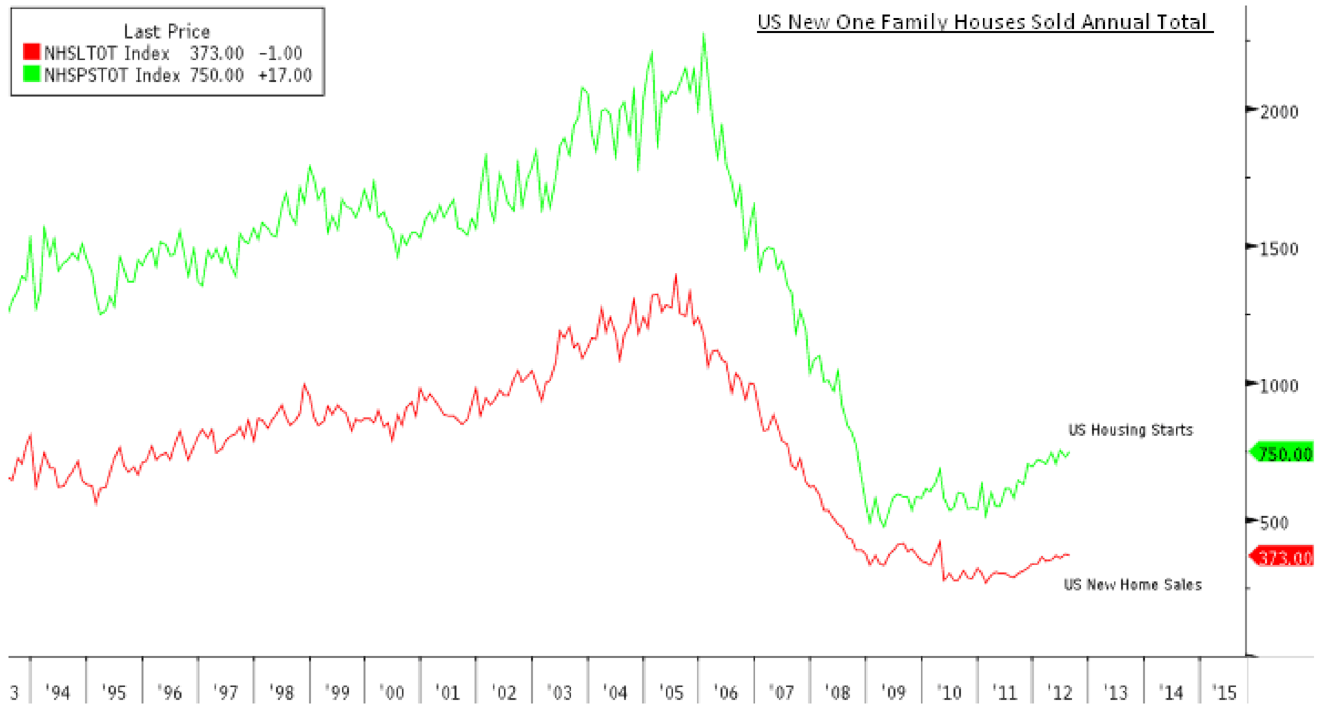
More a Nuke than a Bazooka

3rd October 2012

Ben Bernanke has spoken and it is clear that he and his colleagues mean business. The emphasis on increasing employment provides a clear message going forward meaning that market participants now have more of a feel for how long the Federal Reserve will pursue this latest phase of Quantitative Easing.

We have mentioned before that the single most important catalyst for increasing overall employment in the United States, since WWII, has been an improvement in the residential property market. The programme's clear emphasis on reducing the cost of mortgage finance and the declared intention to continue with 'Operation Twist', whereby the Fed is also seeking to reduce yields on long-dated paper, means that the environment for housing finance should continue to improve.

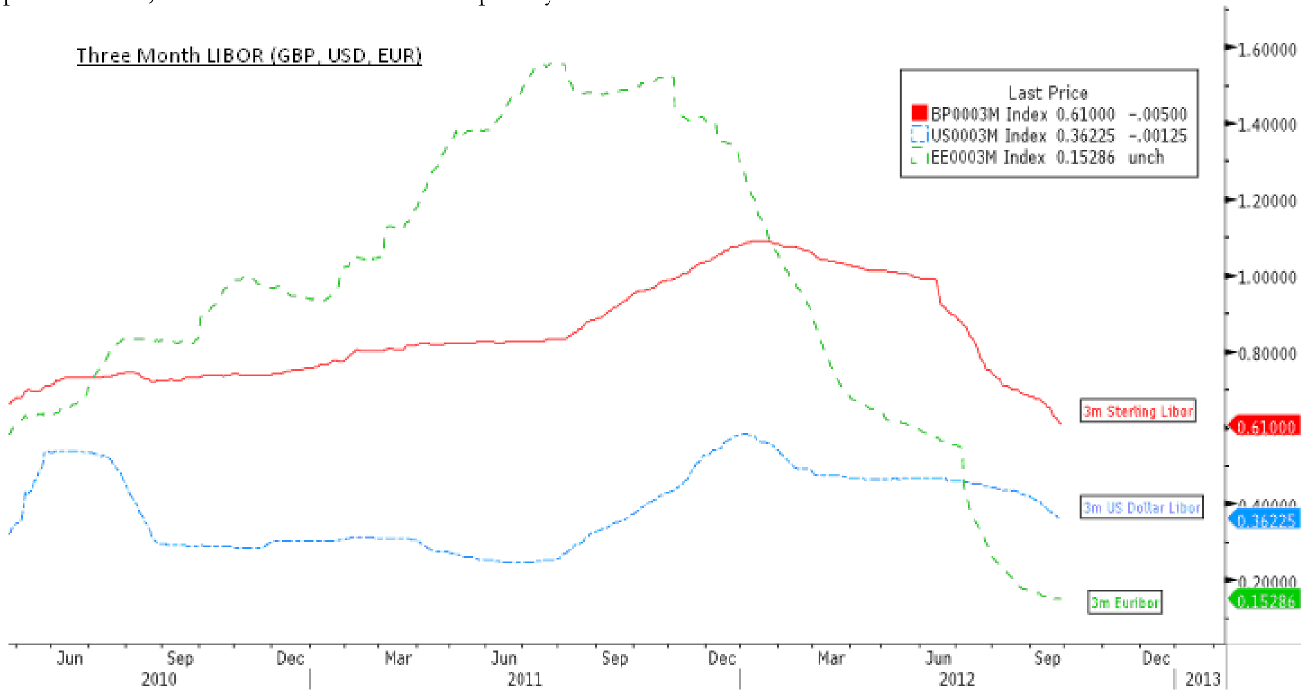
These measures attempt to improve the supply and cost of mortgage finance; however most of us know from reading Keynes that the world economy has spent some time in a liquidity trap where funds have been available, even plentiful. Nevertheless many borrowers have resisted the temptation to sign up for a mortgage, or re-mortgage, as the uncertain outlook has deterred borrowers from taking the plunge.



This is most definitely the other side of the equation. Bernanke explained that there would be further measures on an international front to improve the economic outlook. Studies have shown that in the past QE has improved the rate of economic growth both in the US and UK. However research suggests that the results achieved across the pond have been almost twice as effective as in the UK.

We feel that one of the reasons for this differentiation relates to the composition of the US Quantitative Easing programme. Whereas the UK has relied very heavily on injecting liquidity into the system by purchasing Gilts, in the US the spread of financial products purchased by the Fed has been much broader across the financial spectrum. The clear differentiating factor between the two central banks has been the Fed's consistent purchases in the mortgage based security market.

This has been a notable omission by the Bank of England (BoE). In fact only recently has the Bank recognized its failure to inject sufficient liquidity into the broad economy after the withdrawal of the Special Liquidity Scheme (SLS), which started in 2009 and finished this year. The 'Funding for Lending' scheme, announced by the Governor at the Mansion House to replace the SLS, was more an admission of culpability rather than a new initiative.



Sir Mervyn has now decided that the worst could be over, but he is still extremely unsure about the next few years. Fundamentally he could be right or wrong since the present situation remains quite difficult to read. We believe that things will get better faster than the BoE forecasts since we expect consumer spending to improve over the next 18 months as a result of higher net real incomes. At some stage in the next few months the BoE will also manage to start impacting mortgage rates. At first this will help housing market volumes, followed by a modest rise in prices.

The latest CBI survey suggests that investment intentions have improved and the trade statistics do show that UK industry is gradually moving the focus of its export efforts to countries outside the EU. In addition the balance of trade on services has improved, reflected in the resumption of service sector growth. We expect this trend continue.

Europe

In the euro area the liquidity squeeze is being partially eased by the recent packages from the ECB. Nevertheless, the clear commitment to sterilise the latest Outright Monetary Transactions programme does mean that very little of the extra liquidity will leak into the system. Once more the small and medium sized enterprises are bearing the brunt of the ECB's monetary orthodoxy and this is a severe constraint on any continental recovery.

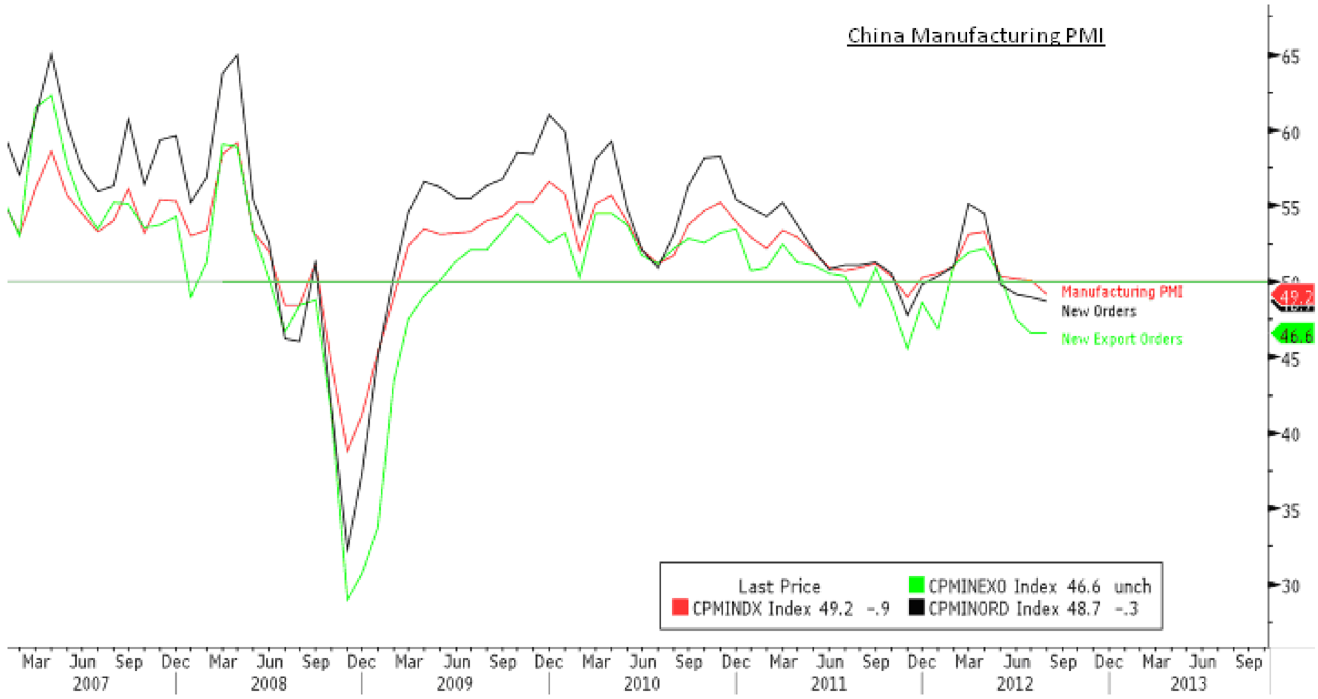
Worryingly deposits continue to migrate from the southern periphery to the north, thus removing liquidity from those nations which need it most desperately. It is true that some of this liquidity is replaced by the ECB, but the net result is further liquidity contraction. Until the European Commission initiates a sensible growth plan for southern Europe, this continued impoverishment cycle - where lower government revenues mean higher deficits; which lead to further cuts in necessary social spending and thus lower growth – is bound to continue.

United States

The brightest spot in the global economy remains the steady recovery in the US. We think this will gain traction in the last quarter of the year, but it will be restrained by the continued uncertainty regarding fiscal policy going forward. Should the Congress and the President miraculously agree a workable compromise to solve this problem then better growth in 2013, given the continued monetary stimulus, is virtually guaranteed. Once more all market participants remain in the hands of the fickle politicians.

Asia

Meanwhile the Japanese economy continues to struggle, and this difficulty is compounded by the incessant waves of Yen purchases by foreigners. At the present time Japanese exports have become too expensive, since attempts by the Bank of Japan to weaken the Yen have been unsuccessful as it remains a safe haven currency. Against the US dollar the yen has consistently strengthened and stabilised. In reality this means that the Japanese have lost a lot of competitiveness against their Chinese neighbours, who have quietly allowed the Renminbi to depreciate as China's trade surplus has continued to shrink. Unfortunately, the days of looking to China for booming growth appear to be over. The PMI index has dropped below the 50 threshold for the first time since November 2011 as weak new orders, particularly from the euro zone, further delay any recovery in growth.



Conclusion

The latest announcement of QE by the Fed marks a watershed in the history of the great recession. The open-ended undertaking to continue injecting liquidity into the financial markets until the rate of unemployment has fallen substantially means that we are looking at continued easing through into 2014. Mr Bernanke's term of office ends on 31 January 2014, by that time we may have a strongly Republican Congress. They could easily insist that he retire from the scene and they will endeavour to appoint new Federal Reserve board members who are much stricter monetarists than the present incumbents. If this happens then the current monthly programme of QE3 might be halted in the middle of 2014.

Since this is a very long shot we think that portfolios should be structured on the basis that QE will continue on a global scale well into 2014. On that basis the following guidelines are relevant:-

1. Equity weightings should be increased due to the higher levels of liquidity in the system, but we think it likely there will be a modest correction at first. There is also the distinct possibility that at some stage this flood of money will increase the price of real assets before moving on to radically affect consumer prices. Under those circumstances investors will need a sensible hedge against the possibility of high inflation.

2. Prime real estate should maintain its value as the cash flow yield is still quite favourable, particularly when compared to government bonds in the perceived safe haven cores such as the US, Germany and the UK.

3. Over the last few months the prices of high yield bonds have performed well, in fact anyone buying Greek bonds four months ago seems to have made very substantial capital profits. Some of this adjustment will continue over the next few months, but we feel that the bulk of this move has taken place. Investment grade corporate bonds are not expensive at current valuations and should be able to withstand the snap back in yields better than safe haven governments or high-yield speculative bonds. Nevertheless portfolios will need some government bonds in order to provide negative correlation to any extreme moves in equity prices. We continue to expect a bumpy ride.

4. The US equity market is not cheap, but there are a number of stocks which still show good value providing the US recovery continues to progress over the next 18 months. For many stocks, price-to-book ratios have fallen substantially and the yield on the S&P at 28 September 2012 was 2.1%. This yield appears quite favourable when compared to the low yield available from government bonds. All our portfolios have substantial weightings in US stocks.

5. Here in the UK the equity market continues to confirm its credentials as a fundamentally international market. For most of the stocks quoted in London, the UK economy remains a small and diminishing part of their business. If our projections for the US economy are correct then growth in the States will help many other countries, consequently the profits of UK multinationals should move ahead on a broad front. On the same basis multinationals quoted in Europe should also perform well.

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