DELMORE
ASSET MANAGEMENT

The Flipside

7th March 2013

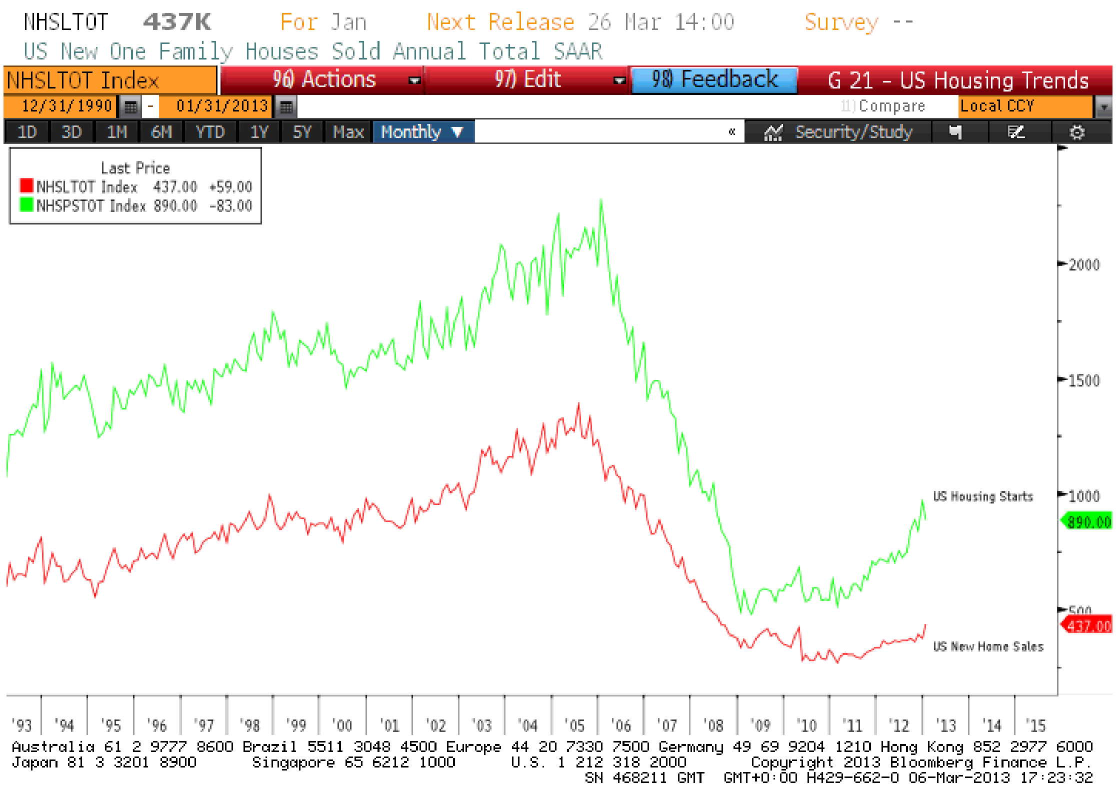
In the previous Globetrot, we discussed the reasons for sterling's weakness and enumerated our concerns regarding the poor performance of the British economy. The other side to this equation is the much healthier progress being made by the American economy and that markets are now beginning to realise that this recovery has legs.

In brief this is the main reason why we expect the US dollar to re-establish its pre-eminence in the currency markets. The most obvious point is that the Federal Reserve (Fed), under Ben Bernanke, has not strayed from its dual mandate to guard against both excessive inflation AND to promote economic growth. Whilst economic growth is on the recovery path, there is no sign yet of a much quicker pace which might put tangible pressure on resources (both materials and wages) which could thus lead to higher inflation.

The Fed now has a declared target of reducing unemployment rate to 6.5%, considerably below the current level of 7.9%. Mr Bernanke and the Federal Open Market Committee have so far used a strong mixture of a flood of liquidity and extremely low interest rates in order to try and achieve this goal. In their seminal work 'This Time is Different' - which provides an economic history of recessions and depressions over the last 400 years - Reinhart and Rogoff categorically state that a balance sheet recession, which is the nightmare we have all lived through since mid-2007, takes at least six years to work its way through the system.

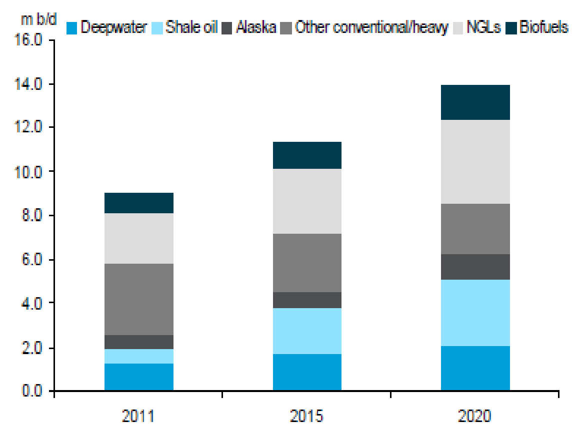
The Fed, the ECB, the BoE, the BoJ and all other world central banks have provided sorely needed liquidity (life support) for the global economy over the last six years. Initially these enormous infusions of liquidity helped to stabilise the difficult situation. What really marks out the Fed from other central banks has been its continued innovation in using its balance sheet to improve the housing sector and promote future economic growth. Clearly this has helped to instil a greater degree of confidence in the US economy. These measures are certainly bearing fruit. QE will of course be removed eventually, however this is not imminent, and in the meantime it will continue to provide a useful tool for creating employment and closing the output gap.

The graph of American housing starts below shows substantial improvement and this is related directly to the easy availability of mortgage finance and the lowest mortgage rates for over 30 years.



Fundamental research on the structure of American economic recoveries since the Second World War shows clearly that it is impossible to have a tangible and substantial recovery without a strong improvement in the housing market. We believe this recovery is now gaining traction and will be the locomotive for steady American growth going forward. When market acceptance of sustainable economic growth takes hold it could be reflected in rising bond yields due to falling bond prices. The counter argument is that foreign appetite for US dollar denominated assets will provide a brake to any big fall in bond prices. The appreciating dollar and the Fed's probable decision to cut QE suggests a rise in US interest rates lies ahead; but not in the immediate future.

The United States is blessed with substantial mineral resources with the presence of hydrocarbons in significant quantities. Fundamental changes in technology now allow the extraction of oil and gas using hydraulic fracturing (fracking) which is dramatically lowering the price of energy extraction. This has led to a vast increase in the supplies of natural gas available.

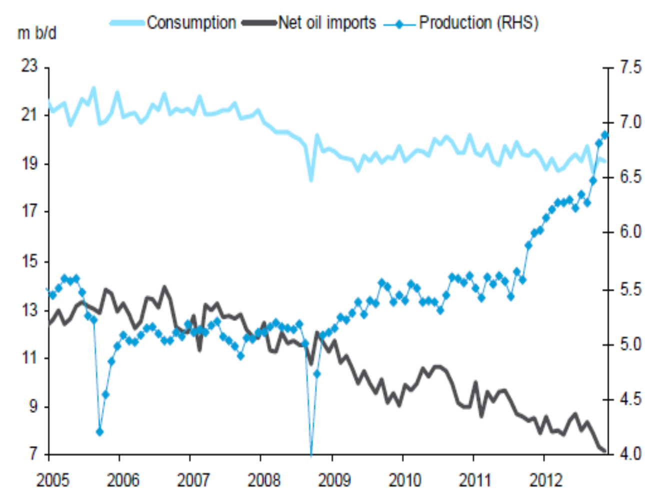


Source: Citi Research

The main objective of fracking in the United States has been to produce oil, which has a much higher value per barrel than natural gas. However much of the shale rock formations in North Dakota also contain a large amount of trapped natural gas which then escapes as the oil is produced. Indeed the amount of gas being flared off as a result of the substantial oil production is now large enough be easily visible by satellite from outer of space. The graph above shows the large proportional increases in shale oil production predicted through to 2020.

The abundance of natural gas which is also expected to be produced AND captured in the United States over the coming years will provide a cleaner and cheaper source of electricity generation than coal. This development also helps overcome the American public's concerns about building too many nuclear power plants.

Make no mistake; we are witnessing a fundamental change in the fulcrum of power and politics in the energy market. Within a few years the USA will be producing as much oil as Saudi Arabia and, as illustrated by the graph below, its domestic production already exceeds its domestic consumption. Meanwhile its neighbours to the north and south – Canada and Mexico – are also set to see output soar. This increased production will lead to a fundamental shift in market pricing power, since OPEC's stranglehold on the hydrocarbons market will be considerably relaxed if not totally broken.



Source: EIA, Citi Research

Naturally the US does have some issues; firstly many economists believe that the rate of population growth is set to slow considerably within 10 years. This will mean that pensioners will represent a growing proportion of the adult population, so placing a strain on the workers and general government finances. Secondly this problem is linked to the battle of entitlement reform in Congress which many commentators believe are too generous at the present time. No one with a basic understanding of American politics expects these problems to have a quick or immediate solution, however the American polity is robust - even though it can be extremely fractious - and we believe that these issues will be resolved over time.

The abundance of cheap energy and, for the time being, cheap finance should continue to promote good growth in the US. A number of corporations have relocated manufacturing operations back to the US in a process known as reshoring. According to the Boston Consulting Group's April 2012 survey, 48% of companies with sales over $10bn stated that they were considering reshoring production from China and elsewhere. This has now become a major trend.

This process enables the supply chain to be managed with much greater finesse as to content and availability, removing the constraint of transport delays and costs. Other forces supporting the trend include rising real wages in Asia, deteriorating innovation due to the chasm between manufacturing and design and the rise of additive manufacturing reshaping the landscape of the manufacturing process itself.

Conclusion

As American economic growth gathers pace and the US trade account improves, we expect the strength of demand for US dollar assets to increase further. This will be particularly noticeable with regard to stocks whilst we believe that the current recovery in the real estate market has further to go over the next few years as bank finance is now more plentiful.

The American banking system has been put through the ringer by the Fed, consequently most American banks have much healthier balance sheets than many of their international peers. This should result in more bank lending on a broad basis as the economic recovery gathers pace. This lending will in turn play a pivotal role in the continued improvement of the housing market.

The American culture of innovation and enterprise will also support this nascent recovery and help to bring down the current level of unemployment. Finally the American labour force has always been willing to adapt to changing conditions, with workers willing to relocate from coast to coast, however the biggest long term challenge facing the US (and all other OECD economies) will be to provide sufficient retraining for workers as the shape of the modern economy rapidly evolves.

The United States is still the largest global economy, representing almost a quarter of world GDP, and despite its problems it has fewer issues than most of the other countries. Consequently we consider that a meaningful exposure to the American economy is the best way to position portfolios as the recovery in the global economy gradually gathers pace.