

IPS View: When the Music Stops...

"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing".

So said Chuck Prince to his Citigroup shareholders a few months before the credit crunch began. In essence he was saying that he would know when the music was about to stop and would be able to do something about it. He didn't, and was fired in November 2007. Citigroup went as close as a bank can to going bust and was eventually rescued by the US government.

Today, the bandleader is Ben Bernanke, the chairman of the world's central bank. The music he is playing is higher growth and higher inflation and he looks ready to do almost anything to avoid the alternative (known as Japan). This includes printing money to buy back bonds and so keeping yields low. Looser US money – and the weaker US dollar – also puts other countries in a tough spot.

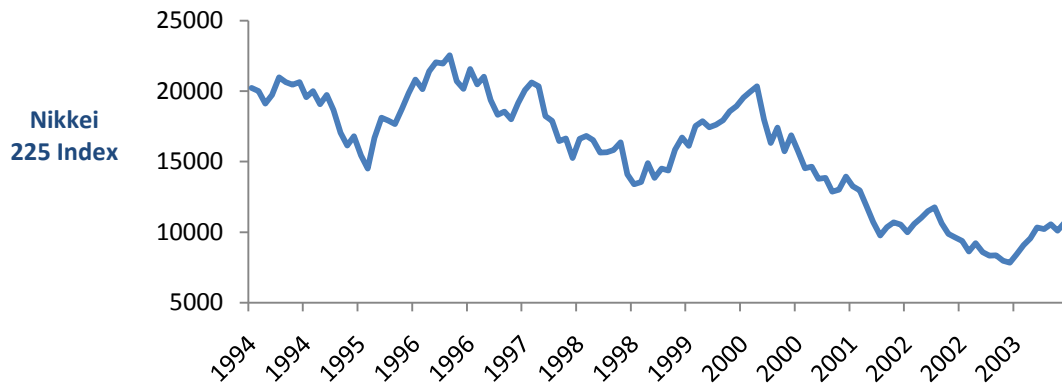
Export driven economies can either see their exchange rates appreciate against the US dollar (and so slow growth internally) or have copycat looser money to preserve their status quo. We think developed markets (particularly the UK and Europe) are more likely to loosen and so, in effect, import cheaper money from the US. Emerging markets, particularly ones where rates were due to rise anyway to dampen down a boom, may instead choose to let their exchange rate rise.

So: the recipe is more, cheaper liquidity for developed markets and rising exchange rates in emerging ones. In the short term this means a lower cost of capital for companies (good for equities) and lower interest rates (good for bonds). We therefore have a goldilocks scenario for nearly all asset classes. Since Bernanke's Jackson Hole speech, US equities are up 13%, precious metals are up 6.5% and the US 10 year bond yield has fallen by 13bps.

However, all parties have to end. What will investors not want to be holding when it's time to stop dancing? The bullish case is that Bernanke gets his way. US growth resumes to long term trend levels and core inflation stops falling. This will be bad for bonds. It is worth noting that a 2% rise in US 10 year yields to pre-crisis levels of around 4.5% would see losses of around -15% for bond portfolios. In other words, many so-called "defensive" (bond-heavy) capital protection portfolios could see significant losses should Bernanke get his wish.

The bearish case is that the reflation fails. For the outcome here, we need only look at Japan. The 10 year Japanese bond yield is currently at 0.9% meaning a (potential) 15% or more gain from here for bond investors. Equities, on the other hand, more than halved in value from 1993-2003 (the decade that began 2 years or so after the bursting of their real estate bubble).

The Case for the Bears: Japanese Equity returns for the decade 2 years after the real estate bubble burst



What to do? First, our style is always to avoid placing all our chips on either one of these particular outcomes. (The best way to make money is first not to lose it if you turn out to be wrong.) We therefore like many credit strategies (particularly high yield). These look placed to make steady returns in either scenario as they will benefit from either falling rates or rising growth and, in the meantime, pay an attractive income. The outlook also looks good for gold. Even though – to our eyes – it looks more and more bubbly with each passing day, it does offer a hedge against deflation and a weakening dollar and so, we think, will stay in demand. Finally, we think many emerging market currencies will be biased stronger and so are looking to own selected local currency assets in our client portfolios.

We also aim to avoid holding asset classes that we do not believe have much long term value with the hope of getting out before it's too late. For us, for now, this means we have very limited exposure to government bonds. Implicit in this is our belief that the US is fundamentally different to Japan (and so yields are not heading to 1%). Generally, as we argued in our last IPS View (*Betting on the St Leger*) we prefer equities on a yield and risk/reward basis and so prefer to allocate our clients' capital there. After what has been a 20 year bull market, the party may be finally over for government bonds. We are mindful of the lesson of Chuck Prince. The music may still be playing, but we are happy to sit out this dance at least.