TROY
ASSET MANAGEMENT

Investment Report No.29

July 2010

Our aim is to protect investors' capital and to increase its value year on year.

QE2. Not if but when

"That's the secret to life...to replace one worry with another"
Charlie Brown, Peanuts

Sequels are rarely as good as the original (perhaps with the exception of *Godfather II*). Having enjoyed the first film, the viewer's sense of anticipation is that much greater. It is hard to live up to those high expectations, especially for those who went to see *Sex and the City 2* recently – so I'm told.

Back in February, the Bank of England announced a pause in its Quantitative Easing (money printing) programme, having started it eleven months earlier. £200bn later, the effects were there for all to see. Investors' risk aversion had abated from the post-Lehman mood of depression and asset prices were rising. In recent months, however, financial markets have suffered the withdrawal symptoms of the removal of this unconventional monetary stimulus.

In March, we passed the one year anniversary of the unprecedented pro-Keynesian fiscal and monetary policies that attempted to resuscitate the economic patient. Countries now weighed down by the subsequent rise in sovereign debt, had few options available to further encourage growth. A further rise in government spending was off the menu. This leaves central banks to do the heavy lifting. Following last month's anti-Keynesian austerity budget in the UK, David Cameron admitted that should economic growth slow as a result of proposed spending cuts and tax rises, the Bank of England would have to take up the slack. But with the UK's interest rates at their lowest in 300 years, there is only one route available –more QE.

We believe it is only a matter of time before the central bank printing presses are activated once more.

Fiscal drag

Austerity budgets are all the rage. Germany showed solidarity with Greece, Spain, Ireland and Portugal. The lesson from Greece is that you are damned if you do choose austerity (by riots and strikes) and you are damned if you don't (by a bond market scare and fears of sovereign default). In the UK, following the Budget, we are more concerned by the risks of a double dip recession. We applaud the direction taken by Mr Osborne but are frankly surprised by the extent of fiscal retrenchment. Having expected a diet, we got liposuction. However, the notion that tightening will lead to an improvement in private sector end-demand is unproven and high risk and has more in common with wishful thinking than economic argument. The newly-created Office for Budget Responsibility's economic growth forecasts for 2011 and 2012 look very optimistic to us. There are already signs that economic growth is slowing in the West *(see Figure 1).* As last year's attempts to revive the consumer are removed, whether they be cash for clunkers or housing subsidies, there is mounting evidence that this is no self-sustaining recovery, which creates cracks in the cosy consensus view. We are self-confessed Austrian school sympathisers at heart and would prefer to see assets find their own clearing level. Alas a second round of the crisis, likely to be 'solved' by another round of panic stimulus, will only defer the problems.

We are indebted to Christopher Wood at *CLSA* for pointing us in the direction of the latest annual report (28th June) from the well

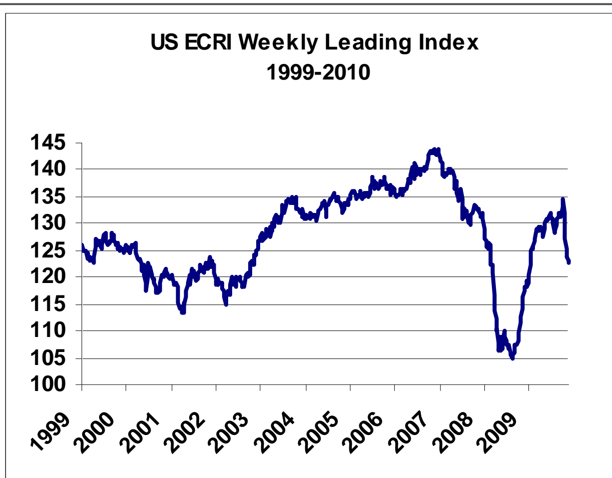

Figure 1 *Source Bloomberg*

respected Bank of International Settlements which, highlights the extent of the challenges we face:

"*Unlike then [2008], however, we have hardly any room for manoeuvre. Policy rates are already at zero and central bank balance sheets are bloated. Although the private sector debt has started to decline, public sector debt has taken its place, with sovereign fiscal positions already on an unsustainable path in a number of countries. In short, macroeconomic policy is in a vastly worse position than it was three years ago, with little capacity to combat a new crisis – it will be difficult to find another source of treatment should another emergency arise. Regaining the ability to react to economic and financial crises by putting policies onto sustainable paths, is therefore a priority for macroeconomic policy.*"

We could not have put it better. This environment provides the ultimate test for those charged with the responsibility of either wealth preservation or wealth creation.

The printing press is no solution

Martin Wolf, respected *Financial Times* commentator and adviser to the coalition government on banking reform, has advocated further money printing, should the economy slow as he expects (*Why it is right for central banks to keep printing – 23 June*). While he claims to not be "recommending the economics of Robert Mugabe", in our view this option is a slippery slope. Mr Wolf believes that the inflation genie, once released, is easy to get back into the bottle. If only it were so. Perhaps Mr Wolf recognises that the only solution to get rid of the country's collective debts and liabilities is to pay them off with devalued money. This is no path to prosperity. It is the road to ruin. Money, as a store of value, will lose its meaning.

Central Bankers are quietly relieved, if not delighted, with the response to QE. The policy succeeded (in their opinion) by goosing up markets and provided a boost to economic growth (or at least averting a further collapse) in 2009. Moreover, there is little evidence of rising inflation (except arguably in the UK, where it is forecast to dissipate later this year). Policy makers may therefore be complacent about the risks posed by a second round of money printing. QE2 may ignite the market again but this time the effects may be even more short lived. As with any blockbuster, the pleasure and surprise of the original will wane with the second and third sequels.

1923 and all that

Quantitative Easing is nothing new, merely the rebranding of deficit monetisation. Following the financial crash in 2008, American and British central banks faced with the prospect of a deep recession or possible depression opted to do 'whatever it takes'. The European Central Bank was more circumspect due to the haunting legacy of Weimar hyperinflation.

The Europeans have belatedly joined the QE party. In May there was concern over possible sovereign default in Greece, Portugal and Spain. The response was a 'shock and awe'

trillion dollar bailout. This involved the ECB abandoning its hawkish Bundesbank principles and buying the government bonds of weaker Euro member states. The trillion dollars has come from the indebted EU itself and is another example of solving the debt crisis with more debt. The Greek phase of the crisis highlights the circularity of risk endemic in the financial system, as while the problems started in the banking sector, sovereign debt crises present themselves in the banking system as it is the banks that own enormous sums of increasingly flaky government bonds.

The Bank of England, the Federal Reserve and now the ECB are committed to sterilise the debt they have issued but as time goes by and they continue to print, the prospect looks less likely. The route they have chosen has echoes of the path taken by Rudolf von Havenstein, the President of the Reichsbank in 1923. In his book, *The Lords of Finance*, Liaquat Ahamed describes the dilemma faced by Herr von Havenstein *"...were he to refuse to print the money necessary to finance the deficit, he risked causing a sharp rise in interest rates as the government scrambled to borrow from every source. The mass unemployment that would ensue, he believed, would bring on a domestic economic and political crisis, which in Germany's fragile state might precipitate a real political convulsion."*

So rather than risk mass unemployment he destroyed the peoples' savings. The consequences of this, in the form of another "political convulsion" ten years later are too well known to need repeating.

While central banks can and may stop printing any time, there are no signs that they will. Notwithstanding the deflationary forces of consumer debt repayment, given enough printing, inflation is inevitable.

The response by investors to the recent chapter of the crisis has been the predictable dash out of risky assets, like stocks, and into 'safe haven' investments, such as US Treasuries. This looks like a flight to *quantity* as opposed to a flight to *quality*. As we wrote in our last report (No. 28) the US is in no better shape from a deficit perspective than many other western countries. We reduced equity exposure in the early part of the year, especially the shares more likely to fall in a correction. As we proposed last summer, we continue to advocate holding a balance between high quality global franchises, gold (where appropriate), and index-linked bonds.

Whither BP?

The explosion on the Deepwater Horizon drilling rig and the subsequent massive oil leak has been the biggest single stock market event this year. The incident has caused loss of life, environmental damage, and wiped billions of pounds off the UK stock market to the detriment of millions of investors. The affair has been so extraordinary that we feel obliged to comment.

The three Trojan funds have had different exposures to BP for some time, largely reflecting differences in their respective investment mandates. The Trojan Income Fund has an income distribution obligation and BP has been an important source of dividends since the Fund's launch. The other funds do not share this income emphasis. The Trojan Fund and Personal Assets Trust sold out of BP entirely in 2009. The Trojan Capital Fund sold down a significant proportion of its BP stake but maintained a more modest holding.

During 2009, debate as to whether BP would have to rebase its dividend in the immediate future was at its most feverish. Questions were asked whether the company would be forced to cut its dividend at oil prices below $60 per barrel. The Trojan Income Fund maintained its BP holding in the belief that the company could meet both its capital expenditure and dividend requirements under most likely oil price scenarios.

As 2010 progressed and up until the oil spill, the BP dividend looked more secure, with the potential for increases in the payout. However, an archetypal "Black Swan" event dramatically changed all that. After an intense period of American political pressure, the BP board has buckled and announced that it is suspending dividend payments for the rest of 2010.

We believe that on traditional fundamentals BP looks very cheap. However, the ultimate size and timings of the company's Gulf of Mexico liabilities are currently unquantifiable. In periods of uncertainty, we believe that inaction can be the best course of action. Therefore, the Trojan Fund and Personal Assets Trust have no inclination to restart equity holdings. The Income and Capital Funds currently want neither to add to their equity holdings when future events are so uncertain nor to sell out of what could be an underpriced and oversold security.

Sunny Afternoon

The UK fiscal squeeze is on and in the spirit of the Kinks 1966 hit (see link http://www.youtube.com/watch?v=1h1oRP7FfBw) we wish our investors a happy summer.

Sebastian Lyon

July 2010

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