TROY
ASSET MANAGEMENT

www.taml.co.uk May 2011

Investment Report N°·32

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

Downgraded

"You *can always count on Americans to do the right thing - after they have tried everything else"*
Winston Churchill

Investors largely remain focused on the Eurozone sovereign debt crisis, especially in the so-called PIGS (Portugal, Ireland, Greece and Spain). But as David Roche of Independent Strategy points out the biggest hog is not among the PIGS, but the USA. We rhetorically ask, 'Will they or won't they? Or is it just too late?' American politicians seem remarkably reluctant to go down the austerity path taken last year by the UK coalition government. Rather than stopping the rot of an ever expanding budget deficit, the US Federal Government has continued to spend over 60% more than they receive in tax revenue (compared to a 'responsible' 32% overspend in the UK). The lack of consensus amongst legislators makes an active decision less likely and the self-imposed debt ceiling (currently at $14.3tn) looks set to be increased in the weeks ahead, yet again. Since 1960, Congress has acted 78 separate times to increase the debt limit.

We may sound like a broken record but for us debt, and sovereign debt in particular, remains one of the two key issues determining the outlook for real returns (inflation being the other). No matter how you carve the hog, the US debt numbers do not look appetising. This year, the Federal Government is expected to run a deficit of $1.4tn (10% of US GDP) following the $1.3tn in 2010 and $1.4tn in 2009. We note that the $1.4tn deficit ***equals*** the entire US federal budget for 1993. In addition to funding the annual deficit, $4tn of debt will need to be rolled over during the next three years.

Standard & Poor's has, at last, caught up with these numbers and has downgraded the outlook of US sovereign debt from 'stable' to 'negative'. Credit rating agencies have hardly covered themselves in glory in recent years with their belated downgrades to mortgage and bank debt during the financial crisis of 2007/8. They have a tendency of stating the obvious but the reluctance by Congress to deal with the deficit provides a good indication of the politicians' intractable problem. Cutting the deficit and ultimately repaying debt will require both spending cuts and tax rises on a mammoth scale – this remains unpalatable for politicians wanting re-election.

In the coming months the market's focus will be on the completion of the latest sequence of quantitative easing (QE) in the US, and then increasingly on the prospect of further monetisation of debt. While the Fed has confirmed the end of QE2, our expectation is that after a pause, which may result in some US dollar strengthening and weaker stock markets, there will be a third round of QE later this year or early in 2012.

The British have offered their American cousins a template 'solution' to the problem - a Faustian pact between the Treasury and the Bank of England. The Treasury engages in austerity, withdrawing its fiscal stimulus, whilst in synchronisation the Bank maintains its monetary stimulus via zero interest rates and QE (when necessary). This cosy arrangement ensures that the Treasury turns a blind eye to inflation in excess of the Bank's mandated target.

Comfortably numb

Attempts to keep interest rates artificially low are as old as the hills. In the ten years ended 1951, the Federal Reserve pegged the long bond rate at 2.5% to facilitate WWII borrowing and to prevent a jump in bond yields after the war. Numerous newspaper column inches have been given to the possibility of explicit sovereign default, particularly with regard to the ongoing woes in the Eurozone. But debt restructuring does not have to be so sudden and violent. It can be difficult to detect, gradual and occur over a prolonged period. A recent National Bureau of Economic Research (NBER) working paper, "The Liquidation of Government Debts" by Carmen Reinhart and M. Belen Sbrancia, demonstrates how "*financial repression*" was used after WWII to alleviate crushing debt burdens. This is a subtle form of debt restructuring and is a combination of actions to maintain negative real interest rates. For short term rates this is easy but for treasury yields the central bank may cap long-term interest rates. Regulation of banks and insurance companies imposes requirements to retain higher levels of capital and liquidity providing demand for government bonds. Exchange controls may also provide a "forced home bias" to the assets purchased by financial institutions. *In extremis* there is the potential for the introduction of capital controls.

The 35 year *financial repression* period up until 1980 offered investors low real interest rates (often negative) with above average inflation rates – thereby devaluing debts to the cost to the saver.

"*For the US and the UK, the liquidation of debt via negative real interest rates amounted to 3 to 4% of GDP on average per year. Such annual deficit reduction quickly accumulates (even without compounding) to 30-40% over a decade*" – savers are thereby quietly being swindled as their purchasing power dwindles.

Policies enacted since the financial crisis have a ring of familiarity to those engaged during the 1945 to 1980 period. The Federal Reserve keeps short-term interest rates at zero whilst its purchases of government bonds (funded by money printing) are an attempt to put a ceiling on long-term rates. Macro-prudential regulation ensures that European pension funds and banks are forced to buy government bonds below free market interest rates. The tools this time around may be different but the outcome is essentially the same: the saver gets "*skunked*" as the "*Bond King*", Bill Gross of PIMCO, would say. With austerity and default such unpopular options, American leaders may quietly opt for this policy and hope that no one notices – as savers are doped up on dishonest money. Will markets permit such a policy to prevail over the required long period of time, in this instance?

£100 to fill the tank

Clearly this is not sustainable forever and what usually goes wrong is that inflation, once argued as temporary, (as both Mervyn King and Ben Bernanke currently tell us with a straight face) becomes imbedded.

Back in the mid 70s, I can recall my father asking the petrol pump attendant (they were called '*service stations*' in those days) to "fill her up please with £5 of four star". Today the cost is heading up towards three figures. While much of this increase is tax (the oil price has merely quadrupled since 1980) it provides a glimpse at the rise in the cost of living in Britain over 30 years. While central bankers attempt to bamboozle us with "core" consumer price indices, which conveniently exclude food and energy, we continue to invest in inflation protection via index linked bonds (linked to the RPI) and market-leading companies with genuine pricing power such as BAT Industries, Coca-Cola, Unilever and Nestlé.

What to do Winnie the Pooh?

Investors should take heed from the wise words of Winnie the Pooh, "*Don't underestimate the power of doing nothing*". The risks of being whip-sawed in this rollercoaster market remain high. We prefer to have a plan and stick to it and so have made very few changes to the portfolios in recent months.

Market volatility has offered plenty of traps for hyperactive traders to fall into. Given all the news that has been thrown at investors in the past three months—Middle East and North African uprisings, continuing spikes in European periphery bond yields (2-year Greek sovereign yields have hit over 20% in recent days) and the oil price, and a Japanese earthquake followed by a tsunami—one would have thought that stocks should have fallen. That market falls have been quickly followed by recoveries is testament to the power of money printing in distorting asset prices.

At a roundtable of investors and strategists, I attended recently, it was said that 'micro' stock pickers tend to outperform a rising market but subsequently lose disproportionately in subsequent falls while 'macro' managers – top-down investors - do the opposite – lagging in rising markets but holding up well in times of trouble. The latter strategy seems most appropriate for private investors with irreplaceable capital, who tend to be more concerned with the downside and it is the one we will continue to follow until we have greater certainty of both valuations and the outlook.

We recently met up with Dylan Grice, strategist at Societe Generale, who encapsulated the challenge so well, "The only certainties are instability and uncertainty". Both will, in time provide us with great opportunities but until that point Pooh's advice is worth taking.

Bubblicious

With the gold price continuing to rise in paper money terms, there has been much idle talk of a bubble building, particularly by those who have never owned or recommended it. There have been a number of impulsive attempts by commentators, investors and journalists to ring the bell and call the top.

In a recent article in *The Times,* "The end of the golden age will soon be with us", Bill Emmott opined that "The trouble with gold is that, just like paper currencies, it has no intrinsic value". Nothing could be further from the truth; gold has always had intrinsic value whereas paper currencies have come and gone. I recently acquired a number of 50 trillion Zimbabwe dollar notes. A fine example that large numbers are meaningless and that money and wealth are not the same thing.

James Grant, of the *Grant's Interest Rate Observer,* sums up the question of the gold price well:

"*To me, the gold price takes the form of a very uncomplicated formula, and all you have to do is divided one by 'n'. And 'n' I'm glad you ask is the world's trust in the institution of paper money and in the capacity of people like Ben Bernanke to manage it. So the* *smaller the 'n' the bigger the price*."

Updated versions of *financial repression* only increase our faith in the merits of continuing to hold the yellow metal.

If only Mr Emmott had seen this remarkable story, posted on the same day in the Hackney Citizen, "Hackney hoard of gold fails to count as treasure, court rules" (see link http://hackneycitizen.co.uk/2011/04/25/hackney-hoard-of-gold-coins-fails-to-count-as-treasure-court-rules/)

The article tells of the forward thinking Mr Martin Sulzbacher, a German Jewish banker, who hid a hoard of 80 gold coins in a garden and subsequently had a streak of bad luck which included internment. He never found the coins but they were discovered by a local resident in Hackney and have been returned to Mr Sulzbacher's son. At a value of £100,000, no paper money could have preserved wealth better over the 70 years.

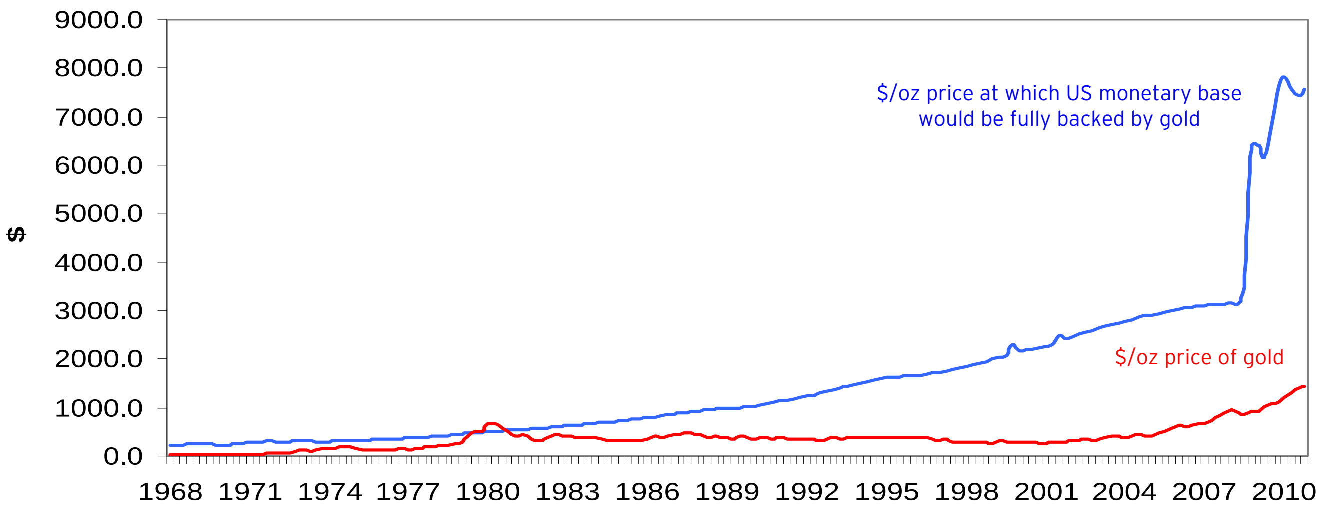
I was asked recently by an investor "what is the difference between gold and tulips?" Mr Sulzbacher's relations can happily answer that question. With only 0.6% of global financial assets invested in gold (compared to 3% in 1980) and with the supply of paper money increasing at an exponential rate – see chart below - we are way off bubble territory.

Sebastian Lyon

May 2011

Is gold expensive or is it getting cheaper?

The price of gold at which the USD would be fully backed by gold is $7,500/oz



Source: SG Cross Asset Research