Investment Report N°37

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

Deleveraging, here to stay

"When you borrow a lot of money to create a false prosperity, you import the future to the present. It isn't the actual future so much as some grotesque silicone version of it. Leverage buys you a glimpse of prosperity – you haven't really earned."
Michael Lewis (*Boomerang – the Meltdown Tour*)

Spain is experiencing reality after being forced by the bond vigilantes to wake up from the dream that ever more debt earns ever greater prosperity. A Spanish investor and friend of Troy contacted me in early September to ask what I had read over the summer and what I might recommend. Was this a test? I happened to know she is a keen advocate of the Austrian School of Economics and I soon admitted that I had chickened out of reading all 1,027 pages of Ludwig von Mises's *magnum opus*, *Human Action: A Treatise on Economics* for another year and settled for some lighter reading, including Michael Lewis's *Boomerang*. Just like elected politicians, I keep deferring the necessary pain.

Fire or Ice?

Our emphasis, since 2008, has been on preparation for the inflationary fire we expect will start sooner or later, although guessing when prices will start rising sharply again remains as problematic as ever. This does not mean that a 'Little Ice Age' of deflation may not precede it. Timing asset allocation for both outcomes is impossible, so we have to attempt to position the balanced portfolios (including Trojan Fund and Personal Assets) for both eventualities. In our last investment report (N°36) we referred to the unhelpful description of *"Risk-on, Risk-off"* markets. There is some logic in the schizophrenic pricing of various assets because different and opposite assets are required for inflation or deflation (with the debatable exception of gold). This is why we have structured the portfolios by building on four 'pillars' - blue chip equities, index-linked bonds, gold bullion (including gold mining shares) and cash. This is more fully explained in our latest Trojan Fund interim report for the six months ended 31st July 2012 - see link http://www.capitafinancial.com/Investor-services-fund-information-uk-funds.aspx.

One observer pondered if we had decided to have one leg in the freezer and the other in the oven to maintain our overall ambient temperature. We appreciate the dry humour, but the accumulation of debt and other imbalances has paradoxically increased the odds of both an inflationary meltdown and a deflationary ice age.

The more obvious but less likely source of a deflationary shock will be the US, in the shape of the 'fiscal cliff'. However, if the past is any guide to the future, politicians would look into the abyss and increase the federal debt ceiling, as they always have since 1917. The unexpected quarter, from where a shock could emerge, is China.

Delicate China

Contrary to popular belief, it is neither the US nor the UK that has been the worst/best for

monetary growth. Emerging markets, and China in particular, have expanded their money supply in order to keep their currencies from appreciating. As Russell Napier from CLSA pointed out to us, China's Capital Account Reserves (*see Figure 1 on Page 5*), which had been growing at a rate of up to 50% a year for a decade or more, have stopped expanding. This could be a game changer for the world economy. The last time there was such a collapse was in 1998 – when a deflationary shock led to Russia's default. Since 2007, China's export prices are down 6%, while wages are up by 70%. Profit margins (for capital providers) have taken the strain and returns on capital have fallen. It is no wonder the Shanghai stock market is making four year lows (high growth does not always lead to high returns). The result: China's currency is much less competitive than previously thought. The way out of this quandary is the invidious choice between deflation and devaluation. Politicians are likely to choose the latter. We will watch with interest.

A visit to Hong Kong last month convinced us that those closest to China are most aware of its declining growth. The world's primary economic engine of the past three years is spluttering and those furthest away are the most confident of a soft landing. The need to shift China's economy from its reliance on infrastructure investment and export-led growth to a more consumer-based model is an aspiration that many agree on. This transition is unlikely to be seamless but the potential remains, in the longer term, for western companies seeking to serve Chinese consumers. Successful rebalancing of the economy could mean short-term pain for longer-term gain.

Synchronised slowdown

Economic momentum has slowed throughout 2012. GDP forecasts have drifted downwards and the burden of lifting the Western world out of its financial morass has seemingly fallen to the US and Germany. This is despite both countries 'enjoying' growth well below their historic rates. Our caution on the UK has been justified by a string of downgrades from the Office of Budget Responsibility and the IMF. Of the major developed nations only Italy and Spain are expected to fare worse in 2013.

As night follows day, so with falling GDP forecasts come reductions in earnings estimates, which have been in reverse gear all year. This implies stock markets have been driven up by a reduction in investors' risk aversion, probably thanks to disaster having been averted in Europe, for now. Equities are the last refuge for income starved investors. Currently, they are willing to pay more for fewer earnings. This is a bit like a bargain hunter stepping out onto Oxford Street at the end of London Fashion Week, rather than waiting until the January Sales.

A flat financial world

On the wall at my bank there is a sign that is beginning to fade with age. It reads, "*With effect from 22nd May 2009 this bank's Base Rate is 3%*" (the bank's actual deposit rates are at or below 0.5%). We live in a strange world where the Bank of England's Base Rate has been unchanged since March 2009 and the eventuality of a rise in the rate of interest seems to slip further and further away. We reflect on the contrast with 1988 when the UK Base Rate was changed twelve times in twelve months. Stable interest rate regimes are not unique. During the last period of such

stability, from June 1932 to October 1951, the Base Rate remained stuck at 2% (with the exception of a blip up to 4% in autumn 1939 that lasted two months). The period ended with inflation, but not before a prolonged period of stasis. Today, once again, central bankers are no longer preoccupied with setting the Base Rate.

QE - to infinity and beyond

While at present we are concentrating on deflationary threats, our longer term concerns are with the on-going bull market in central bank balance sheets which will, ultimately, lead to inflation. In September, the Federal Reserve announced a third round of quantitative easing (or 'credit easing' as Dr Bernanke prefers to call it), taking a further step away from raising rates. The announcement of more QE was not a particular surprise, but the Fed's decision to go 'open-ended' very much was. It is a significant change to policy. In committing to purchase $40bn of assets a month, it would take the Fed three years to replicate the degree of expansion achieved by QE1 between 2008 and 2010. Nevertheless, because the Fed has gone 'open ended' the target can now be expanded at will. Dr Bernanke has come a long way from the principles of former Fed Chairman and Presbyterian, William McChesney Martin, who said the job of the Fed was to "*take away the punchbowl just as the party gets going*". Today the Fed appears to be the barman not calling Time, but an extended Happy Hour!

The US has followed where the UK has led. In the same month the Bank of England confirmed it would "*continue with its programme of asset purchases totalling £375 billion, financed by the issuance of central bank reserves*." This is a game of leapfrog in currency debasement and neither the ECB nor the Bank of Japan wants to be left watching from the side of the playground. Therefore, in September, the Bank of Japan also announced a new round of QE but this was modest by historical standards. It looked like a rather half-hearted attempt to prevent the Yen from strengthening any further. According to Nomura, if we rebase the monetary base to 100, since 2008 the UK has grown to 399, the US stands at 310 while Japan is just 137 (Singapore has barely increased at all). No wonder the Yen has strengthened.

Mopping up

The question remains, does QE work? We have our doubts. The UK, coming first in the race to debase is suffering from a double dip recession. QE does not appear to be succeeding but there are broader concerns. Private demand for debt remains subdued. This can be seen (*see Figure 2 on page 5*) by looking at the fall in broad money growth (M4). Mervyn King's printing has failed, so far, to offset deleveraging. Should demand for debt increase or concerns over the currency's credibility rise, then the Bank of England (or the Fed) will need to mop up excess liquidity quickly by reversing the QE process. This will be difficult, as there is bound to be resistance from their political masters. With base money three to four times the level of 2008 and rising, prices could spike sharply. Inflation rates higher than those witnessed in the 1970s cannot be ruled out. The central bankers will need to sell those bonds (treasuries, gilts or mortgage backed securities), which would put upward pressure on yields just at a time when the economy and lending is recovering. Will they be up to the task? And why do investors so often lose sight of the iron rule, that higher

yields mean lower prices – for bonds axiomatically, and for equities too, in the absence of dividend growth. Ben Bernanke admitted in November 2010 that QE targeted a higher stock market and a rising wealth effect. Since September's announcements stock markets have rallied only modestly. Like interest rate decisions before them, there is a growing recognition that QE is suffering from the law of diminishing returns. Perhaps investors are beginning to worry that any benefits of the policy will be offset by an exit.

Share prices may be buoyed, temporarily, by liquidity but ultimately they must be justified by earnings and dividends. Dr Bernanke would undoubtedly be pleased to see stock market valuations re-rated upwards, but this will not happen unless investors see an improving economic picture. Higher valuations not backed by growth cannot last. With the US stock market now trading above 100% of GDP for the third time since 1970 it seems we are not being paid to take risk. The other two times were in the late 1990s and 2006/7 and both ended badly.

Templeton's different way

Returning to my summer reading, I could not resist Jonathan Davis's latest book (with Alasdair Nairn) *Templeton's Way with Money: Strategies and Philosophies of A Legendary Investor*. John Templeton is, indisputably, one of the best stock pickers of all time. In addition to advice from this guru that might be obvious, if hard to follow, such as "*Buy cheap stocks*" and "*the best time to invest is at the point of maximum pessimism*", other quotes are more profound, "*Great Prosperity only occurs when the people are free. If we regulate, we slow down and perhaps prevent - even reverse – the trend towards prosperity*". We can have a good guess as to what he would make of today's monetary shenanigans.

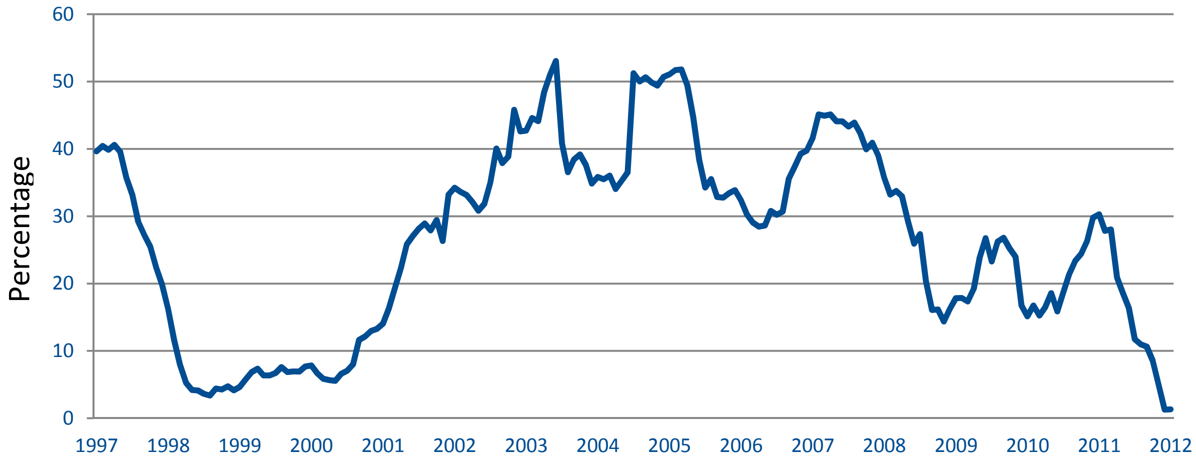
What is perhaps less well known was that Templeton generated much of his early success thanks to asset allocation and not stock picking. His view was that investors should "*adjust their exposure to the stock market in light of the prevailing valuation. If there are not enough cheap stocks to buy then the investor should simply park his or her money in cash... and wait for the next turn in the cycle... holding cash has two distinct advantages in overvalued markets (1) it avoids losses as and when valuations revert to their long term average and (2) those with cash on hand are in a position to profit when the market finally turns.*" Troy's investors will not be surprised to hear that we have great sympathy with this view.

Sebastian Lyon October 2012

The views expressed in this report are not intended as an offer or solicitation for the purchase or sale of any investment or financial instrument. The information contained in this document does not constitute investment advice and should not be used as the basis of any investment decision. References to specific securities are included for the purposes of illustration only and should not be construed as a recommendation to buy or sell these securities. Although Troy uses all reasonable skill and care in compiling this report and considers the information to be reliable, no warranty is given as to its accuracy or completeness. The opinions expressed accurately reflect the views of Troy at the date of this document and, whilst the opinions stated are honestly held, they are not guarantees and should not be relied upon and may be subject to change without notice. The investments discussed may fluctuate in value and investors may get back less than they invested. Past performance is not a guide to future performance and the investment approach and process described may not be suitable for all investors. The information contained in this report is not for distribution, and does not constitute an offer to sell or the solicitation of any offer to buy any securities, in the USA to or for the benefit of US persons. Issued by Troy Asset Management Limited, Brookfield House, 44 Davies Street, London W1K 5JA (registered in England & Wales No. 3930846). Registered office: Hill House, 1 Little New Street, London EC4A 3TR. Authorised and Regulated by the Financial Services Authority (registration No: 195764).

Is this the Most Important Chart in the World?

China (Capital Account) Reserve Growth (% YoY)

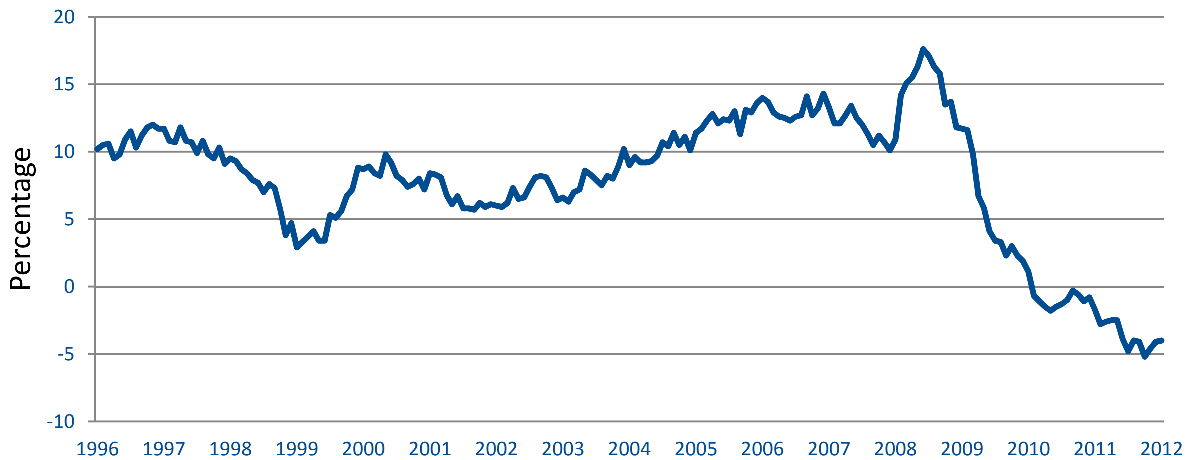


Growth of 50% p.a. at an end – China has stopped creating RMB

Figure 1 *Source CLSA/Bloomberg*

Does Money Growth Lead to Inflation?

UK M4 Growth (% YoY)



Sir Mervyn King's printing press is offset by deleveraging...for now

Figure 2 *Source Bloomberg*