HARGREAVEHALE

INVESTMENT BULLETIN

The Impact of Negative Real Interest Rates

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Registered and settlement office: 9-11 Neptune Court, Hallam Way, Blackpool FY4 5LZ
Telephone: +44 (0) 1253 754700, www.hargreave-hale.co.uk
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In the December Bulletin, we forecast, correctly as it turned out, that the Long Term Refinancing operation put in place that month by the ECB would turn Stockmarket sentiment. Lending 490 billion Euros to 523 European Banks at 1% for three years, with hints of rollover at the redemption date term did the trick. The banks had to deliver collateral, it is true, but the ECB appeared happy to turn a blind eye to the specific quality of that collateral. The fiscally prudent Germans were blind sided, and the harsh deflationary impact of European interest rate hikes and Basle 3 capital constraints, both crazily timed policy initiatives from the Authorities, was thankfully avoided.

And anticipation of a repeat performance continued to fuel the Stockmarkets New Year rally, the strongest since 1991. Last Wednesday, the ECB lent another 530 billion Euros to no less than 800 European Banks. Some of this money was used to pay off debt, probably around half, the rest has mainly to date been used to buy sovereign debt yielding 5% to 7%. Not a bad turn and it helps fund the rollover of sovereign debt up for redemption. Well done Mr Draghi, you are for now a hero.

However, beware confusing what is no more than a liquidity driven relief rally with something more substantial, a rally based on fundamentals like realistic debt recognition finally enabling loan expansion by the banks to their industrial clients. This is a long way away.

The Banks are still bust, and they cannot allow their loan books to be valued in a realistic manner. Tier 1 capital levels remain too small for the "too big to fail" banks. And conditions are generally negative for Bank profitability. Interest rates low, yield curves are flat, growth is weak, and Countries, consumers and mid sized Corporates remain over leveraged. The snail like process of rebuilding margins is now underway. By way of example, Halifax has recently written to borrowers telling them that it is increasing the cap on its standard variable rate from 3 percentage points to above bank rate to 3.75%. If it then acted to move its rate up in line with the cap, then around one million UK borrowers would end up paying 4.25% on their mortgage as opposed to 3.5%. Best not to get too optimistic about the UK housing market. And in terms of snails it is quite difficult to appreciate the sheer size of the debt recognition problem.

For the European Banking sector to return to debt levels which are low enough to encourage non inflationary growth, would require deleveraging of 4.2 trillion Euros, equivalent to 47% of European GDP. It simply cannot happen in the foreseeable future.

So investors should have no illusions about the nature of the rally, why it has happened and what it actually means. To spell it out, this rally is a recognition that the European Banks will not be allowed to go bust, and little else.

The"Little Else" bit is interesting. It all hinges on growth. Continued growth in emerging markets, a serious recovery in the US, and the possibility of some recovery in Europe in the second half of 2012. Let us be optimistic about the first two existing trends continuing and assume that Europe as a whole grows marginally in the second half of the year as austerity measures in the peripheral economies is offset by export led German growth. But, whichever way you look at it, such recovery is going to be something of a grind. What is clearly needed is a sharp burst of serious inflation to destroy the value of our debt mountain.

And this is what the Authorities are trying to induce. And the sheer magnitude of the attempt is astounding. Since January 2009, the US Federal Reserve has printed so many dollars that its balance sheet has expanded from around $900 billion to $1.6 trillion. Nearly doubled. Step forward Sir Mervyn of the Bank of England. According to the Debt Management Office, the total market value of the UK Gilts market is £1.1 trillion, of which approximately £200 billion is index linked and the remainder is conventional. This compares with a total value of £600 billion in 2008. So who has bought all these gilts? It turns out that the Bank of England has bought over half of the new debt issued. As a result the Bank of England now owns around 30% of the UK conventional gilt market, bought by the electronic creation of money.

There is a close correlation between the creation of dollars and sterling and the level of US and UK Stockmarkets. Which is why the markets took something of a breather when Chairman of the Fed, Bernanke failed to hint last week that he might embark on another round of QE, otherwise known as printing notes.

There are two main risks to "inflation creation" scenario and therefore Stockmarket Buoyancy going forward. The first is the creation of such a quantum of inflation that interest rates have to rise. The second is mayhem in Europe on such a scale that austerity measures cannot be implemented and the European Union breaks up.

Given the huge expansion of the monetary base that has recently taken place, it makes sense not to be too sanguine about a big burst in inflation. But as in Japan following the biggest property bust up in history and a massive Central Bank monetary expansion, putting an expanded monetary base to work might not be easy. You need demand for loans from consumers and you need the banks to be keen to lend. In Japan consumers, burdened by property related debt were not keen to borrow more and the Japanese "zombie" banks who could not write-down their loan books were unable to lend. You could argue and many commentators do, that the European experience could mirror Japan's.

If this is broadly the case, it is difficult to see inflation rising rapidly. European Consumers have been saving as much as they can for some time but their ability to negotiate wage increases is very limited and is likely to remain so. There is always the underlying threat to inflation from agricultural shortages and a rise in "soft" commodities. But with GDP growth in Western Economies still weak the likelihood of a commensurate increase in “hard" industrial commodities seems small. Europe, after all is the largest consumer market in the world, with a global market share of 26%. The Chinese, Brazilian and Indian Central Banks remain keen to slow their economies, whilst the US GDP recovery remains patchy.

As a result, most economists are relatively bearish about the outlook for industrial metals. A typical integrated Bank forecast for such metals would be relatively bearish. Copper, $ per lb falling from $4.05 in 2011 to $3.75, in the current year lead from $1.22 to $1.04, Zinc from $1.06 to $0.90, nickel $10.38 to $8.50, and Aluminium from $1.09 to 0.95.

Obviously the price of oil is an exception. Some oil industry executives we meet consider that the market in oil futures is heavily influenced by financial speculation rather than pure industry supply and demand. Each commodity has its own demand/supply characteristics but speculation regarding an attack on Iran leading to supply shortages clearly has had an impact on pricing. Only yesterday, reports that an oil pipeline in Saudi had been destroyed were denied. Clearly the rising price of oil has an inflationary impact on the pharma, food and beverage industry as well as on plastics, speciality chemicals and so on. However, it seems unlikely that the Obama administration would be foolish enough to countenance an attack on Iran given the impact this would have on consumer and industrial costs and therefore GDP growth in an election year. As a result, there must be a good chance that the "war" premium attaching to oil prices reduces. In addition, as China plans to match US investment into its own large reserves of shale oil and gas, there is every argument for the release of oil from the US strategic Stockpile in the event of a short term supply shock. The higher the current oil price, the higher the incentive to invest into shale recovery and infrastructure delivery. The risk to the Stockmarket as a result of higher than expected inflation therefore seems limited at the moment.

The second risk is mayhem in Europe. The liquidity driven rally in Stockmarkets has avoided a spiral of Bank deleveraging and resulting deflation. But it has also triggered a return of confidence to Stockmarkets and with it some complacency. Too many people now seem to believe that a Greek exit from the Euro can be contained. This is not so. Complacency implies that the Euro is reversible. At present, this is not the case. There exists no mechanism by which a country can exit the Euro area, once having joined. This is because once a country, even with a small economy such as Greece leaves the Euro, a Euro held in another particular country more immediately likely to abandon the Euro than other countries becomes a weaker kind of Euro than in a country more likely to keep it. This inevitably means a run on Euro deposits within weaker economic areas of Europe and a panic rush into deposits in stronger economic areas. And as things stand there is nothing much that the ECB would be able to do. This is because of counter party risk, as the National Central Bank of a Country which has decided to leave might well default on its obligations towards the rest of the Union. There will be no hiding place. The important point is that until Europe has fully developed fiscal, banking and political integration, it is highly vulnerable to a breakup as a result of just one member deciding to exit. It is truly amazing that Euroland has been constructed in such a manner.

It is to be hoped that the political elite who constructed the edifice in the first place are fully aware of its vulnerability. If they are, they will cheer on every attempt by the European Central Bank to inflate away Euro debt, and give only lip service to the much promised austerity programmes now being put in place. The German Electorate in particular must forget about the Weimar Republic and remember that it was the Weimar politicians and Central bankers who inflated away the debt created by French war reparations and enabled reconstruction to go forward. Failure to compromise by politicians remains the big risk to Stockmarket stability.

For Stockmarkets to remain buoyant therefore, we need a combination of continued monetisation of debt and sufficient liquidity to prevent a rise in interest rates. We need Western GDP growth of 1 / 2% and continuing budgetary restraint so that fiscal deficits are reduced. We need Emerging Market GDP to slow and limited pressure on commodity prices. And we need the Authorities to turn a blind eye where possible to any lapses in European Austerity programmes. Above all we need to realise that no country can exit the Euro. So talk big about Austerity but do nothing other than provide sufficient liquidity to refinance Sovereign debt. And ideally, we need inflation to erode debt at the rate of 4 / 5% a year. And we need the Authorities to continue to rig the market comprehensively as they are doing at present to ensure that nominal interest rates are very low with real inflation adjusted returns negative to penalise investors who stay out of markets. Investors should keep an eye on US Treasury long dated yields as well as the price of gold as the two best measures of the Authorities success in defying gravity. The "Indian Rope Trick" springs to mind.

Sadly, savers and pensioners as well as pension providers are victims of such negative interest rate policies. The “Save the Savers" website suggests that the average return on savings in the UK amounting to some £1.2 trillion is just 1.6%. Reflecting the sharp fall in long term bond yields, annuity rates have crashed in the last three years from around £8400 per £100,000 invested to just £5400.This does, unfortunately make something of a nonsense of annuities. Why give a pension provider £100,000 to secure an annuity of £5400, when you can invest £100,000 in a high yield portfolio to yield probably up to £6000. And in the latter instance you get to keep the capital. It does not make sense. Of course things could change in the existing structure of interest rates, but sadly from the savers point of view, it does not appear too likely in the foreseeable future.

For example, historically, savers in the UK could expect average inflation adjusted returns of 2% on their money. With inflation in the UK now running at probably just under 4%, it would historically be the case that investors could now expect nominal interest rates of 6%.

Unfortunately this cannot be allowed to happen. If interest rates were raised to 6% to compensate savers, it would have a major and seriously adverse impact not just on the leveraged banking community but on Stockmarkets, bond markets and housing markets worldwide. As a result, savers will not only have to continue to carry the can to protect, amongst other things, banker's bonuses, but they also have to look very carefully at the cost effectiveness and the manner of their own method of saving. There is a clear case for change.

There was a brave article in the FT recently by Merryn Somerset Webb (25th Feb) entitled: "Pensions.... frankly, who needs them". The gist of it was that Pensions are complicated, confusing, expensive to administer, they are not tax free, they just defer tax..... people are endlessly bamboozled by an industry that has complexity on its side. And so on. Their sheer complexity makes them endlessly subject to politicians seeking money, most recently tax relief changes for higher rate taxpayers, muted in the forthcoming budget. And being forced into low yielding annuities when interest rate returns are artificially manipulated by Governments via QE is unfair to say the least. And of course a well invested portfolio of higher yielding equities and bonds can currently match the returns available on annuities and investors in such portfolios retain their capital.

According to Merryn Somerset Webb it is much more sensible as well as simpler to invest in tax efficient ISA’s. No fussing about the tax implications of reinvesting dividends.....no expensive meetings with tax advisors about complicated tax saving devices. If you start early enough you can enjoy fifty years of tax free compounding dividends. If you fall on hard times you can take money out without losing any tax breaks...... no more rubbish jargon about open market annuity options, stakeholders defined benefit ... salary sacrifice. You are in control of your own money, you can do what you like with it and its simplicity makes it difficult for "advisors" to charge you too much. And your heirs can inherit the capital and you can even pair with investments in inheritance tax vehicles so that you can avoid inheritance tax. But critically you remain in control of your own money. You can at any stage say...to hell with this..... I am going on a world cruise and I am, with sound mind, going to fritter away my children's inheritance ... it is up to you. It is not subject to a raft of Government regulation which is often mind blowingly difficult to understand.

All you really need is advice on long term value investing from your Stockbroker.

George Finlay

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HARGREAVEHALE

Office Network

Registered Office: 9-11 Neptune Court,
Hallam Way,
Blackpool FY4 5LZ
Tel: 01253 754700

London: Accurist House,
44 Baker Street,
London W1U 7AL
Tel: 020 7009 4900

Blackpool: 4 Neptune Court
Hallam Way,
Blackpool FY4 5LZ
Tel: 01253 621575

Lancaster: 25 Brock Street
Lancaster LA1 1UR
Tel: 01524 541560

Bangor: 2nd Floor,
30 Dean Street, Bangor
Gwynedd LL57 1UR
Tel: 01248 353242

Worcester: Virginia House,
The Butts,
Worcester,
Worcestershire, WR1 3PL
Tel: 01905 723551

Carlisle: 10b Clifford Court
Cooper Way
Parkhouse, Carlisle
Cumbria CA3 0JG
Tel: 01228 515224

Direct Deal: Virginia House,
The Butts,
Worcester, Worcestershire,
WR1 3PL
Tel: 01905 734988

Email: bulletin@hargreave-hale.co.uk

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