HARGREAVEHALE

INVESTMENT BULLETIN

HOPE YOU HAD A NICE HOLIDAY

6th September 2011

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August, in case you missed it was an interesting month. It was almost as if the speculators, hedge funds, investment banks call them what you like had conspired together to cause mayhem when the policy makers were off on the beach. It has to be remembered that these financial creatures have generally had it rather tough this year. There have been rumours of lay offs on a large scale. Partly trading has been unusually difficult but partly there has been a distinct lack of new financial products to feed markets. There has been the developing "flash trading" product which has added to market instability, but new weapons of financial destruction have not been hitting the markets as in the past. For example, in the year before the tragic abolition of the Glass-Steigal act in 1999, which had provided banking stability for a generation by ensuring the separation of commercial and investment banking, trade instruments such as mortgage backed securities and collateralised debt obligations represented just five per cent of all mortgage lending. By the time the credit crisis peaked in 2008, they represented thirty per cent of the market and mathematicians with first class degrees from Oxbridge were being recruited to invent ever more complex derivative products which, truth be told few practitioners actually understood, let alone were able to value.

In reality, politicians and policy markets have created a series of financial monsters which even now they are struggling to control. Monsters are not an exaggeration because some, like RBS for example have balance sheets the size of large European countries. The UK banks between them represent in asset terms no less than 345% of UK GDP. And they have extreme lobbying power. Not just lobbying power but tax take power with the City said to be contributing nearly fifteen per cent of the UK's tax take. It takes a strong politician to do the right thing and bring back a version of Glass Steigal. Bankers are supposed to take in deposits and lend on a judicious basis to individuals and corporations. They are not there to take in deposits which are then used to punt in derivative and commodity markets, award themselves silly bonuses if they win and if they lose, expect to be bailed out by the taxpayer.

Unfortunately there is probably going to be an unholy compromise. New capital and solvency rules will likely be introduced which will enable politicians to say that structures are in place which will protect commercial banking from insolvency in the event of investment bankers going under. There is likely to be no formal separation. This is unfortunate to say the least because the effect will be to over capitalise commercial banking and ensure that loan growth going forward is at best tepid. We need much bolder leadership from our policymakers. The Vickers report on the banking system is likely to be published in the next few weeks and could well advocate a legally separate retail division. This is the only way to go in the longer term but it has been rumoured that the lobbyists have got to Cameron.

It is vital that European and US politicians recognise what needs to be done and act accordingly. Post 2008, the decision making was in the hands of Central Bankers who were in the happy position of not being answerable to voters and could communicate with each other in a much more informal and therefore effective way. In the event they should be praised for acting decisively to prevent a banking crisis from developing into a depression. Large scale printing of notes, dignified by the term quantitative easing, bolstered assets such as equities, bonds and emerging market currencies and provided a short term palliative to enable banks to have liquidity and corporations to refinance themselves.

The success of the QE programme was partly underwritten by a continuing boom in consumer and industrial demand from emerging economies. This helped the profitability of those US and European corporates with a significant export component to their business and underwrote corporate earnings and price earnings multiples, thereby at least in part justifying the buoyancy of stock market valuations. At the same time, governments were able to keep interest rates low by effectively printing money, which was then used to provide banking liquidity and finance for rising public sector deficits.

This was something of an ‘Indian rope trick’, or the ‘Emperor has no clothes’ fairy tail. It only worked whilst inflation remained low. Post Lehman there was little problem with inflation because activity in the developed economies remained fairly subdued. The problem lay with the emerging economies against the background of much higher economic activity. QE money, as we now know had some unfortunate side effects. Not only did it fail to find its way into productive investment in

developed economies, it also delayed the implementation of programmes to reduce deficits in developed economies. This was because by printing notes to cover fiscal deficits it effectively monetised government debt. Not only that, QE poured into emerging market currencies creating inflation, resulting in countries like Brazil introducing interest rate penalties for importing money into their jurisdiction. Worse, aided it has to be said by Mother Nature's drought creating genius, QE created inflation in virtually all commodities, industrial and agricultural. This has lead to the Arab spring, possibly the Tottenham and Athens Spring and very possibly the Indian and Chinese Spring. We have not yet seen the US Spring, but inflation in the US has risen from 1% at the beginning of the year to 3.6% at present.

The harsh and extremely unwelcome truth is that QE has now outlived its usefulness. Not only that but a fresh dose could have serious consequences for the world economy. There are two main reasons for this. The first is that building fresh inflation momentum could create particular problems for China. The Chinese Authorities have increased the reserve ratio of the banks nine times since last October. The reserve ratio is the amount of money banks are required to keep on deposit with the Central Bank calculated as a percentage of the individual banks own deposits. Despite this, property prices and consumer prices are rising at 6.5%, regarded by the Authorities as politically dangerous. The Authorities in China have been much more strident recently in their criticism of the US accusing them of deliberately depreciating their currency via QE. The US Fed has to listen because if the Chinese stopped buying US Treasuries then interest rates would probably have to rise to fund the US budget deficit. It looks as though the Chinese have drawn a line in the sand and said: no more QE.

And the second main reason that QE has outlived its usefulness, lies in the valuations of US Treasuries, both conventional and indexed linked. Index linked Treasuries are extremely expensive. The yield on the ten year US Treasury Inflation Protected securities has recently turned negative for the first time in history and conventional Treasuries throughout the developed world are riding for a fall with inflation in the EU nearly 3%, in the UK, nearly 5% and in the US 3.6%. Real returns are minus already and more inflation would probably cause a big bust in bond markets.

Strangely enough, the only beneficiaries of further QE, which has been hinted at by the Fed are the investment or casino banks who would enjoy another round of punting, underwritten by the taxpayer, as emerging market currencies and commodities and possibly equity markets were pumped up yet again. And this is the danger. Weak leadership takes what looks like the easy way out even though inflation in most world economies is at a much higher level than when QE 1 was first introduced.

In terms of the FED's remit, it has the power to use any monetary weapon to stabilse the system and/or to prevent deflation. At present deflation is not the issue, it is the return of inflation so it is unlikely that the FED will actually implement another round of QE in the immediate future. If it did happen, it could prove a most unwise gamble. It could lead to higher levels of inflation globally, and higher interest rates, not least in the US, if the Chinese make good their threats not to buy US Government bonds.

The alternative is not particularly attractive either. All the most recent evidence points to a slowdown in economic activity worldwide. This is extremely bad news for those Western Governments seeking to reduce their budget deficits and therefore their funding requirements via a combination of cutting public spending and higher GDP growth. Greece is a good example, with recent estimates of a contraction of up to 5% in GDP in their economy over the next year making a mockery of deficit reduction programmes. In Italy this week the Government assembled a profoundly unconvincing austerity programme which avoided any increase in direct or indirect taxation, depending instead on better tax collection, an intent which the Greek Authorities have had for some decades. Meanwhile, the US Republicans remain convinced that it is a sensible idea to cut Government spending against the background of a weak economy. Pity George Osborne, as he downgrades UK growth forecasts this Autumn.

If history is anything to go by, in particular events following the Wall Street crash of 1929 and the depression which followed, the next stage now is likely to produce a period of competitive currency devaluations. Politicians such as George Osborne will get solace from the belief that rising unemployment as a result of public sector cutbacks will be more than offset by private sector employment growth, such growth, given the weakness of the UK consumer being created as a result of increased exports. You can hear the same rhetoric coming out of the US and from a mix

of economists and politicians throughout out the world increasingly apologists for a return to the Peseta, the Lire, the Drachma, etc. And very convincing it is to markets, with the Greek one year Sovereign bond yielding 72%. Meanwhile the Japanese seek desperately to weaken the Yen with some suggestions as per the Brazilians for a tax on those seeking to invest in Yen denominated assets. And having learnt the hard way from recent experience, countries like Thailand and Vietnam, Switzerland and Japan are introducing measures to discourage currency inflows and/or shorting their own currencies. The end game, if all else fails, is protectionism and the imposition of tariffs, a most unlikely event but one worth keeping in the back of one's mind.

The reality is that competitive currency devaluations, however dressed up could now be on the way and once started it is difficult to see this process unravelling. And this is one good reason why people and Governments are buying one currency which cannot be devalued, which is gold.

The buying of gold started with hedging against the inflationary consequences of expanding the monetary base of Western nations via the quantitative easing programmes, but has recently become much more serious as a result of the slowdown of GDP growth worldwide. This happened following the Wall Street crash of 1929 when rising unemployment triggered the need for competitive currency devaluations in order to stimulate manufacturing employment/exports. At that time, the currencies of the big trading economies in the World were tied to the gold standard. In 1931, in order to devalue Sterling, the UK came off the gold standard. France followed. In the US, policymakers did the same thing but in a slightly more cunning way. In 1933, it was made a criminal offence punishable by up to ten years in jail, for a US national to hold gold. All citizens had to surrender their gold at the then official price of $20.67 per troy oz. One year later, the price per dollar of gold was raised to $35, a dollar devaluation of 75%.

Although currencies are no longer tied to gold, what happened in the four years post the 1929 Wall Street crash is instructive because it could happen here post the Lehman crash. If die hard gold bugs are to be believed, Central Banks are keen to sit on or try to collapse the gold price by a multitude of nefarious means because under "normal" conditions they are keen to prevent gold from being regarded as alternative currency. But occasionally, under unusual conditions, say conditions that happen every 75 years, conditions which could lead to social unrest, high unemployment etc, tie the hands of those remaining Central Bankers hostile to gold. In other words, you get a situation where no Central Banker worth his salt wants to preside over his own rising currency. Everybody wants to create a cheap currency to increase export markets. This scenario now looks like developing, with Central Bankers actually quite keen to create an alternative currency, gold, which then attracts inflows and by default reduces inflows into alternatives such as other Sovereign currencies.

Of course investors are not spoilt for choice when looking for other reasons to buy gold. The first is the very fragile Western banking system which is now facing huge compensation claims in the US for their involvement in toxic mortgage debt and alleged failure to effect due diligence. In addition, it does seem likely that at some point in the future, the Greeks will have to default. If this does happen, then there is the possibility of a severe attack from "Investment Banks" on Italian and Spanish bonds. At present the European stabilisation fund is supporting these markets to the tune of 20 billion Euros a week and this cannot continue, because of reserve limitations, for much more than another month. If the big banks were to take a hit on these bonds then write-downs and fresh funding would be required. Forewarnings about what might happen can be seen by the increasing reluctance by both Chinese and US banks to specific counterparty risk, despite the overabundance of liquidity in the system

Much of the Euro Sovereign bond crisis could be resolved by effective political action. But markets have grasped that it is one thing taking on a few Central Bankers who are well used to working with each other and did so very effectively in 2008 in terms of de-risking the banking crisis. It is quite another thing taking on a host of politicians representing a host of different interests in the babble of the European community. They have correctly identified that you cannot have fiscal unity without political unity. Hence the European adventure will end, but how or when, impossible to tell.

Gold thrives on uncertainty. Uncertainty because of what looks like an extreme bubble in bond markets. Uncertainty in relation to equities, in particular because of over optimistic earnings forecasts for 2012, which could be revised down in coming months. Uncertainty over currencies and the development of competitive devaluation. Uncertainty as to the bank deposit market, with big institutions increasingly stipulating that deposits should reside directly with Central Banks. And

finally the recognition that the easy option for over indebted economies remains devaluations and inflation. Ideal conditions for gold.

There is an interesting opportunity in gold equities at present. This is simply because equities with gold production and exploration are trading at an historic discount to the actual gold price. In theory, if you produce gold and the gold price goes up, the operational gearing in your business is such that the equity should outperform the metal. But strangely it is the other way round at present, reflecting the difficulties associated with the production process. Difficulties include the politics of permitting and licencing, the politics of black empowerment, the price of labour, the price of infrastructure, the price of electricity and so on.

None of these issues are necessarily going to go away although the upside to all these negatives is that it is increasingly difficult as well as costly to bring a new mine into production. Supply of gold going forward could become an issue. In any event, it is of interest that the median price of gold (according to Bloomberg 23 August 2011) used by analysts for their gold price projections going forward is just $1270 compared with the current price of $1870. As a result, if gold can hold above $1800 over the next two quarters, the earnings forecasts will be substantially upgraded. In some of the more highly geared operations, the upgrades could be spectacular. In the event that a magic wand cures the worries in the US and Europe over night, and gold does indeed collapse to the average analysts projections of $1270, investors still have some protection.

We confine our recommendations to two of the world's global leaders in gold production being Newmont (Medium Risk) and Goldcorp (Medium Risk). Both stocks are listed on various overseas exchanges but not the London Stock Exchange. Both businesses have production in politically neutral areas. Goldcorp, for example is operating mainly in Canada, North America and Mexico. Newmont has global operations, but the spread is so large that there is limited exposure to any specific region. Both have limited debt. Goldcorp has a yield of under one per cent, but Newmont has a "non binding guide line" that it will increase its dividend payout linked to the gold price. Newmont recently hiked its dividend by 50% to 30 cents a share equivalent to a yield of 2% but at current gold prices the equivalent dividend would equate to a yield of 3.1%. Target price per share on Newmont is $82 against a current price of $64, and target price of $75 for Goldcorp against a current price of $54. The respective market capitalisations are $27 billion for Newmont and $37 billion for Goldcorp.

Note: The author owns shares in both the stocks recommended in this article.

George Finlay

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