INVESTMENT REVIEW

It is normally rather fun to sit down with a blank piece of paper to see what happens when one starts to scribble away about the outlook for the financial world. This time it is a lot more daunting. It's not because there is a great deal of uncertainty about – the cattery of life always produces the same distinctive odour. The trouble is that everybody can perceive the many uncertainties in the world (which are therefore priced in), but the outcome of these uncertainties is impossible to call. The picture we are painting is one in which economic growth keeps chugging on through the gales, yet the weather conditions have the capacity to create an unprecedented maelstrom by which that economic growth may be horribly extinguished. This is no time for bold predictions, which have all the feel of Sir Humphrey's, 'Very brave, if I may say so, Prime Minister' about them. So this review is one for the doctor's surgery: ('on the one hand . . ., and on the other . . .').

Why do we talk of events being 'impossible to call'? One set of problems falls into the category of the shootout at OK Corral, with everybody pointing a gun at everybody else's head. The likelihood is always that commonsense will prevail, but the consequences of the opposite blow the mind. The Greek crisis is exactly described by this analogy: everybody has put their guns back in their holsters for the moment and the rally in the market over the quarter end was the outcome of relief that this problem is deferred. The budget overspend in the United States is only just entering its crisis phase, and this has a similar characteristic. We all assume that the politicians will find a last-minute settlement to the problem that the United States has got to the absolute upper level of what is allowed by law. We all know that the world will be a different place if this turns out to be too complacent a call and the reserve currency has to be readjusted for such a failure. Like so many of the world's problems, it is a problem partly technical (a legal requirement) and partly real (the US is heavily over-borrowed); they elide into a single event.

There is another set of problems, which come about from uncertainty generated by insufficient data. This can be summed up in one word: China. China is overheating; a dislocative slowdown would disrupt the financial markets, and this, in turn, would likely compromise the global economy. This dynamic was very visible in 2008 in the West: the trade crisis was not predictable, through the soundings of industrialists – trade responded to the mayhem in the financial world.

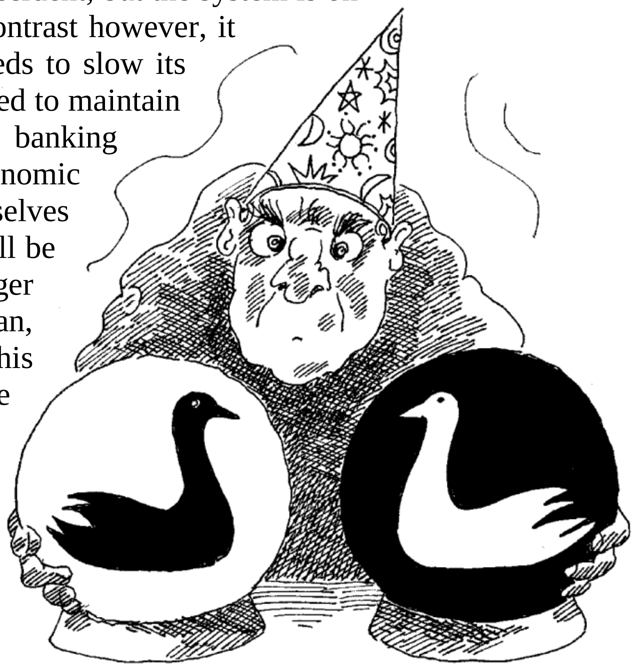
China has the capacity to derail the whole world, and they don't publish their railway timetable. The Central Bank of China, the PBOC, responded to the Lehman Brothers crisis in 2008 by expanding the monetary base in response to the deeply deflationary conditions. Money supply grew by 25% in 2009, and the authorities sought to close off the expansion. The experience of 2010 was instructive in demonstrating that in a modern financial system it is not easy to control the banks when there is an underlying dynamic for growth. Much of the growth in 2010 in China took place off-balance sheet and the result was another increase in money of nearly 30% last year after a 25% growth in 2009.

The choice that they face is to do nothing, or nothing much, with the danger that inflation will become systemic, but if the markets take fright at too comprehensive a Central Bank response, then the danger is of a sharp financial reverse, and a deflationary shock to the system.

The result of this is somewhat to change our thinking as to what has driven the performance of financial assets. For the past two years, the key question was whether reflation was the right judgement-call. It was, and a policy of selling the dollar and buying anything real has worked well, although any speed bumps needed the reverse of this policy. Being short of the dollar was reinforced through a widespread belief that the Federal Reserve's policy of quantitative easing was a dollar debasement exercise.

An investment policy based on a reflation trade is no longer wholly appropriate. There is less alignment from the point of view of global policy makers; a weaker dollar just puts more inflationary pressure on China which would force it to put on the brakes harder and, anyhow, the Chairman of the Federal Reserve, Ben Bernanke, has made it clear that quantitative easing is not the United States' preferred course of action from here.

The markets need to re-calibrate to accept a world in which the dollar and equities can be firmer, but this would be at the expense of commodity prices and less emerging market growth. Without this, a too-shrill response from China would risk a descent back into deflationary mire. This could happen anyway were there to be another financial accident, but the system is on its *qui vive* for this, and we judge it unlikely. In contrast however, it looks reasonable to acknowledge that if China needs to slow its economy, then most of the developed world will need to maintain very low policy rates to support growth and the banking system. The dynamics would make the relative economic merits of the United States manifest, which themselves should provide support for the dollar. Japan can well be seen as a warrant on the United States. A stronger dollar and reasonable US growth is benign for Japan, which is bouncing back from the earthquake (is this what one does from an earthquake?) fuelled by the cheapness of its stock market and strong position in niche markets. Ten years ago there was a lot of money to be made from identifying the *mittelstand* companies in Germany and Switzerland which were lowly rated and were entering a period of capturing market share. We think exactly the same thing could happen in Japan.



Central authorities everywhere are living in a world which is quite new, and all their initiatives are, by their very nature, experimental. Zero interest rates in America mean that the monetary policy of the entire world follows in its wake. It is clearly a powerful weapon to move people out of the passivity of cash, and into investment, whether financial or commercial. Nobody knows whether the anaemic recovery in western economies is testimony to the damage done in 2008 despite this stimulus, or whether the stimulus will have an increasing power to create prosperity. The accumulated debt of the last 25 years looms large; this is sometimes feared and sometimes ignored. Meanwhile the investment community itself experiments with different asset classes designed to protect against some of the darkest scenarios, but all the while assuming that the world will be able to glide on, narrowly missing frightening prospects. We are all aware of the bird which glides serenely on, paddling furiously below the water line – but none of us know whether it is a white swan or a black one.

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