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UK Gilts “rest on a bed of Nitroglycerine”

This is a gross statement for those who perceive gilts as low risk investments, or indeed for those who need to sell billions of pounds of the things in order to meet their borrowing requirements over the coming months.

It is, literally, a gross statement, coming as it does from Bill Gross, founder of one of the largest bond trading companies in the world, Pimco. Probably unsurprisingly, the statement has been dismissed by Stephen Timms (the Treasury Minister and spokesperson for the holders of the nation’s kitty) as being “entirely untrue.” After all, the UK Debt Management Office (DMO) has a remit to sell £225 billion (yes, billion) of gilts this year and a further £200 billion next year, and their task will not be made any easier by public statements of their toxicity.

Gross’s precise words were thus, “The UK is a must to avoid. Its gilts are resting on a bed of nitroglycerine. High debt with the potential to devalue its currency present high risks for bond investors.” The underlining is his emphasis, not ours.

So whom do we believe?

An experienced bond investor with no particular axe to grind and a freedom to invest in bonds issued by the UK, the US, Greece, Germany or any other country in the world which issues such things, or our own Government whose Plans A, B, C through to Z all appear to revolve around selling more gilts to potential purchasers than has ever been even remotely attempted before?

I know whom I’d rather listen to.

I wonder whether those who create the risk-profiling modelling tools that investment advisers are urged to use by the Regulator are listening too. If not, and we see an “accident” in the gilt market this year or next, countless low risk investors are going to get their fingers burned as the very assets that they bought to avoid risk blow up. And, inevitably, there will be an enquiry and many a protestation that “this must never happen again.”
It’s all quite depressing.



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Let's cheer ourselves up

Let's cheer ourselves up with a good read. Ah, what's this? *Debt and Deleveraging; The global credit bubble and its economic consequences* by the McKinsey Global Institute (MGI).

That sounds good.

Now, what does it say?

- "Belt tightening"
- "high inflation"
- "massive defaults"
- "war"

I think I'll try something a little lighter, thanks.

In all seriousness, these are the four most likely outcomes that it has identified having pored over 45 previous episodes of deleveraging since the Great Depression of 1929.

The four archetypal scenarios after a financial crisis such as we've had are prolonged periods of austerity or belt-tightening, high inflation, default of sovereign debt on a massive scale (any alarm bells ringing from Greece, Spain, Portugal and Ireland?) or rapid real GDP growth known as "the peace dividend" after a war. They point out that these are not exclusive from one another but the overwhelming likelihood is that the UK and the US in particular will follow one of these routes back to recovery. And none of them are good news.

Belt tightening is the most common, and we'd imagine that everyone is expecting this after this year's General Election, although a hung Parliament would be close to disastrous in achieving this effectively. If economies follow the norm in this scenario, we would experience six to seven years of deleveraging, typically beginning two years after the event that caused it. This puts the clock at just about now. GDP then tends to contract for two to three years after this before bouncing again afterwards.

Worryingly, MGI forecast that, because of the depth of the crisis, the more mature economies may remain highly leveraged for a more prolonged period, which will create a fragile and potentially unstable outlook for these economies for the next 5 to 10 years.

They also make the point (that is often overlooked) that many 5 year loans are due to roll over between 2010 and 2012. The availability of the credit to allow this is not there yet, so it seems that the default rate in personal and corporate debt will inevitably rise in the immediate short term.

The old adage that "bad loans are made in good times, while good loans are made in the bad" appears to be holding true. When we see what is happening in Europe regarding the Greek bonds we are watching this scenario playing itself out. Germany has said that they will not bail them out, putting the very Eurozone at risk of break up.

The economist Nouriel Roubini puts it succinctly, "if Greece goes under, that's a problem for the Eurozone. If Spain goes under, it's a disaster." If Bill Gross is correct with his earlier statement, it looks like the only good thing for the Eurozone is that the UK is not in it.

All of that optimism at the beginning of January seems to be evaporating fast.



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The Emerging Markets are faltering too

China has begun to tighten its monetary policy in January, trying to slow the rate of growth that it is still experiencing. This has had a knock-on to other emerging markets as prices have taken a tumble across Asia and Latin America.

Interest rates have continued to rise in Australia too, leading to a surge in the Aussie Dollar. This gives us a clue as to what will happen when the QE policy of the US and UK is switched off, and rates are rumoured to rise.

It appears that interest rates will not be on the move just yet, but each month that they don't go up is by definition one month closer to the time that they do. If this coincides with gilt yields rising as their capital value falls, meaning that our Government of whichever colour has to pay more in interest in servicing its own debt, then it's safe to say that it's tin hat time.

We're not there yet but the clock seems to be ticking.

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