

October 2011 Alvine Newsletter

Fixed Income- the benefits of portfolio diversification

Key issues- Confounding the sceptics like Bill Gross, prime government bonds have continued to provide spectacular positive returns. Interest rates on most US treasuries are at post war lows.

Key Recommendation- investors should continue to hold some limited fixed income assets in all but the most adventurous portfolios. A steady income, even a small one, is still of value.

'Gentlemen prefer bonds' Andrew Mellon (source Brainyquote.com)

In the immediate aftermath of the financial crisis, and as recovery took hold throughout 2010, it began to be seen that interest rates were too low. After all, short term rates were at near zero in the leading western economies, with bonds yields at similar multi-decade lows. High profile media pundits like Bill Gross were quick to publicise their market positions as being very underweight US treasuries citing the prospect of a credit downgrade together with ballooning fiscal deficits. **Surely with mammoth supply coming prices only had one way to go?**

Bill Gross admitted 'I'm just having a bad year' when the PIMCO total return portfolio reported less than favourable results at Q3, being only up 1.06% against a BarCap U.S. Aggregate Index which was up 3.99% (source Yahoo.com.) US treasuries, together with their European counterparts of Gilts/Bunds have had no let up from the incredible, continued 30 year bull market. It may be true that weaker sovereign credits, and junk bonds, have not participated, but for most fixed income investors the party has not ended.

Why did so many like Bill Gross, get it wrong? And with interest rates even lower than ever what are the prospects going forward?

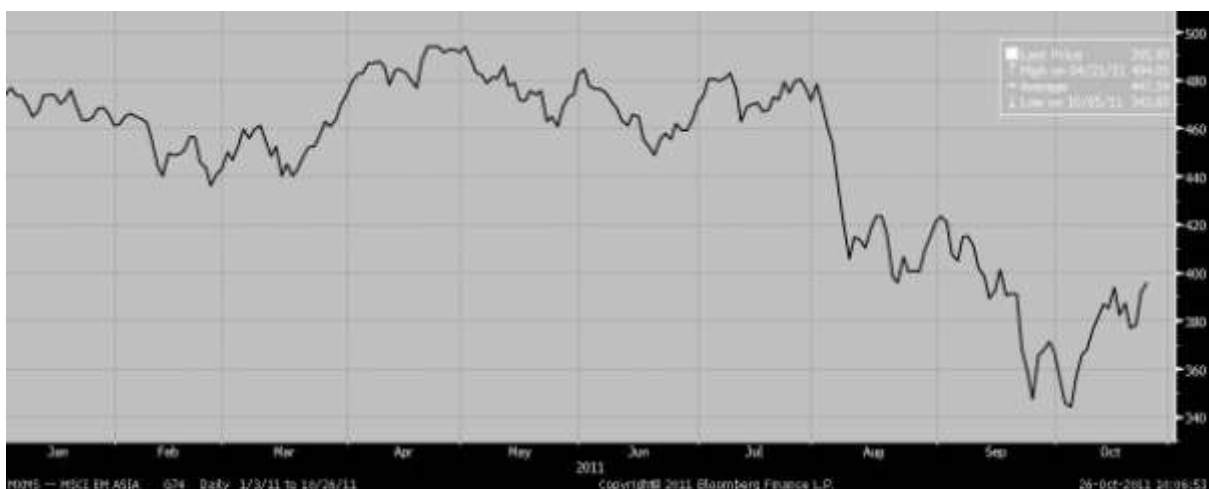
The 2011 Bull market

Before we turn to the future, a few words are needed to try and explain what has happened this year. While the post financial crisis recovery appeared to continue in the early months of the year, several themes were eating away at the prospects of this being a normal recovery.

Europe-- the sovereign debt crisis had started with Greece in early 2010 and was rapidly spreading to the rest of the **PIIGS**. As Europe’s political leaders grappled with this existential crisis, the loss of confidence amongst the continent’s populace was palpable. Consumers and businesses accelerated their pull back as the headlines grew darker in the summer.

US Debt ceiling—while the rigidities of the Euro zone were causing their own problems, over on the other side of the Atlantic the 2010 mid-term elections had ushered in a resurgent Republican party. Tea party zealots were spoiling for a fight on the US’s own fiscal deficit. Accordingly the requirement for Congress to periodically raise the total **debt ceiling** provided a perfect opportunity for these fault lines to be exposed. While few would ever believe that the US would ever default, the ceiling was in fact raised without even a partial shutdown (unlike 1995), this public spat between the two major parties exposed just how malfunctioning America politics had become. Furthermore, the reality of just how much US debt there is was clear for all to see, confidence suffered. The Federal government had really reached its **tape out point** in providing support to an already faltering economy.

Emerging markets—the rebound from the 2009 economic lows had been powered by China and others. Not only had those countries benefited from there long term booms, but as the post-Lehman crisis spread around the globe aggressive fiscal expansion had been used every bit as much as in the west. However, unlike the western powers who are still suffering from a slow deleveraging process, the stimulation aggravated latent inflationary build ups. Meaning that by 2011 most emerging countries had been forced to **tighten policy**. Interest rate hikes in Brazil, India and China have all cooled demand providing an unwelcome shock to the world’s overall demand. Stock markets have suffered.



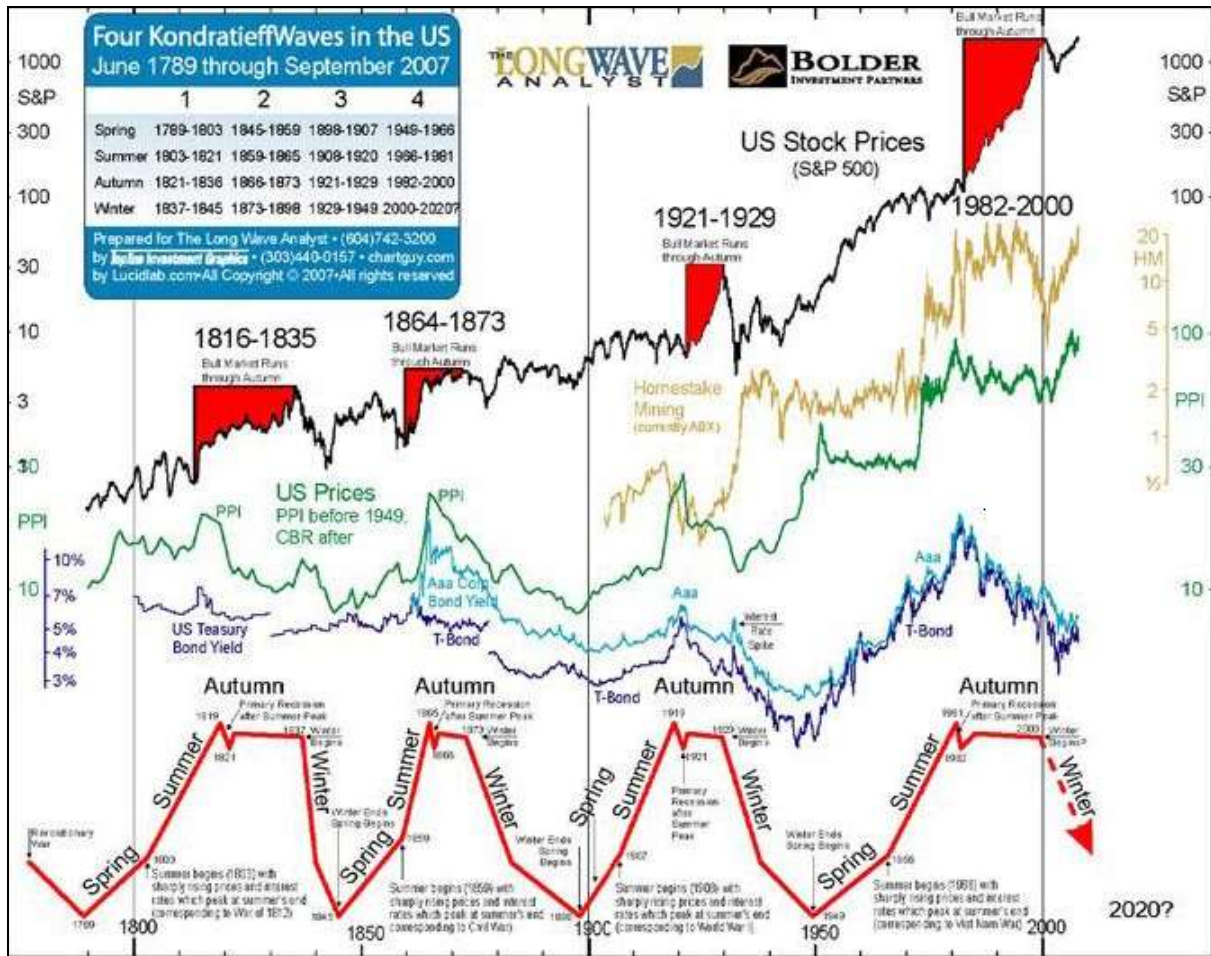
Most market pundits, ourselves included, had expected bonds to fall back as relatively cheap equities took centre stage.

The deflationists

The 'dismal science' has as ever many opinions about how we got ourselves in the current economic mess, and how to get out of it. But credit must go to **Danny Blanchflower** the former Bank of England MPC member who predicted in 2007 quite how much pain was to come. He was the leading **dove** when other such as the Governor was calling for higher interest rates weeks before the collapse of Northern Rock.

The long credit boom of the 21st century has left the world's economy so indebted that any recovery is likely to be painfully slow. Moreover, the **over capacity built in this cycle is causing sever deflationary forces** that require extraordinary low levels of interest rates. It is this fact that justifies today's bond yields. As Blanchflower commented on his blog, 'inflation is slowing around the world, oil and commodity prices have collapsed over recent days and there is no wage pressure' (25/10/11.)

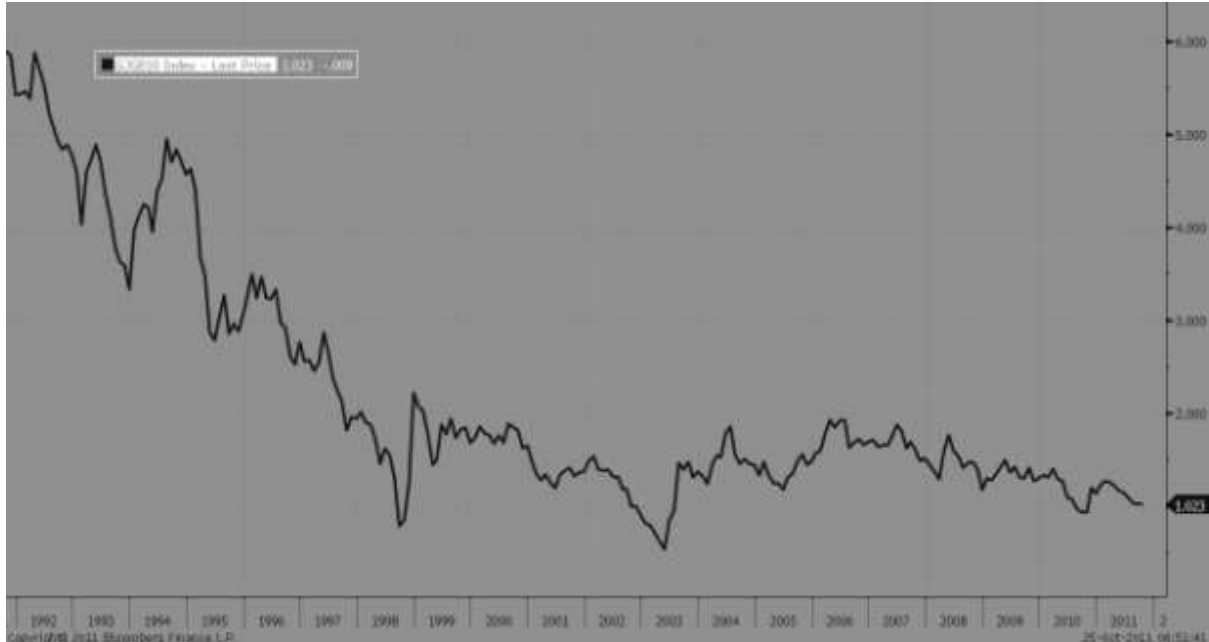
Longer term forecasters have made much of **the Kondratieff cycle**, whereby it may be that human nature produces natural 54 year cycles of credit expansion and bust. It can be asserted that the post war boom in financial products and leverage probably peaked with the collapse of Lehman brothers, economic growth will struggle without the oxygen of this creativity. This view supports a long term bull market in top quality bonds.



(Source the Longwavegroup.com)

Japan shows the way

If you need to find a modern day example of just how low rates can go, and be sustained then look no further than Japan. We all know about the lost decade, which has now mysteriously stretched into 20 years plus. Other key factors are an ageing population, zombie banks and an explosion in government debt now familiar issues for us all.

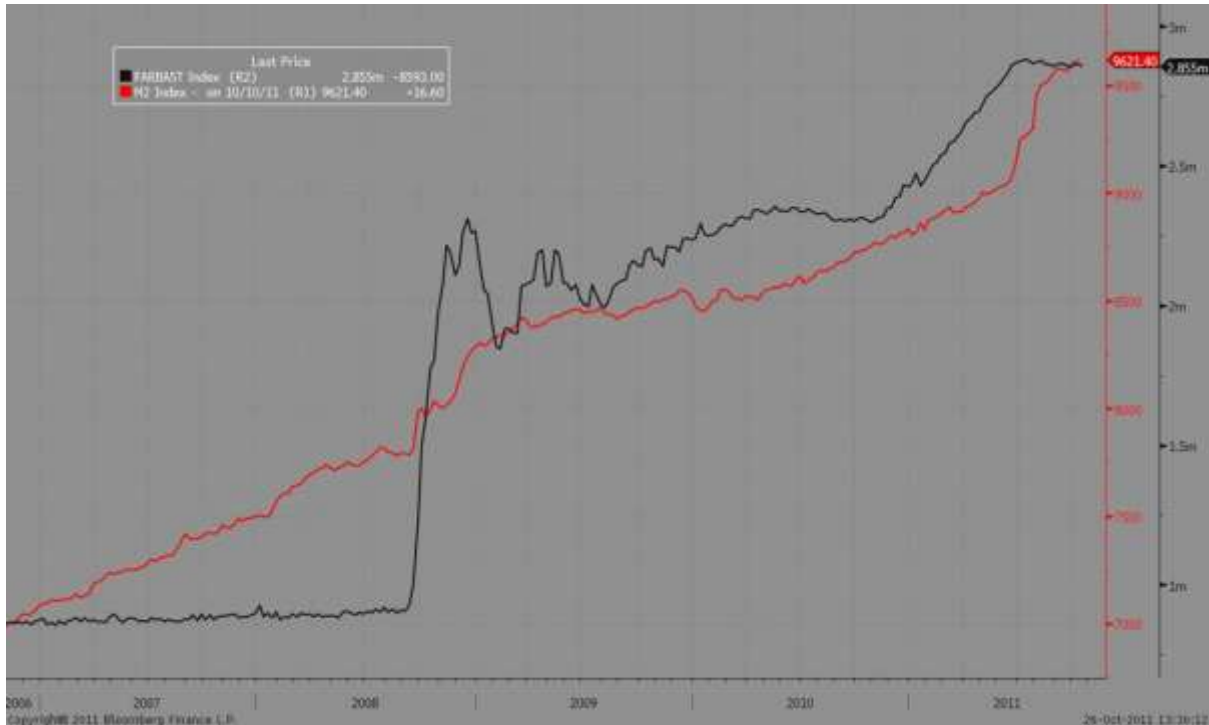


10 year Japanese government bond yields (source Bloomberg)

The Inflationists

RPI for September came in at 5.6% UK, 3.9% US and 6.1% in China hardly encouraging statistics for those in the deflationary camp. With commodity prices having staged a 10 year bull market driven by worldwide demand actual recent inflation has tended to be stubbornly high. While weak growth may support the bulls, fears of excess central bank supply remain a concern for the bond market vigilantes.

Private sector credit expansion within G7 has seized up since the onset of the credit crisis, but this has been largely replaced by central bank activity. As long as money supply can at least remain constant, and then be topped up by more infusions of printing, it is difficult to see the case for deflation (admittedly the velocity of circulation can vary for a while.) As 'The Sceptical Inflationist Steve Saville writes **'it depends on the ability and willingness of the Fed to monetize sufficient debt to keep the supply of money growing'** (gold-eagle.com 4/10/11). Following Bernanke's critique of Japan's lost decade ('Helicopter Ben' speech 2002) it is simple how much money you are prepared to create, if it's enough then the demand gap can be met and normal levels of inflation restored.



US money supply versus the Fed's balance sheet (source Bloomberg)

It's the politics stupid—with an apology to Bill Clinton

So will they or won't they? The BOE has already shown it's had restarting the printing presses announcing a further £75bn Quantitative easing to be injected into the economy. The fact that inflation is way above the target 2% seems to have barely troubled the Bank.

The Europeans are locked in a battle to find exactly the right vehicle, leverage or instrument to deal with their own debt problems, in this case the peripheral governments. Whichever you look at it a degree of monetizing is taking effect as the ECB has become the mainstay of Italian and Spanish debt having already filled its boots with Greek debt.

For the Federal Reserve the situation has been complicated by a resurgent Republican party invigorated by next year's elections. Cries of 'treason' by Rick Parry, and threats to prosecute Bernanke for debasing the nation's currency, form some barriers to a freedom to operate.

So will the gravy train resume, or does operation Twist and the 3 dissenters on the FOMC lead to a new limit on further monetary stimulation?

'It depends on inflation. And finally it depends on how the economy looks Bernanke in answer to a question of the likelihood of QE3 (Philipp Bagus 31/12/10.) We are back to the concept of a Federal Reserve put, in other words if the economy deteriorates then the Fed will be obliged to engage. The **dual mandate** forces the Fed to consider **employment** as well as inflation when deliberating interest rates.

With the Europeans already in some sort of leveraged, monetising of their debt; and with the BOE committed to do whatever it takes Bernanke has the cover to face down Republican objections. In an election year, the President will be deploying his considerable political skills to work too.

Something must be done is the cry.

Technical Analysis

With Fixed income markets having surprised so many investors we are now at an interesting technical crossroads. The very recent rally in equities that started in early October has stalled major rallies.

US 10 years



'Bonds are on their key levels and a break either way would likely determine the next directional move. They failed to fall through 127.50, with a weak bounce however, and for now the next leg is not clear.'

'So we have signals to sell a break under 127.50 or buy a break over 129.10. If either of these were done, we would have a high confidence level of a follow through, initially to over 132 on the upside or 125.50 on the downside. However, with equities steady and 3 month rates edging higher, we would guess the move in rates might be higher'. (source Market Focus Services October 25th 2011.)

Gilts



'Gilts follow the same pattern, being on key levels together with the unusual convergence of all indicators, which sparked the July rally'.

Short sterling



'Finally, this chart might just be straw in the wind that helps determine the next direction for interest rates.

March short sterling has broken down through convergence of indicators, and we suggest you might want to be short from 98.92, with a stop over 98.97.

Whilst I find 3m sterling to be a technically difficult contract to trade, it has given a sell signal, and so on balance, we might guess that rates elsewhere would be headed higher, especially if equities remain at these levels with no more nasty surprises'. (Market Focus Services)

Conclusion

With charts uncertain, fundamentals mixed, it really is all about the Politics.

'With policymakers playing such a critical role in how the shock shakes out, markets become more focused on politics relative to growth, making markets for a time less driven by growth news, and more by political outcomes or expectation' (Jonathan Wilmot Credit Suisse October 2011.)

We have all become transfixed by the minute to minute political dramas.

Investors should be mindful of no panaceas. Bonds may now yield little and be subject to higher risks as Government monetisation continues, but the reality of ignoring this asset

class has been brutally exposed yet again in 2011. Ask Bill Gross why he now finds it necessary to re-engage so forcefully with fixed income.

Fixed income has a role in a modern portfolio.

Model Portfolio

Our approach since we started this portfolio was to sustain a broad based range of assets and hence to protect ourselves from the extreme volatility of markets. So while we only retain a 10% weighting in bonds, the out performance of this asset class all year has enhanced our overall return and compensated for some lower returns.

Furthermore our significant hedge fund position gives us further leeway to side step mere risk-on or off trading.

In September we elected to move to a more balanced overall profile due to the increased difficulty of forecasting the political process, one that is now dominant to investor's concerns. That situation has not changed with Euro zone visibility in particular poor.

During October the Bank of England moved to purchase another £75bn of securities, re-opening its QE programme. Operation 'Twist' and further moves to mop up Euro zone government bonds by the ECB are further evidence that monetary printing is never far away.

For this reason we have decided to move 5% of our cash holding to a Gold ETF. This is an effective anti-paper money trade.

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