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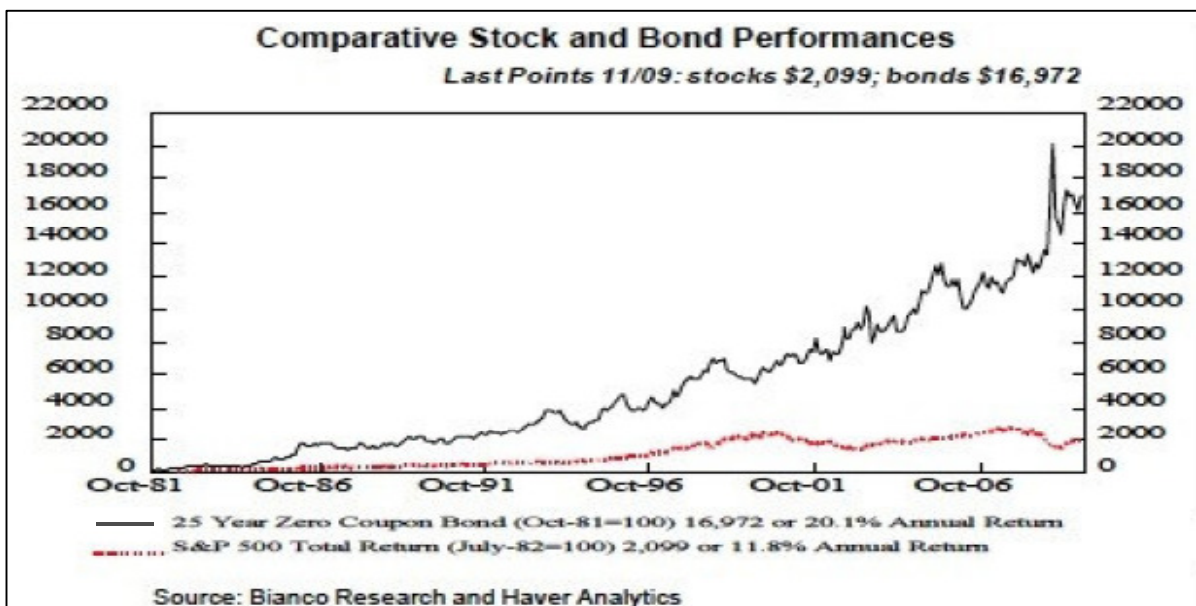
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A SHILLING FOR HIS THOUGHTS

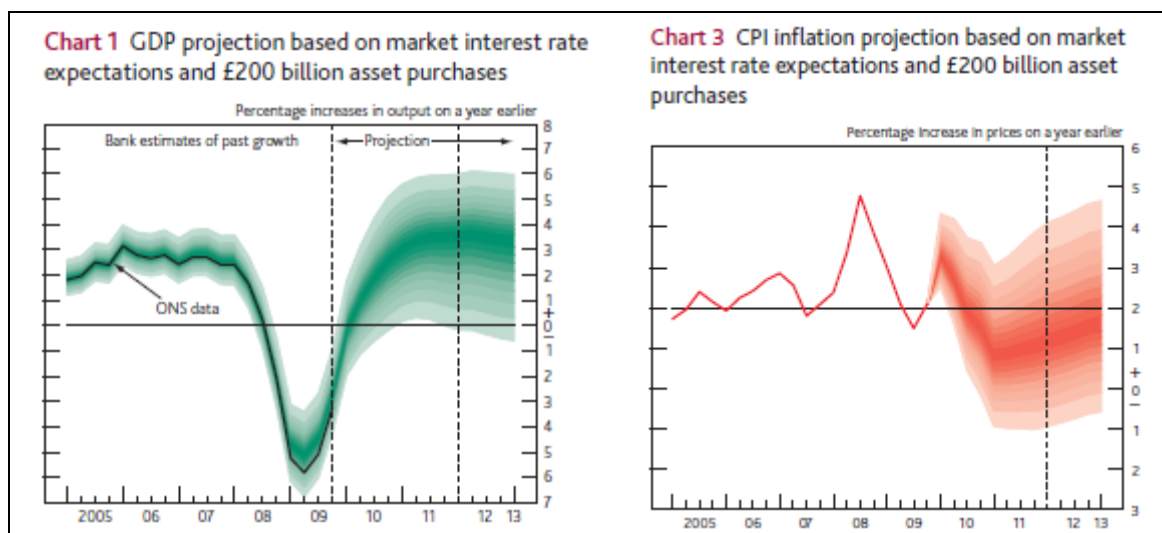
“Many believe (US) Treasury yields are headed up, not down. They think that all the bank reserves created by the Fed that have not generated bank loans will do so, flooding the economy with money and create excess demand and inflation. They also think that the continual heavy issuance of Treasuries to fund the non-stop federal deficits will push up yields. In contrast, we don’t foresee the rapid economic growth needed to induce chastened banks to lend and cautious creditworthy borrowers to borrow. And, if we’re wrong, it will take at least several years to eat up global excess capacity during which the ever-inflation-wary Fed will no doubt remove the excess bank reserves, as Fed officials have already indicated.” This quote from Gary Shilling appeared in an article recently distributed by John Mauldin as an ‘Outside the Box’ feature. Gary has had a fantastic run with his disinflation-deflation theme (his book on Deflation appeared in 1998) and his associated recommendation of US Treasury bonds (since 1981). But all good ideas come to an end, and I believe that Gary’s deflation theme expired in 2008. Like all powerful thinkers, Gary makes a good case for the continuation of deflationary forces and has many adherents to his view. In 1998, he chastised the central banks for fighting the last war (inflation); now he is guilty of doing the same. Gary correctly predicted that the 30-year bond yield would fall to 3%. In fact, it fell to 2.53% on 18 December 2008 and there were 18 trading days on which the long bond yielded less than 3%. He showed terrific foresight in making this call. Today, the long bond yields 4.63%, having twice reached 4.75% in recent months; the inflationary landscape has altered beyond recognition since the credit crisis erupted. There is too little space here to do justice to the counter-arguments to those contained in Gary’s quote, but here are some pointers. First, money is created when the banking system expands its



balance sheets, either by lending to the private sector or the government. It doesn't matter that private credit demand (net of repayments) remains weak. Government has and will provide sufficient asset growth for the financial sector to transport us to an inflationary world. Inflationary risk can present as a symptom of excess demand or restricted supply: today, the latter is the greater threat. Commercial viability has become far more important than corporate empire building. The strength of competitive forces operating prior to the credit crisis has been significantly weakened. Governments will also play a key role in transferring costs to consumers through taxation and user charges. The consumer is dealing with monopolists and oligopolists in almost every context: true retail price competition is dead on its feet. Global excess capacity is a myth: there is no super-abundance of commercially relevant supply. The supply capability of the global economy has shrunk as a result of the credit crisis. Unused physical capacity is not a good indicator of pricing pressure in the extreme circumstances of a global credit shock. Finally, the Federal Reserve, with other central banks, is merely paying lip service to the control of inflation: it is preoccupied with more pressing matters.

OVER THE RAINBOW

The arrival of a new *Inflation Report* from the Bank of England yesterday does not appear to have been accompanied by any new thinking about the inflation outlook. Indeed, its two-year inflation forecast has been trimmed since November. Skies remain blue, over the rainbow. The projections assume that a second jarring experience with headline inflation in less than 2 years will have no impact on consumers' inflation expectations because they will continue to keep faith with the ability of the central bank to observe its inflation target. Last year, real GDP in the UK is reckoned to have fallen by 4.8%. On revision, the drop is likely to be trimmed to nearer 3.5%, but 4.8% is the current estimate. Perversely, real household disposable income seems likely to have risen by more than 2% last year due to falling inflation and rising government transfers. The position is reversed this year as rebounding GDP coincides with shrinking after-tax real incomes. Tensions in the labour market were muted last year because there was a disconnection between the depth of the slump and the common experience; this year will be different. The arrival of a Conservative government would heighten the disgruntlement of employees and their pay negotiators. The *Inflation Report* seems to disregard the political economy dimension altogether. The maintenance of low inflation is not merely a technical matter, like keeping the drains clear. Rather than trusting "excess capacity" to control inflation, the Bank should have raised its interest rates at the end of 2009. The pause (or cessation) in the quantitative easing (QE) programme is the wrong instrument to deal with inflation. In undermining the prospects for Sterling, the end of QE may well contribute to rising inflationary expectations.



FULL CIRCLE

As this is edition number 360 of the Halkin Letter, it seems appropriate to mention some currency trivia. When the Japanese Yen was rebased in 1949 as part of the Bretton Woods system, having become worthless during the war, the Americans chose the rather odd parity of 360 Yen to the US

Dollar. Odd, that is, until we realise that ‘yen’ (or ‘en’, as it should be) literally means ‘round object’ in Japanese, as ‘yuan’ does in Chinese. Originally, the Chinese had traded silver in blocks, but when Spanish and Mexican silver coins arrived, they called them silver yen for their circular shapes. So, the origin of the 360 parity was the number of degrees in a circle.

DIARY DATES

Our next event is a dinner on Tuesday 2nd March with Jeremy Charles, Global Head of Precious Metals at HSBC, the custodians of 80% of the world’s gold Exchange Traded Funds. Jeremy will speak about ‘The Mechanics of the Gold Market’. On Thursday 11th March, we are delighted to welcome back Tony Plummer to give a special presentation of his research into the psychology of market patterns and cycles. Tony has assembled some fascinating material on the psychological basis of repeating technical patterns. In a change to our regular format, the presentation will begin at 6.30pm and we will sit down to dinner at 7.30pm for discussion over the meal. The venues for these events will be announced shortly.

Peter Warburton

GREECE: PLOT DEVELOPMENT

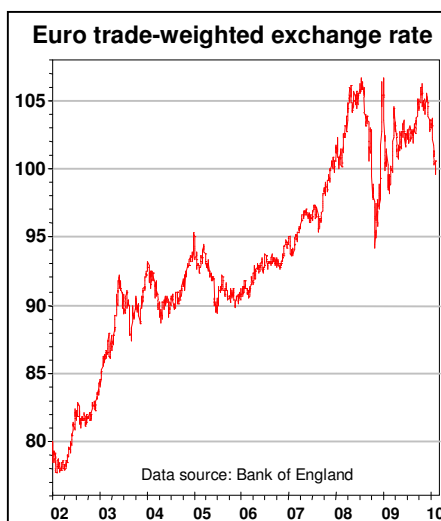
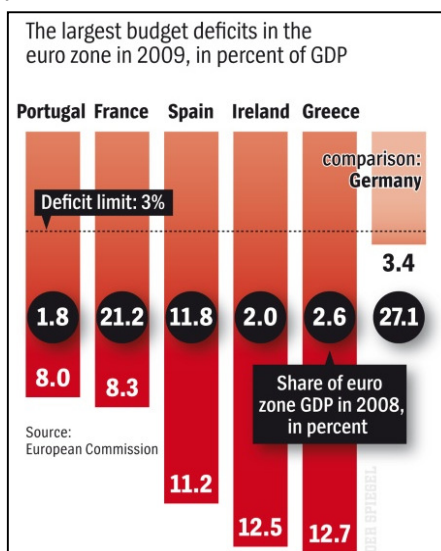
It’s no use: there is only one theme in Europe today, and that is Greece, but the strands of that theme are changing and maturing. For weeks it was mostly just hand-wringing and voyeuristic alarm, now more subtle analysis is emerging. The immediate focus is today’s EU summit. The mere fact of the bringing together of the whole of the EU’s leadership has focused minds on broader issues. Martin Wolf – never one to avoid the blindingly obvious – pointed out in his [article](#) in yesterday’s *FT* that the crisis is at least as much the fault of Germany as Greece. ‘Germans must start spending’ was his invective. More significantly, there is something of a ganging up within the EU against Germany. This has and will achieve nothing in terms of German economic policy, but it has provoked a PR counter-attack pointing out the sacrifices that Germany had to make to regain competitiveness when the Euro was initiated. (See [Der Spiegel](#) for a flavour of this.)

Hence the German psyche is being pulled in two directions: the recognition that its own self-interest demands action, and a deep resentment of pressures to accommodate budgetary excess. On top, there is a sense, born out of bitter experience, that Germany is always the paymaster in such crises (it has helped out Greece, Portugal, Spain and Italy before) but France is always the political beneficiary. (NB: Nicolas Sarkozy had lunch with George Papandreou yesterday.)

Der Spiegel is also responsible for the first of the charts. You will have seen many such before, but the combination of deficits with relative size of GDP is illuminating. Greece, Portugal and Ireland may have big deficits in domestic terms, but as countries they amount to less than 6½% of Eurozone GDP. Spain – and even France – are much more disturbing. This truly is a Eurozone problem, not just a Greek problem.

I have included the chart of the Euro’s exchange rate index to reflect a point made by several observers: that the Euro’s weakness is relatively trivial and, in any case, a weaker Euro is a Good Thing. A look at the chart suggests another slant: ‘Gosh, doesn’t the Euro have a long way to fall!’.

Robin Aspinall



JAPAN: CYCLES TURN

The troubles at Toyota, noted in last week's Letter, continue. It is tempting to consider at length how the company is coping with what looks like the price of its race for global dominance, but the issue has also served to focus attention on a broader set of questions that deserve greater prominence.

Put simply, the Tokyo market is stretched to extremes in a number of dimensions. Applying the critical approach of examining interstitial evidence, three extremes bear particular examination. First, there is one difference between Japan and the rest of the world that should dominate investment thinking, because it holds the potential to dominate investment returns. The argument runs as follows. Japan is at the bottom of a once in a lifetime credit cycle. There is scope to negotiate over whether the country is just before, right at or just after the bottom, but there is little room to argue about the general position. That contrasts with the rest of the industrialised world, led by the US and UK, which have just gone past the top of a once in a lifetime credit cycle. Market noise reflects and reinforces these two positions: the common perception looks for opportunities in the west and risks in Japan. In truth, it should be the other way round.

Second, this contrasting cyclical situation is reflected in relative market performance, but not in quite the way expected. Since 1973, there have been just three major phases of relative performance between the US and Japan (including currency moves). Phase I was from 1973 to 1988. During this period, Japan outperformed as a major trend, but the two markets moved in roughly the same direction at roughly the same time. Phase II lasted from 1989 to 1998. This included the bulk of the great Japanese bear market, leading Japan to underperform the US by 90% from peak to trough. What is more, this was a period of decoupling writ large. While the Tokyo index lost about two thirds of its value to 1998, the New York index kept on rising. Phase III has been the last 11 years since late 1998. This has seen Japan back in line with western markets, rising and falling at roughly the same time. Over this period, Tokyo has actually outperformed the US in common currency terms and is right in line with the UK. The gap is in popular perception, which believes that Japan is an inveterate underperformer (a negative image built up during the 90s which persists unfairly today).

That leaves a challenge. This 11-year sideways relative period is now mature. At some point it will end. Which way will it break? Japan to outperform the US as a major trend, or a renewed period of major underperformance? Back to the two countries' different positions in the credit cycle.

Third, and this is where Toyota comes in, relative performance by sector within the Tokyo market is extreme on a scale I have never seen in the last 25 years. The drama is led by financials. In brief: at their peak in April 1987, the combined financial sectors (banks, insurance, brokers, but dominated by big banks) accounted for 40% of market capitalisation. Today, almost 23 years on, that figure has fallen to below 12%. This is the lowest since the end of the 1960s, even lower than at the worst of the banking crisis in April 2003. A direct comparison of Toyota and Sumitomo Mitsui Financial Group, one of Toyota's main banks, shows that Toyota has outperformed by a staggering 40 times since 15 April 1987. Yet these are big companies: Toyota is largest by capitalisation while SMFG is 14th.

Cycles turn. When relationships become as stretched as they are now, they deserve respect on a matching scale. We have been warned.

Robert Brooke

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