

GBIM

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“The world of reality has its limits; the world of imagination is boundless” (Jean Jacques Rousseau)

It has been clear since 2008 that the growth trajectory for over-indebted developed economies for much of the subsequent decade would be weak relative to previous experience. Very substantially this has been the result of the excessive accumulation of debt during the two preceding decades, during which future spending power was used to satisfy impatient current yearnings.

We remain at an early stage in the unburdening of our economies of this debt. In the UK the Government should be congratulated upon its early grasping of the problem. Sadly politicians in the USA and the Eurozone need the sharp retorts they are now receiving from the markets to shake themselves from their complacency, and to get something done. We must hope that it succeeds for while these so-called leaders sit on their hands investors throw up theirs in despair.

This absence of responsible governance is inevitably causing an array of fears in markets, from recession and deflation to outright inflation, from the complete breakdown of the European project to the financial collapse of China. In reality none of these outcomes is especially likely, but the vacuum of political leadership allows flights of fancy to take hold.

We should expect that concerns about debt, growth and bank solvency will recur repeatedly over the next few years, and that moods will swing between angst about inflation to fear of deflation. This is the inevitable consequence of the balance of slow growth in “the West” and rapid growth in emerging economies, and their concomitant effects of deflation from the deleveraging of debt and simultaneous inflation from the consumption of commodities.

In this environment asset prices will be volatile, and the risk of policy error high. The potential for governments, whether in developed or emerging economies, to intervene to the degree they did in 2008/9 is substantially reduced, and thus we should expect little stimulus from fiscal policy, and increased dependence upon monetary policy. The difficulty for central bankers, who are already trying to calm skittish markets with monetary injections, is that until the politicians grasp fiscal policy they cannot credibly offer an assertive monetary policy. Hence the exasperation of market participants.

Nevertheless while politicians meander towards a clearer denouement in both Europe and the US, the Federal Reserve and the European Central Bank have acted to provide two elements of certainty. The “Fed” forecasts that US interest rates will remain close to zero until mid-2013, while the ECB has started buying Italian and Spanish to prevent a systemic crisis.

It is very likely that “western” bank rates will remain low for years to come, and that asset purchase schemes, like QE, or arguably the European Financial Stability Fund, will be used extensively. When bank interest rates are so low, what constitutes a high yield is no longer 5-7%, but 4-5%, and investors should set their expectations accordingly.

With such a prospect it is important to focus upon well-financed investment opportunities, which appear to have strong internal cash flow generation. It is also right to look at areas of scarcity, where provision of capital can be rewarded despite relative fragility of broad economic demand growth. This is the strategy we have employed for a long time now, and we remain positive about its merits, subject always to reasonable valuation. We also continue to avoid banks and most other financial shares, and our exposure to economic growth remains through emerging markets rather than through more cyclical western companies.

This strategy has allowed GBIM portfolios to be less volatile than markets, and to have outperformed them recently. We hope that this will continue, but will feel more comfortable and less imaginative when European politicians put their words into action.

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