



Investment Letter – Q1 2015

“Politics is not the art of the possible. It consists in choosing between the disastrous and the unpalatable.”
John Galbraith, 20th-century American economist, in *Ambassador’s Journal*

Policy was the name of the game last year. As monetary policy objectives diverged, investors scrutinised the rhetoric of each central bank for clues about what might come next. Mark Carney’s intimations of policy tightening sent the pound soaring, while the mere whiff of a rate rise from the Federal Reserve caused a flash crash in markets around the world in October.

Despite all the talk, however, not a huge amount has changed. In fact, as economic data began to deteriorate further in both the US and the Eurozone, more central banks than ever have taken to loose monetary policy. Faced with the twin threat of deflation and economic stagnation, the European Central Bank (ECB) launched a new programme of quantitative easing (QE), causing equity markets to rise and the Euro to start its freefall. Meanwhile, Swiss, Swedish and Danish central banks were forced to impose negative interest rates to prevent their currencies from rocketing in value against the Euro. While many welcomed the ECB’s return to a looser stance, a whole new set of problems has been ushered in. Quantitative easing has become competitive easing, thanks to the international currency war begun first by the Fed during its first programme of quantitative easing and taken up by both the Bank of Japan (BoJ) in Asia and the ECB in Europe. To date twenty central banks have loosened their policy stance, and in turn devalued their currencies to improve their terms of trade in the face of continued Euro weakness. While weaker currencies may be beneficial in the long term, continued depreciation serves only to pass deflationary conditions on to other countries over the short to medium term – one hopes this is not the ECB’s main goal.

The likelihood of the ECB losing control of monetary policy is a much greater threat than it was for its US counterpart. When the Fed began its programme of QE in 2009, US Treasury yields were around 4.00%. In 2015, the playing field has altered dramatically: the ECB now faces German 10-year bond yields as low as 0.15%, with \$2.4trn of long-term global sovereign debt now trading at negative yields. Low inflation coupled with negative interest has created an environment where there is little discernible upside left in bond markets. And while most other currencies compete in the race to the bottom, expectation of a normalisation of interest rates by the Fed has caused a sustained rally in the US dollar since the middle of last year. We are now beginning to see some of the negative effects this is having on the US economy, with the Bureau of Economic Analysis revising down its estimate for US GDP growth in the final quarter of last year. Company profits are already suffering as their exporting power diminishes. The US does not want to offer up its own currency as a foil against which others can depreciate their own to increase their competitiveness. At some point, something will have to give. We maintain a sizeable underweight to US equities due in part to the currency headwinds faced by American companies and the fact that they remain overvalued on a relative basis. We have maintained an unhedged USD position across a number of holdings in our portfolio to take advantage of continued dollar strengthening.

As we write this quarterly letter, however, the focus has shifted from policy to politics – at least in the very near term. January saw the election of Syriza, the far-left Socialist party headed up by Alexis Tsipras, in Greece. Its leaders wasted no time in threatening the international community with default on its debts or “Grexit” from the European Union if it is unable to restructure the terms of its current debt and future aid packages. At the time of writing, Greece has reached a standoff with its creditors. Its next payment of €450m is due to the IMF on April 9th, and Greece is running out of cash. What would happen if Greece were to leave the Eurozone is still largely speculation. But what is clear is that it would most likely be forced to give up the Euro, and to reintroduce its own currency. If the drachma were to be introduced following a failure to pay back debt to its international creditors, there is a chance that its convertibility into Euros and other currencies would be threatened. Cut off from international capital markets, the Greek economy would come under severe strain, new currency or not.

As ever, though, this is more about political capital than capital markets. Equity markets have barely shown any reaction to Greece’s threats due to the continued support of the ECB’s QE programme. But political leaders in European countries will be watching closely. Moral hazard is a term we are all familiar with after 2008; if creditors allow one entity to default without repercussions, they may cause a chain reaction as other entities take the chance to



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extricate themselves with impunity. It would be a major snub to European central bankers if Greece manages to restructure its debt to a considerable extent while maintaining its place in the Eurozone.

And it sets the stage for further dissidence; Greece is not large enough for any default to be a systemic problem, but it sets a precedent. With similar left-wing populist parties in France, Spain and Italy hoping to ride the wave of Syriza euphoria, the latent risk is not of Grexit, but of a mass Grexodus. So far we have taken only a small underweight to European equities; ultimately markets will be supported by QE. However, by taking part of our exposure via a long-short manager, we are able to reflect our cautious stance.

In the UK, May's general election is the most prominent feature on the political calendar. The run-up to any election tends to see a sharpening polarisation of views between the major political parties. This time the divergence feels particularly acute, as our *own* membership within the EU has come under fire. In our last quarterly letter, we wrote that we find it hard to see a positive outcome, and this still stands. An outright win by any of the major parties seems remote at this point: it now looks increasingly likely that smaller parties like the SNP, Plaid Cymru, and potentially the Democratic Unionist Party will have a far greater influence on the UK's political landscape. Whether we see a Welsh, Scottish or an EU referendum, any of these potential scenarios could be extraordinarily damaging for UK companies. We took a sizeable underweight to UK equities in January to reflect our caution, and continue to position ourselves in smaller companies and value-oriented managers. We have only a very small amount of direct exposure to the FTSE 100, whose constituents might become less attractive relative to QE-driven European equity markets following the election, at least from the perspective of global investors. We have already seen a considerable increase in currency volatility: a protracted period of uncertainty post the election could cause problems in equity and foreign exchange markets.

In terms of our positioning, our outlook remains cautious: we have kept a very high level of exposure to cash throughout the first quarter of 2015 and intend to maintain this for now. We continue to favour Japan and Asia Pacific over other developed equity markets. Within other developed markets we have identified managers that we rate highly, and we look forward to having an opportunity to raise our exposure to them. Even with our cautious stance we have managed to generate positive returns for our investors. We have been particularly gratified by our performance on a risk-adjusted basis as we have managed to maintain returns with a far lower level of volatility, capturing most of the upside but limiting the down. As the old expression goes – pride come before a fall – and we have that ringing in our ears, but we are pleased with the progress of the portfolios. We have accessed some truly excellent fund managers on behalf of our clients and we passionately believe that we have the right solution in place to manage investment assets over the cycle.

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