

INVESTMENT NOTE

December 2011

Silver Bullet?

Will the salvo of collective action from global central banks be big enough and of sufficient calibre to add up to a silver bullet?

Earlier this week the US Federal Reserve led a group of other international central banks in reducing the rates paid by the European Central Bank for US dollar loans in an attempt to alleviate liquidity problems for Euro zone and other non-US retail banks needing to access affordable US dollars via swaps. Central banks including the UK, Japan, China, Switzerland and Canada joined together in coordinated action which took a fragile market by surprise and, in some ways, raises more questions than it answers. The TAM investment team have our own views about the timing and whether it is linked to the European Council Summit or whether some other, unreported, emerging crisis behind the scenes may be to blame. Why now? What was the catalyst?



On Wednesday afternoon, equity markets were given a boost when the People's Bank of China announced a lowering of reserve requirement for domestic banks. At a glance this might have been seen as action to ease fears of a hard landing for the Chinese economy which has been looming for some time and compounded by recent rating agency downgrades on Sovereign Debt as a result of slowing economic forecasts.

But the story broadened out somewhat as it became apparent that action was underway to ease a credit crunch in markets that supply US dollars to global institutions, typically via swaps. This is something which is not a problem for US institutions that can borrow from their own banks who, in turn, borrow from the Fed. And so the finger of suspicion turned to the bad boy of the moment, the Euro zone. While it's true that the rate at which Euro zone, and all non-US, institutions access US dollar swaps has been rising, the catalyst for the move is not clear. One could simply argue that similar actions to bring down the rate took place in 2008 and 2010. It is not without precedent. Rather than watch the bickering from the sidelines, the US Federal Reserve has taken the bull by the horns and forced European policy makers to take action.

By forcing them to take the first step it is hoped that future action will be easier to implement, or at least easier to sell to reluctant voters in their home states.

Assuming that European financial institutions are safe from collapse for now (it is worth noting that BNP Paribas, for instance, is the largest bank, by assets, in the world) the next mile stone on the road to normality is the European Council Summit next week. This week's action, may have calmed the waters, but does little to solve the debt crisis in Europe. Firm and wide reaching compromises will have to be found; whether this involves the ECB becoming a lender of last resort, the Issuer of Euro Bonds, or some other form of debt monetisation is unclear. Unfortunately, European leaders have proved their skill in brinkmanship and are sure to wait until the final minute before reaching any agreement. Until such time we expect financial markets to remain volatile and unfortunately prone to short term changes in sentiment. This week's rally

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may prove short lived and markets will need a substantial catalyst to reignite risk appetite and take us back into positive territory for the year end.

Cautious but Opportunistic

Given the uncertainties facing us we are maintaining a cautious stance within portfolios; though with an eye for opportunistic investment when warranted. Although portfolios are near a neutral allocation against respective benchmarks they remain generally underweight with generous cash balances. Such liquidity allows us to increase allocations when markets look under-valued or when a clear catalyst for positive performance emerges.

One recent change to our allocation models is an increase in the international allocation. With a near-certain recession in Europe and economic growth in the UK teetering, one region looks more attractive on a relative basis; the United States. We have therefore made an allocation to the region by investing with a fund that focuses on larger capitalisation income generative companies. These companies are generally global in nature, highly cash flow generative with solid franchises which we believe demonstrate the growth and defensive characteristics we desire in such an uncertain environment.

At the time of writing in this fast moving market there are some interesting and important comments from Mario Draghi, President of the ECB that may pave the way for a step-by-step approach that will lead to an agreement which allows some resolution without massive political loss of face in France, Germany or the ECB. This sounds as flaky as anything we've seen before and laced with new phrases such as "fiscal compact" which, we suppose, we should take as "Fiscal Union Lite". But signs of accord, rather than disagreement, so close to the Euro Council summit next week are encouraging. If stock markets carry on rising at the rates that they are, we will quickly have gone from making opportunistic purchases in equities to having to consider taking profits. At the margin, we believe this is the right thing to do in order to keep portfolios aligned with their long term objectives whilst maximising returns.

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