

Universally Challenged - who is smarter?

"[Central Banks] think they are smarter than the market" – Jim Rogers, February 2016.

From ZIRP to NIRP – (From zero to negative interest rate policy).

It seems scarcely believable now but after the Federal Reserve finally raised interest rates back in December, following years of speculation about the timing of the hike, we now have more central banks than ever running a negative interest rate policy, or "NIRP". This is unsettling for a number of reasons. First and foremost, as an experiment, this has never been tried by central banks before and opinions on the consequences range from a welcome return to normality to the chaos of an end of the financial world as we know it.

Whilst we have not entered either of these endgame scenarios, the adoption of negative rates at this stage of the game has thrown into doubt whether the US economy, and indeed the rest of the world, was strong enough to take a 0.25% raise in the first place. The Fed evidently thought so. Stock and bond markets are not so sure.

When the acronym "ZIRP", meaning zero interest rate policy, first started doing the rounds, the expression itself seemed to imply that ZIRP was the end of the road. A finite monetary policy destination of nought. Some readers may remember our Ferrari number plated with "ZIRP 4EVA" – and that was December 2013!

However, although the Fed is moving in the opposite direction we're now coming to terms with NIRP. It started small. Sweden was the first central bank to introduce negative rates in July 2009 in the wake of the Great Financial Crisis (GFC). Switzerland followed in December 2014 in an attempt to stave off the safe haven strength of the Swiss Franc. Denmark is also there with negative rates.

But the big one is the eurozone where the 19 countries enjoy a deposit rate of minus -0.3% since December. The latest joiner to the club is the Bank of Japan who caught the market off guard by reducing interest rates to minus -0.1%. And it's not just base rates. Japanese 10-year bond yields have been flirting with negative rates all last week.

Make no mistake, we are into new unchartered territory and to many it is a confusing concept for both seasoned market players as well as the man on the street.

Lowflation

One ambition common to all the main central banks that have implemented the emergency measure of ZIRP or NIRP is to raise inflation from its current malaise to somewhere around 2%. This fits with the commonly accepted view that price stability is part of a central banks responsibility and that inflation is as reasonable a gauge of price volatility as anything else. The concept of adopting inflation targeting was first adopted by New Zealand in the 1990's with the Bank of England following two years later. We had to wait until early 2012 for the Federal Reserve to adopt something similar under the then Chairman, Ben Bernanke. Inflation fell markedly from over 2% into negative territory but has recently rebounded in the last couple of months.

Yellen (and probably Kuroda, Draghi or Carney) would be quick to point to this as evidence that QE is working. Even the more benign core inflation has moved north of 2%. However, whilst the direction of travel is indeed positive, these are very low levels of inflation in response to the amount of money that has effectively been printed and considering interest rates are either negative or close to zero.

We have asked before whether it is possible that low interest rates are actually CAUSING low inflation? From the perspective of a saver, if you had £50,000 deposited in a bank yielding virtually nothing, what would be your propensity to go out and buy a new car if the prices of new cars had gone up? You could borrow the money from a bank at low rates (if they'll lend it) because you think that lashing out now is better in case prices keep rising. But if your confidence was low due to bad headlines on the economy, you might decide to stick with the car you have.

In this theory of a non-inflationary world, car dealerships intrinsically know that you have no more money from interest than you did the year before and, therefore, do not raise the sticker price.

Again, generalising to make the point, lowflation (we can say lowflation – it's in online dictionaries; it might make Oxford English Dictionary one day) that lasts for 10-15 years can change the mentality of the average worker. A whole generation of Japanese workers have never experienced inflation. In Tokyo, you can see the minimum fare etched into the rear windows of taxis and the prices of staples never seems to change. This same generation rarely seek a pay rise and, ultimately, one can see how it could lead to the demise of unions with nothing to agitate for.

Gurus or broken clocks that tell the right time twice a day?

If this scenario is quietly being played out, the wait for higher inflation and growth will be a long one. Some of the most famous investors on earth have a major problem with this.

Jim Rogers, as well as being a well-known investor and TV market pundit (and a major in history) has, in addition to motor biking around the world, set a world record for his 3-year drive through 111 countries in a converted Mercedes SLK. Of the wisdom of central bankers, he recently said on CNN TV, "They think they are smarter than the market, they are not! We are all going to get hurt by a global recession". He added "We're all going to pay a horrible price for the incompetence of these central bankers," and went on to say "This is going to be a disaster in the end, you should be very worried and you should be prepared."

He did hedge himself by predicting that all of the unconventional monetary policy will lead to a stock market rally in the near future and, as we follow these things at TAM, he was bearish on the US dollar from 2008 until 2015 during a period of extraordinary strength only to turn bullish in April 2015 just as it peaked out. Still, it makes for entertaining TV.

Another critic of the central banks is Marc Faber. If you're in any doubt about where he's normally coming from, he's the publisher of the "Doom, Boom and Gloom Report". In keeping with his usually negative stance, he's recently said that central banks are toying with the idea of forcing a cashless society to stop us from stuffing cash into mattresses and knowing where and what we're doing, but said that it will fail because humans will simply adopt a barter system. Anyway, here's a delightful exchange trying to cheer up Maria Bartiromo, Global Markets editor at Fox Business News:

Marc Faber: You see, I want to tell you something, Maria, about gold. I buy gold because I'm fearful that we will still have a systemic crisis, that we will have wars and so forth in sum. So I'm buying gold because I'm fearful. I'm sorry to say, Maria, you don't own any gold and you are in great danger because you don't own any gold. So I'm fearful and I own gold, and you are in danger because you don't own any gold.

Maria Bartiromo: You don't know that I don't own any gold….. actually, you're right, I don't own any gold. Okay, guilty as charged, I don't own any gold.

I first met Mark Faber personally in 2004. He held gold then and still holds gold now. Goldman Sachs thinks we should short it. Go figure. But I remember we at TAM wrote about gold during a particularly gloomy January 2012 when a gold ATM machine made an appearance at Westfield shopping centre. We cautioned against owning it at all, even as a diversifier. Happily it lost 40% in US dollar terms in the 4 years

to the end of December 2015.

Bill Gross set up a small bond fund after co-founding PIMCO in 1971 at the start of one of the most extraordinary bull markets of all time. His firm amassed $2 trillion of global funds running one of the best performing funds in its class giving an annualised total return of 10% over 30 years.

He's been talking to CNBC this month where he expressed his concerns:

"They all seem to believe that there is an interest rate SO LOW that resultant financial market wealth will ultimately spill over into the real economy. ... How successful have they been so far? Why after several decades of zero percent rates has the Japanese economy failed to respond? Why has the U.S. only averaged 2 percent real growth since the end of the Great Recession?"

It's a great question and we share his concern that investors remain vigilant. But Bill Gross has been calling time on bond markets for some time. In 2010 he declared that the UK's bond market was like a bed of nitroglycerin, ready to go off the moment the Bank of England was forced to raise rates. He reiterated his bearish stance again in 2013, since which time, US and UK, bonds have moved higher still.

That's not to say we don't share his view of government bonds now, it's hard to disagree with much of it.

Conclusion for TAM portfolios

We believe that government bonds are now very expensive and, far from representing "risk free return", they offer not much more than "return free risk". TAM client portfolios now have a far lower exposure to bonds and Government debt than anytime in the past.

Stock markets are now trading mid-range between last year's highs and this year's lows when the sell-off failed to budge the Federal Reserve's resolve to consider scaling back their schedule of future rate hikes. This has happened several times in the last few years. We have kept only a mild overweight in equities and, even then, almost entirely in very specific themes with a small exposure to ETFs which we use for shorter term investing which this kind of market demands.

Whether the investment gurus are right or wrong, it seems to us that the central banks are in no mood to be pushed around and it is still them in the driving seat.

They are both universally challenged.

This document is not intended in isolation as an offer or solicitation or recommendation to use or invest in any of the services or products mentioned herein. Investors should be aware that the value of the portfolio and the income from it can go down as well as up so you may get back less than you invested. Past performance is not necessarily a guide to future returns. The value of investments denominated in foreign currency may fall as a result of exchange rate movements. The investments and services referred to in this document may not be suitable for all investors and, if in doubt, you should seek qualified independent financial advice. Any opinions, expectations and projections within this note are those of TAM Asset Management International Limited, represent only one possible outcome and do not constitute investment advice.

TAM Asset Management International Limited is regulated by the Financial Services Commission of Mauritius and is an authorised Financial Services Provider regulated by the South African Financial Service Conduct Authority.