

Double Dip Unlikely

At the beginning of the year, we described the challenge facing governments and monetary authorities in keeping the recovery on track, as walking a tightrope. On one side lay deflation and renewed recession; on the other, inflation and sovereign bond market crises. In our view, the analogy remains accurate; the global economy has been through several major wobbles, but has stayed on the tightrope. Meanwhile, careful observation of events during the first seven months of the year has given us a better understanding of the forces maintaining this balance, and therefore greater conviction in the current positioning of recommended portfolios. We believe that deflation, or a double-dip recession remains unlikely, and that risk assets are attractive relative to both government bonds and cash.

Our reading of developments in the global economy thus far in 2010 is that there are some powerful stabilisers counteracting the tendency of developed economies to veer towards either deflation or inflation, as the following examples illustrate:

- For several weeks at the beginning of the year, strong data releases and recovering asset prices, including equities, prompted concerns that economies were heading for inflation. In the UK, for example, RPI reached 5.3% - a long way from deflation. However, such concerns were countered by (i) central banks, which started to remove exceptionally supportive policy, and (ii) rising government bond yields, which delivered a mild monetary tightening.
- By mid-March, economies were beginning to move towards the opposite outcome: the deflationary slump. This was triggered by deteriorating economic data and plans for fiscal consolidation, hastily introduced by governments to ensure their bond markets remained credible in the light of the Greek sovereign debt crisis. In response, equity markets fell sharply. Once again however, the natural stabilisers were activated to counter the extreme outcome; central banks started to prepare plans for further quantitative easing while sovereign bond yields fell sharply thereby delivering easier monetary conditions.

Of key importance in both examples above is the part played by the monetary authorities. However, in our analysis, both policymakers and central bankers in the developed economies are much more fearful of deflation than inflation. Through various statements and actions, such as Ben Bernanke's testimony to Congress last month, the authorities have signalled that they will go to whatever lengths necessary to avoid deflation. Of equal importance, central banks have the weapons in their armoury to make it highly likely that deflation can be avoided. Whereas fiscal and conventional monetary policy is all but exhausted, unconventional monetary policy (quantitative easing) can be extended almost without limit and, as Messrs Bernanke and King have intimated in recent weeks, if necessary, it will be. This is a powerful force to counter the risk of a 'double-dip' in economic growth.

From an asset allocation perspective, the conclusion that deflation will be avoided, if at all possible, means that it is much more sensible for us to build portfolios that will prove resilient to the inflationary outcome and resist paying too much for protection against deflation. Helpfully, inflation protecting assets, such as property and equities, are far more attractively valued than their deflation counterparts: government bonds and cash. We therefore continue to recommend that portfolios contain a healthy allocation to these 'risk assets', with diversification achieved through corporate bonds (see below) rather than gilts or other sovereign debt.

On a separate but related matter, the above assertion may prompt some readers to ask whether quantitative easing can simply be extended without dire consequences for 'sound money' and the value of currencies. Our answer is that, expanding the money supply may indeed result in lower exchange rates for developed nation currencies. If this transpires, it would be welcomed by policymakers as part of the solution to global imbalances. After all, the US government has for some time been pressuring the Chinese to revalue the renminbi. Such a revaluation would, of course, also be achieved through a dollar depreciation triggered by quantitative easing.

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Corporate Bond Allocations

In our May update, 'Corporate Bonds 20, Government Bonds 0', we emphasised the continuing attraction of corporate bonds. Despite the greater likelihood of inflation rather than deflation, as discussed above, our conviction that portfolios should continue to maintain allocations to corporate bonds remains strong for three reasons as follows:

- Corporate bond yields remain sufficiently above those on gilts (see chart below) to provide a degree of comfort that the former will remain resilient to rising interest rates, moderately higher inflation or rising gilt yields;
- The income generated by portfolios of corporate bonds is attractive relative to that available on other asset classes;
- Corporate bonds should reduce overall risk by providing valuable diversification to portfolios.

Gilt and Corporate Bond Yields since 2005

