Investment Bulletin

SAUNDERSON HOUSE

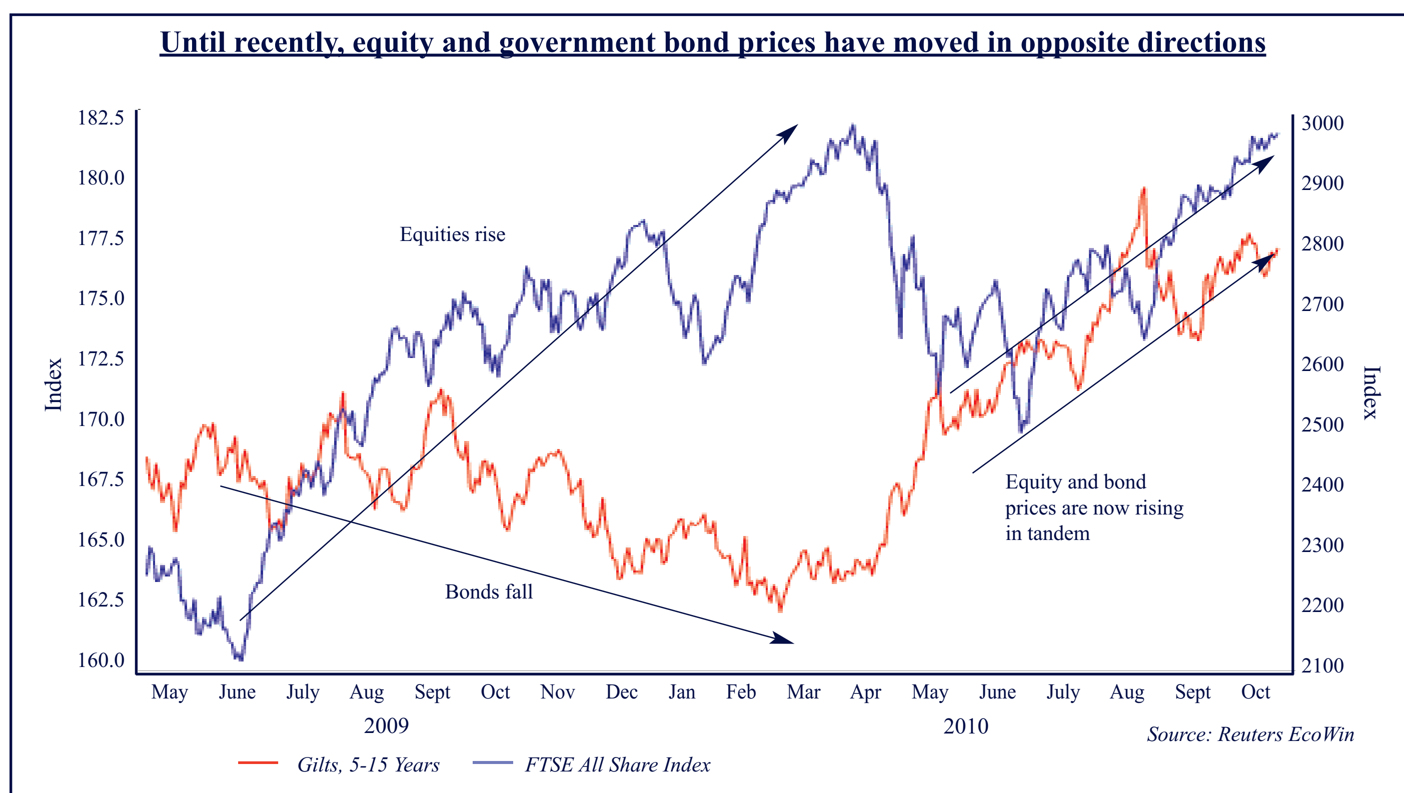
21 OCTOBER 2010

CONFLICT-FREE FINANCIAL ADVICE

QE2 LAUNCH LIKELY TO CAUSE WAVES

The prospect of a second round of quantitative easing (QE2) is driving investment markets higher and distorting the traditional relationships between asset classes. This note highlights the economic rationale for QE2, its impact on currency and commodity markets, and gives our view on the implications for investors.

From its low point in August, the UK's FTSE All Share Index has risen by 10.4%. Over the same period the FTSE All World Index is 12.8% higher. However, this equity market rally has been quite different from those seen earlier in the year on two counts. Firstly, equity prices have risen while news on the economy has, for the most part, disappointed. Secondly, government bond prices have risen along with equities. Typically, when confidence in the economic outlook increases, government bond prices fall as investors switch to equities in search of higher returns. Conversely, when caution prevails, investors sell equities and retreat to government bonds. This relationship has been distorted by the prospect of a wave of liquidity from QE2, resulting in rising prices for both bonds and equities.



The Economic Rationale for QE2

With economic data continuing to disappoint, QE2, in the US and the UK, looks likely. The aggressive fiscal and monetary stimuli administered by the authorities in 2008 succeeded in stabilising developed economies, but little more. For example, US unemployment remains stubbornly above 9.5% amid weak consumer confidence and a moribund housing market. With government debt already very high and interest rates almost zero in Western economies, further quantitative easing is one of the few remaining policy levers. The aim of QE2 will be to boost liquidity within financial systems. In the US, for instance, the authorities will hope that more QE reduces mortgage rates for America's heavily indebted households, supports asset values (including house prices) and increases the liquid assets on bank balance sheets, tempting them to increase lending.

Saunderson House Ltd, Independent Financial Advisers, 1 Long Lane, London EC1A 9HF
tel: 020 7315 6500 - fax: 020 7315 6550 - web: www.saunderson-house.co.uk

Exchange Rates
There is also an international trade dimension to QE2. Part of the increased liquidity injected into the US economy will inevitably leak abroad as investors sell dollars to finance assets in stronger growing economies overseas. This will put downward pressure on the value of the American currency on foreign exchange markets. In anticipation of QE2, the dollar has already weakened, triggering talk of currency wars. As we wrote in August, if the Chinese refuse to revalue the renminbi, the Americans have the option of devaluing their currency by increasing the supply of dollars. The Chinese want to keep the renminbi cheap to facilitate continued rapid urbanisation but the US wants a weaker dollar to support exports and thereby boost its recovery. However, it is a zero sum game. The renminbi and US dollar cannot both weaken against each other at the same time – hence the war of words between the two.

Commodities
QE2 is also driving commodity prices higher. Copper rose to its highest level in two years last week, while gold continues to make all time highs, at least in nominal terms. On first inspection, such moves make intuitive sense; if the international value of the dollar is being undermined by QE2, commodities priced in dollars should rise to compensate. However, beneath this superficial analysis lies a paradox and, possibly, danger for investors. If the recovery in the developed world is so weak that more quantitative easing is required, it follows that demand for commodities is likely to disappoint. So why are commodity prices rising? The answer lies not in economic fundamentals but in anticipation of the extra liquidity provided by QE2.

Implications for Investors
How should investors respond to such developments? First, we must acknowledge that QE2 is a short term palliative. As discussed last month, QE2 should fend off deflation, but it cannot solve the structural problems of the global economy. These require higher savings in the Anglo-Saxon world and higher spending in developing nations. Secondly, we should note that QE2 is justified only because the economic recovery in the developed world has thus far been anaemic. Moreover, a further round of quantitative easing is not without risk; it could trigger an inflation shock in the medium term. As such, the outlook for investment markets is becoming more uncertain, not less. In conclusion, we should resist the urge to increase portfolio risk at this time in response to what looks very much like a liquidity-fuelled rally.

*　　　*　　　*　　　*　　　*

The UK's Comprehensive Spending Review
Yesterday's Comprehensive Spending Review saw George Osborne reveal the details of departmental spending plans for the fiscal years to 2014/15. While analysis of the winners and losers will no doubt occupy many column inches in the press, in our view, the key discussion point is whether the cuts risk plunging the UK back into recession. The arithmetic here gives us cause for optimism. The value of goods and services produced by the UK economy in one year is close to £1,500bn. By comparison, the required reduction in government spending is c£83bn, spread over the lifetime of the current parliament. According to the Office of Budget Responsibility, this will knock just 0.6% p.a. from economic growth. Moreover, if growth looks likely to weaken, spending cuts may well be rescheduled or delayed. In conclusion, while the fiscal retrenchment is large, it is unlikely to make the difference between continued growth and renewed recession.

This note is for general guidance only and represents our current understanding of law and HM Revenue and Customs practice as at 21 October 2010. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments and any income therefrom can go down as well as up and you may not get back the full amount you invested. Levels and bases of, and reliefs from, taxation are those currently applying but are subject to change and their value depends on the individual circumstances of the investor. Saunderson House Limited is authorised and regulated by the Financial Services Authority.

Saunderson House Ltd, Independent Financial Advisers, 1 Long Lane, London EC1A 9HF
tel: 020 7315 6500 - fax: 020 7315 6550 - web: www.saunderson-house.co.uk