



Quantitative easing

In a few short weeks most commentators and investors have become authoritative speakers on quantitative easing. The idea of introducing money into the economy to kick start it is hardly new, but in the UK on this scale it is certainly newsworthy.

In this note I would like to look at what quantitative easing is, and how investors might think about reacting.



Quantitative easing is often translated as “printing money”. I am guilty of using this inaccurate explanation. What really happened on 11 March is that the Bank of England (BoE) went into the gilt marketplace and started buying gilts. The BoE bought gilts from, largely, banks, insurers and other commercial organisations. This puts cash into the banks, pension funds and so on. The idea is that the banks will then lend more money and pension funds will invest. The BoE did not of course have the money sitting around to buy these gilts – hence the use of the term “printing money”. The BoE just created the money.

As any O-Level economist knows, when a big buyer appears and starts flashing his cash, sellers start putting their prices up. Sure enough this happened exactly as the text books would have expected. In fact the impending arrival of the big spender was already well known and prices had moved up well ahead of its arrival. Gilt prices rose which means yields dropped. If long dated gilt yields drop then other thing being equal annuity rates fall, but few of our clients are contemplating annuity purchase.

In fact, since March gilt prices have fallen back a little though not enough to make a huge difference to the yield. This small decline may be a function of a realization that whichever government is in power, it will have huge debts to finance and gilts are likely to form a huge chunk of the financing and so will be a net seller rather than buyer of gilts. The same O-Level economist should also be able to tell us what happens to price when supply goes through the roof. In fact, although prices have fallen back they still remain at historically high levels.

What follows from these gilt price changes is less certain and less obvious. It is not certain that the banks will in fact lend more money. But the cost of borrowing should also drop because gilt yields will have fallen and these are used as benchmarks for fixing other interest rates (except base rate). This in turn should stimulate economic activity.

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But then many models will predict that inflation and interest rates will rise.....so (conventional) gilt prices will drop. And gilt yields have risen by a small amount rather than gone down.

Therefore if investors think that the government policy of quantitative easing will work then investors should sell gilts and buy equities, which normally fair better in times of inflation. If they think the policy will fail they should, like the BoE, buy gilts.

This displays the circularity of the process that feels intuitively uncomfortable. The government is issuing a huge amount of debt [gilts] to finance its spending, and then buying the same debt back on the open market.

If the policy works "too well" then inflation becomes a very serious worry. [Though probably not in the next year – commercial pressures on businesses and particularly producers are huge and there is no appetite for increasing prices]. If inflation takes off then conventional gilts are destroyed by increasing prices and index linked gilts are the assets to own. Equities and property may also do well.



So how should investors react? Well above all else I would argue that they should react calmly but that is not very specific.

The only scenario where conventional gilts look good is where quantitative easing fails. This is the Japan scenario. Negligible interest rates, no economic growth to speak of, no equity growth to speak of. Conventional gilts are almost the only broad asset class that wins here. Note that the return from corporate bonds can be pretty hopeless in this scenario. Such conditions could lead to many corporate failures, including businesses previously perceived as rock solid. The risk of corporate bonds failing to repay would become a reality for many investors. Interestingly, the market already appears to be pricing in an unprecedented default rate, and quantitative easing is of course (partly) designed to reduce the level of corporate default.

Both equities and index linked gilts could benefit from the policy working well (recovery) or from working too well (inflation). Index linked gilts have already moved further up in price as the market continues to anticipate the return of positive inflation.

Returning to the "quantative easing fails" scenario, another asset class which might perform well would be non UK equities. If depression, as in The Depression, sets in then the returns available from countries that did not get it wrong are likely to be rather higher than in the UK. A further advantage about owning non UK businesses is that if inflation takes off in the UK then one could reasonably expect sterling to fall still further. This argument must not be overused; the global nature of business means that the country where a stock is listed has less and less to do with the business itself and picking the right countries may prove tricky.

The general point I hope to have reached is that under all scenarios it is intelligent diversification that is key to protecting portfolios. It would appear that international equities and index linked gilts can perform well in several different scenarios but that conventional gilts will only perform well in one particular scenario.



It is hard for us to recommend conventional gilts. At the time of writing almost every gilt maturing up to and including 2020 is trading at a premium to par. Purchasing and holding to redemption will result in a loss that is unrelievable against Capital Gains Tax. The yields available are of the order of 2% to 3.5% per annum (gross). These assets can only be attractive purchases in the event of medium term deflation.

The bottom line is that intelligent investors will hold a diversified portfolio. That diversification should be managed scientifically. Commentators everywhere are suggesting that there is a new world order and that this demands a new way of investing, a new way of looking at the world. The more desperate investment returns become in the short term, the more compelling the arguments seem to become. We disagree with the commentators. In fact the current serious and painful difficulties even when coupled with quantitative easing, point clearly towards sticking to the basics:-

- Revisit short, medium and long term goals.
- Thoroughly and carefully diversified portfolios, both within and between markets, give investors the strongest chance of achieving returns greater than the return on cash.
- Manage costs, manage taxes and manage risk factors.

Diversification will not protect you from volatility or from falling global markets. But it will protect you from stock specific risk and can help to control volatility. The case is stronger rather than weaker when our government is experimenting with quantitative easing.

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