Alvine Capital August Newsletter 2010

The Case for Sterling

August 2010

Key recommendation: Continue to diversify out of the US $, and in particular favour a significant exposure to sterling

'It isn't the euro. Second, it isn't the dollar' WSJ, 4th August.

Key issues: sterling has total political stability, a revitalised and retrenching Conservative government, and has suffered significant declines in recent years. The spotlight should now turn to other countries problems, in particular the US $.

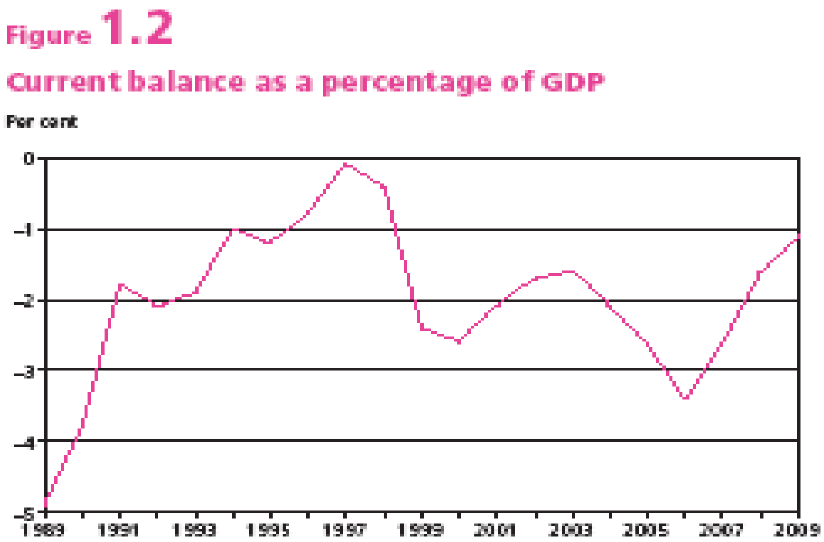
Sterling, a long history.

With the folding of the French Franc into the euro, it leaves £ as the undisputed European oldest champion currency.

Incredibly the pound is 1200 years old, founded literally as a pound weight (454g) of silver coinage. This modern means of exchanging goods was used by the Anglo-Saxons. The origin of the word 'sterling' is more obscure; it could derive from the meaning of 'ster' in old German-strong, pure, stable and reliable (The Telegraph.) The Bank of England is also the G20's oldest central bank .The Queen's face appears on every Bank note with a personal 'promise to pay the bearer on demand.' More recently, when the Bank was granted operational independence in 1997, it has **an inflation only mandate of 2%.** The parliamentary legislation affirms 'The Bank's monetary policy objective is to deliver price stability low inflation and**, subject to that**, support the Government's economic objectives including those of growth and employment' (Bank of England website.)

Even the perennial UK Balance of Payments has shrunk to a mere 1% of GDP in 2009. With the austerity policy introduced by the government reducing private consumption, and the positive effect of the depreciation since 2007 now spilling through to exports, a surplus may yet come.

Chart UK balance of payments (source Pink book.)



Foreign capital has always been attracted to Britain's political stability.

Coalition—Gladstone meets Thatcher.

Despite some early promise 'New' Labour, echoed the tax and spend route of old Labour. It's not surprising that international investors grew tired of sterling, with the currency underperforming over the last 3 years.

However, the new government elected in May has already taken a dramatically new direction to correct its predecessor's fiscal irresponsibility. Some investors had hoped that David Cameron's Conservatives would emulate Mrs Thatcher and turn Britain towards a lower taxed, **supply side** economy. However the introduction of the Liberals into a genuine coalition has proved a more interesting fiscal tonic. Maybe Nick Clegg's party were just too keen to enter power, or they are replicating their great 19th century forbearers.

The 19th Liberal party was famous for its tax cutting and simplification zeal, a blend of Mr Macawber style idealisation and self reliance. As the 'Grand old man' and four times prime minister William Ewart Gladstone himself put it, '**Liberalism is the trust of the people tempered by prudence** '(Brainyquote.com.)

In any event George Osbourne has launched an ambitious plan to rescue the UK's fiscal deficit. He appears to recognise how close to the monetary precipice the country really is.

As Richard Lambert, CBI Director General stated; 'The Chancellor has achieved his twin objectives of setting out a credible plan for the public finances and producing a convincing growth strategy for the long-term. This Budget is the first important journey back to economic health' (BBC.co.uk.)

But more pertinently for international investors **this frugal direction was largely unanticipated**.

Perhaps it was just pre-election propaganda or David Cameron's 'hug a hoodie' rebranding of the Conservatives. Expectations were low. It is when markets are surprised you often get the biggest moves. Mr Cameron wrote on August 8th, in the Sunday Times.' When a company is failing-when spending is rising, sales are falling and debt is mounting you need someone to come in with energy, ideas and vision.

How cheap is the pound? Let's get some historical perspective

Source: Bloomberg

Cable in the mid-1.50s, near the bottom of a 20yr range.

Source: Bloomberg

Sterling / yen, product of a 20 year bear market.

Source: Bloomberg

And cheap against the Swiss Franc.

These long terms charts help us to see how far sterling has depreciated over the last 20 years. There may be a plethora of reasons why this has taken place, but to move the discussion on it may now be other currencies that have bigger problems to face.

The US $, politics takes centre stage.

David Frum, President GW Bush's favoured political pundit, wrote in the FT on Bastille day 'Hell no' is not a platform for power. This manifesto was written to rally a programme for the mid-term elections.

Let's see what he thinks a potential future Republican Congress might do. 'To get cash moving we need moderate inflation, which reduces the burden of debt. Even better, since the largest holder of US cash is the Central Bank of China. **US inflation conscripts an uncooperative China into contributing its fair share to global economic recovery.'** This is a pretty chilling outlook from the mainstream Republican leadership and for any overseas holders of $.

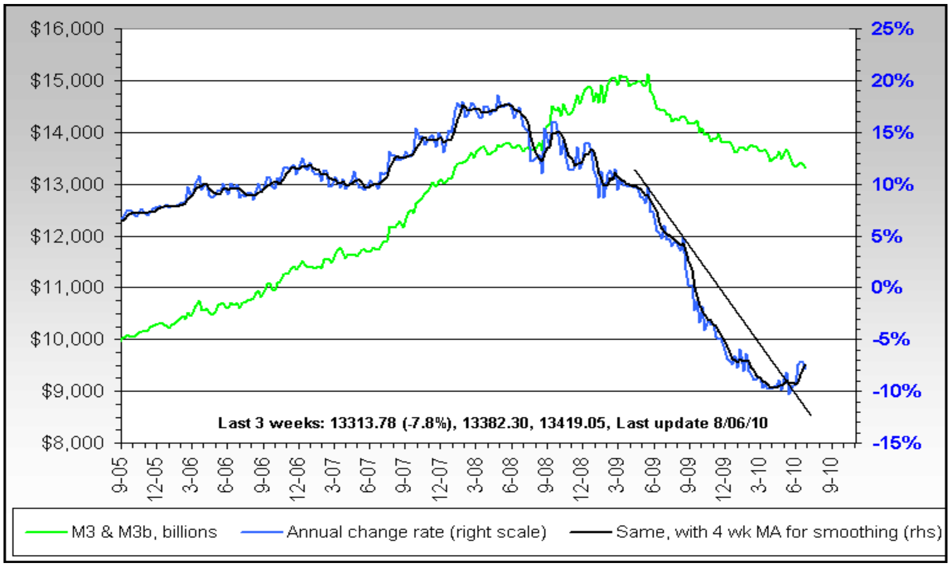
A brief look at history shows us, that unlike in Europe where right-of centre Governments tend to be fiscally responsible, it has been Presidents Reagan and GW Bush, who have presided over huge increases in the Federal deficit.

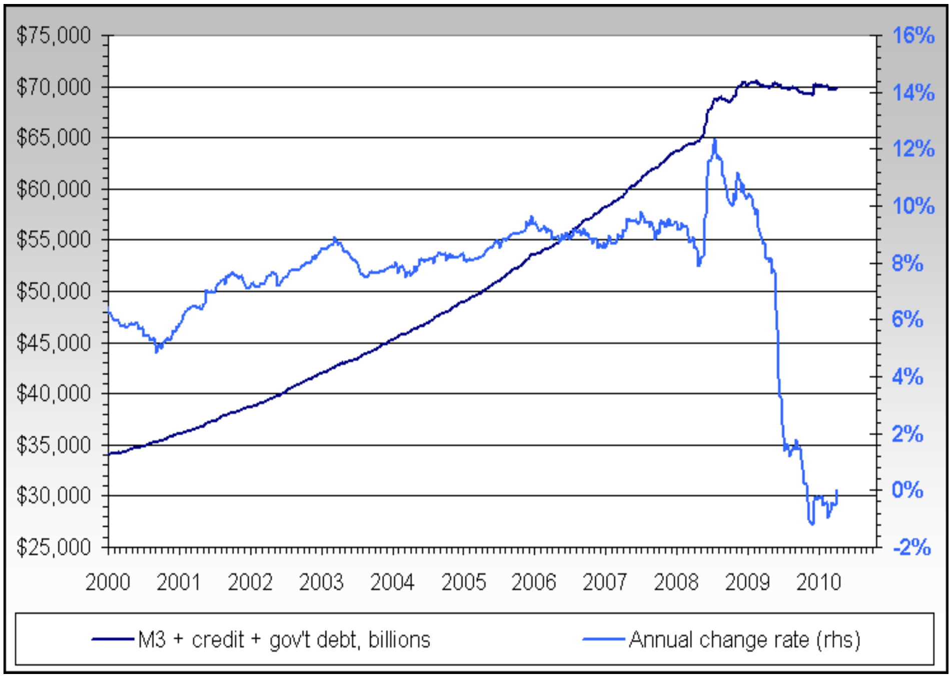
A note on Fed policy is warranted. Let's look at the actual mandate and goals elucidated, '**maximum employment**, **stable prices, and moderate long-term interest rates'.** (Federal Reserve website.) This order and the inclusion of employment as an objective have long been noted as quite different from the Europeans. Surely with close to zero interest rates, there is now very little room for manoeuvre or difference between the major economies central banks?

In what has become a famous speech given by Ben Bernanke in 2002 he stated, 'under a fiat money system, a government should always be able to generate increased nominal spending and inflation, even when the short-term nominal interest rate is at zero.'(Federal Reserve website.) From someone who has **already spent $1.5 trillion** dollars as part of an asset purchasing programme, we should believe him. If there is the will, Bernanke will find the way.

Money Supply - check your facts.

Some commentators attach great significance to the recent contraction in M3, now falling 'at the fastest pace since the great depression.'(The Money illusion.) But if you look at these two M3 charts you will see that by including government expenditure that M3 has in fact stabilised at near 0% growth. It is another axiomatic matter of monetary policy it can take up to 18 months for the effects of changes in conditions to be felt. Time will see the huge monetary stimulus pay.





Source: Charts (nowand futures.com)

Combine a militantly dovish Federal Reserve, packed with Obama appointees and you have a recipe for America trying to export its problems via a weak dollar. The 12% or so appreciation of the US currency against the Europeans has not been welcome in the near hysterical air around Washington. As Brian Gardner of Investment firm Keefe Bruyette & Woods put it**, 'We're in a very populist era'** (CNBC.com.) A similar sentiment was expressed by CNBC's Patrick Allen, who quipped after the G20 summit in June 'Europe austerity makes America look socialist.'

So why not the single currency?

The comeback of the Euro since June's lows of 1.18 against the US dollar has been impressive. We need to give credit where it's due, that the ECB was able to tackle the immediate crisis head on, without the need to spend too much recourse to the much vaunted €750bn rescue package.

But legitimate long term concerns about the whole European project remain very much on the table. While we have always believed the elites in Europe would continue to' play the game', and that the Euro will survive. The need for Germany to shoulder so much Southern European dead weight must hold back the currency's attraction. Jonathan Loynes of Capital Economics summarised the situation recently, 'With the worst fears concerning peripheral debt easing a little, it is not surprising that the euro's rally has continued. But **as further falls in consumer confidence in the periphery** has highlighted the damage that fiscal austerity can do.'

The advantage of sterling is being on your own.

Anyone for Yen?

No, Japan is not a place to invest. With a 20 year recession still is showing no serious sign of abating, a paralysed government, 200% government debt/GDP ratio (OECD) and the first serious demographic problems surfacing. This is an accident waiting to happen. What might trigger the crises is more prosaic, but we are of the opinion to leave Japan well alone.

But don't short it either; quite a few fortunes have been lost trying to call this one. It may be a natural disaster like an earthquake is required to act as catalyst.

Anywhere else

This article is not going to stray into the emerging market sphere. So we are concentrating on western, OECD economies, ditto commodity currencies that need more space than we can offer as part of an evaluation of the entire long commodity strategy.

Sweden is a nice place to consider. It has like sterling the merit of being outside the Euro zone, and the ability to follow an independent monetary policy (the Riksbank even increased rates to 0.5% in July, the first major European Central Bank to do so). Bearing in mind several of my colleagues come from that fine country, I should also point out that Swedish growth has now topped 3% in the 2nd Q2010 and that over 80% of companies reporting earnings for the 2nd Q beat expectations. SKF, the world's largest maker of ball bearings even reported its biggest quarterly profit, led by export sales to the world's automotive industry.

But sorry Tom/Tina/Ola, while we can recommend some Swedish Krona you would need to keep it small. Sweden with less than one percent of world GDP cannot make a large part of all but the most adventurous portfolios.

Something for the Bulls

To a major extent, your view on the world's prospects must also play a part on the forecast for sterling. For the doomsayers, a currency with a heavy dependence on the financial sector like the UK may not be the best place.

However, if you are broadly bullish on the markets sterling can provide some extra juice. **If the Fed**, **and others will print money then in essence they will guarantee the nominal and hence actual** growth in financial asset prices. It's also worth noting that the UK's ability to thrive over the 21st century can only be enhanced as certainly Europe's major financial/legal and design centre. This heady mix, centred around the burgeoning metropolis of London, is a very real asset.

We must finish this article by turning back to the US scene, as this market call is dependent on a bearish view of the $. Even the Chairman of the Joint Chiefs of Staff in Washington, Admiral Mullen feels compelled to comment on financial matters with, 'the Nation's debt is the biggest threat to U S National security.' (The Huffington post)

With Obama in the White house for at least another two and half years, Bernanke at the Fed and the likelihood of a Republican populist Congress, this heralds a policy mix which will be inimical to the dollar.

I sign off with Congressman Ron Paul, of the 14th District of the famous Lone star state of Texas. 'The greatest threat facing America today is the disastrous fiscal policies of our own government, marked by shameless deficit spending and Federal Reserve devaluation. It is this one-two punch; **Congress spending more than it can tax or borrow, and the Fed printing money to make up the difference—**that threatens to impoverish us by further destroying the value of our dollars.' (Thinkexist.com)

Conclusion

'An ounce of performance is worth a pound of promise.' Mae West (Brainyquotes.com)

July proved to be a good month for equities with the S&P 500 making its best performance since March 2009. Despite this, and with **early August wobbling** again, we still feel there will be better levels to return to a positive market weighting. Our advice is to wait for a seasonal blow off low, which we expect in risk assets sometime in the autumn.

Our model portfolio produced a creditable 3.57% return. We will look to act on our view, and increase equity exposure later in the year. A copy of this model is attached to this newsletter.

The main thrust of this month's argument is to focus on £, where we feel a significant opportunity exists over the next 2/3 years.

ACM Model Portfolio

July

				Contribution	
Asset class	SAA	TAA	Over/under	SAA	TAA
Cash	5.0%	15.0%	10.0%	0.00%	0.00%
Fixed income	25.0%	25.0%	0.0%		
Government bonds	15.0%	15.0%	0.0%		
US	12.5%	12.5%		0.13%	0.13%
Europe	12.5%	12.5%		0.41%	0.41%
RoW					
Corporate bonds					
US					
Europe					
RoW					
Equities	40.0%	30.0%	-10.0%		
US	18.0%	16.5%	-1.5%	1.24%	1.13%
Europe	12.0%	9.0%	-3.0%	1.42%	1.06%
Japan	4.0%	0.0%	-4.0%	0.17%	0.00%
Asia ex-Japan	4.0%	3.0%	-1.0%	0.28%	0.21%
Emerging market	2.0%	1.5%	-0.5%	0.16%	0.12%
Hedge Funds	20.0%	25.0%	5.0%	0.01%	0.01%
Eq hedge	5.0%		-5.0%		
Conv Arb	3.0%		-3.0%		
ED	3.0%		-3.0%		
Fixed income	3.0%		-3.0%		
Macro	3.0%		-3.0%		
CTA	3.0%		-3.0%		
Real Estate	5.0%	5.0%	0.0%	0.48%	0.48%
Commodities	5.0%	0.0%	-5.0%	0.30%	0.00%
Total	100.0%	100.0%	0.0%	4.60%	3.57%

This material is confidential and is intended solely for the use of the person or persons to whom it is given or sent and may not be reproduced, copied or given, in whole or in part, to any other person. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be solely relied on in making an investment or other decision.

The information and opinions presented here are for background purposes only and do not purport to be full or complete. No reliance may be placed for any purpose on the information or opinions contained in this document or their accuracy or completeness. No representation, warranty or undertaking, express or implied, is given by Alvine Capital as to the accuracy or completeness of the information or opinions contained here and no liability is accepted by Alvine Capital for the accuracy or completeness of any such information or opinions.

No information provided herein shall constitute, or be construed as, an offer to sell or a solicitation of an offer to acquire any security, investment product or service, nor shall any such security, product or service be offered or sold in any jurisdiction where such offer or solicitation is prohibited by law or regulation.

UK Residents: Alvine Capital Management Limited is regulated in the conduct of investment business by the Financial Services Authority, ("FSA").