Newsletter No.7 – February 2011

The euro emerges as a serious currency

'If you are looking for where there could be a surprise, the Europeans are probably a place you may want to look' Richard Bernstein (CNBC.com 2/12/10.)

Key issues, as the fallout from QE2 gathers pace amid no sign of any serious US fiscal restraint the euro's now decade long life has demonstrated a real store of value.

Key recommendations, investors should fully weight portfolios to the euro. As political risk returns in the emerging world, the single currency can be favoured as a counter balance to the US $.

It seems as if the euro has had a baptism of fire, with the latest sovereign debt crisis perhaps the final straw. No doubt its creation could have been simpler with a smaller group of countries. But with the German economic locomotive now firing on all cylinders, strength now exists to carry the weaklings. Some sort of Teutonic fiscal rectitude is finally emerging in contrast with America's profligacy. The likely-hood of a German at the helm of the ECB, will also contrast well with the US's apparent permanent ultra-loose monetary policy.

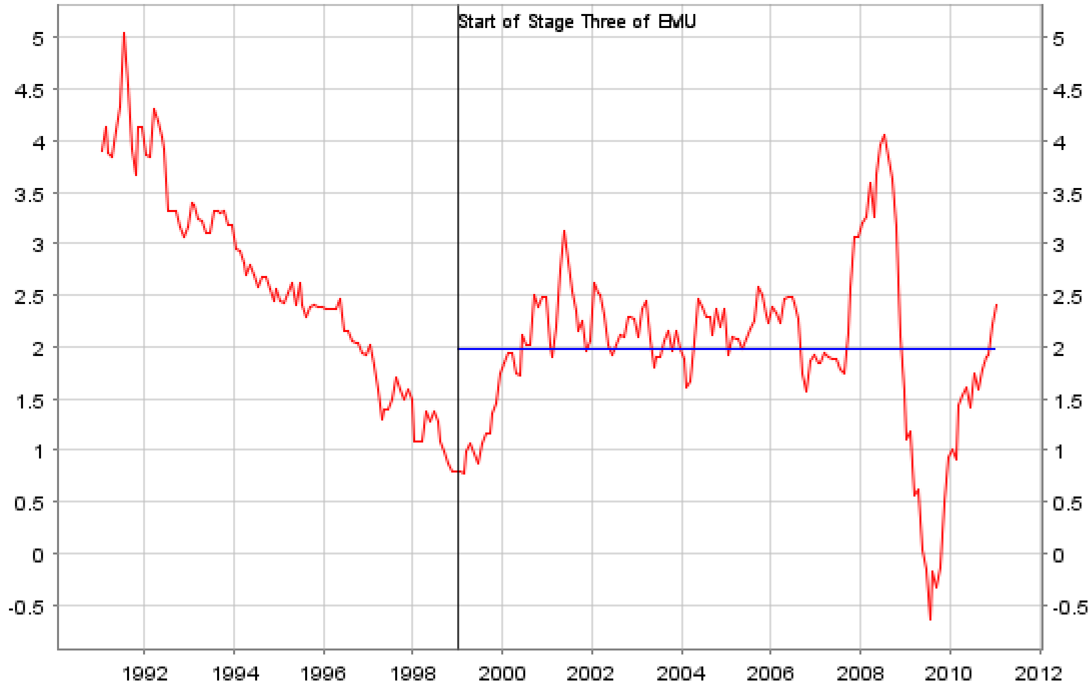
Help is also at hand from other geo-political players like China that have a clear objective to support a counter balance to the US $. Anglo-Saxon pundits, as a matter of deep prejudice, have been too quick to call the death of many European projects and the euro will survive, and may yet prosper.

A strong first decade- source Bloomberg

Monetary matters- 'we are profoundly attached to our mandate.' JC Trichet (WSJ 23/1/11)

The cost of, and the supply of a currency, must be the single most important factor in determining its price. 'In pursuit of price stability, the **ECB aims at maintaining inflation rates below, but close to, 2%** over the medium term.' (ECB website) this mandate is unlike the Federal Reserve's dual objective of inflation and employment. In a helpful chart from the website, the ECB flag's that this target has been met for the 10 year life of this institution**.**

From this does currency credibility stem.



Inflation and against target-source ECB website

Much has been made of the recent 'hawkish' comments made by ECB President Jean-Claude Trichet in response to an uptick in the single currency's inflation rate. What is equally pertinent to understand is the thought process behind the policy as this will allow us to deduce future action.

As part of a wide ranging interview with the Wall Street Journal already quoted, Trichet gave further explanations as to why Europe's monetary policy may be quite different from others. It is one thing to protest that you are serious about an inflation mandate, as the BOE may do, it is another to explain how you may interpret that task. The ECB's president illuminated why core inflation, that excludes food, energy and other important every day products, cannot be the sole arbiter. As he explained, in contrast with the Federal Reserve that does follow core CPI,' **core inflation is not necessarily a good predictor for future headline inflation.'** Ergo, the ECB will be likely to take a more rounded view of inflationary data to reflect real price pressures in the economy.

The Fed openly argues that by focusing on core inflation policy makers are not whipsawed by the volatility of products such as oil prices. The trouble with this view is that for the man in the street, and hence the workforce, a real inflation rate does include essentials such as food and hence is every bit as important as other so called non-core ones. Accordingly if headline inflation is extended, it is likely that wage demands will follow suit. Furthermore, by excluding more and more things such as most housing costs (in the UK) you soon end up with an indicator that is not believable**. Anchoring inflationary expectations with credible statistics is vital**.

Trichet's legacy ' we will continue to deliver price stability'

Fiscal turnaround

At a time of recent fiscal crises in peripheral Europe it may be a little brazen to call the corner as being turned. But from Greece, through Ireland to the major economies at the centre there is a real understanding of how important this issue is. Turning again to Trichet's interview in the WSJ, '**we strongly believe that fiscal soundness is confidence-enhancing and therefore part of a growth strategy.' David Cameron could not put this better.**

Many commentators have questioned whether people in general could stomach the substantial turn around in government expenditure. In fact good examples may be seen in the Baltic States where these cuts in 2009/10 coincided with brutal recessions. Here the public has seems to understand that the benefits of EU membership over many years have translated into high living standards, even if some retrenchment now is inevitable.

When considering currencies it is relevant to look at the alternatives, and this is where Europe's fiscal consolidation seems to contrast with America's. Already undermined by the collapse in tax revenues that hit during the recent recession, repeated fiscal stimulus have put the US's total deficit to a scarcely credible $1.645 trillion for 2010(OMB). While this is a frightening enough figure the recent mid-term elections have ushered in a new Republican majority in the House. This is where the fun starts.

While Republican leaders in the run up to the election where quick to castigate Obama's fiscal policies, the reality is looking quite different. In a leading editorial for the New York Times on 31/12/10 the paper really takes the Republic leadership to task, with the new rules' gutting pay as-you-go... will codify the Republican fantasy that tax cuts do not deepen the deficit'. This is as Paul Krugman fulminated in the same paper '**that old voodoo economics- the belief, refuted by study after study, that tax cuts pay for themselves**.' Cue the agreement between Obama and Congress to extend the Bush era tax cuts, and in doing so splurging another $800bn to the deficit over 5 years.

There is something near hysterical going on in American politics that means that fiscal and monetary reality is yet to be grasped.

As Philip Cerny, Professor of Politics at the University of Manchester wrote in a letter to the FT 3/11/10 ' In the last analysis, the US's inevitable decline as the rest of the world develops and catches up is the real cause of the rise of the Tea party. And should its rise continue, the US will be more and more divided and unstable exacerbated by the tendency of its political system to gridlock.'

The situation in Japan may be even worse, where a rapidly declining workforce continues to crimp tax receipts. With government debt to GNP ratios already over 200% there is a tendency to have given up any fiscal plans to even begin to reign in this imbalance.

Europe stands out amongst the old G3 as the one trading block where it is understood that government expenditure must eventually balance.

Political support is still mainstream across the Community

We have already touched upon how the peripheral nations such as Ireland, have acknowledged just how good a ride they have had within the EU.

But what of Germany, the main paymaster and apparent loser by abandoning the Deutschmark?

During the early days of the Community it was France that led the political process, being able to rely on Germany still wracked with wartime guilt to play along. The latest budgetary crisis has caught Germany in a very different post unification mood.

In a leading article in The Times (14/1/11), the paper found that it is now**' Merkel's Europe. It is her word that the markets hang on.'** This would not happen if Germany was only master of it's own currency and hence domain.

Germany is now in a position to dominate the next stage of European development. Furthermore the deepening of the EU's markets over the past decade goes someway to explain the export strength of her economy. The euro has given Germany a competitive currency and a store of value compared to the most obvious alternatives. While a few mavericks hark back to the pre-common currency era Germany's main political parties and leading businesses and banking community are right behind what has been delivered to the Federal republic.

While the news that Axel Weber the Bundesbank's President has resigned might be the catalyst to find another German candidate suitable to all and fill the ECB's shoes. As the Jack

Ewing writing in the New York Times speculated **'a name that has been floated is Klaus Regling**...with German support crucial.' (NY Times website 14/2/11) **It is our view that he will get the top job.**

Trade plays a part

What moves currency markets? There are many theories, but until quite recently balance of payments was thought to be important.

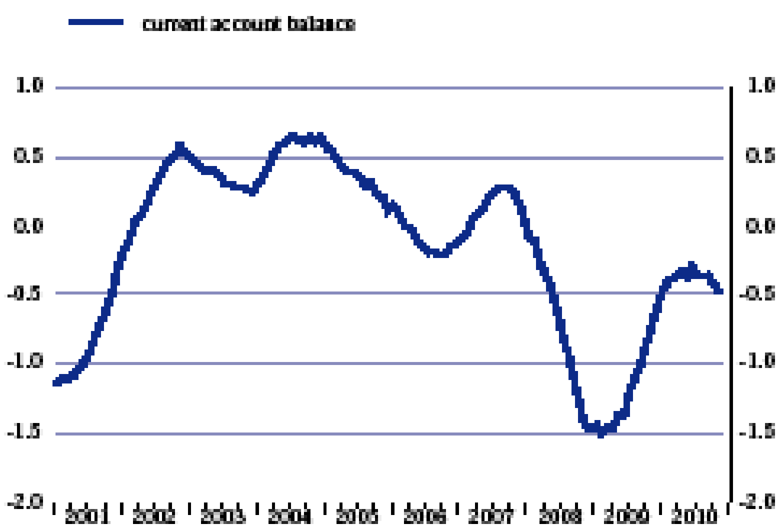
The argument is quite simple. If a country like the United States runs a deficit, in this case a substantial sum of $40bn per month, then every month those dollars are deposited in the bank accounts of whoever sold them the goods or services. It maybe that these new owners of these nice new shiny dollars will be happy to hang on to them, but if even a proportion are not then they will sell them in the market.

This theory has become less popular as seemingly large deficits seem to be run indefinitely. Indeed the size of trade flows compared to speculative, or capital flows is now severely diminished.

However over time it must also be understood that substantial deficit nations will see the accumulation of large external balances of their currency. This can be held for long periods, but may also be subject to leakage and hence sale**. Deficits matter to currency value over time if they are large and sustained.**

The United States still runs massive trade deficits, even after a painful recession. While we have not yet reached the figures of 2006/7 when it was over $700bn pa, but even in today's world we are at big numbers. Likewise the UK has just seen a monthly trade deficit of £4.8bn.

For the Euro zone no such long term deficits, and hence accumulations of surplus currency exist. A deficit did open up in 2008 when in particular Germany's export machine was stymied by the recession, but by 2010 this appeared to be narrowing.



Source: ECB website

Geo-political support for a non-$ reserve currency

During the recent bout of Euro debt worries it was surprising to find the Chinese vice-premier turning up in Spain. Li Keqiang found time to have a meeting with King Juan Carlos, and apparently pledge €6bn towards further acquisitions of government debt. It may be that the Chinese, as big holders already of Spanish debt were protecting these existing bonds, but it may also be that the desire to see the euro survive and prosper was in their minds.

Spain is not the only recipient of China's largesse, with the Greeks, Portuguese and Irish all benefiting. As one Iain Dey reported 'China wants to have an alternative to the dollar' (Sunday Times 9/1/11.)

Oil producing middle- eastern nations and Russia may have a similar desire to park their excess funds outside Uncle Sam's reach. The euro is one of the very few currencies that can provide the liquidity, and range of financial products.

Conclusion-the euro stays the course

The problem with currency forecasts is if you sell one, you have to buy another. So we need to be clear it is the US $ that we are most uncomfortable with.

The rise of the Tea party, the dislocation from fiscal reality, and with 'helicopter Ben' in charge at the Fed all make us believe that the dollar's long bear market that started in the 1960's is still upon us. For sure there will be occasions when market forces will sell off US treasury bonds and give some yield advantage, but these will be short lived if official rates stay so doveish.

Maybe we should turn to the historian Niall Ferguson to give us some perspective;

'it is not just the numbers that matter, it's the perception. In imperial crises, it is not the material underpinnings of power that really matter but the expectations of future power. It will not be just a few policy wonks who worry about the sustainability of US fiscal policy but also the public at large, not to mention investors abroad. It is this shift that is crucial: ***a complex adaptive system is in big trouble when its component parts lose faith in its viability.'***

If you follow this argument then the euro has a major part to play in a portfolio and has established itself as a real counterbalance to the US$.

Model Portfolio

For January we recorded continued growth as equities pushed on. With our bullish year end forecast, we are going to stay overweight stocks.

The most significant news during the month, and in February, has been the revolutions in Tunisia and Egypt. These genuine shocks have combined with serious interest rises in several emerging economies. In a reversal of the last few years, it has been the western developed nations that have rallied while the EM markets have faltered.

We do not buy into the argument that EM will weaken much further, in what is a very bullish economic environment. Global liquidity levels continue to be boosted by the ultra-easy western nation's monetary policy. Indeed, if there is any changes due to turbulence in the EM world it may be for unelected governments to baulk at too strenuous tightening.

If you fear revolution in the streets, you will pay less attention to inflation.

The deal of economic growth, as a price for liberty, which is effectively the Chinese contract, must prevail.

Accordingly, we view recent weakness in EM as short term and likely to end once the tightening cycle comes to an end. We think it will, as a result of the development in Egypt, be sooner than is recognised by the market.

We will be increasing again our model portfolio's equity holdings to 50%, and will make this in emerging markets.

During February we will be picking an actual Hedge fund portfolio, rather than relying on indexes.

This will be reported in the next newsletter.

ACM Model Portfolio

				Contribution	
Asset class	SAA	TAA	Over/under	SAA	TAA
Cash	5.0%	15.0%	10.0%	0.00%	0.00%
Fixed income	25.0%	10.0%	-15.0%		
Government bonds					
	25.0%	10.0%	-15.0%	-0.12%	-0.05%
Corporate bonds					
Equities	40.0%	45.0%	5.0%		
US	18.0%	20.0%	2.0%	0.41%	0.45%
Europe	12.0%	15.0%	3.0%	0.23%	0.29%
Japan	4.0%	0.0%	-4.0%	0.00%	0.00%
Asia ex-Japan	4.0%	6.0%	2.0%	-0.05%	-0.08%
Emerging market	2.0%	4.0%	2.0%	-0.06%	-0.11%
Hedge Funds	20.0%	25.0%	5.0%	-0.04%	-0.05%
Eq hedge	5.0%				
Conv Arb	3.0%				
ED	3.0%				
Fixed income	3.0%				
Macro	3.0%				
CTA	3.0%				
Real Estate	5.0%	5.0%	0.0%	0.16%	0.16%
Commodities	5.0%	0.0%	-5.0%	0.19%	0.00%
Total	100.0%	100.0%	0.0%	0.72%	0.61%