Peter Elston: Investment Letter

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This document is intended for professional investors only

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It has been another eventful month. The Federal Reserve decided not to raise interest rates while Norway and Taiwan cut theirs and India cut more than expected. It would appear that growth generally is still too weak rather than too strong. This month's letter is largely dedicated to considering the risk that central banks fail to prevent their economies from slipping into deflation.

Captain Murphy's Diary

Murphy's Law says that what can go wrong, will go wrong. It is thought to be named after Captain Ed Murphy, an aircraft engineer who, frustrated with the work of an incompetent colleague, is alleged to have remarked, "If there is any way to do it wrong, he will." This section is dedicated to combing the financial markets for risks that are lurking out there, preparing to pounce.

Let's face it, being Chairman of the Federal Reserve is a pretty thankless task. Janet Yellen came in for a huge amount of stick last month following the FOMC's decision to not raise interest rates, and Bernanke before her was often slated in the press.

Much of the criticism is from people who are either unqualified to comment or who do not have access to the same data that the Fed does. Furthermore, the fact that the entire world was fretting over an increase in one country's interest rate from virtually zero to practically zero – or is it the other way round? - suggests that we have become over-dependent on our central bankers. If the likes of Janet Yellen and Mark Carney are now our only saviours, what happens if they fail? Although a difficult risk to assess, it is the one considered in this month's Captain Murphy's Diary.

To ask 'what happens if they fail?' requires one to understand what they are trying to do in the first place. On the face of it this seems clear: the job of most if not all central banks is to maintain price stability and promote full employment. The problem comes when deflationary forces in an economy are so strong that interest rates hit zero and can't go any lower. When this happens, central banks are forced to use the unconventional monetary policy known as quantitative easing which involves central banks buying assets such as government bonds.

This bond buying has the effect of reducing real interest rates which increases private demand for credit which in turn props up inflation, stopping real interest rates from rising, and thus further stimulating private demand for credit. In other words, it is supposed to create a virtuous circle in which central bank stimulus causes credit demand to return to normal.

The problem is it has not returned to normal. As the chart below shows, broad (M4) money supply growth in the UK is close to zero, far below levels seen in the decades leading up to the financial crisis. In fact, the total M4 money supply is lower now than it was in April 2010, over five years ago! While the Bank of England has succeeded, just, in keeping inflation above zero, it has certainly failed in getting private credit demand back to normal.

UK M4 Money Supply (YoY%)

Source: Bloomberg

Why is private demand for credit so weak?

One answer would be that the price of credit – the borrowing rate - is too high. And yet borrowing rates are as low as they can get. Or at least they are in nominal terms. In real terms they can get a lot lower if inflation rises. They can also rise if inflation falls, which is why central banks are so desperate to stop that happening, or at least should be.

Another answer might be that banks are not able to lend because they're restricted by reserve requirements or by low capital adequacy ratios. In fact, as a direct consequence of QE, commercial banks' actual reserves held with their central bank are way above required reserves (in the case of the US 30 times higher!) so that isn't a restraint. And capital adequacy ratios are generally ok too. Not great, but ok.

The FT's Martin Wolf suggested that the weak global demand (for which read weak private demand for credit) reflects a slowdown in potential growth, due to "some combination of demographic changes, slowing rises in productivity and weak investment".

It is certainly the case that workforce as well as broad population growth in many countries are not the drivers of economic growth they once were. Companies may not want to invest in new capacity if their markets are shrinking or at best not expanding. As for productivity growth, the latest Bank of England inflation report notes that it "has been subdued since the financial crisis but appears to have picked up recently: in the four quarters to 2015 Q1, productivity growth was 0.8% and is expected to have been 1.5% in the four quarters to Q2."

The report notes that productivity growth may until now have been held back by the abundance of labour – if labour is abundant and thus cheap there is less need to increase productivity – as well as by forbearance and low interest rates that may have "allowed businesses that face persistently lower demand to remain operational, impairing the reallocation of resources to new or more dynamic companies with the potential to achieve higher productivity."

Putting my somewhat rough and untrained slant on things, it seems that there is a Catch 22 situation with respect to labour productivity. Namely, that there is so much scope in today's world to replace humans with machines and computers that in the absence of legislation to limit hours worked per person, there is increasingly a structural surplus of labour that economies cannot put to work. This surplus will keep wages, and thus inflation, low, perhaps even negative, presenting a problem for central banks seeking to maintain price stability.

In fact, this is nothing new. Since the invention of the plough the human race has been freeing up labour for use in superfluous activities such as pyramid building, commercial dog walking and proprietary trading. As a result, we have generally always been able to find ways of making things or providing services more cheaply as time goes by. Indeed, from 1209 to 1913 - excluding the war- and disease-ravaged years from the middle of the 16th to the middle of the 17th century - inflation in the UK was just 0.2% per annum. It is interesting that this period of low and essentially stable inflation ended at the same time the world's greatest money printing machine – aka the Federal Reserve – was established but that is a topic for another time.

Coming back to the topic at hand, namely the risk of central banks failing to prop up inflation, it seems to me that as unemployment rates fall, particularly in the US and UK where they have already come down a long way, upward pressure on labour costs will rise. In turn, this should increase the incentive for companies to boost labour productivity through increased investment. Increased investment feeds directly into stronger economic growth which should boost inflationary pressures.

Milton Friedman said that inflation is "always and everywhere a monetary phenomenon." I have sympathy with this view, in that if everyone all of a sudden had ten times the amount of money, sellers of goods and services would quickly jack up their prices by the same multiple. But it of course is more complicated than that, otherwise the job of maintaining price stability would be an easy one which it clearly isn't.

Former Fed Chair Ben Bernanke wrote in 2002 that "under a fiat (that is, paper) money system, a government (in practice, the central bank in cooperation with other agencies) should always be able to generate increased nominal spending and inflation, even when the short-term nominal interest rate is at zero."

On balance, I am optimistic that sensible government (fiscal and monetary) policy in combination with sustained if not accelerating scientific and technological progress should allow economies to continue to heal and for private demand for credit to recover. I just wish Ms Yellen and Mr Carney did not seem so keen to raise interest rates and jeopardise what is still a fragile recovery.

Current Fund Targets (as at 22 Sept)

The targets in the table below are where our funds should be positioned currently. Actual positions may deviate slightly from these target weights as a result of market movements or ongoing trades for example.

Target Weights (%) (previous month in brackets)		OEICs		Investment Trust
		CF Seneca Diversified Income Fund	CF Seneca Diversified Growth Fund	Seneca Global Income & Growth Trust plc
Equities	UK	22.5 (22.5)	20.0 (20.0)	28.0 (28.0)
	North America	0.0 (0.0)	4.0 (4.0)	2.5 (2.5)
	Europe ex UK	10.0 (10.0)	13.0 (13.0)	12.0 (12.0)
	Japan	0.0 (0.0)	8.0 (8.5)	4.5 (4.5)
	Asia Pacific ex Japan	5.0 (5.5)	10.0 (10.0)	9.0 (9.0)
	Emerging Markets	1.2 (1.2)	4.5 (4.5)	3.0 (3.0)
	Global Funds	2.3 (0.8)	1.5 (0.0)	1.0 (0.0)
	Equities Subtotal	41.0 (40.0)	61.0 (60.0)	60.0 (60.0)
Fixed Interest	DM Government	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
	EM Debt	5.1 (5.1)	2.0 (2.0)	0.0 (0.0)
	Corporate	26.9 (27.9	10.0 (11.0)	11.0 (11.0)
	Fixed Interest Subtotal	33.0 (32.0)	12.0 (13.0)	11.0 (11.0)
Alternatives	Property	8.5 (8.6)	4.9 (5.0)	8.9 (9.0)
	Private Equity	2.9 (2.8)	4.4 (4.2)	5.7 (5.6)
	Specialist Financial	10.2 (10.2)	13.4 (13.5)	8.9 (8.9)
	Infrastructure	4.4 (4.4)	1.8 (1.8)	4.5 (4.5)
	Commodities	0.0 (0.0)	1.5 (1.5)	0.0 (0.0)
	Alternatives Subtotal	26.0 (26.0)	26.0 (26.0)	28.0 (28.0)
Cash		1.0 (1.0)	1.0 (1.0)	1.0 (1.0)
Total		100.0	100.0	100.0

- During the month we added Blackrock World Mining Trust (categorised under "Global funds" in the earlier table) to the funds in the belief that its 8% yield was very attractive and left room for material dividend cuts among underlying holdings

- We also reduced our fixed income target slightly in the OEICs via reductions in the AXA US Short Duration High Yield Bond Fund and the Legg Mason Income Optimiser Fund, principally to fund the increase in the Blackrock World Mining Trust target mentioned earlier

- Our broad equity target weights are in line with or close to being in line with our strategic asset allocation – a neutral position – reflecting the view that while dividend yields are not low, nor are they particularly high

- Within equities, we are lightly positioned in North America and Japan, where we think valuations are too high

- Our big equity overweight is in Europe ex UK, which we think is at a much earlier stage of economic expansion than other developed economies, as evidenced by unemployment rates now falling but still being well above historic averages

- We have zero targets in developed market government bonds, reflecting the view that real long-term yields that are below 1% and in many cases negative are not good value

- There is still good value in corporate bonds where although spreads are not particularly high in relation to history, default rates should remain low

- Our alternatives exposure seeks to target investments that offer something interesting in relation to equities and bonds; in the case of equities this is more stable income streams and in the case of bonds it is income streams that are index-linked

- Our private equity exposure in each of the three funds is largely in AJ Bell, a private company in which we are one of three external shareholders

- Elsewhere in alternatives, we like non-core REITs, asset leasing and renewable energy