

Markets & Investing



**Hugh
Hendry**
INSIGHT

Time to look at bonds but keep an eye on our heroes

Someone once said there are certain things that cannot be adequately explained to a virgin, either by words or pictures. It is therefore with some trepidation that I attempt to outline our investment policy. We are bullish on agriculture and bearish on the financial community. For 10 years we have contended that equity markets can, and do, stagnate for periods as long as a quarter of a century. Accordingly, we have refused to follow the market, choosing instead to invest in unleveraged sectors which have endured long bear markets.

However, there are complicating cycle considerations. A process of debt liquidation is under way that resembles a turning point heralding weaker global growth. This undermines almost all risk taking, including agriculture, and for this reason we presently favour only government bonds.

According to Prada: "There is a rejection of fakeness - the fake avant-garde." And the inflation scare that took the price of oil to almost \$150 per barrel, and created a hawkish central banking community, was perhaps the biggest head-fake of all. Certainly, the market for 10-year government bonds is beginning to think so. It is trading near a record high.

And today, even those regional Fed governors and hawkish European central bankers seem to see it as well. As I say, this is the time to own government bonds. But we are aware of just how out of sync we are with our heroes. Can the combined intellectual weight of Mark Faber, George Soros and James Grant all be wrong? Why do they insist on shorting Treasuries during the worst financial crisis since the Depression? I blame the Romans.

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Monty Python's *Life of Brian* famously asked, "What have the Romans ever done for us?" In a similar vein, one might enquire: "What did the central banks do to contain inflation in the 1970s?" As in most things, fate and chance play an important part. Let's consider the facts. The Fed reacted to the first oil shock 36 years ago by driving up its rate from 3.5 per cent in February 1972 to 13 per cent in the second quarter of 1974. Such high nominal rates were unheard of and at the time ranked as the highest in American economic history. The average US stock lost 74 per cent of its value from its 1968 high. The real economy went into reverse and contracted in both 1974 and 1975.

Perversely, I would attribute the decade's inflation to the lack of leverage in the economy. The bankruptcy of so many banks during the 1930s encouraged the politicians to de-risk the sector. For more than 40 years, the banking sector grew modestly, attracted modest people and produced modest returns. The emergence of today's cadre of cavalier banker was only detected by Soros, Rogers et al in their 1972 report, *The Case for Growth Banks*, some 43 years after the stock market peak in 1929.

If a tree falls in a forest and no one is around to hear it, does it make a sound? Likewise, if house prices fall but mortgage debt is low, does it really matter?

This was the case in the mid 1970s and, in the absence of today's unprecedented leverage, house prices did not falter, repossessions never soared and there was no major bank insolvency. I would contend, therefore, that it was the phenomena of low asset prices and a conservative banking sector that ensured that the Fed's monetary policy response failed to tame inflation.

Contrast with today and the prospect of containing inflation should be high. Thirty years of unfettered monetary expansion has left the banking sector fully leveraged and vulnerable to insolvency. For instance, the mere act of holding UK interest rates at 5 per cent from April through to October of this year has guaranteed a sharp contraction in the economy which has the Bank of England reaching for the "D" word.

Don't get me wrong, I think Soros, Faber and Grant are right to fear the inflationary consequences of our present breed of central banker. But my paradoxical recommendation is to buy bonds. Many scoffed, but this policy is working. A paradox, remember, is a self-contradictory statement based on a valid deduction from acceptable premises. Here is another: the smartest investor in London is short bonds. I'm long bonds, yet we share the same vision of the future. I'll let you decide.

The writer is chief investment officer and founding partner of Eclectica Asset Management

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