

Market Comment - Ian Williams

By Ian Williams | Tue 06 September 2011

Ian Williams, manager of the [City Financial Strategic Gilt Fund](#), comments on the recent market volatility. This is the original, unedited version and should not be seen as a personal recommendation to invest or make any changes to your portfolio. Please note that Hargreaves Lansdown and City Financial do not necessarily share his views.



The early summer of 2010 witnessed a panic attack in capital markets as evidenced by a fall of 17% in the FTSE100 between April and June 2010 and an associated rally in UK gilts which drove the yield on long dated gilts down to levels not seen since the crash of 2008, whilst shorter dated gilts actually registered new highs in price. A year on and another panic attack has occurred, this time resulting in a 21% fall in the FTSE100 and another rally in gilts taking the long dated gilts above the highs of 2010 (but not quite to the levels of 2008), whilst the shorter dated gilts registered higher prices than both 2008 and 2010. Gold has also soared to ever higher levels as well. The latest rally in gilts and the associated sell off in equities has left equities at their cheapest level relative to gilts for more than 30 years.

The latest panic has been fuelled by extreme dislocations in the European debt markets as central banks and other investors have dumped peripheral Euro debt such as Italy, Spain, Greece etc to switch into bonds that are perceived to be safer, namely US Treasury bills, German bunds & UK Gilts. Another theme doing the rounds is that the West (in particular the UK and USA) are heading for Japanese style deflation. This has helped spur the current mania to own Gilts and US Treasury bills despite the latter being downgraded recently from AAA. At first glance it would seem there is little chance of the UK suffering any deflation given that UK Retail Price Inflation (RPI) is currently chugging along at 5% per annum whilst UK Consumer Price Inflation (CPI) is a mere 4.4% per annum which is somewhat above the Bank of England's target of 2% per annum. Even core CPI has increased to over 3%. This is in stark contrast to Japan where inflation has been flat to negative for most of the past decade.

For those investors who believe that inflation (and deflation) is a monetary phenomenon there is a crucial difference between Japan on the one hand and the UK and USA on the other, namely the willingness and ability on the part of the UK and USA to print money to offset any deflationary forces that may be at work. This is not the same as in Japan whose central bank is constrained under Japanese law from indulging in Ben Bernanke type printing orgies as witnessed with QE1 and QE2.

As both the Fed and the Bank of England (BOE) have been careful to keep the option of more Quantitative Easing (QE) as a policy option it is open to question how deflation could manifest itself in these two countries. As we witnessed with QE1 the powerful deflationary wave that was unleashed with the bankruptcy of Lehman Bros & the crash of 2008 was offset by a massive injection of liquidity by the Fed and others. This caused the stock markets and gold to soar in value (whilst bonds went nowhere) as it dawned on investors that deflation (1930's style) would be offset, regardless of the amount of new money that had to be printed.

So why should deflation happen now when it was not the outcome in 2008 when the crisis was far worse than anything around today. Also, if deflation really was on the

cards why does gold keep hitting new highs? In simple terms you cannot simultaneously experience deflation and inflation so that twin bull markets in gold and Gilts carry an inherent contradiction with the likelihood that one of these bull markets will end in tears. On the assumption that the money printing activities of the various central banks will prevent deflation from gaining hold (and will ultimately lead to higher levels of inflation) then the greater probability is that it is the fixed income market that offers the most risk at current levels.

Furthermore the risks contained in the gilt market at current levels are heavily asymmetric because yields are now so low in historic terms that the upside in price is strictly limited whilst the downside becomes ever greater the lower nominal yields become.

Gilts and Treasury bills today have an identical feel to the tech stocks at the height of the dotcom boom – manias do occur in financial markets from time to time and this has the feel of one. Furthermore when the inevitable “bond bubble” does burst there will no way back – bouncebackability is not a word that will apply when this one goes pop. (Unlike the dotcom boom where at least some winners did emerge from the crash, i.e. Google, Apple, Amazon, etc).

For the City Financial Strategic Gilt Fund the current overvaluation of the gilt market presents a major problem as we do not wish our investors to suffer what could be quite nasty capital losses when the inevitable bursting of the bubble takes place. As a result we took a view last summer that due to the asymmetric risk reward characteristics on offer, a safety first policy aimed at safeguarding investors capital was more important than chasing further gains from an already extended asset class. This has meant that the fund has suffered a loss of relative performance over the last 5 months or so, as we have missed out on some gains, but the alternative in our view is to take undue risks in an asset class that is overvalued on any historical measure.

City Financial Strategic Gilt Fund

Initial charge	5.00%
Initial saving	5.00%
Net initial charge	0.00%
Annual charge	1.25%
Annual saving	0.10%*

*Annual saving is not available in the SIPP

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