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Strategy Outlook

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Editorial



This creeping politicisation that is threatening the US Central Bank, coupled with a growing need to bail out certain peripheral European economies suggest 'lower rates for longer' across much of the developed world. This brings with it the risk of persistently higher core inflation, and also makes asset price inflation bubbles more difficult to contain in the booming economies of China and much of the emerging world. Despite the equity declines of recent days investors should not despair; what we are seeing is a necessary but painful focus on government debt in the west and an equally urgent focus on inflation, asset bubbles and undervalued currencies in the east.

While these adjustments are underway, portfolios focusing on a new global 'Nifty Fifty' of diversified, cash flow rich companies offering yields at or close to government bonds, but with progressive dividend growth to protect against inflation, look to be a compelling place to hide...

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Economic Outlook

Back to the future...

As the 1930's regulatory, political and economic scenarios are replayed in 2010, what are the strategy 'lessons' for today's global investors? And, how are they relevant to the emerging world as China battles not a deflationary banking crisis, but an inflationary asset bubble?

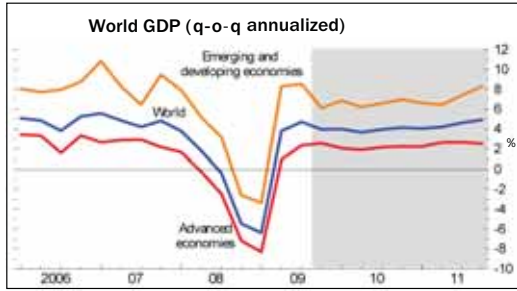
As we watch a slow re-enactment of many of the economic, financial and political dramas of the 1930s, we appear also to be re-enacting many of the regulatory changes that went with them. The 'Obama-Volker Plan' launched last week to limit proprietary trading for deposit-taking institutions, resembles much of the Glass Steagall acts of 1933. Similarly the tighter capital requirements suggested by the Basel Committee and a host of 'bank' taxes are the product of highly charged political debate that was the norm in the 1930s, as a discredited, lame duck Republican administration gave way to the 'FDR' White House and with it the 'New Deal.' This overt politicisation of central bank policy and government pressure for more economic growth all argue for 'lower rates for longer' across much of the developed world and with it the risk of persistently higher core inflation. It also suggests greater political stress for any structurally unsound, peripheral economy and, of course, an asset and inflation bubble for the booming economies of China and much of the emerging world.

It certainly appears as a confusing and somewhat alarming world for global investors, with equity markets responding to the President's banking speech last week with six consecutive 'down days.' Investors, though, should not despair; what we are seeing is a necessary but painful focus on government debt in the west and an equally urgent focus on inflation, asset bubbles and undervalued currencies in the east. These were never going to be easy discussions but as policy makers start to address these issues in earnest the longer term underpinnings of a truly global economy will start to be formed and strengthened. While these adjustments are underway, portfolios focusing on a new global 'Nifty Fifty' of diversified, cash flow rich companies offering yields at or close to government bonds, but with progressive dividend growth to protect against inflation, look to be a compelling place to hide...

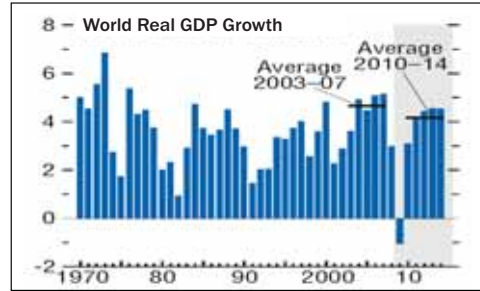
1933 rules for 2010?

In 1933, Franklin Delano Roosevelt took charge of a nation facing 25% unemployment, 50% collapse in output and all 48 states closing or restricting bank activity. There was little to lose and, in the spirit of 'there is nothing to fear but fear itself', Roosevelt embarked upon aggressively restructuring the economy and the banking sector. Within months he passed the Glass Steagall Act that created a Federal Deposit Insurance Corporation, which ring-

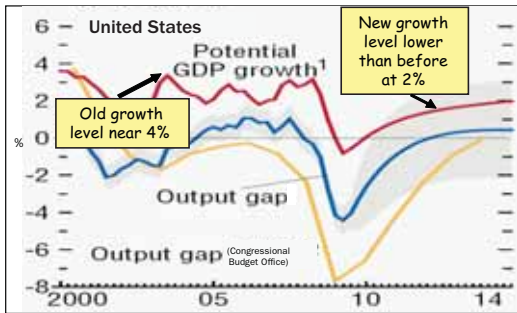
Chart 1: Out of the crisis – a smoother than expected recovery but a two tiered world economy...



Source: World Economic Outlook, IMF Staff estimates January 2010



Source: World Economic Outlook, IMF October 2009



Source: World Economic Outlook, IMF October 2009



Source: World Economic Outlook, IMF October 2009

fenced deposit taking retail banks from trading and securities activities. FDR’s template to fight the crisis was broad and relevant then. How relevant is it for Barack Obama in 2010? Clearly its sponsor today, Paul Volker (Chairman of the ‘Fed’ under Jimmy Carter and Ronald Reagan), who flanked President Obama as he proposed a partial re-enactment of the legislation, thinks so. In an interview with the New York Times on Oct 20th he said, “People say I’m old-fashioned and banks can no longer be separated from non-bank activity. That argument brought us to where we are today.”

Perhaps, in February of 2009 at the depths of the crisis, FDR’s broad brush along with an updated Glass Steagall would have made sense. However, a year on with confidence restored, systemic failure forestalled and growth revived it is not so clear. Instead, it appears as if Barack Obama, having recently lost three key elections in a row (New Jersey, Virginia and Massachusetts), is seeking to reconnect with an electorate disillusioned with a ballooning health care proposition at a time of acute employment anxiety. With all the seats in the House of Representatives and 37 seats in the 100 seat Senate up for grabs on November 2nd at the mid-term elections, Obama needs to make his party relevant. There is huge risk of a populist lurch and the imposition of a

regulatory reform that makes little economic sense but a lot more political sense. We, therefore, could be faced with even more populist attacks on the banks and more fiscal pump priming in the run up to mid-term elections.

A politicised Fed

There is a clear trend in Congress to politicise the Federal Reserve and compromise its independence. Ben Bernanke’s “down to the wire” re-confirmation, proposals in Congress to have the General Accountability Office (GAO) audit not just the Federal Reserve’s balance sheet but also its monetary policy decisions and congressional initiatives that would make the presidents of the 12 Federal Reserve banks along with the Chairman of their boards subject to presidential appointment and Senate confirmation, are all manifestations of political interference in an independent monetary authority. The warnings this week by the President of the Dallas Federal Reserve, Richard Fischer, show the passion and depth of feeling in today’s debate:

“Students of history are keenly aware of the course we chart when we discuss the possibility of politicising the Federal Reserve system. They know the pathologies that afflicted Weimar

Germany and modern Zimbabwe, and the economic mess that still cripples Argentina. Those who will determine the future scope and shape of our central bank would do well to keep these lessons in mind and to resist the agreeable urge to strike out at the Fed.”

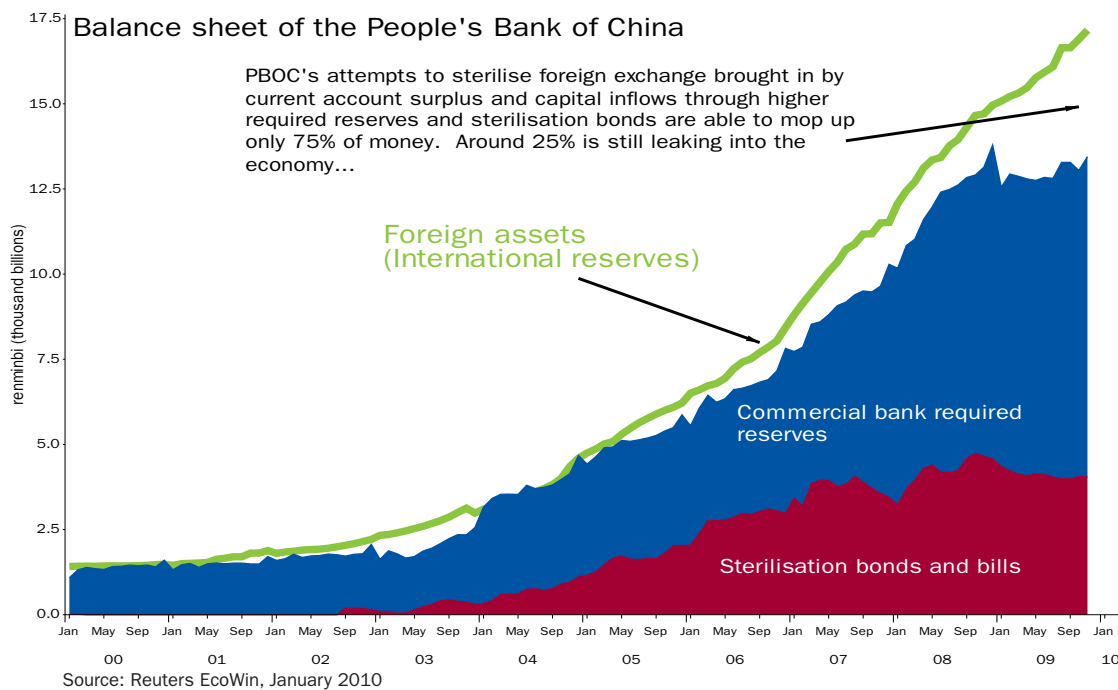
Richard Fischer, President of the Federal Reserve Bank of Dallas, January 26th 2010.

In this environment, despite Ben Bernanke’s re-appointment as the Fed Chairman on 28th January, the risk remains that monetary policy becomes highly politicised in the run up to mid-term elections.

Regulations and banks – the only thing we can count on is change

There appears to be a simultaneous regulatory and political assault on the banking industry with new proposals coming in fast and furiously. The Obama-Volker plan on January 21st wants to limit deposit-taking institutions’ ability to participate in “riskier” businesses such as hedge funds and private equity to ensure that “never again will the American taxpayer be held hostage by a bank that is too big to fail”. In just the last few weeks we have also seen massively higher capital requirements proposed if the unexpectedly tough Basel Committee proposals

Chart 2: Chinese policies need more teeth: foreign exchange sterilisation is not wholly effective



announced last month are adopted (Barclays Capital suggest the impact on some banks “would be penal”), as well as the demands of the US Commodity Futures Commission in asking banks that deal in energy swaps to not participate in proprietary trading. Meanwhile, marginal taxes on bank bonus payments have been imposed in London with sympathetic noises across much of Europe while a longer term tax on bank assets/balance sheets has been proposed across the US.

Our lesson here is that the authorities will almost certainly overreact in tightening regulation. The key issue is retail funding and investor confidence – both in short supply in what is becoming an increasingly unstable, election-driven, economic backdrop. We will be very cautious of all banks, especially in economies with weak national savings bases, while the political and legislative backdrop is so volatile. We note though that valuations are now extraordinarily low, and selected European institutions with autonomous funding and the pick of quality lending opportunities are starting to look attractive.

US domestic politics are also a problem for the runaway Chinese economy...

US domestic politics, mid-term elections and legislative throw-backs to the 1930s

must seem gloriously irrelevant to Asian entrepreneurs playing the extraordinary economic boom across China. The country’s remarkable stimulus plan enacted in November 2008 stabilised a tottering global economy at a time when every other policy maker looked ineffective.

And this massive gambit worked. GDP growth accelerated from a pace of 6.2% yoy (year-on-year) in the first quarter to 10.7% yoy in the fourth quarter. By December 2009, all sectors were roaring ahead - retail sales were rising at a pace of 17.5%, fixed asset investment by 30.5% yoy and exports by 17.7% yoy. The pace of international reserve accumulation picked up to an astounding rate of half a trillion dollars annually and banks have been lending at a ferocious pace. In just the first two weeks of January, Chinese banks have lent out Rmb (renminbi) 1.1 trillion against a full year target of Rmb 7.5 trillion. No small wonder that Chinese property prices are rising at a 20-30% annual rate and the stock market is 75% higher than the start of 2009.

So what are the Chinese officials likely to do? In the absence of viable interest rate tools, a conventional policy exit is certainly not in the cards. The authorities’ hands are tied and unconventional tools like lending

curbs, punitive hikes in reserve requirements, explicit guidance (dictat) on lending policies for banks and supply increases in housing are the only means to reign in the economy. But this will prove difficult. Take the two most widely used tools - foreign exchange sterilisation and reserve requirement hikes. Chart 2 shows that at the best of times the PBOC only manages to sterilise roughly 70% of all the foreign exchange inflows into the economy. Roughly 30% or \$150 bn still leaks into the economy and the banking sector. In other words, we have two possible outcomes, neither very palatable in the short term; either liquidity conditions remain buoyant and the economy overheats by mid-2010, or the authorities get much more aggressive in their policy tools. The obvious choice is a currency revaluation that would take the steam out of the economy in the short term and rebalance it over the medium term, but if this is deemed politically impossible (as the world watches and waits) a much more determined bank reserve or interest rate policy could radically tighten liquidity conditions. Indeed every infringement of the Federal Reserve by Congress only heightens the risk of political interference and with it an interest rate policy that remains too low for too long. Hence, our caution for the short-term outlook of China related assets in 2010.

Investment backdrop

As the world economic recovery continues into 2010, political tensions from the 'bank bailout' are running high. In the US, this is taking the form of increased politicisation of the Federal Reserve and a continual assault on banks, where the only thing we know with certainty is that the existing regulatory environment is unlikely to survive. In the UK, pre-election jockeying has obfuscated the urgent need for fiscal consolidation with more populist attacks on the banking system. What we have essentially is an election backdrop across much of the indebted Anglo-Saxon world that will likely delay fiscal consolidation and monetary exit strategies.

At the other end of the spectrum, a tight dollar peg is forcing Chinese policy makers to adopt these emergency monetary

measures which are clearly unsuitable for an economy that is experiencing double digit growth. Liquidity conditions are buoyant and while a revaluation of the currency would be an expedient solution, it's unclear whether the authorities will embrace it. Instead, they are likely to try to tighten credit by unconventional means - raising bank reserves and verbal guidance. Only time will tell how successful these will be. In the meantime, the risks of unstable asset price inflation in an overheating economy loom large.

Finally, in Europe, intra-euro area political tensions are running high, as the framework to implement a credible fiscal consolidation platform for the troubled periphery remains uncertain. There is an urgent need for a clear 'transition path' for

economies that are fiscally unsound and have lost competitiveness within the euro-zone. While politicians establish this template, the euro is likely to weaken in an effort to restore the external competitiveness of the zone.

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