Perspective from our Far East friend.

We have an agreement about commodities; the longevity of decline is more critical than the prices? Cyclical or secular? Critical to Canada.

Enjoy! Comments or questions welcome, as always.

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Investment Outlook

Life Below Zero

Last week, the Bank of Japan cut its key interest rate to -0.1%, joining the ECB, Switzerland, Sweden, and Denmark in the negative interest rate club. This surprising announcement means that, from the perspective of Tokyo, the risk is of more deflation and lower growth as oil and other commodities continue "lower for longer." It is very difficult to understand what is happening today from an historical perspective. Consulting Homer's History of Interest Rates, I have not been able to find a single instance in the last 500 years where there was a long period of negative interest rates. Eventually, deflation will bring down property values, punish debtors, and leave standing those companies which are able to maintain prices, whether telecoms, utilities, or consumer staples. Every business depending on a key price of a commodity – oil, food, minerals, even water – is subject to unmanageable cycles, as the Chief Executive of Exxon Mobil reminded us recently. If cash at the bank yields a negative return, then investors will redouble their search for income and for dependable yield.

The only problem in this environment of competitive devaluation is what happens to the US dollar and currencies linked to the US dollar, such as the Hong Kong dollar? We have seen enormous pressures coming to bear on the Hong Kong dollar and on Hibor, so that interest rates may have to be raised in Hong Kong as they were in 1997-1998; and property values and wages will deflate sharply.

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We expect now that the US Federal Reserve will probably not increase rates again in 2016; and if the economic and deflationary trend worsens, then we may eventually see negative interest rates in the US also. The dollar may have peaked. Canada and Australia have seen a 30% devaluation, which enables many of their extractive and export industries to maintain some form of profitability. Japan looks like a relatively promising market this year, especially compared to China, thanks to its cheap yen and also encouraging corporate reforms.

One of the "unknowable" figures that will greatly affect Hong Kong, and China's market and currency, this coming year is: what is the real national debt figure in China? Estimates as high as $5 trillion of NPLs or total debt of 300% of GDP (or about $30 trillion) have been talked about. Is this, in fact, a purely domestic and internal issue (China has relatively little foreign debt, although some Chinese corporates may have borrowed heavily in US dollars) in which case, it would be similar to Japan after 1990 – a generation of deflationary debt rescheduling, especially of soured property loans – but China should have the twin advantages of real national growth and central (party) direction.

China's government will resist market forces as long as possible in maintaining the Renminbi at a stable level, although we expect, now that they use the trade-weighted basket of currencies, that we will see a 5%-10% devaluation of the Renminbi, against the dollar by the end of 2016. This will, in turn, put more pressure on its Asian trading partners, including Korea, Taiwan, and Southeast Asia. Also, capital outflows are now running at over $100 billion a month so Forex reserves could be run down in 2 years.

India is the one major economy in the world which is not subject to the negative influences emanating from China, the US, or the EU. It has an economy growing at nearly 8%, a population now fast approaching China's at 1.3 billion, of whom half are under 30 years old. It has a large and vibrant service sector, with very well-managed companies in fast-moving consumer goods, travel and entertainment, food and beverage, and financial services. We have found at least a half dozen midcap Indian companies under US$5 billion market cap with 20% earnings growth and excellent medium-term prospects. Although there are few bargains, we

believe that investors will continue to pay a premium for the real growth that India offers. The Indian Rupee is also one of the most stable Asian currencies, well managed by RBI Governor Rajan. The current account deficit has been reduced thanks to US$150 billion of oil savings from 5% to 1% of GDP.

In 2016-2017, our major bet, therefore, is on India and its surrounding markets, including Pakistan, Bangladesh, Sri Lanka, Mauritius, and even Myanmar. Although people in the west are now taking a very gloomy view of growth, and the geopolitical situation in the Middle East and Europe remains quite bleak, there is always some region of the world where it is possible to make money. This year, we believe it will be India.

One final note on gold, which has now risen nearly $100 from $1050 to $1150 per ounce, while oil and commodities have collapsed. Historically, commodities have always returned to the level of gold. Also, during the past 200 years, there have been three notable periods of deflation (1814-1830, 1864-1897, and 1929-1933) when gold's purchasing power has appreciated by over 40%, whereas it always loses purchasing power during inflationary eras. We may now be in the last throes of a long cycle of disinflation turning into deflation, as suggested by commodity prices, which will further support the case for gold (especially if the dollar weakens); and, in an era of "Life Below Zero" interest rates, perhaps gold has a place in investors' portfolios, in the next 5 years of currency volatility, and falling confidence in the infallibility of central banks.

R. Lloyd George

15th February 2016

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