THE Adviser

Page 1 - 2
Quantitative Easing

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Oh yes! Ok I am getting a little excited because I am off to Tenerife on Friday but this does feel like a time to celebrate. The markets have had a great end to the summer, even if our weather has not been up to standard.

We've been banging on about Quantitative Easing (QE) so much that we should consider renaming the newsletter the QE update! I'm afraid that this is more of the same but the good news for you is that stock markets love QE which drives up the value of your investments.

Last month, we stated that we expected Ben Bernanke, head of the US Federal Reserve (FED), to embark on his third round of QE, unimaginatively named QE3. However, we have decided to name it QE4EVA because the latest round is unlimited and the FED have said that they will keep buying $40bn a month of mortgage backed securities (MBS) until the employment market improves. Clearly, the FED is putting much more emphasis on employment rather than inflation.

The Republican Party in America is angry at the FED for this announcement just before the US elections. No incumbent president has ever been re-elected when the US unemployment rate was above 7%; it currently stands at 8.1%. If QE4EVA works as it should, it should bolster Barack Obama's chances of re-election.

There are likely to be many other effects from this policy. If this works, Americans will spend and banks will lend to facilitate further spending which is likely to cause inflation. As we have previously noted, inflation is the most palatable solution to the tax payer in order to reduce the developed world's huge debt.

Essentially the FED is forcing people to spend or invest. Saving or hiding in cash is not an option as inflation will erode your purchasing power over time. This means that there is likely to be more demand for risk based assets like equities and we have already seen this filter through to the market as seen in the graph below.

Asset Class/Index	QE1 (%)	QE2 (%)
MSCI World	39.10	24.00
MSCI Emg Mkts $	102.00	19.1
FTSE 100	36.20	16.40
FTSE 250	74.30	24.00
FTSE Small Cap	61.40	19.00
CCI Equal Weight	31.20	29.70
Gold	37.30	22.00
Silver	69.40	88.00
Dollar Index	-7.10	-9.00

Table: FT – Source Investors chronicle 15th September 2012

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Quantitative Easing (Continued)

There are a number of ways that we can protect against and even profit from inflation. Within our fixed interest funds, we hold index linked bonds which have their income and capital protected against inflation. Income funds are also a good hedge against inflation; companies are able to raise their prices which results in higher profits in £ note terms. These increased profits are then distributed to shareholders in the form of higher dividends.

We also think that many savers will begin to chase yield rather than capital growth and cash and low risk bonds don't offer attractive yields. This means that investors will be looking to companies with an income bias which should drive up the asset price; all this means good news to the investors that already hold these assets such as our clients.

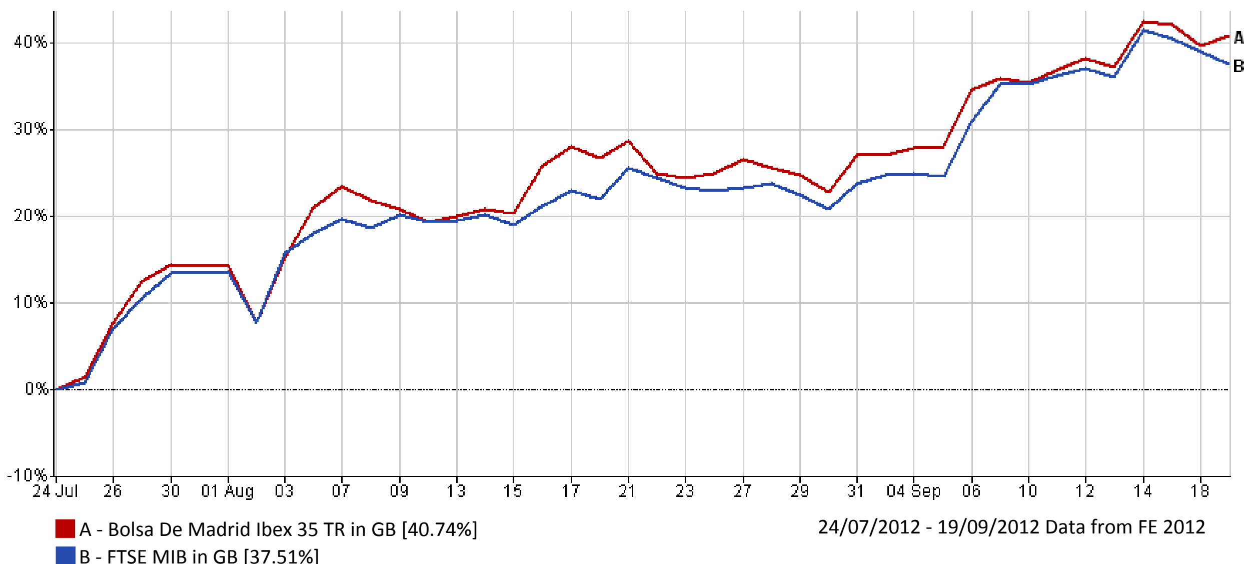
Inflation also has another effect of reducing the value of the Sovereign currency which allows domestic companies to export more easily and make imports more expensive; this helps with a country's balance of payments.

These are key themes that the FED wants the world to follow and as investors, we would be very foolish to fight the FED. This latest round of QE shows massive intent and should be a very bullish signal.

Across the Atlantic, Mario Draghi (Super Mario) had his moment in the sun a week earlier. He announced Outright Monetary Transactions (OMT's) which is another unlimited bond buying announcement aiming to calm the markets and take away the risk of a sovereign default.

Unlike QE this is a promise rather than an actual monetary commitment. As long as the promise is seen by the markets as credible, it may end up costing the European Central Bank (ECB) nothing. We have already seen speculators back away from pricing in a major default; Spanish and Italian 10 year bond yields have fallen by around 1% in just under a month and people have stopped talking about the break-up of the Euro.

Super Mario said around 6 weeks ago that he "would do whatever it takes" to make sure the Euro doesn't collapse and it certainly appears that he is sticking to his guns. The stock markets of Spain and Italy have risen over 35% since July so it seems like investors are taking the promise seriously!



A - Bolsa De Madrid Ibex 35 TR in GB [40.74%]
B - FTSE MIB in GB [37.51%]
24/07/2012 - 19/09/2012 Data from FE 2012

The figures in the graph refer to past performance, which is not a reliable indicator of future results.

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