The VT De Lisle America Fund

Manager's Commentary on Cable

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DE LISLE PARTNERS

ARE THE BOUNDS OF CABLE CHANGING?

We are introducing a Hedged Class for our VT De Lisle America Fund because the dollar's recent strength has generated investor interest in hedging against it at these levels. But what is the history of the dollar-sterling relationship, known as the 'Cable' by forex traders, and where is it heading? Before you bundle into this enticing opportunity, I ask that you consider whether it could be different this time.

Since the Plaza Accord in 1985, which depreciated the dollar in relation to G5 currencies, sterling has traded in a comfortable range between \$2.05 and \$1.20. Any breach of these boundaries has been quickly rectified when we ventured too far from Purchasing Power Parity (PPP), like the reverting force of a stretched rubber band.

Since the Accord, sterling been outside this range only 2% of the time. The band limits have been stable because PPP has been stable. The two countries have had similar inflation rates over the past four decades and whichever arbiter we turn to, the OECD or the Big Mac index, the PPP rate has been around \$1.44. If you poll your friends you tend to find it's around \$1.55 though we are all resigned to any electronic import from the US, whether it's a washing machine or an iPhone, costing the same in pounds as in dollars, as has been the case for decades.

In the last few years, however, sterling has tended towards the lower end of the band and, as I write, is actually in breach at \$1.18. What is happening? What heavy force is pulling sterling down - three standard deviations from the middle of the band - and keeping it there? It doesn't feel as though the elastic will rebound so strongly this time.

There is a list of sterling negatives that we're familiar with: Brexit affecting the balance of trade, weak transient politicians, low growth, high inflation. The last of these is the big one because it will finally move PPP. For 40 years inflation has been low and falling in tandem between the two countries and so it hasn't mattered. Now it has burst into life and the UK is on 10.1%, projected to go to 18%, versus the US at 8.5% and falling.

In the 1970s, when the UK was labelled 'the sick man of Europe', our university tutor asked us why UK inflation was chronically higher. Cultural, I insisted, thinking the whole country was as lax as me. No, he fumed, it was geographical: our island trading nature made our trade larger and with our great deficits and weak pound we imported it.

Today we have a new excuse: structural. The Debt Management Office has structured 25% of UK gilts to be inflation linkers. In this way the cost of debt service magically goes up as inflation rises and the UK is locked into higher deficits as inflation increases. How could they? How did it get so bad?

Before we start packing for New Zealand, we should remember that this country has a long history of financial innovation which ingeniously impoverishes its citizens for the benefit of the State. The State financed the national debt through the South Sea Company and did so well they created a bubble in 1720 and Chancellor Aislabie went to the Tower. The remaining debt left with the public from this triumph was repaid by Chancellor Osborne in 2015. He also repaid 120,000 holders of War Loan 3.5% which dated to 1917. He said: "This is a moment for Britain to be proud of."

The gilts wheeze came from Chancellor Howe in 1981, a pioneering innovation undertaken after Margaret Thatcher had already committed to break inflation. For the next 40 years the State won big again as inflation undershot and the linkers cost the government a lot less than the fixed coupon gilts. The more timid Americans, knowing it was a scam, didn't even issue their Treasury Inflation Protected Securities (TIPS) until 1991 and today they form only 8% of US debt. Now the jig is up for the UK; it's locked into paying more and more but from the government's point of view it's not all bad. A good dose of inflation is the perfect remedy for the highest real debt since the Second World War and, once again, the public pays.

If four decades of getting away with it have just ended for sterling, how fares its counterparty, the mighty dollar? Here an extraordinary paradox has arisen which makes the dollar feel like a one-way bet. Most investors are still catching up with the US as the biggest oil producer. We know this as when inflation kicked off, there was much debate as to what was the store of value: Bitcoin or gold? The answer was neither; both went down. The store of value was the dollar, as new petro-dollar. This was totally counterintuitive as past inflations were dollar bearish.

Today the dollar does well with de-globalisation scares via energy prices, does well in 'risk-off' times, and does well when the Federal Reserve threatens to tighten rates as it leads the interest rate cycle. If oil goes up, the dollar goes up. If a crisis hits and people take risk-off, the dollar goes up. If the US economy is strong, the dollar goes up. Whatever the circumstances, it seems the dollar goes up and so it's no surprise that it is trading at a 20-year high.

Despite all the money creation since 2008, clearly the dollar is the asset to hold, and remains the reserve currency. What could possibly go wrong? Really only a slumping US economy spoils the narrative. Even then, we have to wonder where everyone else would be in that scenario? With this in mind, we must challenge the exchange rate limits that have held since the Plaza Accord. It has worked spectacularly well for almost 40 years but we are moving into a new era.

No longer does a spike in the oil price lead to sterling above $2.05 as the UK no longer has a petro-pound. It's the new petro-dollar that correlates with the oil price because per capita oil production in the US is now three times that of the UK.

In conclusion, a higher inflation rate than the US is baked into the UK economy, as it always was. That differential, which has been in abeyance for 40 years of negligible inflation, is about to bite the PPP. Additionally, the dollar is supported by new factors which could see it trading above its PPP for a long time. Maybe not as significantly as the Norwegian petro-kroner but, with its additional support as the reserve currency and store of value, we could see it trading above PPP for a long time.

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