

Joseph Jekyll Advisers LLC

P.O. Box 48821

Telephone: 706-255-9469

Fax 706-546-4559

Athens, Georgia 30604

Web: www.jekylladvisers.com

May 16, 2012

The Jekyll Theory

The recent election in Greece forces Greek bank depositors to ask themselves:

- “Should we keep our deposits in Greek banks?”
- “Should we transfer our Greek bank deposits to a foreign bank?”
- “Will Greece drop out of the euro zone and revert to drachma?”

It is likely that Greece will drop out of the euro zone. At that time, Greek debts written in euros will be hard to repay because the exchange rate is also likely to make difficult the repayment of principal and interest. Defaults are expected.

Such a change to drachma will also force creditors outside of Greece to write down their Greek loans denominated in euros.¹

Debt write offs could lead to selling of some assets and materials and a fall in the level of prices in general. Consumers and companies may want to rearrange their balance sheets for more liquidity and some Greeks may be unable to pay off their credit cards and bank loans. This is not a pretty picture for the Greek banks, especially if the current bank withdrawals turn into a rout à la Lehman Brothers in September 2008.

This is the Jekyll Theory, derived from the work of US economist Irving Fisher. He was not always right as he lost his shirt in the 1929 stock market crash.

If the U.S. should experience lower or even negative changes in inflationary data, then such an event would have a material effect on the outlook for real interest rates and impact the US bond market. For example, now:

The nominal 10-year current yield is 1.80% and inflation is some 2% p.a.

Hence, Nominal rate = real rate + inflation²

Nominal rate – inflation = real rate

1.77% -2% = negative 0.23%

This is not a good scenario for fixed income investors who would lose money when the purchasing power of interest income reduced by inflation.

¹ Recently, Greek lenders “voluntarily” took some \$100 billion in write-downs in their Greek loans in order to keep peace in the euro family.

² Nominal rate = real + inflation is known as the “Fisher Equation.” Inflation can be historical data or expectations of future data.

If inflation were to reverse, then

Nominal rate – inflation = real rate

1.77% - (-) 2% = real rate

Recall minus times minus = plus

1.77% + 2% = real rate

3.77% = real rate

Such a development of lower or negative change in the consumer price index or the GDP deflator argues well for capital gains in long term bonds, even though nominal rates are low. The capital gain, percentage wise, on a 30-year bond going from 3% to 2% is much greater than a 30-year bond changing from 10% to 9%. This is counter intuitive but is the way the long-term bond market works.

The most common argument against lower rates is the theory that the debt build up in Washington will lead to higher interest rates.

But do not forget the evidence from Japan where government debts are high but interest rates in Japan have been low for a long time. Do not forget also that European fixed income investors may want to switch out of the euro into “The Almighty US dollar.” Yes, the dollar is now strong after decades of being scorned.

The Jekyll Theory is a theory.

The Jekyll Theory is likely to lead to more capital gains in long-term bonds.

But buyer beware.....*theories are not always correct.*

General Disclaimer and Release:

Investment advisory products and services are available to residents of Georgia through advisory representatives of Joseph Jekyll Advisers LLC, an Investment Adviser registered pursuant to the laws of the State of Georgia. Joseph Jekyll Advisers only conducts business in states where licensed, registered or where an applicable exemption or exclusion is afforded. Neither this report nor The Joseph Jekyll Advisers LLC's web site at www.jekylladvisers.com (hereafter referred to as “the jekyll webs site”) should be considered a solicitation to buy or an offer to sell any securities or other financial products and services. Investment advisory services and products of Joseph Jekyll Advisers LLC are not available in those states where not authorized or permitted by law to solicit or sell the services and products.

The publications, information and opinions of Joseph Jekyll Advisers LLC have been compiled from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. The publication, information and opinions are not intended to be used as the only basis for investment decisions, nor should they be construed as advice designed to meet the particular needs of an individual investor. The products, services, securities and financial instruments described herein may not be suitable for you or available in the jurisdiction in which you are located. Viewers or users of these reports and “the jekyll web site” will not be considered clients of Joseph Jekyll Advisers LLC just by virtue or access. Viewers or users of “the Jekyll web site” are advised to seek the advice of their independent financial adviser, legal or tax professionals, prior to making any investment decision based on any specific publication, information, opinion or other content here, or to become a client of Joseph Jekyll Advisers LLC by calling 706-255-9469. Some clients of Joseph Jekyll Advisers LLC and its principal have investments in long term US Bonds and or bond mutual funds. This disclosure of ownership is not in itself an endorsement but simply for the record.