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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 drops 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 + inflation[2]
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.

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[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.*