

Shadow Monetary Policy Committee

February 2013

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IEA's Shadow Monetary Policy Committee votes by six to three to raise Bank Rate by 1/4% in February

Following its most recent quarterly gathering, held at the Institute of Economic Affairs (IEA) on 15th January, the Shadow Monetary Policy Committee (SMPC) decided by six votes to three that Bank Rate should be raised on Thursday 7th February. Four SMPC members wanting an increase of ¼%, while two advocated a rise of ½%, implying a rise of ¼% on normal Bank of England voting procedures. The recommendation of a rate rise in February was the first time since September 2011 that a majority of the SMPC had voted in favour of higher interest rates. One reason was that fiscal policy seemed even further off course than was previously believed, and risked damaging the credibility of all UK policy making. Another was that the lull in the storms engulfing the Euro-zone provided an opportunity to raise Bank Rate while the markets were still reasonably calm.

However, there were also some noticeable intellectual differences between the SMPC majority, who wanted a rate rise, and the approach more commonly favoured by UK policy makers and the financial media. In particular, it was believed that the almost unprecedented degree of government intervention in the UK economy in recent years was leading to major problems with aggregate supply and preventing the re-allocation of resources from Zombie sectors to those with genuine growth potential. It was also feared that sustained artificially low interest rates were leading to a growth-destroying misallocation of capital. However, three SMPC members believed that there was a genuine demand shortfall, which would be alleviated by additional monetary stimulus. Most SMPC members thought that there should be no additional Quantitative Easing (QE) for the time being, however.

The SMPC is a group of economists who have gathered quarterly at the IEA since July 1997. That it was the first such group in Britain, and that it gathers regularly to debate the issues involved, distinguishes the SMPC from the similar exercises carried out elsewhere. Because the committee casts precisely nine votes each month, it carries a pool of 'spare' members since it is impractical for every member to vote every time. This can lead to changes in the aggregate vote, depending on who contributed to a particular poll. The nine independent analyses should be regarded as more significant than the exact vote. The next SMPC gathering will be held on Tuesday 16th April 2013 and its minutes will be published on Sunday 5th May. The next two SMPC e-mail polls will be released on the Sundays of 3rd and 31st March, respectively.

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Minutes of the meeting of 15th January 2013

Attendance: Phillip Booth (IEA Observer), Roger Bootle, Jamie Dannhauser, Anthony J Evans, Graeme Leach, Andrew Lilico, Kent Matthews (Secretary), Patrick Minford, David B Smith (Chairman), Akos Valentinyi, Peter Warburton, Trevor Williams.

Apologies: Tim Congdon, John Greenwood, David H Smith (*Sunday Times* Observer), Mike Wickens.

Chairman's introductory comments

Recent SMPC membership changes

The Chairman commenced the gathering by recording the thanks of the Committee for the contribution made by the retiring SMPC member, Ruth Lea, over many years. He then welcomed the newest recruit Graeme Leach, Chief Economist of the Institute of Directors, to his first physical meeting of the Committee. As there were eleven members in attendance, the Chairman announced that the comments of members that arrived after the first nine turned up would be recorded but not counted for the final rate recommendation. This followed the precedent of the rare previous meetings when the gathering had been super-quorate. The 'extra' pair of comments and votes have not been 'lost', however, but are recorded in full in the Appendix to the main vote. The Chairman then invited Andrew Lilico to give his assessment of the global and domestic monetary situation.

Economic Situation

Risks to the world economy in 2013

Andrew Lilico started his presentation by listing the risks faced by the different economic blocks that made up the world economy, beginning with the USA. The risk facing the USA was that the present activist stimulus policy could generate only a temporary expansionary effect, followed by inflation. The risks confronting the British economy included a small likelihood of a gilts crisis and the loss of its AAA rating. The Euro-zone crisis remained in the wings. Looking further afield, the risks of higher inflation in China, and of an oil crisis arising from geo-political tensions, were ever present. Last year had been a poor one for the Euro area and the outlook remained flat. Furthermore, the developing and emerging economies had not been unaffected by the weakness of the developed economies. The leading indicators compiled by the Organisation for Economic Co-operation and Development (OECD) had signalled positive for the UK and USA but less so for China and the Euro-zone.

US public spending burden has risen to European socialdemocratic levels There followed a short discussion about the fiscal situation. This had been initiated by Phillip Booth asking about the projections for the US economy. David B Smith said that the rise in the share of the general government sector in US GDP to over 40% – i.e., what used to be considered European social-democratic levels – would almost certainly have impaired America's long term growth. He added that the 'big government' policies of George W Bush and President Obama may have had a qualitatively similar – but smaller – impact on America's supply side to Gordon Brown's policies in Britain. However, Graeme Leach, Trevor Williams and Andrew Lilico were more sanguine about US long-term growth prospects citing: the political

deal with the Republicans, who will be looking for spending cuts; the utilisation of shale gas, and the resurgence in US manufacturing productivity.

UK price level 8.4% higher than if inflation target had been met since March 2007

Resuming his presentation, Andrew Lilico stated that broad money growth had weakened in the USA and China but had picked up in the Euro area and Britain. UK GDP grew in 2012 Q3 but may have contracted in the final quarter of last year (*Editorial Note:* the 'flash' output based measure of fourth quarter real GDP, released on 25th January showed a quarter-on-quarter decline of 0.3% but no change on the year-on-year comparison). The Bank of England's central projection for GDP was that it would not regain its 2007 peak until 2014/15. Since the first violation of the inflation target in March 2007, the price level had risen 8.4% above the level that would have prevailed if the 2% target had been continuously met. Nevertheless, the Bank of England continued to project easing inflationary pressure based on current interest rates and £375bn of QE.

Monetary policy has reached the limits of its growth-promoting effectiveness

Andrew Lilico went on to present his analysis of the economy in the context of the Wicksellian theme of the natural rate of interest (*Editorial Note*: Knut Wicksell, 1851 to 1926, was a pioneering Swedish monetary economist). Interest rates below the natural rate were good for growth in the short run but bad for growth in the long run because of the misallocation of capital that resulted (i.e., so-called 'mal-investment'). Interest rates had been near zero for almost four years now and there had been further stimulus from QE. At some point, the long-run negatives would outweigh the short-run positives arising from the current ultra-lax monetary stance where the world economy was concerned. QE had boosted the demand for bank reserves. However, this had not been translated into an increase in bank lending. Commercial banks were prepared to lend at low rates to existing business customers – in effect, this was a strategy of 'gambling for resurrection' where Zombie companies were concerned – while new and viable businesses had to bear higher rates. This lending priority: first, created a competitive distortion; and, second, led to a misallocation of capital towards areas where its productivity was lowest.

Raise Bank Rate now, while markets remain calm

In summary, the policy challenge was to raise the long-term growth rate, not just to recover from a temporary recession. Monetary policy had run its course. This meant that the objective had to be to normalise interest rates in periods of market calm, in Andrew Lilico's opinion. While recent Euro-zone developments had led to a calming of markets, a rise in Bank Rate of ½% immediately, followed by later rises would not be inappropriate.

Discussion

How do supply-side improvements feed into effective demand?

The Chairman thanked Andrew Lilico for his thorough and thought-provoking presentation. He then asked Roger Bootle and Patrick Minford to make their respective comments there and then as he was aware that they both had to leave early. Roger Bootle then said that he had not heard a cogent argument as to how supply-side policies would get translated into consumer demand. Andrew Lilico and others said that an increase in aggregate supply would work through expected future income, which was a standard transmission mechanism in New Keynesian models. Patrick Minford added that, after four years, it was hard to continue to label the state of the economy as a lack of demand.

Monetary policy may have reached its limit

Roger Bootle said that four years needed to be compared with the length of the Great Depression of the 1930s which lasted nearly a decade. As to the fall in potential GDP, he agreed that this may have occurred but it was a question of degree. To argue that it was all a matter of the supply-side was a mistake. He said that he had never believed that QE would create growth. The alternatives he mentioned were that that the exchange rate should be lower but not a precipitous decline that would endanger a collapse. The Funding for Lending Scheme (FLS) may yet have some effect.

Lessons from the Roosevelt new deal

Akos Valentinyi said that the interventionist policy of the Roosevelt government delayed the recovery in the USA in the 1930s. Recovery may well have come sooner in the absence of the New Deal. Jamie Dannhauser disagreed and said that he had a lot of sympathy for Roger Bootle's position. He added that the micro evidence did not support a supply side interpretation. Both supply and demand were interrelated. Demand could come from corporate investment and exports. Roger Bootle said that, if the 1930s was not a situation of weak demand, he asked why the Second World War created demand. Philip Booth said that the comparison of a wartime economy with a functioning market economy was inappropriate.

British experience in the 1930s was different to US and argues against a Plan B Kent Matthews added that a study of the Roosevelt Works Progress Administration programme in the 1930s by Dan Benjamin and himself, published by the Institute of Economic Affairs (IEA) as a Hobart pamphlet in 1992, reported research that showed that for every ten jobs created by government intervention in the New Deal, nine jobs were destroyed in the private sector. In a similar way, Bank intervention in keeping rates so low for so long was probably creating more harm than good. David B Smith added that it was worth bearing in mind that the British experience in the 1930s had been very different to that of the US. Since he had recently published an article on the subject (*Britain in the 1930s: Lessons for Today*, in *B & O, The Quarterly Journal of the Economic Research Council*, Summer 2012, Volume 42 No. 2, www.ercouncil.org) he would not comment further, apart from noting that the draconian fiscal discipline of the time, which saw a rise in the constant employment budget surplus to a peak of some 4.2% of GDP in 1933, was quite consistent with an average growth in real GDP of 41/4% per annum between 1933 and 1937. If only we were so fortunate today.

Zombie companies have crowded out new businesses from access to bank credit Kent Matthews next proposed that Andrew Lilico's analysis of the relative ease with which insiders and outsiders had access to bank credit fitted the facts. A recent report by Deloitte suggested that the number of Zombie companies being kept alive by low interest rates and available credit could be as high as one-in-ten. These insider borrowers were kept alive by banks that were afraid to 'pull the plug' for fear of the negative outcome of accepting the resultant write offs on their balance sheets. The other side of the coin was that new credit was not being granted to viable companies, except at high interest rates and tough collateral conditions. In the case of insiders, risk was being 'under-priced' whereas it was 'overpriced' for outsiders. Recessions normally lead to a clear-out of unprofitable companies through the Schumpeterian process of 'creative destruction'. However, this can only work if credit markets were well functioning. Exceptionally low interest rates for this length of time work against the process of efficient credit allocation and acted as a hindrance to a natural recovery.

Voting procedures

Having already taken the votes of Roger Bootle and Patrick Minford, the Chairman stated that it was now time to go round the table and record everybody else's votes. These are listed in their customary alphabetical order below. As Kent Matthews and Roger Bootle were the last to arrive the Chairman ruled, in line with established SMPC

practice, that these two would have their views recorded but their vote discounted. To avoid confusion, these two comments are set out in an Appendix.

Comment by Jamie Dannhauser

(Lombard Street Research)
Vote: Hold Bank Rate.
Bias: Expand and widen QE.

Risk of Japanese style minimal growth

Jamie Dannhauser said that he had no disagreement with the supply-side arguments that called for greater deregulation. These arguments had merit. Nevertheless, it was a question of balance. The danger was that the economy sleep walked into a Japanese state of long-run minimal growth. Jamie Dannhauser added that it would be better to err on the side of a more aggressive monetary stance and, possibly, ease further, employing more and wider QE beyond gilt purchases. He said that the dominant risk was the Euro-zone crisis. QE would have worked if it had not been for the uncertainty created by the events in Continental Europe. What was needed now was wider, and marginally more, QE.

Comment by Anthony J Evans

(ESCP Europe Business School) Vote: Raise Bank Rate by 1/4%.

Bias: No further QE; raise Bank Rate further as the opportunity arises.

Additional monetary interventions likely to do more harm than good

Anthony J Evans said that he did not believe central banks were out of ammunition and there was more that they could do to loosen the monetary stance. Nevertheless, the risk was that additional intervention would be more likely to make things worse rather than better. The existing low interest rate policy was causing damage and rates should not be kept low indefinitely. Central bank activism had failed because policymakers had failed to lift expectations – it was better to threaten a loose policy but actually keep it neutral, than it was to forecast low growth and keep it loose. In his opinion, the Bank of England should not do any more QE. Anthony J Evans concluded that interest rates should be moved towards the natural rate and that the current situation presented a window of opportunity to do so. He voted to raise Bank Rate and had a bias towards further increases.

Comment by Graeme Leach

(Institute of Directors)

Vote: Hold Bank Rate and hold QE.

Bias: Neutral on Bank Rate but maintain additional QE available as a contingency measure if Euro crisis worsens.

UK condemned to slow growth

Graeme Leach said that the economy seemed to be condemned to a low growth scenario due to supply-side influences and in particular the size of the state, which was undermining potential GDP growth. Whilst there was scope to support demand through further QE, he argued that any decision to further boost QE should await clearer numbers as to the sustainability of the slight improvement in broad money growth on the M4^{ex} measure seen towards the end of 2012. He also stated that a significant expansion in QE was almost inevitable at some stage over the next twelve months, in view of the high probability of a further flare up in the Euro crisis.

Comment by Andrew Lilico

(Europe Economics)

Vote: Raise Bank rate by ½%; hold QE.

Bias: To raise Bank Rate.

Bank Rate should revert to its higher norm

Andrew Lilico said that the Bank of England could generate a temporary expansion through an easy monetary stance but that this would be followed by higher inflation. Monetary policy had to be rebalanced and the interest rate should be allowed to revert to a higher Wicksellian norm. The rate of interest could not stay at the current level forever. The calm in the markets provided this window of opportunity for rates to rise.

Comment by Patrick Minford

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by 1/2%.

Bias: To raise Bank Rate, while reducing regulatory burden on banks; unwind

QE.

Recession too long lived to be a demand problem

Patrick Minford stated that he agreed with Andrew Lilico's assessment. Money could not be used to systematically stimulate growth. The forthcoming Bank of England Governor, Mark Carney, had implied that more QE would be deployed and that the inflation target would be abandoned. Patrick Minford said that any abandonment of the inflation target would represent the worst kind of time inconsistency. He said that it was time to signal that monetary policy could not be used indefinitely to stimulate growth. He said that he was getting used to being a lone voice. He voted to raise Bank Rate to 1% immediately, followed by further rises in future months.

Comment by David B Smith

(University of Derby and Beacon Economic Forecasting)

Vote: Raise Bank Rate by 1/4%.

Bias: To raise Bank Rate further and hold QE.

UK economy faces both macro and micro supply-side problems; neither can be helped by monetary looseness David B Smith said that the economy was facing a macro supply-side contraction – fundamentally, this was caused by the massive increase in the public spending and regulatory burdens since 2000 – but also the culmination of a whole series of microeconomic problems. The recent spate of changes to the international environment, and the marked rise in energy costs since 2005, meant that many individual sectors of the economy, as well as specific companies, were now technically obsolescent. This was something that some household name retailers had recently found to their cost. However, the same argument applied to wider swathes of the UK economy. The implication was that resources needed to be reallocated rapidly from the Zombie economy to the sectors that had a future. This required a background of low regulation and frugal tax costs if the necessary flexibility was to be achieved. Unfortunately, the political process – as well as the commercial banks' wish to keep bad debts off balance sheet – militated against the required re-allocation of productive resources to socially more useful ends.

Mr Osborne has acted as the 'son of Gordon Brown'

In this situation, monetary policy was not a workable source of stimulus and neither was a conventional fiscal demand boost. The more he had examined the details of the December 2012 *Autumn Statement*, the worse things appeared. Despite his rhetoric to the contrary, Mr Osborne appeared to be acting in practice as the 'son of Gordon

Brown', rather than the 'anti-Brown' that the economy needed. The Bank of England had lost all credibility and the yield on 2½% Consols – where yields had probably been less distorted by QE – had already broken upwards through 4% at the start of the year. Policy-induced nervousness was likely to see gilt yields rising further (and sterling weakening) and not necessarily in a controlled manner. A shakeout of the British government bond market looked particularly likely if the financial markets suspected that one reason for Mr Carney's appointment was Mr Osborne's desire to whip up an unsustainable credit boom before the 2015 general election. He said that a modest rise in Bank Rate was needed to signal a change in monetary stance to the market and that the monetary authorities were not simply supine accomplices to the breakdown of fiscal integrity. David B Smith voted to raise rates and to hold QE (subject to events in the Euro-zone) with a bias for further rises in Bank Rate until it was somewhere in the 2% to 3% range.

Comment by Akos Valentinyi

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ¼%. Bias: To raise Bank Rate further.

Three major sources of uncertainty but monetary stimulus had run its course

Akos Valentinyi said there were three sources of uncertainty that impinged on UK interest rate policy. The first was the Euro crisis; the second was domestic regulatory policy, and the third was US fiscal policy. He said that he believed monetary policy had run its course and keeping interest rates at the current level worsened the misallocation of capital. QE had distorted bond yields. He voted to raise rates with a bias to further increases.

Comment by Peter Warburton

(Economic Perspectives Ltd)

Vote: Raise Bank Rate by 1/4%; no extension of QE.

Bias: To raise Bank Rate further.

Physical overinvestment in some sectors, underinvestment elsewhere and mal-investment have all held back growth

With reference to the earlier discussion regarding the competing diagnoses of aggregate demand deficiency or supply-side bottlenecks, Peter Warburton argued that the UK economy suffered from a combination of both. Excessive credit growth in the global economy over a number of years had been accompanied by physical overinvestment in some sectors, under-investment in others and mal-investment in yet others. Some industries faced structural over-capacity and were deliberately running down the capital stock, resulting in a lengthening of the median asset life. There was a suspicion that additional labour resources were being deployed to keep aging assets in operation. In other sectors, including energy, transport and food, there had been under-investment in the infrastructure and supply constraints were evident. A shortfall of demand in relation to productive capacity could just as well be read as a signal for supply to contract as for demand to expand. Certainly, with public expenditure representing such a large proportion of GDP, there could be no presumption that government should act to remedy a supposed demand deficiency. The size of the government sector lay beyond the range of effective counter-cyclical fiscal policy. It was highly probable that further additions to public current spending would have a negative impact on GDP.

QE stock should be held but gilts deemphasised in favour of private sector assets

Peter Warburton then added that QE, in terms of government bond purchases, should be thought of in global terms and not just nationally. The aggregation of QE in different countries had a pooled effect in the global bond market, rather than a ring-fenced effect in the national bond market. Peter Warburton said that he agreed with Jamie Dannhauser that there was a need to widen the scope of QE by extending it to other assets. However, this should not be through additional QE but by reallocating the existing stock of QE, perhaps up to £50bn, over a wider range of assets. The overall stock of QE should be increased only as a contingency. The Bank of England needed to learn from the experience of the Bank of Japan, that relatively small purchases of private sector assets – for example commercial property, exchange-traded equity funds and commercial paper – could have potentially more powerful effects on the real economy than huge purchases of gilts. At the same time, the removal of Bank funding of the budget deficit would help to discipline fiscal policy. On the basis that more could be done to leverage the Bank's existing balance sheet size, he believed that it was time to revisit the normalisation of Bank Rate. He voted to raise Bank Rate with a bias towards further increases.

Comment by Trevor Williams

(Lloyds Bank Commercial Banking)

Vote: Hold. No further QE.

Bias: Neutral.

Higher Bank Rate at this juncture would be a disaster for the recovery

Trevor Williams said that a rise in the Bank Rate at this juncture would be a disaster. Households would be less likely to spend and corporations less likely to invest. In some sense, they had a 'desired' target in mind. So, if rates rose and debt payments went up, they would have to save more to make up the gap between desired saving and the actual. There were both demand and supply issues and 'Minsky moments' that were unfolding, according to Trevor Williams. The Bank of England could not do anything about Europe except to react. UK economic growth over the past five years had just been a smidgen better on average than that of Spain, despite the latter's well documented problems. It was difficult to resolve all the problems that the British economy faced with interest rate policy alone, since many of these were structural and long term in nature. Public spending needed to be cut and the need for a rebalancing of policy remained an important issue in the medium term. While Trevor Williams felt that there should not be any further QE, for now, he believed that the Bank should continue with its efforts to reduce the cost of credit to small businesses. He said the Bank of England needed to think more creatively about monetary policy. He voted to keep interest rates on hold.

Policy response

- 1. On a vote of six to three, the IEA Shadow Monetary Policy Committee recommended a rise in Bank Rate in February.
- 2. There was disagreement as to the extent at which rates should rise. Two members wanted rates to rise by ½% which would have been the traditional policy response in the past, when rates came down in quarters but rose in halves while four said that rates should rise by ¼%. One reason for limiting the recommended rise to a ¼% was so as to avoid an undue shock to the financial markets after such a long period of stasis.

- 3. All those who voted to raise rates expressed a bias to raise rates further.
- 4. There was a general agreement that the delay in implementing Basle III was welcome because it allowed commercial banks more time to rearrange their balance sheets and made it less likely that there would be a damaging and internationally-synchronised reduction in the supplies of money and credit to the private sector.

Date of next meeting

16th April 2013.

Appendix to Main Vote

This appendix sets out the views of the two SMPC members who attended the gathering but did not have their views recorded in the main vote, because nine members had already arrived.

Comment by Roger Bootle

(Deloitte and Capital Economics)

Vote: Hold Bank Rate. (Vote discounted)

Bias: Neutral.

UK demand was weak because of weak consumption

Roger Bootle said that monetary policy may have reached its limit however that was no argument for raising interest rates. UK demand was weak because of weak consumption. Therefore, he would have voted to maintain the rate of interest.

Comment by Kent Matthews

(Cardiff Business School, Cardiff University)

Vote: Raise Bank Rate by ½%. (Vote discounted)

Bias: To raise Bank Rate; additional QE to be used only if the Euro crisis reemerged.

QE should only be extended in response to Euro-zone crisis Kent Matthews said that QE was always available as a contingency if the Euro crisis flared up again, as it certainly would in due time. However, QE should not be used to bolster domestic monetary policy until then. A rise in the rate of interest would certainly cause pain in the short term but it was a necessary action for two reasons. First, it was necessary to signal to the market that monetary policy was being rebalanced towards some normal position that would create the conditions for the efficient allocation of credit and a natural recovery. Second, monetary policy would have no traction at interest rates already at near zero in the event of a terminal Eurozone crisis. Correspondingly, Kent Matthews would have voted to raise rates and to hold QE as a contingency.

Note to Editors

What is the SMPC?

The Shadow Monetary Policy Committee (SMPC) is a group of independent economists drawn from academia, the City and elsewhere, which meets physically for two hours once a quarter at the Institute for Economic Affairs (IEA) in Westminster, to discuss the state of the international and British economies, monitor the Bank of England's interest rate decisions, and to make rate recommendations of its own. The inaugural meeting of the SMPC was held in July 1997, and the Committee has met regularly since then. The present note summarises the results of the latest monthly poll, conducted by the SMPC in conjunction with the Sunday Times newspaper.

Current SMPC membership

The Secretary of the SMPC is Kent Matthews of Cardiff Business School, Cardiff University, and its Chairman is David B Smith (University of Derby and Beacon Economic Forecasting). Other members of the Committee include: Roger Bootle (Capital Economics Ltd), Tim Congdon (International Monetary Research Ltd.), Jamie Dannhauser (Lombard Street Research), Anthony J Evans (ESCP Europe Business School), John Greenwood (Invesco Asset Management), Graeme Leach (Institute of Directors), Andrew Lilico (Europe Economics), Patrick Minford (Cardiff Business School, Cardiff University), Akos Valentinyi (Cardiff Business School, Cardiff University), Peter Warburton (Economic Perspectives Ltd), Mike Wickens (University of York and Cardiff Business School) and Trevor Williams (Lloyds Bank Commercial Banking). Philip Booth (Cass Business School and IEA) is technically a non-voting IEA observer but is awarded a vote on occasion to ensure that exactly nine votes are always cast.

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