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Dear Readers

Let us not tiptoe around the obvious: it is our first anniversary and we are young. However, we are old enough to have witnessed unprecedented economic policies of few of the largest democracies of the world, resurgence of Islamic extremism in the Middle East and rise of radicals in Europe. We also saw the US restoring full relations with Cuba, erasing the last trace of cold war hostility. We witnessed the Russia-induced crisis in Ukraine with alleged involvement of bringing down a civilian plane. On the backdrop of the super slump in commodities led by oil, we watched how the same country got downgraded to junk with the Rouble on the verge of a crisis. While on one hand we saw the emergence of the smart watch that threatened to dethrone the entire Swiss watch industry, on the other we observed legislations to legalise marijuana trade.

Exactly a year back, from the inaugural edition of The Bottomline, we tasked ourselves with bringing differentiated content with a subtle disruption to the regular news feeds and opinions. We have considered economic, geographic and political matters, sometimes all of them together, to remind us how dramatically such issues can change the society.

In this anniversary issue, on the cover we feature the most burning issue of today’s geo-political environment – the Eurozone. Elsewhere, we discuss the ramifications of the UK general election to the possibility of China emerging as the world’s alternate banker. As geopolitics of oil continues to evolve, we explore the effect of Quantitative easing as a theory. Post one of the worst economic crises of the century we revisit the roles of greed, fear and human complacency. Also, in this edition we have introduced a Concept paper which will eventually feature as a separate publication from the Investment Desk.

Anniversaries are also thresholds. Where will this threshold lead us? That will largely depend upon the contributions from our authors. Certainly in this issue, no less than any other, we are proud to offer you, the reader, a diverse range of topics, which usher us into the second year of The Bottomline.

We hope you enjoy reading our work as much as we enjoy bringing them to you.

Aniket Bhaduri, Manager Investments
From the CEO’s Desk

It has been a wonderful journey. We started over Seven years ago with a view to provide operational support to the JLT Group and with a vision of continuously developing our talent base to expand that original thought. The intent being, to keep adding to the proposition that we offer to the group’s clients globally. The change has been visible in our first few years as we developed Actuarial and Investment skills, then our Legal and Research skills and so on. And it is heartening that this momentum is gathering pace.

JLT India is a rapidly evolving organisation. And our evolution into an innovation and knowledge hub for the JLT group is going to be through leadership in thought and expression. I am delighted that The Bottomline, which embodies both those basic tenets is celebrating its anniversary. Over the last twelve months I have seen this publication grow in depth and it has helped me read and learn while enjoying the subtle humour in its editorials or lead stories. While much has changed in The Bottomline over the last year, my conversations with the team are very encouraging because they continue to be hungry for improvement and that sentiment I am sure will drive not only another successful year of diligent publication, but sustained step changes in its content. Congratulations to The Bottomline and all the best for future.

Puneet Satyawadi, CEO JLT India
The beautiful game amidst the antagonistic while Uncle Sam stands on his feet, once again

Brazil hosted the 20th FIFA World Cup with national teams from 31 countries. 64 games were played across 12 cities. With all their might, countrymen of Brazil and the one million guests that arrived from across the world cheered on the beautiful game inside the stadiums. Sadly, even before kick-off of the first game, the story outside the stadiums was quite different. Brazil fell into recession in the first half of 2014 and the government was marred by corruption and criticism. The run up to the World Cup saw protests from those who felt that the country’s money could have been used to invest in much needed infrastructure rather than doing it out on building new stadiums. Making matters worse, a horrific defeat of the hosts in the world-cup finals only added to the woes of what would end an abysmal 2014 for the country.

While 2014 proved quite disastrous for the Latin American country, for its neighbour up north, the United States of America, 2014 in its last leg proved fruitful. A fantastic hiring stretch (the best since the 1990s), record auto sales and a plunging gasoline price helped put the country back on track. 2.7 million jobs were added in the past year, which dropped the unemployment rate to 5.7 percent in December from 6.7 percent a year earlier. Also, for the first time in five decades, the Obama administration moved to re-establish diplomatic ties with Cuba. In a year that saw so much conflict, this move seemed like a breath of fresh air!

Rise of the new age Bonaparte and the collapse of gold, black gold

Talking about conflicts, 2014 started and pretty much ended with continued conflicts. Events in Ukraine from the very beginning of 2014 dominated headlines and overshadowed the year with a sense of cold war déjà vu. Uprisings in Kiev led to the collapse of President Viktor Yanukovych’s government and saw scores of people getting killed. Struggles in Ukraine did not end there and only worsened when Putin-led Russia invaded eastern Ukraine and took control of Crimea. These actions drew considerable flack from western governments who imposed sanctions on Russia, targeting their banking and energy firms. To make matters worse, a fall in global oil prices left the country reeling and the energy exporting economy bleeding coming into 2015. A flood of crude from US shale disrupted the global oil market. Oil prices fell almost 50 percent in the second half of 2014. Even though thirst for global oil diminished during the year, none of the producers, be it USA or the OPEC, chose to cut on their production. With reduced demand for their produce, the US consumed a sizable chunk of their own production, which wallop countries such as Columbia and Nigeria who traditionally had exported their oil produce to this region.

Good, bad and the ugly, the emergence of the Jack Ma-s (once again), Ebola and ISIS

History repeating itself?

Alibaba created history when it went public with its IPO, a USD 25 billion listing. Facebook bought messaging service application – WhatsApp, whose revenue model is still a mystery amongst its users, for more than USD 20 billion. Uber, the app-based taxi service was valued at USD 40 billion in its latest round of funding. According to Dealogic, an international financial software company, the US markets saw more money raised through IPOs in 2014 since the peak of the dot-com bubble in 2000. Did we say the word? Can that be true? A bubble ready to burst?
reshaped the political landscape across the Middle East. Ghoulish videos of beheadings of American and British nationals provoked these countries to intervene via a campaign of air strikes.

**Fight for my right, designate for change**

Pro-democracy protests in Hong Kong began in the second half of 2014. This came after China’s announcement that a committee rather than an open nomination process would select candidates for Hong Kong’s chief executive. Demonstrations began outside the Hong Kong Government Headquarters by the Hong Kong Federation of Students and Scholarism who ultimately managed to occupy several major city intersections. This movement would pose as one of the biggest challenges to Chinese rule since the handover to Beijing in the 90s and would eventually be called the Umbrella Movement. 2014 did not see the end of it.

Another ‘movement’ in the Asian region, albeit not a protest, took place when the world’s largest democracy took to the electoral booths to cast their votes. Over 550 million voters voted in India’s general election which nominated Narendra Modi – a seemingly pro-business candidate in a landslide victory for the Bharatiya Janata Party giving them absolute majority. This would be the first time in thirty years that the country would be governed by a non-coalition government.

**Past tense? Yes. And future tense? Probably.**

2014 was supposed to be the year the Eurozone exited its debt crisis and when growth would finally return bringing with it confidence and jobs in the region. Sadly, 2014 proved different. Drastically different. The Eurozone remained stuck in the doldrums even after the ECB announced a slew of stimulus measures, including negative interest rates. The outcomes weren’t the intended ones and even Germany, the Eurozone’s powerhouse, lost considerable momentum coming into the New Year.

Another region that had its fair share of stress found its way (again) in the Latin American continent. The continent’s woes didn’t end at Brazil. Argentina defaulted again, the second time since 2001 and the eighth time in its 200-odd year history. This default however, could be touted as one of the strangest in history. Argentina didn’t default because it couldn’t pay its bondholders, but because a judge sitting in New York wouldn’t let it pay its bondholders – not unless the country also paid the hedge funds that were holding out for a better deal on its old defaulted debt.

**2014 – You shall not be missed!**

Overall, it would be fair to say that 2014 has been year of struggle for most. But it has helped others. It isn’t the end of the road. While the Europe area has struggled in 2014, corrective measures are being put in place and drastic steps to revive markets and investor confidence are being implemented. A major positive coming into 2015 is that the US economy is on a certain path of revival. Expectations of positive ripple effects hold good, going into 2015. Falling crude prices also bode well for most oil importing, emerging economies and they will look at 2015 to lap up excess production and stockpile larger inventories, not to forget the benefits to their current accounts.

Surely we haven’t seen the end of the Ebola-s and the ISIS-s in 2014, but the IMF expects growth in 2015 to exceed that of the past three years.

**Hello 2015!**

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**A calling from God’s acre.**

Ebola emerged as a global health crisis ravaging the African continent after taking away thousands of lives. Countries such as Liberia, Sierra Leone and Guinea, which were already pressured by civil unrest and crushing poverty, were left devastated due to this outbreak. Health workers from around the world who helped treat patients in Africa faced extreme risks and some even transported this disease beyond the African continent and into their homelands. This would end up being the most widespread epidemic of the Ebola virus to reach such rampant proportions.

**And Satanic travails.**

Troubles for the ‘dark continent’ did not end here. Boko Haram, an Islamist terrorist movement based in northeast Nigeria continued to make its presence felt in the year when it kidnapped schoolgirls and the wife of Cameroon’s vice-president in two separate instances. Abubakar Shekau, who leads this movement, claimed to sell the kidnapped girls into slavery, which eventually brought upon Boko Haram extended global media attention. Elsewhere, another group that rose to infamy in 2014 was the Islamic State (ISIS). Led by a Rolex-wearing self-proclaimed caliph, the group’s devastating blitz through Syria and Iraq put the world on notice, provoking the US and other Western powers to launch military campaigns against the group. The international community also ramped up efforts to address the humanitarian crisis unfolding in the region, particularly in Iraq and Syria.

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Central Bank Blues

For generations, Central bank interventions in economic policies have impacted the fair value of assets across the board. Now as the global economy struggles to exhibit a steady growth, the central banks are coming under increased scrutiny.

Till 2013, the situations of developed economies were similar. So the central banks were able to implement co-ordinated and favourable policies for their respective economies. Following the contrasting economic performances then on, central banks seem to be confused and have been changing their objectives and stance more frequently in 2014. In addition, a subdued demand and a deflationary scenario are being blamed to be challenging the central banks’ initiatives.

While cost of capital was addressed in every policy meeting in recovering economies, stimulus was the last resort for the fragile ones. As US and UK economies recovered beginning 2013 and retreated to a steady growth in 2014, the Federal Reserve and Bank of England sent signals to raise benchmark rates in 2015. On the contrary, Eurozone and Japanese economy remained fragile due to the political disturbances along with weak growth and inflation. This prompted the European Central Bank to provide stimulus by stepping up purchases.

**United States**

Federal Reserve started QE in 2009 to steer the economy through the depths of the financial crisis. Though QE coupled with low interest rates did free up capital, it encouraged financial speculation more instead of improving credit flows in the real economy. Thus US intended to go for a rate hike for eventual normalization of monetary policy with growth recovery in 2013.

Beginning 2014, the Federal Open Market Committee’s (FOMC) forward guidance included quantitative thresholds, stating that it would be appropriate to maintain the federal funds rate well past the time the unemployment rate declines below 6.5 percent, especially if projected inflation continues to run below the Committee’s 2 percent longer-run goal. With the unemployment rate quickly approaching the threshold of 6.5 percent, the FOMC decided to update its forward guidance by providing a qualitative description of the factors that would influence its decision regarding the appropriate time of the first increase in the federal funds rate and its pace. The Committee agreed to assess the progress--both realized and expected--toward its objectives of maximum employment and 2 percent inflation. Based on its assessment of these factors, the Committee indicated that it would be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends. The Fed, facing a much improved U.S. economy, completed its last round of balance-sheet-expanding bond purchases in October 2014.

**Europe**

Private sector lending remained weak as the European Central Bank conducted asset quality reviews and banking stress tests to check the health of Eurozone bank balance sheets. The ECB unveiled an unprecedented package of measures in June in an attempt to support the Eurozone’s flagging economy and ward off a damaging deflationary spiral. The ECB governing council cut the deposit rate for the region’s commercial banks to -0.1 percent from zero. It had also cut its main interest rate to a new record low of 0.15 percent from 0.25 percent, and announced a €400bn (£325bn) package of cheap funding for banks on the condition it is used to lend money to companies outside the financial sector, and not for mortgages.

After a slowdown and a quarter of decline in Germany GDP, Mr. Draghi had the backing of the German government to embark on further easing. ECB officials appealed for patience from financial markets to let the new measures take effect before demanding new stimulus. However beginning 2015, ECB embarked the much awaited and delayed quantitative easing (QE)
programme amounting to €60 billion a month, largely comprised of purchases of Eurozone sovereign debt. The asset purchase programme is planned to begin in March and last until September 2016, and add approximately €1.1 trillion to the ECB’s balance sheet. QE is more complicated in the Eurozone than anywhere as the euro bloc has 18 national bond markets, making it hard to target such stimulus where it is needed.

United Kingdom

The Bank of England (BOE) governor Mark Carney dispensed a galore of insights on interest rates in 2014. However, the trajectory conveyed by the Monetary Policy Committee (MPC) meets appeared to be conflicting.

Adjudging the minutes of early 2014 meetings, the prospect of the term of a stalled benchmark policy rates to come to an end is likely by the end of 2014. MPC has kept the interest rates on hold at just 0.5 percent since March 2009. The policymakers cited reasons for rate hike as they want to avoid the chances of a stronger than expected growth in the second half of 2014 eating up the spare capacity in the economy. This could result in a faster than expected fall in the unemployment, putting upward pressure on wages and in turn might trigger a more urgent monetary policy tightening.

Notwithstanding the anticipations, the rises in wage rates have been slower than inflation in recent months. Hence, a perplexed perception was observed in the following MPC meetings. Mark Carney notified that there is more spare capacity in the labour market than their previous estimates. Thus, there is still some requirement for parallel growth momentum that will push up the wage rates and in turn interest rates.

Japan

Prime Minister Shinzo Abe’s “arrows”-aggressive monetary easing, fiscal stimulus and structural reforms failed to achieve the stipulated economic growth and inflation. Further, the optimistic Japanese government perceived that the economy is strong enough to absorb the impact of an increase in sales tax in April and this would aid their huge fiscal deficit. However, it scaled down the consumption and the GDP slipped by 1.9 percent during April-June 2014.

Following, the Bank of Japan shocked the global financial markets in October by expanding its massive stimulus spending to avoid a deflationary scenario.

Going ahead in 2015, it is expected that the deflationary environment is not likely to lead borrowing costs to anywhere from record lows. But, inflation expectations in US and UK are steady while Eurozone continues to face deflationary pressures. This is backed by the core inflation data in these economies. The core inflation rate (excluding energy, food, alcohol and tobacco) for US remained unchanged for year ending December 2014 while it actually improved for UK in January 2015. On the other hand, the core inflation rate in Germany decelerated to 1.1 percent in January 2015 from 1.6 percent in January 2014. As oil prices stabilize, the core inflation is likely to get reflected in the headline inflation. The rate hikes in the US and the UK, which have been delayed following a disinflation in second half of 2014, are expected no later than late 2015 or early 2016 while Germany remains far from it.
2014 marked the centenary year for the US dollar. It was exactly a 100 years ago when the printing presses rolled out the current incarnation of the US dollar. Over all these years, the currency has stamped its authority over its competition. The US dollar has been the most distinguished currency in the world over the last century. Like any other reserve currencies of the past, dollar has managed to become so by the sheer magnitude of its demand; both internally and externally. One of the most basic tenets of a reserve currency is that it comes from a nation that has a huge domestic market. If the external demand for such currency reduces for any reason, it is expected that sufficient internal demand will support the currency. However, equally, and perhaps more importantly, it is the external demand that lends the credibility that is required to become the largest and most sought after currency in the world. Such status for the US dollar has been cemented over several decades by the perception of international financial institutions, federal governments, central banks and investors alike that if you need...
to buy something where your capital is absolutely safe, it is the greenback. This perception has presumably driven billions of dollars of flows into the United States, and many believe what has helped the country to live beyond its means, running sizeable deficits by borrowing from the rest of the world.

However, ever since the financial crisis of 2007-08, there have been various arguments on just how the dollar is at risk of losing its crown. Conspiracy theories on how China might prop up the gold-backed Yuan to become the world’s most traded currency has started to emerge. The economists and analysts, conservative at heart, have time and again warned that the urge of the Federal Reserve to create money out of the thin air to fund its asset purchase programs would ultimately lead to demise of the dollar, create hyperinflationary scenario, spook global investors and saddle the treasury with trillions of dollars of debt, crippling the economy.

2014 marked the centenary year for the US dollar. It was exactly a 100 years ago when the printing presses rolled out the current incarnation of the US dollar. Over all these years, the currency has stamped its authority over its competition. A check on just why through the prism of history could give us an indication of the future that lies in store.

It wasn’t as if the US did not have paper currency up until 1914. It was however marred with inconsistency in the policies. In the eighteenth century the currency system was a concoction of banknotes issued by various private chartered banks and the treasury. Needless to say, without the stamp of any federal authority, the credibility of such notes started getting discounted as soon as the notes went into a different territory. Add to that the tendency of such private banks to go bankrupt did not help the cause either.

1987 - 2006
Alan Greenspan
- US Stock market Plunges, Fed announces liquidity support
- Savings and Loan association bailed out with $124 billion of funds
- NAFTA implemented
- Glass-Steagall Act of 1933 repealed
- $350 billion tax-cut announced

2006 - 2014
Ben Bernanke
- Housing bubble bursts
- Lehman Brother collapses, TARP announced, QE announced, banks bailed out.
- US debt rises to $11 trillion
- QE-2 and QE-3 begins
- Tapering of QE announced, linked to economic recovery

2014 - Present
Janet Yellen
- Fed Tapering
Eventually in 1913, the US government created the Federal Reserve and armed it with the authority to create elastic money—essentially the power to control and create money supply as needed in the economy to build the confidence in the system.

However, that in itself did not elevate the status of the currency in the global markets. The British pound held that spot for nearly 100 years after the British government pegged the sterling to a fixed rate convertible to gold. Most countries followed suit although US stood as an exception for most parts. UK was the centre of global trade and commerce and pound was the currency of choice. A lot of that changed during the First World War. The war compelled many nations to abandon the gold standard to allow themselves to print money at will to finance the war; often at the cost of spiralling inflation. As the war started sucking every ounce of capital available, the demand for money sky rocketed. Britain stuck to the gold standard and therefore had lesser money than the US which had ample to lend as it wasn’t a part of the gold standard. The US started to finance the needs of most war-torn nations. So much so, that countries like Switzerland and Canada started issuing bonds denominated in US dollar to increase their appeal to the investors. As the war dragged on, Britain went from lender to borrower. Dollar had started to gain prominence in the global financial markets with increasing acceptance from most parties. Eventually, when UK was forced to abandon the gold standard in 1919, scores of investors and international institutions were left holding the bag as the value of pound plunged. There was no looking back for the US dollar thereafter.

Then came World War two. The picture wasn’t much different. Like the First World War, US benefitted from exporting everything it could in exchange of gold. After the war ended, the realisation dawned upon the world that going back to the gold standard was not possible simply because the US owned most of it. What followed was a chain of events. Instead of pegging to gold, the developed nations of that time started to peg their currency to the dollar. As the dollar was by now linked to gold, in theory each of those currencies were pegged to gold and could be converted to gold if and when required. This system of pegging the currencies at a fixed rate to dollar came to be known as the Bretton-woods agreement in the post war period.

Everything was fine, except that there was one small issue. During that time, much like the China of today, most of the countries were running trade surpluses. As a result, these nations had built-up a huge war chest of US dollars. It needed to be parked somewhere. The only market with the capacity to absorb such huge amounts of money was again, US sovereign bond market. Looked another way, the world started lending to the US without even it asking.

What would happen if you are given increasing amounts of money every single day at rock bottom rates? You start spending. Exactly what the United States did. It spent on everything from infrastructure to housing to social benefits. It was encouraged to run huge deficits as the flow of money never stopped. But nothing lasts for ever. As the US started running large deficits and printed more and more money, confidence in its ability to repay the dollars for gold diminished. As the pressure mounted, President Nixon abandoned the gold standard in early 1970s. Henceforth, no one holding US dollar would be entitled to convert their holdings into gold.

The first few years thereafter was volatile, and expectedly so. Loss of confidence and fears of hyperinflations led the dollar to gyrate wildly. Eventually though, the currency stabilized and continued to remain a preferred choice in the global financial system.

There are many theories why. One of the reasons considered is the masterstroke by Richard Nixon as his attempts to keep the dollar as the world’s reserve currency led him to strike a deal with the Saudis to make the dollar as the only currency in which it would accept payments for oil—the commodity without which the world just could not do. This is we commonly refer to as the Petro-dollars. That apart, many other fundamental factors were also at play. This included, the size and dominance of the US domestic markets as well as its willingness to open up its financial sector to the world. It was willing to tolerate—unlike Japan and Germany—to let its currency appreciate even at the cost of its export-driven industries.

But perhaps, what was probably the most important factor in the revival and sustenance of the dollar as the king drew its roots from somewhat transcendent elements of trust and belief. The belief in the fundamentals of the demand for the dollar from within the country due to the inherent strength in its economy as much as external demand, more so due to lack of any credible alternative.

That is not to say that it will remain so forever. Sure the dollar is issued by the largest trading nation today and its currency has held its value over other currencies over the years—the two most important factors to
make any currency the choice global reserves—but things have begun to change lately. Over the last few years, the Fed has also been pushing the dollar lower to pursue its growth strategies, causing the value of dollars held abroad to fall. What the world witnessed in post the 2008 crisis can happen again if the Fed thinks so, should another crisis strike or geo-political situations warrant. It is also true to some extent that the fact that most countries today are in what is known as ‘the race to the bottom’—a term popularly used to denote the pursuit of lower currency exchange rate by many countries at the same time to lead an export based recovery—that the US dollar continues to find support.

Today, we are beginning to witness the seeds of change. Many corporations and countries are moving away from dollar denominated settlements to other currencies. None more so prominent than the other ‘axis of global power’—China, backed by Russia and some of the other nations.

If history serves as a guide, no one maintains reserve currency status forever. The reserve currency is a cycle that has typically lasted somewhere between 80 to 110 years in the past. Spain and Portugal dominated the 15th and 16th centuries, the Netherlands in the 17th century, France and Britain the 18th and 19th centuries, and the US dominated the 20th century. What is common in all the cases is the way it ends. Each of the nations that rose to the level of global dominance in trade and commerce, ultimately declined due to going overboard. The US has nearly a thousand military bases in nearly 130 countries and spends nearly USD 700 billion in defence expenditure every year. That is greater than combined total of all the countries in the world. It is no longer the largest creditor to the world but the largest debtor to the world.

Today, while it dominates in all the traditional warfare departments more than anyone else, it is the turf itself that is changing. Present day warfare is more about economics than military. Through trade sanctions and market price manipulations it is possible to wage a war without even having to cross the borders. A slugfest in the oil price, for example, could bring countries to the knees. Although the US dominates modern warfare technologies much as it does the traditional mechanisms, it will be naive to think that there are other powers in the world that are less capable.

US dollar has ruled the global currency markets for more than seventy years. Will the law of averages catchup? The answer would probably lie in how fast the world can create a viable alternative. For now though, there does not appear to be one.

Seven decades on from Bretton Woods, the governments of Brazil, Russia, India and China led a conference in the Brazilian city of Fortaleza to mark the establishment of a new development bank that, whatever diplomatic niceties are put on it, is intent on competing with the IMF and World Bank.
In the first ever leader’s debates for the 2010 general election David Cameron caused some amusement when, in reference to immigration policy, he began to tell a story. ‘I was in Plymouth recently, and a forty-year-old black man made the point to me. He said ‘I came here when I was six, I’ve served in the Royal Navy for 30 years. I’m incredibly proud of my country. But I’m so ashamed that we’ve had this out-of-control system with people abusing it so badly’.

There are some peculiar things about this story: it feels forced, it fits the subject too well, and as a rule the Royal Navy does not recruit people at the age of ten. Newspapers subsequently stated that the man was 51 years old, had served in the Navy for six years, and was of the opinion that ‘Britain needs immigrants’. Odder still is that he was not the only person to have a walk-on part in the debate.

Why did the party leaders tell these stories and quote these people? What were they trying to accomplish? Politicians virtually always make a squabble of some kind. They want us to comprehend things their way, to agree with their dogma, to find them electable and they try to provide logic for us to do so. But in public
and particularly political argument (where there is uncertainty, ambiguity and contestation) it is impossible to curb those reasons to the purest of logical expressions.

General elections in the UK are around the corner. Political pundits are forethoughtful like never before. They all agree on one thing – anything is possible in this scenario. The current scenario is the most unpredictable in the recent years. The previous elections were close but none of them had so many uncertain factors with the ability to have a decisive impact on the result.

Since the financial crisis of 2008, trust in political leaders has collapsed across the globe. In Britain, the rage has been intensified by political and banking scandals that have deepened public distrust. This can be clearly noticeable in the opinion polls, as new generation of electorates, empowered by internet, gives thumbs down to the way traditional parties work.

In earlier elections, Labour and the Tories were dominating parties, however, these days the landscape has changed with these parties struggling to reach 60 percent of votes as per opinion polls. Now there is a likelihood of three or more party alliance. This election is hard to call partly because the economic arguments that are central to the campaign are greatly mixed. Wages and family incomes are far below where they were at the last election. The deficit remains obstinately high, and the government pledges on it have been broken, yet the political fallout from austerity to date has been much less severe than predicted.

The economic argument that will frenzy over the near future is quiet wide open as the public seems unlikely to swallow whole any of the main arguments on offer: they are unconvinced by the case for additional profound spending cuts, sceptical of claims about how policy measures will lift living standards and unsure of what the recovery will mean for them.

Certainly, no election run in isolation, and this election may not be any different. The volatility may return to the markets, potentially provoked by the ambiguity twirling around Westminster, and may present opportunities for the active investor. But what would another coalition mean for the market as a whole? Coalition is certainly on the cards but majority by any one party would decide how much volatile the markets would be! Pundits, with a pinch of salt, think that a Conservative majority might be the most business and stock market friendly outcome. Under these circumstances, the sectors and companies that have been most hurt by the political and regulatory rhetoric of the recent past could perform particularly well.

Furthermore, a Conservative majority or a UKIP coalition would make EU referendum virtually certain. This would introduce a high level of uncertainty about investment policies in the UK and raise peril for corporates doing business in the Europe. These could dawdle for some time given the proposed 2017 date for such a referendum.

A labour win may possibly be not well received by the markets, and may be seen as the anti-business aftermath. But to what extent is unclear. Shoot first, ask questions later is usually the way stock markets behave in these situations – meaning any business or sector possibly in the firing line is not likely to do well.

The most likely outcome of election 2015 is another hung parliament and another coalition. All the other minority parties are holding the key to running the government. But with only couple of months to go – and so many influences at work – you won’t find many pundits who are willing to go further than that. If the uprising parties suggest a novel epoch of multi-party government has arrived, the new media – most accustomed to three million young people who will be entitled to vote for the first time – offers new opportunities for political engagement. The party which connects with the Facebook and Twitter generation most will have an upper hand, but no one can predict what that will be.
The Eurozone

Between Fiscal Disintegration and Monetary Concord

The financial crisis engulfing Europe is often expressed in the media and political set up of the continent as a clash of ethnic stereotypes. For instance, there is the Swabian housewife who looks at the crisis disapprovingly, even as the south looks expectantly, in the hope of securing a loan. The Italian charmer is trying to sneak through the calamity, while the Irishman is annoyed at having put all of his savings into the wrong basket. And, all this while, the hapless Briton is trying to get away from this unhappy place. But lest we forget, there is the Greek, sitting idle in the middle of the day, steering clear of the tax authorities, driving a car someone else has paid for, and yet sparking outrage at any suggestion that he mend his ways. Especially now, that his country has elected a government run by the left-wing, anti-austerity coalition Syriza.

Eurozone’s economic difficulties were never to do with being the overspending Mediterranean types borrowing from thrifty northerners. Greece, which really did pile up huge debt, is an odd exception, but the countries that ran into serious trouble include the likes of Spain and Ireland, which ran some of Eurozone’s leanest, most austere and debt-free public-sector economies. If the past five years were to be looked as a period that witnessed a contest between the Eurozone and the U.S. over who had the better idea for fixing a wrecked economy, the U.S. stands out as the clear champ. The U.S., having used stimulus to kick consumption back into the gear, is now getting back to full employment and growth. Europe, which tried choking off its economy, is falling deeper into trouble. It is beginning to admit as much – the European Central Bank (ECB) finally proposed $1-trillion in quantitative easing (QE), the bond-buying stimulus program that had put the U.S. into recovery.
An Era of Slip-ups and Imprudence

In March of 2010, an announcement from troika confirming financial support to Greece by members of EU, the ECB and IMF officially started the European sovereign debt crisis. The real start to this crisis however was years into making. This was the culmination of a long era of miscalculations and irresponsibility.

To understand this crisis, a look at what happened before 2008 is important, and in retrospect, self-explanatory. This was the era of growth, low interest rates and consumption related borrowings. Pre-2008, the debt levels of Greece and Italy were much higher than other Eurozone countries. Markets did not expect substantial default risk, thus charged low spreads for the countries with comparatively bad fiscal and debt levels. This ensured cheap money to countries with inherently bad financial health. However, 1999-2007 was the era of good performance and growth which masked financial and macroeconomic vulnerabilities of many countries. Being a part of Eurozone also provided a sense of confidence to the creditors. Moreover, the currency union facilitated domestic banks to borrow from international sources in their own currency i.e. the Euro, thus eliminating exchange rate risks which meant that the European peripheral countries went through strong credit booms. High debt level posed medium term risks for the countries where capital inflow was invested in projects with little effect on future productivity.

In addition, most countries were running a current account deficit which carried short term risk, in case of a credit crunch in market. Large reversals in capital flow meant that countries had to narrow the deficit quickly which proved costly in terms of rising unemployment, contraction in output and decline in asset prices.

The budget imbalances and rising current account deficit of peripheral countries were aided by securitization boom in international financial markets, the subprime boom in the U.S. and low financial risk indices. However, the main borrowers were not government, but households in the period of 2003-2007 with exception of Greece and Portugal where the government and corporations were net borrowers. The high growth phase provided opportunity to governments to tighten their fiscal policies and significantly reduce debt levels which most of the countries failed to do. Instead, the focus was more on tax cuts and increased public spending in non-productive sectors. Risk factors associated with external imbalances, credit growth and housing prices were largely ignored in evaluating budget balances by both domestic and international organizations, resulting in financial policies which were less prudential and forward looking.

The 2008 global financial crisis was the trigger that forced investors and creditors to re-assess the position of their investments in countries with large external deficits and credit growth.

In 2008-09, when the world was focussed more on the U.S. and the housing bubble, the concern about European sovereign debt was minimal. While ECB was focussing on its response to global financial shock, cross border financial flows and short term funding dried up in Europe. Countries like Ireland whose banks were largely dependent on external funding especially in the short term were highly affected. By late 2009, the recession exerted significant downward pressures on fiscal revenues which resulted in higher than expected debt to GDP ratios. However, the revised figures from Greece at the end of 2009 were the shock that started sovereign debt crisis. The budget deficit forecast was
revised to 12 percent, more than double of the previous estimate, which were also in violation of rules mandated by ECB. It was this revelation that shaped the political narrative of crisis that put major blame on fiscal irresponsibility of governments of peripheral countries and also sealed the response to the crisis - a long and painful austerity which led to even higher unemployment and plunged many peripheral countries into lengthy recessions.

**ECB’s Last Throw of the Dice**

Over the past few years, QE was used as a long-term survival tactic for three major markets of the U.S., UK and Japan. China too, adopted a version of it, via soft loans to the banking sector. Long-standing German hostility towards the policy, however, has made the ECB a late adopter. The ECB plans to spend €60 billion ($70 billion) a month for at least through September 2016, adding hefty purchases of sovereign bonds to the prevailing scheme to buy covered bonds and asset-backed securities (currently around €10 billion-worth a month). Although the purchases are set to run for at least 19 months, the plan is effectively open ended as the ECB would continue until inflation is back on the path, towards its target of 2 percent.

Markets clearly applauded the move, with the yield spread between peripheral and core Eurozone bonds narrowing, the euro dropping and stocks rallying. The ECB President, Mario Draghi, managed to beat sky-high expectations and avoided disappointing investors. But concerns remain. The concern being—unlike the Fed or other big central banks that have deployed QE—the ECB remains constrained by the fragmented nature of the Eurozone. As a result, there’s less to the ECB’s version of QE than meets the eye. The big rub is that, special rules will apply to purchases of the bonds of countries like Greece which have received bail-outs. The bulk of any losses on sovereign debt that has been purchased will be borne by national central banks. Only 20 percent of the purchases will be subject to risk-sharing, implying national central banks will be responsible for 80 percent of the losses on bond purchases. Caveat of this degree wasn’t unexpected. But the problem is that it significantly complicates the program. It is being viewed as a kind of peace offering to Germany, which was averse to the idea of QE and feared that the programme knowledge that, if losses mount then they can always print more money to get themselves out of any trouble. While in this case, assets and risks sit on the balance sheets of national central banks that don’t have the power to print money. If those assets lose value, the national central bank might still require a rescue from its national government.

The programme, as intended, should help reinforce inflation expectations, and in turn help the Eurozone avoid prolonged deflation. The policy is also likely to take effect through boosting asset prices and leading to a weaker euro.

The deployment of QE in the U.S. and U.K. involved an element of “shock and awe”, since financial markets were unacquainted with the new measure when it was introduced in both countries. It is known that the central bank is turning to QE because of the weakened state of the European economy. The recovery since the double-dip recession in the critical phase of the euro crisis has been weak and wavering. Slack demand has resulted in “lowflation”, headline
prices fell in the year to December by 0.2 percent. The concerns pertaining to the state of inflation in the bloc has been so grave that financial markets no longer believe that the ECB will be able to get inflation back to its goal of nearly 2 percent over the medium term. Its previous array of efforts to stimulate the economy, which included becoming the first big central bank to impose negative interest rates, has been inadequate.

Over and above the fragmented nature of the Eurozone, there are other reasons that raise questions on the extent to which the QE will be effective. The deployment of QE in the U.S. and U.K. involved an element of “shock and awe”, since financial markets were unacquainted with the new measure when it was introduced in both countries. As a result, it brought down yields sharply. By contrast, the markets have long been expecting the ECB to introduce QE. This has already been sort of accounted for and has in turn led to a remarkable rally in sovereign-bond markets, especially in the troubled economies of southern Europe. In Portugal, for example, ten-year bond yields already fell by 3.5 percent in the course of 2014, from 6.2 percent to 2.7 percent. (The exception is Greece, where fears of a political
crisis, and even of a possible exit from the Eurozone after the election, have recently driven yields up again). As a result, the effect of implementing QE is expected to be limited.

Another difference between QE in the Eurozone and elsewhere, the U.S. in particular, arises from the nature of their financial systems. Because firms rely way more heavily on capital markets there, they benefitted a lot as falling yields on government debt pushed investors into riskier assets such as corporate bonds. By contrast, banks are more dominant in the Eurozone, so its companies will benefit less from the boost to European capital markets. There are two main channels through which QE is likely to work in the Eurozone. One is the so-called “signalling” effect. By adopting the policy, the ECB is sending a clear message to markets and to firms that it is determined to bring inflation closer to 2 percent. The other is through the exchange rate. The euro has already been weakening since last spring. Further weakening of the single currency seems likely.

All this makes the ECB’s venture into QE less like the programmes launched
by the Federal Reserve and the Bank of England (BoE) at the pinnacle of the crisis and more like those of the Bank of Japan, which continues to combat the more treacherous threat of deflation. As with Japan’s recent bond-buying spree, the main effect seems likely to come via the exchange rate. The apprehension is that the ECB may be introducing the policy too late, like Japan in the early 2000s. This delay from ECB to embark on stimulus programme is a story about long standing ideological conflict between various schools of thoughts in the field of political economics.

The Continuation of Ideological Struggle and Resurgence of Keynes

The largest recession since the great depression saw resurgence of interventionist policies with a brief period of consensus on the response to the global financial crisis. One of the main pillars of capitalist ideologies- the Keynesianism which took the western world out of great depression in 1930s had taken a back seat among policy makers since 1970s due to its failure to address stagflation which was the dreaded combination of high inflation and low growth. The world since last three decades had become accustomed to market driven policies with little scope of active intervention from government, de-regulation of financial markets and a tilt towards Austrian school of thought propagated by “Chicago boys” led by Milton Friedman.

John M. Keynes propagated counter-cyclical public policy which aimed to tame the fluctuations in business cycle broadly by stimulus and debt driven growth during recessions through public spending and fiscal tightening during periods of growth. Keynes’ macroeconomic philosophy ruled the world till 1970’s and provided the world with era of high growth, low unemployment, minimal recessions and stability in markets. However, there was a deep realization among policy makers that they cannot spend their way out of period of low growth when inflation was rampant. On the other hand, the free market ideology forwarded by Chicago school of thought emphasised on market correction and self healing which is a reflection of reality. Thus, when global financial system faced a total collapse, many economists and policy makers had little answer than to go back to old remedies of stimulus through both monetary and fiscal mechanisms.

It is this ideological battle between many thoughts in economics that raged in high pitch while finding a solution to both global financial crisis and Europe’s sovereign debt crisis. While Keynes emphasised on irrationality of human behaviour and tried to tackle this issue with control measures, others were confident about accuracy of markets. Keynes saw markets as “newspaper competitions in which the competitors...
have to pick out of six prettiest faces from hundred photographs, the price being awarded to the competitor whose choice most nearly corresponds to average preference of competitors as a whole”. Thus a person doesn’t have to pick those faces he finds prettiest but those that he thinks are likely to catch the imagination of other competitors.

Obviously this explanation of markets and perspective of economy is starkly in contrast with non-Keynesians. Eugene Fama’s “Efficient Market Hypothesis” which states that the stock prices reflect true intrinsic price given that public information is available to all the market participants became backbone of economic theories and free-market ideologies which dominated the last three decades. This, in view of many masks the irrationalities of markets and human behaviour, which causes bubbles and makes it very difficult to foresee recessions. These different perspectives also explain the difference in response to financial crisis-stimulus and growth.

**Austerity vs Stimulus: The Battle for Growth**

While the policy makers in the U.S., U.K. and to some extent China were quick to respond using huge stimulus packages, in retrospect it might puzzle why Europe did not respond with the same measures and instead embarked on austerity which proved disastrous to countries in European periphery. One explanation provided is high level of debt of these countries, which made it even riskier to go with expansionary fiscal policy. But many Keynesians question the continuation of austerity measure even after it failed to lower the debt levels and disastrous consequences for the people while the effectiveness of stimulus had already been seen in several other countries.

It would be hard to write off the ability of austerity in improving the financial health of any nation, but the debate is more about its timings and cost. Austerity measures have proven to be good tools in an era of strong growth and high business confidence when spending cuts provide resources to private sector and increases the competitiveness in market. But the same leaves idleness in periods of recession. A case for austerity can be made in recessions too, but it is the cost in terms of high unemployment, prolonged periods of low growth and poverty that comes with austerity which makes it a less effective tool.

Some of the countries like Spain are expected to catch up on growth in near future, after five years of near zero or negative growth. Other countries like Greece are still way behind. Moreover, debt-to-GDP ratios of many countries have seen an upward trend. It is these countries that needed a stimulus package like that in the U.S., through quantitative easing and fiscal deficit to spur growth which would have enabled them to repay their debt and improve their fiscal position in future.

As Milton Friedman, one of the most passionate believers in free markets said “one of the great mistakes is to judge policies and programs by their intentions rather than their results”, the results of austerity measures given their cost do not look very good at this moment.

**The Cost of Austerity: Rise of the Radicals**

The bailout package provided to needy countries had strings attached - austerity and structural reforms. Even though the crisis was mainly the result of irresponsible behaviour and countries living beyond their means, the price that they were asked to pay resulted in what some like to call as “humanitarian crisis”. Greek GDP is about 25 percent lower than pre-crisis period while that
of Spain, Ireland and Portugal are about 15 percent lower. The current youth unemployment rate of Greece and Spain stands at about 50 percent. The same is about 34 percent for Portugal and 42 percent for Italy. The numbers clearly show the extent of calamity which has hardly improved since the crisis began. The consensus among people is that austerity has cost them dearly and has had a drastic impact on whole generation. Sudden reduction in health care and education spending besides overall reduction in safety net and welfare schemes for the needy has increased poverty. It has also helped to produce a generation which has shown affinity towards radical ideologies.

The post crisis phase has empowered extreme ideologies at both ends which might prove costly to the social fabric of Europe in long run. The increasing frustration with workings of EU led to rise of the Euro sceptics on the extreme right while lack of attention given by mainstream political parties to increase in poverty provided space to radical left. At the time when economy is the central issue, less attention was paid to social developments in recent years. The political groups demanding clampdown on immigration have seen a rise in popularity (like in recent election for European parliament) and even right wing fringe groups like neo-nazis have become significant in political discourse. It is the rise of radical left wing that worries many. Syriza – the coalition of radical left wing in Greece resonated with the plight of common people and Podemos – the Spanish left wing party is currently buoyed by rising tide of approval ratings where elections are to be held later this year.

Failure of mainstream political groups in providing a viable alternative solution, lack of prosecution of culprits belonging to political and financial elite for the crisis and perception of corruption might be few causes attributed to the phenomenal popularity of extreme left. The proximity of these parties with power is expected to increase populism and reduce competitiveness of the countries they rule. Given the inability of policy makers to sort out the crisis in effective manner, the remedies for this crisis and any other in future to come is not just fiscal stimulus and restructuring of debts, but robust institutions with capability to take the challenges with flexibility and effectiveness.

The post crisis phase has empowered extreme ideologies at both ends which might prove costly to the social fabric of Europe in long run.

Why Not Start Building a Tighter Fiscal Union?

Most believe a tighter fiscal union is required for the Eurozone’s sustainability. The instances below highlight the fact that Eurozone has taken moves in the right direction but the results say otherwise. The steps taken in the direction towards a tighter fiscal union include the Eurozone leaders approving a permanent sovereign bailout mechanism in 2012, in turn providing greater financial firepower and a more clearly defined process than programmes used in the crisis’s early stages. Member-states also went on to establish a banking union, which made the ECB the primary bank regulator and established common bank resolution procedures. Though the blueprint will perpetrate losses on large depositors in failing institutions (similar to Cyprus in 2013), its existence diminishes uncertainty about who takes losses when a bank fails and how much each national government must contribute.

All doubts about the effectiveness of QE would be wiped out if the former is deployed in unison with a complementary fiscal stimulus. Fiscal Stimulus, however, is being ruled out by the worrying combination of institutional ineffectiveness and mutual animosity. To be certain, it is widely believed that Eurozone as a whole is
not lacking in fiscal capacity. In fact the Eurozone government debt is less than the U.S. public debt. The economic reason why Europe shouldn’t borrow (at extremely low interest rates) and spend the money on, say, large-scale infrastructure investments, is difficult to find. But when Europe designed its monetary union, it probably missed out on considering even the basic fiscal union that, as the world at large now believes is mandatory and what the larger enterprise needs anyway.

Then why is the Eurozone averse to building such a union? Does the reluctance emanate from the need to formulate an all new European treaty or is it the amount of hard work required to strike the required consensus, given the background of mutual animosity? With the union and its works not so unpopular, governments probably dread embarking on that process. More fundamentally, the commitment to European solidarity, invoked down the years to motivate the whole project, has all but gone missing.

And as Clive Crook, the columnist who writes for Bloomberg View, puts: “Far from thinking “we’re in this thing together,” Germany sees Greece as a nation of scroungers and thieves, and Greece sees Germany as a nation of atavistic oppressors.” He also goes on to say (in one of his blogs which sums it up for us): “Unless this failing union is reshaped in far-reaching ways, the optimistic scenario is protracted stagnation. The pessimistic scenario is political collapse, followed by who knows what. Where are the European leaders willing to rise to this challenge? Name me any who’ve even begun to think about it.”

What Lies Ahead?

It’s quite hard to speculate the future where Eurozone is headed at this point. At the time of writing, negotiation are underway to reach a deal between Greece and the troika – EU, IMF and the ECB which will have significant impact on future of Eurozone. However, there is a clarity among people that status quo cannot be maintained. While probability of Grexit remains, many commentators including the authors of this article are betting against it. Tackling this crisis is in larger interest of both EU and Greece in long run, but it is not the economic rationale but political fallouts of the failure that are more important. Let us not forget that main objective of European Union was to provide political stability to the “dark continent” through trade which culminated into a monetary union. Grexit might shake the foundation of a common and united Europe with far reaching implications including but not limited to political re-alignments and return of fault lines to Europe which we last saw during cold war.

This crisis has shown the vulnerabilities and shortfalls in the working of Eurozone exposing inability of the ECB to tackle sudden financial shocks and lack of institutional mechanism for a quick response. It has also provided a learning curve for the ECB resulting in a sort of banking union. But the most important concern has been the absence of a fiscal union which is essential for a robust single currency and monetary policy. The concerns regarding sustainability of single currency without large scale fiscal transfers do sound legitimate which requires a single political platform with substantial powers currently deprived from the European parliament. However, the dream of a united Europe as a political union seems far fetched at this moment.

More fundamentally, the commitment to European solidarity, invoked down the years to motivate the whole project, has all but gone missing.
The rally in global equity markets continued year-to-date through February, particularly in developed markets such as Japan, the US and several European countries. Emerging markets had a mixed performance. On the back of falling crude prices, oil importers like India, China and Indonesia performed well while the exporting nations like Russia and Venezuela faced significant crisis.
Source: Bloomberg. As of February 2015.

All returns are based on price changes only and exclude the impact of dividends.

Past performance does not guarantee future results, which may vary.
“Long ago, Sir Isaac Newton gave us three laws of motion, which were the work of genius. But Sir Isaac’s talents didn’t extend to investing: He lost a bundle in the South Sea Bubble, explaining later, ‘I can calculate the movement of the stars, but not the madness of men.’ If he had not been traumatized by this loss, Sir Isaac might well have gone on to discover the Fourth Law of Motion: For investors as a whole, returns decreases as motion increases.” — Warren Buffett

In April 2011, the United States Senate Permanent Subcommittee on Investigations came out with a 639 page report on the financial crisis of 2007–2008 called Wall Street and the Financial Crisis: Anatomy of a Financial Collapse. A key finding of the report was that the crisis was not a natural disaster, but the result of high risk, complex financial products; undisclosed conflicts of interest; and the failure of regulators, the credit rating agencies, and the market itself to rein in the excesses of Wall Street.

Much have been discussed and analysed about the global financial crisis. Banks and its financial engineers have been severely criticised as they were subject to open censure from regulators, central banks and governments — not to forget the critics, academicians and even the man on the street.

However financial crisis is not merely a function of economic forces — it is about the complexities of human behaviour. Andrew Lo, professor of MIT Sloan University believes that the emotions of greed and the fear of the unknown are notable factors to any economic collapse.

In fact, there is evidence that financial gain affects the same ‘pleasure centres’ of the brain that are activated by certain narcotics. This suggests that prolonged periods of economic growth and prosperity can induce a collective sense of euphoria and complacency among investors that is similar to the drug-induced apathy of a cocaine addict.
Euphoria and excessive optimism, which often accompany financial bubbles, are usually followed by fear and panic when crisis arrives. Generally, people claim to not know how the crisis happened or that they could not see it coming.

There have been at least sixty recorded crises since the early seventeenth century. Human beings seem to have always been obsessed with money, and greed drives them to obtain increasing amounts of it. Notably, humans tend to spend more than they have, thereby creating huge debts that undermine the stability of the financial system. As early as 33 A.D., Emperor Tiberius of Rome had to inject public funds into the financial system to prevent it from collapsing.

In the US, the ratio that measures household debt to GDP doubled from 50 percent in the 1980s to 100 percent of GDP by the mid-2000s. The last time the level of debt was 100 percent of GDP was 1929, the beginning of the Great Depression. For a prolonged period of time, individuals have borrowed to improve their standard of living until a point where people on an average could not repay the debts they accumulated.

Memory is short-lived and history has time and again proved that the lure of short term gains is more enticing than the boring benefits of the longer term. Global markets are trading at all time highs. Central banks continue to supply cheap credit to the global economy and six years after the collapse of Lehman, subprime mortgages are returning to the markets!

In the years following the financial crisis, access to mortgages has been limited to only those with pristine credit. Large banks continue to turn down credit-impaired borrowers. The reasons are clear. Banks like Citibank and Bank of America have spent many years and tens of billions of dollars settling claims from investors, government regulators and the U.S. Department of Justice because they allegedly sold toxic subprime loans packaged into securities to investors, fully cognizant of the potential damage thereby causing the financial crisis. Following the Dodd Frank act and associated regulations of mortgage lending they have naturally resisted efforts by the Federal Housing Finance Administration, to open up lending to riskier borrowers.

This story is a reminiscence of history not from a very distant past. In the pre-crisis era, home ownership was pushed by the U.S. government as an indisputable right, despite borrowers’ inability to repay loans. The demand for subprime loans was driven by a culture of privilege and a sense of egalitarianism that appealed to the self-esteem of common Americans. Fannie Mae and Freddie Mac made more money available to lenders and borrowers by purchasing loans from the lenders and selling them to investors in the secondary markets.

Sadly, greed almost always exploits a well intentioned motive—in this case it was speculation and securitisation.

Fast forward to present. A handful of small lenders have started to offer subprime loans again in the US. These lenders are charging interest rates of as high as 8 percent to 10 percent and requiring borrowers to make down payments of as much as 25–35 percent. When compared against a conventional loan the borrowing rate could be as low as half of this rate. However, the same loan seen prior to the 2008 crisis had a subprime rate exceeding 15 percent.

Borrowers are delighted. Upset for years by the nation’s banks which virtually shutdown mortgage lending after the financial meltdown, and stricter rules imposed by federal regulators, a growing number of credit-impaired borrowers are again finding their piece of the American dream. Many have lost their homes during the crisis to a sale or foreclosure. Under the new mortgage rules, such borrowers will have to wait for a minimum of four years before they can apply for a government backed loan. In the new subprime market, the waiting period is just one day!

There is evidence that financial gain affects the same ‘pleasure centres’ of the brain that are activated by certain narcotics.
Investors have taken notice and are pumping billions into the lending institutions making these loans. The quantum has yet been small but plans are big. Hedge funds, private-equity firms and several foreign banks are betting billions of dollars that the new subprime market will explode in the coming years. Nomura, for instance, has provided a $150 million credit line to Angel Oak, a subprime lender, to fund its mortgage program, while hedge-fund manager MountainView has started a new fund it hopes will eventually raise upwards of $1 billion to finance new loans. It plans to offer 30-year loans with fixed rates ranging from 6 to 9 percent to subprime customers. Among the big banks, Wells Fargo has recently entered the fray. However, the funding of these loans is different. The big bank is packaging them into bonds and selling them to investors, while the smaller, nonbank lenders are making mortgages known as “nonqualified loans” that they are often holding on their books.

Where are we headed then and will the use of the same products with the same intentions lead us to the same path? To put things in perspective, there is nothing inherently wrong about the product making a comeback in the financial markets. Just like the lessons learnt from history—the dotcom bubble, LTCM’s collapse, and the hyperinflation of the early 1980s—if a product or strategy is abused or overused, there will be repercussions. Call it a natural extension of capitalism, where greed can inspire innovation, but if unchecked, major market forces are required to bring balance back to the system.

Einstein once said that the definition of insanity is doing the same thing over and over again and expecting different results. Will the latest trend of return of the subprime end in a way which is different or will it be similar to the episodes we have witnessed in the past? The answer probably lies in how much of the financial markets is science than art.
A Conversation With John Finch

John Finch, Director of JLT Investment Consulting, discusses his views on the current geopolitical and economic landscapes with The Bottomline.

Last couple of years have been torrid for the commodities sector as a whole. Gold plunged in 2013 while oil prices have been decimated in 2014. Also, both base metals and agro-based commodities have witnessed steep sell-offs over the last twelve months. Do you believe that there is now an opportunity for investors to do bottom-fishing with medium term views of next 3-5 years or is it still a case of falling knife?

This is a difficult question. If you are already invested in Commodities then I would not sell the existing holding although the way exposure is structured will be very important. I would look to give a commodity manager as much flexibility as possible to rotate through the exposure between energy, metals and other areas.

If you do currently have a holding I would hold off investing at this moment as there may still be some downside and upside may not be clear cut by asset type exposure.

Developed equity markets have been scaling new peaks albeit with structural weaknesses in a few pockets. What is your sense and how do you foresee things to come in 2015?

I think that some equity markets do represent at least fair value, particularly the U.S. and possibly the UK. Some other markets cause me concern, most notably Europe.

In the Emerging markets, the opportunities and risks vary from country to country and between companies depending on their economic position and exposure.

Whilst Frontier markets may struggle in the near term because of political unrest, longer term I feel they still represent an opportunity.

Overall I believe we will see high single digit returns in 2015 although we could see volatility over the year. I would be a buyer on weakness.
Now that the ECB has finally pushed the button on quantitative easing, the big question is, will it work?

In some ways the answer is simple. It has to as the ECB has nowhere else to go. If the current agreed levels prove not to be sufficient, a major concern is whether they will be able to make more funds available given the challenges they have had to overcome seeking agreement for the current programme.

My personal view is that it will work but the delays in getting the agreement have made it harder as the European economy is now struggling because of the delays.

QE in the UK has distorted investment risk in ways we do not yet understand. The long-term impact of QE on investment risk is uncertain, but the impact of low bond yields on annuity rates is clear viz. permanent lower income for those who are buying lifetime annuities now. What is JLT’s advice to clients in such a market?

The low levels of bond yields impact Defined Benefit and Defined Contribution members differently.

In the DB space the Scheme is committed to providing a given level of benefit at any cost. Low bond yields (particularly at the long dated end of the market) are one of the major reasons why liabilities have risen so strongly over the last several years. Our advice a few years ago was to use interest rate and inflation hedging techniques to provide ‘protection’ against bond yield falls. Those clients who heeded our advice have done well, but now the advice is more difficult. On the interest rate side, yields are at historical low levels making protection expensive. The question is will they fall further or will they start to rise, and if so, how quickly and to what level? On the inflation front, with inflation levels so low, buying protection looks potentially cheap and maybe worth buying.

Our advice is, as always, client specific and is dependent on the goals of the Trustees and the Sponsor. Key elements will be 1) the current funding position; 2) the return required to meet funding objectives and 3) the level of ‘risk’ the scheme can tolerate. At the moment mostly the advice is that purchasing interest rate protection is expensive but inflation protection is fairly priced. The solutions recommended are that generally protection should be ‘leveraged’ to make most effective use of capital and at the very least, clients should put in place a plan (a set of triggers) to buy protection as yield levels improve.

On the DC side life is very different as the level of benefit will depend solely on the amount of capital in a member’s ‘pot’. Benefits have been greatly reduced as yields have fallen as annuities have become so expensive. The new ‘Pensions Freedoms’ give members some hope as the increased flexibility eliminates the need to buy annuities at retirement.

The challenge for us is to design and find solutions that can meet these flexibilities. We have been working with our colleagues in JLTIM to make this happen.

With the likelihood of a profound consequence of the Budget on the pensions industry, how do you see the dynamics changing and how prepared are we as Investment Consultants to cater to the subsequent shift in the requirements as being exhibited by the early trends?

The ‘Pensions Freedoms’ introduced in the 2014 Budget are indeed major and impact not only our Defined Consulting business but also the Defined Benefit schemes we advise.

For the latter, the likely impact is that a number of older members (those over 55) may well decide to take a transfer from the scheme either to maximise the cash available to them or give themselves more flexibility in retirement. One of the fears for Trustees is that the exodus could be large and disruptive to the funding and investment strategy of the scheme. We are likely to see a good deal of consulting work in re-appraising investment strategies as the member profiles of schemes change.

On the Defined Contribution side of our business, we have been working closely with our colleagues in JLT Investment Management (JLTIM) to launch a range of Target Dated Funds that can provide access to varied investment strategies depending on whether members wish to take Cash, an Annuity, or to ‘Drawdown’ their Capital over a period of time (or a combination of all three).

These TDFs are currently being rolled out to clients and within the 5 years to the Target date, the asset allocation will change through a Flightpath to the end goal, depending on the member’s objectives.
Critical in these funds will be cost as those being used as a ‘default’ fund cannot have charges in excess of 75 basis points. From the work we have done and the structures we have built it is possible to include administration costs (or at least a proportion of them) into the Annual Management Charge. This will make our offering very compelling. Our major challenge is speaking to all our existing Trust Based DC clients. Potential income is over £1m and this therefore presents a very important opportunity for us.

So, the Budget makes significant changes to the pensions landscape but provides substantial opportunities and will keep the Investment Consulting team very busy!

The UK general election is being touted as the most uncertain electoral event for many decades. What do you make of this big event and how justified are the concerns around the likely outcomes?

It is 40 years (Feb 1974) since we last had an election result where it was not possible to form a Government and there was a re-run in the October which led to Harold Wilson having a majority of just 3 seats.

There are no clear indications, as yet, of who might hold the majority this time round or whether some coalition will need to be formed and between which parties. Over the next month hopefully the mists may clear but it is likely to be a close call.

Key for us in terms of Investment advice is what will be the impact on markets and what might a new government actually do.

Increasingly, and particularly over the longer term, the colour of domestic government has little impact on the economic and market situation as economies and markets are driven by global events over which local political events have only a short term impact. Perhaps Central Bank decisions have a greater importance unless politicians downgrade the Central Banks power which seems unlikely.

Therefore whilst there may be a short term knee jerk reaction to events (which we will need to deal with), in the long term we need to look at what is happening within the global scene.

Impacts could be felt in certain of our market propositions (Local Government, DC etc.) but I stick with Benjamin Graham’s view that investment markets are voting machines in the short term but weighing machines in the long term. We have to advise clients accordingly.

About John Finch

John joined JLT in April 1997 from Norwich Union Investment Management where he was Manager of their Pension Fund Investment Service.

He spent the previous 17 years of his investment career with Confederation Pensions Investment Management where he was responsible for both Segregated and Pooled funds. He chaired their Asset Strategy group, and managed their £4.5bn Balanced Fund.

John qualified as an investment analyst in 1989 and is a member of the UK Society of Investment Professionals (UK SIP). He is also a Fellow of the Chartered Insurance Institute and an affiliate of the Institute of Actuaries.

John manages a small portfolio of clients including three of our major Local Government Pension Scheme relationships.

As a Director, John has responsibility for the JLT investment platform which manages assets of circa £2bn, providing a bridge between JLT’s investment consulting and investment management teams.
Insurance Linked Investments

A Diversifying Opportunity
Introduction

Positioned at the cross-roads, Alternative Risk-transfer instruments (ARTs) provide a mechanism to transfer the risks from the insurance industry to capital markets—the payoff of such securities depending on the occurrence of a specific insurance event.

Over the last decade, ARTs, most notably Insurance-linked securities, have increasingly found favors with the insurance industry. Insurers—and particularly reinsurers—have begun to offload their risks onto the capital markets. On the other hand, investors have discovered this new asset class as an investment opportunity.

Both the insurers and the investor class have an incentive for adopting this asset class. While it provides insurers with better risk mitigation through diversification of risks, it provides investors with diversification benefits and attractive yields; albeit with a higher risk profile. In addition, enhanced risk distribution also helps in increasing capacity for the insurers while at the same time driving down the insurance premiums for the insured.

Compared to the wider financial markets, securitization of insurance risks is still at a nascent stage, although its growth has been rapid over the last few years. The market, which witnessed a slump during the financial crisis, has initiated a revival again and looks all set to expand faster than the pre-crisis levels soon. Insurance-linked securities (ILS), and Catastrophe (Cat) bonds in particular, have seen the most rapid development over the last decade; although other forms of ILS are also getting increasingly accepted in the markets now.
The economics of ILS

Consider 2011 in which the world witnessed the Japanese tsunami, the New Zealand earthquake and Hurricane Irene. In addition to loss of human lives by thousands, properties worth billions of dollars were devastated and the cost of rebuilding the affected areas was enormous. Japan alone suffered an estimated USD 210 billion in economic losses due to the devastation. To the extent the losses covered, insurers needed to service the substantial claims made. Insurance payouts topped USD 105 billion for the year. In the event of such exorbitant payouts not reinsured, it could wipe out the entire equity base of the insurance companies. And even if re-insured, it is likely for the equity capital to prove insufficient, if the losses are too large.

Against this backdrop, ILS can be used by the reinsurers to cede their risks to financial markets in the same way as traditional insurance companies use the reinsurers. The only difference is that the risk buyer in case of a traditional insurance company is a reinsurance company while the risk buyer in this case is a financial market participant, typically institutional investors such as pension funds and hedge funds.

Transfer of insurance risk through an ILS is, however, not the first time that financial market participants have assumed insurance risks. Prior to the evolution of such securities, risks were assumed by investors, albeit in the form of common stock of insurance companies. However, risks associated with the ownership of stocks of insurance companies were generic; with stock prices factoring in every possible risk associated with the organisation, from financial to operational. Investors never got the opportunity to get exposure to specific risks that the companies transacted in. With this advent, it became possible to bundle risks and returns associated with specific events or disasters.

From Insurers’ point of view:
As explained above, the quantum of losses in case of any catastrophic event could assume gigantic proportions, much beyond the capacity of any single insurer or reinsurer. ILS helps break these into smaller pieces spread across the larger financial services sector. The sheer size of global financial markets makes it easy to absorb such losses. For example, in case of Hurricane Katrina—one of single largest catastrophe events in the recent history—total losses amounted to a mere 0.6 percent of the US private bond market. Thus, ILS is the key to create greater capacity for the reinsurers.

From investors’ point of view:
ILS are ideal diversifiers to a portfolio comprising of traditional asset classes such as bonds, equities or real estate, as well as non-traditional asset classes such as hedge funds. The risks within an ILS portfolio are not correlated amongst each other- an earthquake in California doesn’t trigger a windstorm in Europe—indicating that risk of extreme losses becomes marginal for a well-diversified portfolio. Also, ILS generates attractive and stable returns, superior to fixed-income investments with a similar risk profile, especially when considered in the low interest rate environment in the contemporary world.

Typical ILS Structure

<table>
<thead>
<tr>
<th>Investors</th>
<th>$ debt instruments</th>
<th>ILS VEHICLE</th>
<th>(re) insurance policy</th>
<th>(RE) INSURED</th>
<th>$ premium</th>
</tr>
</thead>
</table>
Since its birth in the 1990s, development in the ILS market has been a remarkable story of growth and innovation. Reinsurers, governments and corporations continue to access capital market solutions to finance growth, manage capital and transfer risks related to extreme events. Volume growth has been as exemplary as the adaption of new products along the requirement curve, as cedents seek to find innovative methods to meet the changing dynamics of the market.

The influx of new capital into the reinsurance industry constitutes the largest change to the sector’s capital structure in recent history. Over the past 24 months, approximately USD 20 billion in new capital has entered the market through investments in ILS, funds and sidecars as well as the hedge fund-related reinsurance companies and collateralized reinsurance vehicles.
Capacity outstanding and size of the overall global property catastrophe limit continues to expand for all forms of capital markets capacity (catastrophe bonds, private catastrophe bonds, collateralized reinsurance and sidecars). Capital continues to flow in from an ever broadening investor base, including pension funds, endowments, sovereign wealth funds and asset managers from different geographies around the world.

The growth in the ILS market has enabled several advantages to investors:
- More opportunities for fund managers to exploit and a broader range of ILS simplifying the diversification of portfolios
- Greater liquidity (easier to invest and withdraw money)
- Ease that investment structures have been tried and tested

As the market has grown, so has the range of investment options available to pension funds. It is currently possible to invest in pooled funds covering the following:
- Cat bonds
- Cat bonds, private cat transactions and other non-life risks
- All of the above plus life insurance risks

A growing asset class, market size in USD

Source: Swiss Re

Source: Schroders Investment Management
The Product

While there are various forms of ILS being traded in the market including mortality bonds, sidecars and insurance loss warranties, cat bonds have by far been the most popular. The performance of these bonds depends on that of a pool or index of a natural catastrophic risk. Cat bonds are usually structured in a manner that the securities represent as a reinsurance contract for an insurance company. For buyers, it means assuming the risk of an insurance company, for which they expect to be compensated with a higher risk premium.

Consider an example of a vanilla cat bond structure wherein a protection buyer (cedent) purchases protection for a one-year term. There are three parties involved in the transaction. The protection buyer or the cedent is typically a reinsurance company that wishes to offload some of its risks in the capital markets. A special purpose vehicle (SPV) is set up as a licensed reinsurer, typically in an offshore location such as Bermuda or Gurnsey whose sole purpose is to engage in the business relating to the securitization of risks. The cedent purchases protection from the SPV and pays a risk premium in lieu of that. The SPV in turn bundles all the risks and creates securities which are sold off to investors.

Cat bonds are usually structured in a manner that the securities represent as a reinsurance contract for an insurance company.

The money received from the investors is used to buy high quality bonds and are held in a collateral trust. The income generated from this pool of assets plus the risk premium paid by the cedent is used to pay periodic income to investors. The additional premium enjoyed by the investors compensates for the additional risks undertaken by them. In case of any non-event, the money from the trust is returned to the investors at the end of the period. However, in case of any event, the same money is used to make good the reinsurer and the investors stand to lose the extent of their principal as much as required to compensate the cedent.

Source: Swiss Re Capital Markets
Types of trigger mechanisms

Cat bond transactions use a variety of mechanisms to determine whether an event qualifies as a trigger payoff for the ceding company. Some of the most widely used tools include industry index, pure parametric, parametric index, modelled loss and indemnity. Each of these offers a varying degree of risks to sponsors and transparency to investors. At the time of advent, the industry primarily relied on indemnity, but as it has matured over time other mechanisms have gained popularity.

Industry index trigger operates on a principle that the reinsurer recovers a certain portion of total industry losses beyond a hurdle point to the extent of available capital. There are various indices available published by some of the most renowned players in the market. Pure parametric trigger on the other hand is a more transparent form for investors as a sponsors’ recovery depends solely on the location (precisely defined by latitudes and longitudes) and the magnitude of losses. Parametric index trigger is an adaptation of pure parametric triggers. It simply refines the pure parametric index triggers by defining the underlying parameters more clearly and precisely. Modelled loss triggers use a third party model to calculate the recovery amount basis the inputs from the data collected after the event has actually occurred. Indemnity trigger, as the name suggests, is the loss that needs to be made good as per the dent in the books of the ceding company.

Parametric index trigger is an adaptation of pure parametric triggers.

Source: Swiss Re Capital Markets
Yield on Investments

ILS presents an opportunity for the investors to earn additional premiums. The investors in ILS undertake significant amount of additional risks when compared to a typical fixed income investment of a similar credit rating. The fact that science of modelling the risk of an earthquake or a tsunami is far more difficult than modelling a loss arising out of a typical corporate bond default adds to the risk. In addition, since the ILS market is still evolving, it is considered illiquid and small. Given the risks involved, a Cat Bond would typically yield a lot higher than a comparable corporate bond with similar rating.

Also, till the time the industry remains at a nascent stage, every issue or kinds of issue involve what is commonly known as ‘newness premium’. This is the additional premium that reinsurers pay for the lack of product information. The premiums in such cases are over and above the LIBOR plus spread that are associated with yields of comparable credit.

As the market matures, however, the ‘newness’ premium slowly shrinks, if not vanishes, causing the prices to rise, thus giving the investors the opportunity of realising capital gains.

Even in cases where the products now are reaching a ‘standardisation’ phase, yields on the securities are much higher than those of comparable bonds to compensate for the additional risks that the investors take on potential catastrophes associated with such securities.

<table>
<thead>
<tr>
<th></th>
<th>Cat Bond</th>
<th>Govt Bonds</th>
<th>Global Equities</th>
<th>Investment Grade</th>
<th>High Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cat Bond</td>
<td>1.00</td>
<td>0.06</td>
<td>0.08</td>
<td>0.12</td>
<td>0.18</td>
</tr>
<tr>
<td>Govt Bonds</td>
<td>0.06</td>
<td>1.00</td>
<td>-0.38</td>
<td>0.81</td>
<td>-0.12</td>
</tr>
<tr>
<td>Global Equities</td>
<td>0.08</td>
<td>-0.38</td>
<td>1.00</td>
<td>-0.24</td>
<td>0.54</td>
</tr>
<tr>
<td>Investment Grade</td>
<td>0.12</td>
<td>0.81</td>
<td>-0.24</td>
<td>1.00</td>
<td>0.14</td>
</tr>
<tr>
<td>High Yield</td>
<td>0.18</td>
<td>-0.12</td>
<td>0.54</td>
<td>0.14</td>
<td>1.00</td>
</tr>
</tbody>
</table>

CAT BOND RETURN, VOLATILITY AND CORRELATION, FROM JANUARY 2002 TO JANUARY 2012 Source: AXA IM as at 31 Jan 2012.
**Diversification**

Financial market movements in general are stimulated by economic activities, while ILS performance depends on the event or non-event underlying the security. Both have little in common, and as empirical evidence has indicated, the correlation between the ILS and stocks or bonds is marginal.

In fact, a Swiss Re study suggests that the risk reduction achieved by adding an ILS to a well diversified portfolio is not much different to adding a risk free security to the portfolio. It is well established in finance that adding a treasury bond reduces the risk in a risky portfolio in a linear fashion. To illustrate this, adding 5 percent of treasuries, reduces the risk in the portfolio by 5 percent (as measured by standard deviation). Alternatively, the risk reduction achieved by diversifying through an ILS is just under 5 percent, albeit with sufficiently higher returns. However, the study also concludes that such payoffs are achieved only at lower levels of diversification. As the proportion of ILS in a portfolio increases, the risk-return payoffs start getting skewed towards risk. As a result, it is advisable to use this asset class as a diversification bet in a global portfolio.

Consider an example of four securities; 1 Treasury bond and 3 Cat bonds with probability of total principal loss being 0.5 percent, 1.0 percent and 2.0 percent respectively for the 3 Cat bonds. So how effectively will risk reduction be achieved if these four securities are added to a portfolio of risky assets?

Risk reduction achieved by adding an ILS to a well diversified portfolio is not much different to adding a risk free security to the portfolio.

It is evident from the below diagram that there is a marginal difference between the risk reduction achieved between a Treasury bond and a Cat bond with 0.5 percent probability of default, if 5 percent of the assets in a risky portfolio are diversified using these two securities. To be more precise, the Cat bond with 0.5 percent default expectations achieves nearly 97.4 percent of risk reduction that a risk-free security would achieve.

Broadly, the Cat bonds achieve anything between 89.0 percent and 99.7 percent for diversification between 1 percent and 10 percent within a risky portfolio. That said, however, it will be worthwhile to notice that as the allocation to the Cat bonds rise, the risk reduction achieved tends to fall significantly. As such, the study concludes that the asset class can be used as a powerful diversification tool in a portfolio of risky assets, albeit only with smaller allocations.

Source: Swiss Re New Markets
Concept Note

Pricing

The quantum of the risk undertaken or reduced when such a security is included in a diversified portfolio is often one of the prime factors that affect the pricing of such securities.

In the case of the above example, the study indicates that for the security with 0.5 percent probability of default and one which achieves 97.4 percent risk reduction when compared to Treasuries, would typically command a premium of 113 bps over the Treasury yield. Of this, 100 bps would compensate for the expected loss while 13 bps would compensate for the marginally smaller amount of risk reduction achieved.

However, as is the case with any financial market product, the market price seldom trades at its fair value. The reasons for difference between the two can be varied. From an investment perspective, cost advantage or disadvantage (spreads over treasuries) usually depends on the stage of the underwriting cycle in the reinsurance market.

During certain time periods, for example, in the immediate aftermath of a catastrophic event or a disaster when the industry capital is in short supply, insurers and reinsurers will typically boost premiums and investors are likely to get a better deal in terms of yields. On the other hand, during times of excess supply of capital, reinsurers will typically lower the premium as they compete for additional business. During such times investors are likely to receive lower risk premiums for the invested capital.

Market life-cycle also affects pricing. As the market matures, products start getting standardised and transparency increases. Given some amount of history as a guide to refer to, explaining the costs and benefits of products becomes easier to explain to investors. Higher the level of transparency, lower will be the associated risk premiums. As a result, the yield spread between ILS and government bonds should reduce over time, much like the case of mortgage bond securities.

Also, as the market matures, liquidity in the ILS markets should improve, followed by reduction in risk premiums. As premiums reduce, however, investors with existing investments in the securities stand to make capital gains.

It is also worthwhile to consider that the example cited above considers only one security to be included within the portfolio. As is the case with Pension funds, owning a pool of such assets, which are diversified further, would be more beneficial.
The Risk-Return Trade-off

While there are obvious benefits of diversification of a risky portfolio through Cat bonds namely low correlation and higher yields, there is more to it. One of the most attractive features of Cat bond investing is the fact that periods of poor performance tends to be self correcting. In the immediate years following an aftermath or a natural disaster, a number of factors tend to push the premiums significantly higher, in turn driving the potential returns in the Cat bonds higher. This helps investors recoup, if not all, the losses within a relatively short time frame. Increased demand for insurance and reinsurance, lack of excess capacity, reduction in risk appetite in general and upward revisions in the models used to price the securities in terms of events, all help the self-correcting prophecy.

Additionally, while the investment risk in a cat bond may go up to the extent of losing part or entire capital invested in case a catastrophe does occur, the risk exposure can be dramatically reduced by diversifying within the cat bonds portfolio both in terms of geographies and the perils covered. It is extremely unlikely that both Japan and Britain will experience an earthquake in a particular year or, say Japan would experience both an earthquake and a volcanic eruption, again in a single year.

Finally, if the loss models in the industry are anything to go by, the chances of realizing extreme investment gains are much larger than the probability of making extreme losses. This is clearly demonstrated on the graph below, which models the distribution of probable returns to a catastrophe risk fund. At 3 percent, the probability of losses greater than 10 percent is far below that of obtaining a 14.5 percent return, and there is an 87 percent chance of positive returns.

The graph illustrates the risk-return trade-off in a catastrophe risk fund. It shows the probability of various annual performances ranging from -15% to +15%. The red line indicates the performance with a 3% probability of losses greater than 10%, while the blue line shows a 14.5% performance in a loss-free year. The graph also highlights the impact of historical events such as Hurricane Katrina and San Francisco earthquake, as well as the combination of historical and single events.

![Graph showing the risk-return trade-off in a catastrophe risk fund.](source: Schroders/Credit Suisse/Bloomberg)
On the flip side..

However, the investments in the Cat bonds are by no means devoid of risks. In case of underlying losses being triggered, the loss amounts may wipe out the entire investment capital made in these instruments. That is the single biggest risk of investing in ILS. It is, therefore, important to understand the risk-return dynamics of the instruments involved fully well before making any investments. As most of the studies have shown, these instruments therefore are more suitable from a diversification perspective for any given institutional portfolio more than anything else. Highlighted below are some of the risks involved in ILS:

- **Event Risk:** The underlying risks in terms of one or more peril, embedded in any Insurance-linked security could be of varied nature which is very difficult to predict or model.

- **Market Risks:** over the nearly two decades of existence, ILS has evolved and has gained immense popularity with the investor community. As a result, these instruments are now regularly (sometimes even daily) traded in the secondary market. Depending on the demand and supply, most often dictated by the reinsurers’ capacities, the prices are subject to volatility on a regular basis in secondary markets and the value of the investments may fall significantly even if there are no triggers and no defaults in a security.

- **Structural Risks:** ILS are complex structures with a number of counterparties and service providers. A number of risks can emerge which can either expose investors to counterparty credit risk or to unexpected outcomes. The most obvious source of counterparty credit risk is the investment of the proceeds of the issuance of the notes, which collateralize the ILS obligation to the sponsor.

- **Underwriting Risk:** ILS with non-indemnity triggers is not reliant on the operational performance of a protection buyer, if we ignore its obligation to pay the risk premium every quarter. This is commonly known as the problem of Moral Hazard wherein the protection buyer may not be taking adequate preventive measures to protect the losses from happening, just because of the fact that the losses are insured and can be recovered.

Although low, as explained earlier, there is always a probability of the entire capital being wiped away in the investments made in the ILS. Below is a hypothetical example of the losses that can occur to a portfolio which has been modelled using the actual catastrophes data. The resulting loss probability curve is below:

### Loss Probability Curve

**As of 4/30/2013**

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Net Loss ($)</th>
<th>Portfolio Loss percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 in 10000 Yr event</td>
<td>60,579</td>
<td>89.0 percent</td>
</tr>
<tr>
<td>1 in 1000 Yr event</td>
<td>56,300</td>
<td>82.7 percent</td>
</tr>
<tr>
<td>1 in 100 Yr event</td>
<td>32,624</td>
<td>47.9 percent</td>
</tr>
<tr>
<td>1 in 50 Yr event</td>
<td>22,440</td>
<td>33.0 percent</td>
</tr>
<tr>
<td>1 in 30 Yr event</td>
<td>15,057</td>
<td>22.1 percent</td>
</tr>
<tr>
<td>1 in 20 Yr event</td>
<td>9,355</td>
<td>13.7 percent</td>
</tr>
<tr>
<td>1 in 15 Yr event</td>
<td>6,044</td>
<td>8.9 percent</td>
</tr>
<tr>
<td>1 in 10 Yr event</td>
<td>3,208</td>
<td>4.7 percent</td>
</tr>
<tr>
<td>1 in 5 Yr event</td>
<td>800</td>
<td>1.2 percent</td>
</tr>
</tbody>
</table>

Source: Pioneer Investments
In the above table, the EP percent refers to the expected probability in the next one-year period. According to the first line of the table, based on a simulation derived from historical events and an assumed initial portfolio size of USD 68.1 million, there is a 0.01 percent expected chance of a USD 60.6 million loss in one year. This occurrence, which would result in an 89 percent decline in the portfolio market value, would correspond to a 1-in-10,000-year event. Similarly, a 1-in-10-year event would trigger an expected loss of USD 3.2 million, which would equate to a 4.7 percent loss in the portfolio market value.

Conclusion

Although, the ILS market has grown substantially over the last decade, it still remains in a nascent stage, driven by the needs of large reinsurers to hedge specific risks and create additional capacities. Due to relatively fewer issuances, there is a lack of volume and liquidity in the secondary markets—one of the most important characteristics for financial markets to attract large institutional money. As a result, the market has not yet made its way into mainstream asset management; albeit there is a growing interest from the money managers to reap the benefits from the higher yielding asset. Only a handful of dedicated cat funds, hedge funds and money managers currently act as the counterparty to the insurance companies. However, given the economic benefits of the product both from a buyer’s as well as a seller’s perspective, the market remains poised for growth in the coming years.

Source: Pioneer Investments and Bloomberg
In this fast-paced world, geo-political re-alignments have become a continuous phenomenon. The changing political landscape and shifts in policies pose substantial risks but also offers opportunities to businesses and investors. We take a look at major events in the recent past with significant impacts.

- **JANUARY, 2015**
  - **Interest Rate Hike on Horizon:** Fed signalled hike in interest rates in 2015 in wake of strong economy after it ended its QE program in mid of 2014.
  - **QE in Europe:** ECB announces sovereign bond buying program to spur growth and meet inflation target.

- **SEPTEMBER, 2014**
  - **Scottish Referendum:** Scots vote to remain in UK after Westminster promised to give substantial powers to Edinburg.

- **FEBRUARY, 2015**
  - **Minsk Agreement:** Russia, Ukraine, France and Germany sign peace agreement to end civil war in Ukraine. The deal provides constitutional reforms in exchange with withdrawal of fighters from eastern Ukraine.

- **NOVEMBER, 2014**
  - **Midterm Elections in U.S.**
    - Democrats lose control of Senate while Republicans increase their strength in House of Representatives.
    - Collision is expected between white house and Capitol Hill on major political and economic fronts.
  - **Cuban Thaw:**
    - U.S. and Cuba announce beginning of normalization of relations. Lifting of travel restrictions, access to financial system and re-opening of embassies are on agenda.
  - **Elections in Brazil**
    - Incumbent Dilma Roussef led worker’s party to a slim victory in general elections.

- **DECEMBER, 2014**
  - **Cuban Thaw:**
    - U.S. and Cuba announce beginning of normalization of relations. Lifting of travel restrictions, access to financial system and re-opening of embassies are on agenda.
  - **Russian Economy:**
    - Central Bank increases the interest rate by 6.5% after spending significant amount of foreign reserves to save Rouble.

- **OCTOBER, 2014**
  - **European Parliament Elections:**
    - European people’s party remains largest group but lost grounds to alliance of socialists and democrats, far-right and Euro sceptics.
Too Much Too Little

“It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning”

— Henry Ford

Wiki describes Quantitative Easing (QE) as monetary policy used by a central bank to stimulate an economy when standard monetary policy has become ineffective. A central bank implements quantitative easing by buying specified amount of financial assets from commercial banks and other private institutions, thus raising the prices of those financial assets and lowering their yield, while simultaneously increasing the monetary base. This differs from the more usual policy of buying or selling short-term government bonds in order to keep interbank interest rates at a specified target value.

The process of printing and pumping money is not new and has been practised in the past especially during 1945 – 1971 i.e. post war economic upliftment, when most of the countries (read US and European) were devaluing their currencies to either become more competitive or to reduce their post war debt. In the 1920’s, Germany too resorted to money printing i.e. in the post First World War era and went into hyperinflation. They eventually introduced a new currency towards late 1923. Fast forward this to 2008 where US frantically printed money for monetary expansion to kick-start their troubled economy post crisis. With US Dollar being the dominant trade currency the social and economic responsibility of the Federal Reserve increases even further. There are several schools of thoughts on the impact of QE but none of the answers are conclusive. However, as Karl Marx rightly said - “Money plays the largest part in determining the course of history,” (Communist Manifesto – 1848)

Let’s start with basics of Economics i.e. the GDP or Gross Domestic Product. GDP comprises of 4 components C+I+G+(X-I).

C = Consumption in an economy
I = Investments by Private sector
G = Government spending
X = Exports; I = Imports

The component break up for US is: Consumption (~70 percent); Investment (~14 percent); Government Spending (~18 percent); Net Exports (~2 percent)

Post the financial crisis of 2008; most of the financial engines were choked with loss of trust and confidence, resulting in collapse of overnight money markets. As a result, jobs were lost and consumption plummeted, leading to recessionary effect. In order to revive confidence and to spur growth, the Federal Reserve printed money with the purpose of increasing consumption (this included a valiant effort to distribute Food stamp). However, due to non-availability of jobs and poor credit off-take, consumption remained low and hence the effect on GDP was muted. When none of the efforts succeeded, the US government resorted to increase the GDP through Government spending. A large part of this is based on the principle of multiplier effect i.e. for every 1 dollar increase in the monetary base or money created; the demand should increase by more than a dollar, so as to have a positive multiplier. Currently, the US has a multiplier (M1) of 0.702* i.e. for every dollar increase in the monetary base, the money supply is increasing by only 70 cents (it was 1.622 as of December 2008). The principal of multiplier was a

* Source: https://ycharts.com/indicators/m1_money_multiplier (January 21, 2015)
Keynesian concept which worked well in 1945 – 1971 i.e. the post war era. However, this system in post economic crisis era of 2008 holds less significance, given the following reasons:

1) In post war era of 1945, there was genuine need for liquidity, due to lower peg of Gold to Dollar (due to low peg rate there was less liquidity in the system as compared to what was required) and the need for developing infrastructure post war. In 2008 and post crisis era, although liquidity was available, the confidence of lending was missing. Hence, the lack of trickle-down effect led to low consumption which resulted in a low impact of money creation on GDP.

2) The Government sector in post 1945 era was a major employer as a percentage of total population; hence, any government spending led to kickstart of the local economy and worked well for the Multiplier. The money spent by the government had a positive and direct correlation to investment in infrastructure and real estate development. The cogs of economic wheels hence started to churn and business investment confidence revived, leading to positive impact on GDP growth. Post 2008 crisis, the private sector was by large the biggest employer, however, given the low business confidence, the credit off-take was low thereby negating the money supply creation impact. On the contrary, private job market fell and US registered high unemployment rate post 2008. Government sector employment fell from a high of 22.5m at the beginning of 2009 to 22m in 2013, whereas the private employment fell from 111m in 2009 to 107m in 2010 before recovering to 111m in 2013. The multiplier concept hence had a converse effect i.e. for every Dollar spent in the system the effect was less than 70 cents. Whoever earned dollar, either stacked it away or invested some part outside the US (again loss of confidence in lending, hence choking the economic cycle). This was partly due to internationalization and interconnectedness of the world, with developing economies offering higher yields and the dollar finding its way in those economies. Else, the pressure of shareholder delight in order to arrest the outflow of investors from capital markets, most companies were off-shoring their production or cost lines to low cost destinations (reducing costs for margin improvement or denominator management), thereby creating a positive multiplier in those countries as opposed to theirs.

The positive impact of QE is hence questionable. There is also the free market hypothesis which emphasises on market correction and self-healing process through recessions. Japan has long embarked on QE to fuel growth and inflation but has faced serious challenge to achieve the intended purpose. After years of deliberation we now have stimulus through ECB to revive the fragile European Union. But what is the guarantee of a favourable outcome and what really happened to the US economy? Did it truly come out of the economic slump as a result of QE or was it the outcome of half a decade long self healing process?

“In our time, the aureate has become brazen—the golden has become brass. A return to true value based on trust is long overdue.”

- James Rickards (The Death of Money)
After a successful revolt against the Qing dynasty in 1911, the newly formed Republic of China was left with empty coffers. Europe, the then world banker, had sent its moneymen to Beijing to offer assistance. A century on, the European moneymen returned to Beijing, this time to borrow. China has emerged to be a banker to the world in just 100 years.
In 2009-2010, China’s lending to developing nations was $10 billion more than those made by the World Bank and if continues to do so, there would be little work to do for the International Monetary Fund, the World Bank and the Asian Development Bank as it willingly grants to whosoever needs it. In essence, nations in dire need of financial backing, have now found a new door to knock when all others turn them away.

China stepping up its role as lender of last resort upends an economic development game that’s been decades in the making. As oil prices continue to plummet, oil exporting nations especially Russia, are bleeding capital and facing budget crisis. Russia’s Ruble has followed lockstep with global oil prices over the second half of 2014. China extended support to its cold war ally by opening up a $24 billion currency swap line. This was add-on to the landmark $400 billion Natural Gas deal that was struck in 2014 at a time when the Westerners had imposed sanctions due to Russia’s involvement in Ukraine crisis.

Despite a slowdown at home - which has been a factor in plunging oil prices, China has kept its purse strings loose. It has been particularly shoring up its lending activities in the Latin American region where its loans would be of immediate help. Cash starved nation Venezuela was granted with an aid of $20 billion recently, taking the total grant money to $50 billion since 2007. China also aided an isolated Argentina with $2.3 billion in currency swap in addition to a loan of $7.5 billion.

These loans made by Chinese governments generally have no strings attached to them, as there isn’t any policy conditions like for the recipients of IMF cash. The objective of lending is not to improve the tax regimes or upgrading the borrower’s economy. They rather behave like any other lender on the street, looking for recovery arrangements like cash-for-oil deals but few of these policy conditions are mentioned in public. Out of its many objectives, one of them is internationalizing Yuan, for which it has signed currency swap arrangements, with countries across the globe. For now, the Yuan is not acceptable as the dollar. But providing it in times of economic malaise is a good way of acquiring global clout.

“\textit{I will do belly-dancing if that’s what it takes to get the US to ratify}” – Christine Lagarde, IMF chief on greater voting share to EM

Alongside, teaming up with BRICS counterparts, China has setup a World Bank rival, the New Development Bank and has also spearheaded the formation of the Asian Infrastructure Investment Bank aimed at Japan led and America backed Asian Development Bank. It would now use this bank to establish a stronghold in its hinterland countries at the expense of Japan and America.

Although, China is the biggest economy in Asia, its voting share at the Asian Development Bank has been less than half of that of Japan.

Apparently lending has not been limited to the developing countries alone; China had participated in the EU bailout fund during the crisis. This move starkly highlighted the rapid shift of global economic power to the East. By bailing out economy larger than that of its own and by holding US debt worth USD 1.3 trillion, second only to the Federal Reserve undermines the existing diplomatic order and the financial supremacy of the West. Like ADB, at IMF China has been deprived of voting share befitting its economic size. US lawmakers, for many years, have deferred reforms that would give China and other developing nations a little more representation at the IMF. This has largely been the root cause of the China’s pursuit to challenge, if not, replace the World’s financial institutions.

In realizing its ambitions, Chinese loans have made inroads into countries with abysmal financial situation and this would adversely affect itself if these deprived nations weaken further.

Would the US led Bretton institutions accommodate new institutions or would they allow the Dragon to spread its economic clout and strengthen its soft power. The Obama administration, in private, firmly opposes this development as it threatens its dominance and has thus asked its allies to steer clear of China Bank.

On the face of it, the two institutions emit divergent views, the World Bank backs China’s move by stating the fact that these new institutions can fund the ever growing needs of the developing nations. The IMF, on the other hand, is leaving no stone unturned in giving China and other EMs a larger representation to avoid giving the world an alternate to existing multilateral international lending.
Geopolitics of Oil: The curse of black gold

It was 1973, when small, seemingly powerless and tribal countries of Middle East imposed a sanction on west. The embargo of oil stopped the industrial nations, quite literally and era of powerful, fuel sucking mustang cars came to an end. By the end of crisis, the price of oil had increased by 400 percent. This was a turning point in geo-politics of world which helped shift the frontlines of global conflicts from Europe to Middle-East.

The 1973 oil embargo reflected the power vested in oil exporting countries. This was a catastrophic event in global politics and soon, measures were taken to prevent any supply crash. The subsequent policy of US led western countries to safeguard the continuous oil supply from Mid-East has been through installation of friendly governments, military bases, broking peace in troubled areas and also search a source of oil back home. Thus, began a game of conflicts, coups, price wars and revolutions which continues till today.

But high oil prices and revenues for oil exporting countries of middle-east comes at a cost. High oil prices made investments in costly new technologies and horizontal drilling attractive, which helped increase the production of oil in US and other countries from 1979 onwards. Oil exporting countries risk fading into oblivion of irrelevance if their market share drops and power to determine prices is lost.

The current price war going on in oil markets have refreshed the memories of 1986 when OPEC led by Saudis opened their spigot and sparked a crash in prices leading to 67 percent plunge which left oil just above $10 a barrel. In the middle of good Bull Run going in markets, the oil exporting countries looked to regain their market share and relevance as they are doing it today. The low oil prices dried new investments in exploration and costly technologies, and forced marginal producers out of market which cemented the prominence of OPEC as supplier of oil for next two and half decades.

The plunge in prices today might have been contributed by weak demands, but OPEC has refused to play its traditional role of maintaining stability in prices by matching demand with supply. The shale boom and horizontal drilling in US has effectively made it one of the largest producers in the world. Any cut in supply from OPEC is likely to directly benefit their rivals. Although lower prices will hurt the OPEC, they are likely to act in what they see as their benefit in long run – preserving market share. But oil is as much as about politics as it is about economics. Oil not only brings riches, it also funds the military and technological progress of countries thus spewing rivalries that at times reaches to the brink of catastrophic destructions, which makes the timing of this price war quite interesting. US in normal circumstances would have tried to stabilise the prices and keep its oil industry going, but it looks like they might trade off losses in domestic production with gain in foreign influence.

The fall in prices might as well be result of US led campaign (along with sanctions) to prevent Russia from re-gaining any influence in Ukraine as many commentators have stated.
The region. Rise of powerful extremist groups is not only a threat to the production and supply of oil (mainly in Libya and Iraq), they have also shown appetite for violence in global arena. The price wars and desire to be relevant in world politics of oil exporting countries are clear indication that world is not going to get rid of cheap Middle Eastern oil, and OPEC by and large is still a force controlling the deterministic power of oil prices. Oil might have brought tremendous riches to some, but the game of geopolitics has never been so dark before in middle-east.

We don’t know whether there is any understanding between US and Saudis, but the fact is that low oil prices are accelerating downfall of Russian influence in Eastern Europe. The policy of US looks more inclined towards reaping the benefits from a power vacuum in Eastern Europe and expanding the borders of NATO at the cost of domestic oil boom. Venezuela too needs high prices to sustain their budget. A social uprising in Venezuela like that in Ukraine might just be the chance US is waiting for to expand its influence in Latin America.

Oil has been the greatest player in middle-eastern politics in modern times. With Strait of Hormuz in Persian Gulf carrying 30 percent of seaborne oil and Suez Canal transporting another 8 percent, this region is the artery of world economy. The regional rivalries impact the production and prices of oil to which world economy is closely linked, thus they suck the major world powers to play a role in regional conflicts. This, in opinions of many has contributed to undemocratic governments run by families who do not represent the aspirations of people.

The spot of regional superpower is openly contested between Saudi Arabia and Iran. With major global powers looking for a settlement with Iran, Saudis might be playing their hand to get a better deal for themselves which prevents Iran from developing any technology that can be used militarily. Although Saudis have strong conventional force, they do not have human capability or the population as compared to Iran to sustain any future conflict. The current price war looks less targeted on Iran than on Shale or Russia, it is expected to benefit the Saudis as Iran fails to balance its budget and might as well agree to a deal in current nuclear negotiations which is favourable to Saudis.

This rivalry has also forced smaller countries to chose sides and become pawns in this game of politics and proxy wars, currently being fought in lot of countries including Syria, Iraq and Yemen. The proxy war has helped financing of military dictators as well as extremist groups by both sides in the region. Rise of powerful extremist groups is not only a threat to the production and supply of oil (mainly in Libya and Iraq), they have also shown appetite for violence in global arena.

Oil might have brought tremendous riches to some, but the game of geopolitics has never been so dark before in middle-east.
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Economic recovery and monetary policies were the dominant themes in 2014. Upturn in the business cycle in advanced economies, notably the US and the UK, additional quantitative easing from the BoJ and expectations of a full-fledged asset purchase program by the ECB boosted equities. Stubbornly low inflation expectations and dovish commentaries from central banks drove yields lower across the developed world. Commodity markets continued their downward spiral led by a free-fall of crude.
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