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Viewpoint

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Viewpoint is our bi-monthly research bulletin for private investors. This review of topical investment issues is written by our chief economist, Peter Bickley.

Packages

All around us ‘packages’ are falling from the skies like autumn leaves. Timeo Daneos et dona ferentes is a sound maxim for all times, never more so than when economies are clearly in need of drastic action and there are politicians desperate to throw someone else’s money at them. It does make you wonder, when the dust finally settles and we can separate truth from rhetoric, how much collateral damage will have been done by people whose quest for sound-bite glory consistently trumps any residual grains of common sense. Maybe it is premature to be passing judgement, after all it is still early days for most of the grand recovery plans, but it is still worth a try. The news is not all bad.

That the developed world is sinking into recession should not be surprising anybody, significant slowdowns having been written into the script many, many months ago. Indeed I was emboldened (unwisely, in hindsight) to make just this point in the last regular Viewpoint, noting just how well the global macro economy was running to expectation. But for what seems now like forever, the unfolding credit crunch has once again thrown several spanners into the works and the past two months have been torrid.

I have been (I hope) quick enough and open enough to acknowledge that while the macro economic forecasting here has been pretty reasonable I have struggled to grasp how the chain of events we now call the credit crunch would unwind. Since the balmy days of last August/September we have seen a cascade of events that would have been regarded as totally impossible even just weeks before, culminating as we all know in the first legs of the UK’s contribution to the package jamboree. So I suppose what I am trying to say in an oblique sort of way is this: if I put my hands up and admit the credit crunch has had me foxed please don’t be too quick to shoot – I’m in good company, along with every central banker and every finance minister in the entire world. Which may be a pretty lame defence but it’s the best I’ve got.

Package analysis shows us that in some countries policymakers have still not caught up with what is happening. In others the problem may be more one of agreeing the right solutions rather than understanding their need. Here in the UK we may even be ahead of the game, though next Monday’s pre-budget report has something of a make or break feel to it. What is quite clear is that right now longer term consequences will have to look out for themselves; the world needs aggressive monetary and fiscal stimulus and it needs it now. When dealing with cardiac arrest, keeping the patient alive takes precedence over lifestyle lectures. And everywhere, even including the laggards, this is where policy is going.

It is something of an irony for those of us unable to find a single good word to say about our former Chancellor turned P.M. that it is in broad outline the UK bank rescue package that has set the pattern for others. There are aspects of it that clearly are not right – the penalties and future finding costs imposed on the participating banks, for example, are plainly too high

and will considerably hinder the return to profitability – but the overall mix of bail out and refinancing makes good sense. If the high street clearing banks were the very last domino left to fall, they were well on their way; what was so critical about the UK's intervention was that it came in time. And with so little thinking space we have to excuse some wrinkles in the detail. The money markets are still not functioning as they should, 3 month LIBOR still trades at 110 basis points over bank rate, but that premium narrows in day by day.

Taking the UK policy responses in the round there are three identifiable phases. Rescuing the banks came first, tackling monetary policy came second, fiscal stimulus is on the way next week if the leaks are to be believed. Phase one ticks the box for us, even though the treatment will take time. Phase two doesn't, yet, and phase three may be something or nothing.

The 150 basis points cut in bank rate came as a very pleasant surprise; I'd been hoping for 100 bps while the consensus was for just 50. The rate will come down further and fast and I've cut my target from 2.50% to 1%. There's an argument that such rapid rate cuts are the wrong prescription, the disconnection between managed rates and reality in the inter-bank markets making the actual level of base rate irrelevant, but that's wrong. In the current environment the right level of base rates is as close to zero as possible, the only question is how quickly we can get there. The Monetary Policy Committee has seen the light – or rather the dark – and is on the case. Phase two will tick the box soon.

So how about phase three, the much-vaunted fiscal stimulus to come. The leaks say we'll get north of £15bn, with a focus towards low earners and headline grabbing splurges on the usual suspects – schools and hospitals. There are several things to be said about this, not all bad. The problem with tax cuts (US style) is that we canny people put them in the bank rather than helping out John Lewis' profits. Which is rational and right – if excess debt got us here, higher saving is the technically correct solution. But remembering this is an economic heart attack, we need the technically incorrect answer, we need spending. Bring on the principle of Ricardian Equivalence which argues that contrary to daily experience we are not actually stupid. Offered a tax cut to make us feel better off today, we know that we shall feel poorer in the future as the debt is repaid. That's why we save rather than spend. Ricardian Equivalence cuts the mustard rather less with the lower paid so targeting any tax cuts there makes perfect sense.

A(nother) splurge on capital investment will, I promise you, waste just as much money as during the rest of the past decade's splurging. We won't get new railways, wider motorways, better telecoms etc; we'll get a new day centre here, a new community relationship interface facility there, some useless sporting white elephants and a rapid resurgence of public sector inflation. We're about to waste yet another shed load of cash.

Finally, one of those nice little secrets the Treasury loves to hide in the most impenetrable parts of budgets is that the last one set us up for taking £15bn out of the economy. So the first £15bn of whatever the headline number is merely keeps us treading water; we aren't into genuine stimulus until £15,000,000,001, another depressing legacy of a decade's economic mismanagement.

But if phase three is only ticking perhaps half a box, two and a half ticks is better than most. Helped along by the collapse in sterling, it may be that the UK gamble will pay off.

Over to America where I am losing my erstwhile admiration for Hank Paulson at the Treasury. When he strong-armed $700bn out of Congress for the TARP scheme I thought it was pretty hot stuff, but that was because I thought he probably had a clear idea how to allocate the money. Seems he didn't, it's just being used as a fire-fighting fund with no discernable strategy. So if that is 'the package' it's hard to know quite what to make of it.

Banks, insurers, mortgage lenders and now car makers; there's no obvious end to the line up of supplicant parties.

The first salvo on the fiscal front was, of course, the tax cut. US tax cuts aren't like ours, their way you get a cheque from the revenue. Nice. But Ricardian Equivalence is right up there in US households' financial planning so only some 40% of it was spent. For that we got a temporary blip in retail sales; the squib was damp indeed. For all the talk of a follow up we're actually in a bit of limbo-land right now. If it looks like a lame duck, squawks like a lame duck and walks like a lame duck it probably is an outgoing Bush. An incoming Democratic Presidency will likely be more aggressive on the fiscal front but will want the package to be its own, meaning unfortunate delay.

More important than policy interventions for the immediate outlook in the US is the fall in the price of gasoline which thanks to a very low tax overlay and the absence of currency complications has been seriously impressive. Already this has started to feed through to consumer confidence, albeit they are only in 'less bad' territory and a long way from feeling good.

All in all you get the feeling that while the Fed is doing an impressive job at nursing the banking system through – with the spectacular exception of the disastrous decision to let Lehman fail, a decision that led directly to the implosion in our own high street banks – the overall US response is ragged and lacking in focus.

At least there is a US response; in the EU the ECB has performed as well as any central bank thus far in sustaining the financial system but is trailing the pack in terms of policy. It feels as though some ECB Council members are still in denial even though 5 member states are already in recession with several more joining them soon. At the political level too, there seems to be some reluctance to face the facts. Most EU members have higher total public sector debt than the UK but lower running structural deficits; this is really no time to be pious about the Maastricht rules but for some Eurozone Governments pious is what they do best.

For a real humdinger you need – as usual – to look to China and its 4 trillion Yuan announcement earlier this month. Sadly China is learning a thing or two from our Mr Brown and not all of this is actual new money. Details are thin right now but maybe 1 trillion is previously announced; we shouldn't quibble too much, any figure is big enough to make a difference. Whatever the tricks with the abacus, the lasting impact of China's blockbuster is its unequivocal demonstration that here we have a serious player on the global economic scene. Major country confabs have for too long overlooked the growing importance of China, India and the like; it will be hard for the G whatever to meet again now without China at the top table.

Back to the economics; China's growth is slowing but it does not have anything resembling the western style liquidity crunch. So 'package' in China is all about fiscal change. When Governments in the West talk about bringing forward major infrastructure spend it rightly elicits a hollow laugh; there is no way our planning system, the creaking bureaucracy or the sheer logistics will let it happen. In China, things are different; spending announced is spending that will happen, now. And on the information available to date this is infrastructure investment that will repay in spades for decades to come.

After this somewhat disjointed world package tour what we can conclude is that for all the talk there is little in the way of coordination going on here. Central Banks are working well together but Governments are not. Understandable perhaps, after all each territory's slowdown is essentially home made and therefore different, the credit crunch being the one genuinely common overlay. But it's a shame; studies show that coordinated fiscal action gives you 50% more bangs for your buck.

What to do?

We've lived through unprecedented times this year with the worst of it in the past few weeks. Nerves are frayed, confidence shattered, stress levels super-elevated and ulcers pending. Every attempt to be calm, logical and rational seems to enjoy only a moment of success until pounded by yet another triple digit market fall. On this side of the fence we don't worry too much about our personal investments, we know this will blow over and in time paper losses will revert to profit. But we do worry for our clients for whom this is genuinely scary stuff, grinding on month after month. The big trap that must be avoided is making reactive decisions which may look smart short term but are catastrophic longer term. But on this last page I'm not going to repeat the lecture, I'll just tell you what I am doing for myself.

Developed v Emerging: when the dust settles, the growth gap between the old world and the new will be even bigger. I'm shifting the balance more and more to the latter. People say it's aggressive, I say it's the only rational thing to do.

China: you all know the story but may think it has gone awry. It hasn't and the bubbles in local stock markets have well and truly burst. I'm buying China; or rather I'm adding more.

Commodities: I expected something of a downdraft from the elevated levels reached by many hard commodities but not the rout we've seen. Many now trade below the cost of production and capacity is being reduced. This is madness; markets have adjusted with supreme inelegance to an admittedly abrupt change in demand but this change is a blip. Think China, think railways, highways, airports, power stations; think commodities, think mining stocks – I am.

Turn off the TV: not strictly true, my twin Bloomberg screens flicker away in front of me all day, a real challenge for the blood pressure tablets. But that's my job; if it isn't yours, stop worrying about today and yesterday and focus on tomorrow. Remember, the media love bad news. Above all – **do not read financial journalists' blogs**

And finally: for all the reassurances I'm not gung-ho. Don't buy stuff just because it's cheap (Russia, for example); being contrarian is good except when what's coming the other way is an express train. Stick to quality, there's no need to dabble in the really damaged stuff. If you fancy a punt - in UK Banks, say - go ahead (unless, like me, you bought them aeons ago as safe high yielders) but recognise that, even now, it may be costly.

Peter Bickley

Peter has been in the investment business since 1970. Initially working in private client stock broking he spent 12 years running a large private sector pension fund before joining Tilney in the pension fund team in 1991. In 1993 he became Head of Research. He is now our Chief Economist and is also chairman of Tilney's Investment Strategy Group, responsible for the direction of Tilney's diversified multi asset class investment process. Peter is a popular writer in the media and is noted for being probably the only UK Investment Strategist to run an alpaca farm in his spare time.

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