

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.

Following the script

Something rather unusual is going on out there; for a change the world seems to be following the script. Spooky! Last time I dragged you through the escape plan, how the developed world economies would extricate themselves from what at the time was generally portrayed as an inexorable slither into stagflation. Almost as soon as that hit the wires the general thesis – that the real problem for policymakers was a deflationary demand shock rather than an inflationary price shock – rapidly established itself as something akin to consensus. Given the credo that the consensus is usually wrong this poses a bit of a dilemma, resolved on this occasion by accepting that there are exceptions to every rule.

So as I look this morning at the mass of live data spread across my screens by that miracle we call Bloomberg I see what amounts to a long list of ticked boxes. Brent Crude is trading at \$103 and Gold at almost \$800, declines of 30% and 20% from their highs. Bond yields have tumbled with the British Government 10 year yield now 80 basis points from its peak and 50 bps below its level in early July (1 basis point = 0.01%); this is a big move and a very profitable one for those who took the hint. Equity markets have risen, albeit without much conviction; hesitancy is understandable (it was in the script, even) given that the emerging economic data is looking increasingly dire. Even the Banks of England and Euroland are joining in, at least in terms of altered rhetoric if not – yet – in actions. The BoE's August Inflation Report was as clear a signal as you could want that rates will be coming down. And one other development that our Investment Strategy Group has been mumbling about for some time has fallen into place too – the US dollar has staged a substantial rally.

Everything in the garden is, therefore, lovely? Sadly it isn't that simple. I have a high level of confidence in the broad outline of the evolution I predicted last time, with if anything greater conviction now than then. But on closer examination not everything is exactly on song and even if it were, it is far too soon for miraculous delivery to be taken for granted. Remember, the game plan did include considerable uncertainty about how markets would cope with the setbacks to earnings (and, in places, dividends) which must be faced before things get better.

If this starts to sound like a typical economist's prevarication ('on the one hand, on the other hand...') then I'm inclined to plead guilty but with mitigation. Economies are at not just one but several coincident inflection points, complicated further by the intrusion of the credit crunch into what might otherwise have been a fairly normal cyclical pause. The 'big picture' may indeed be correct but within its extended timescales a lot of 'small picture' stuff can run contra and cause all manner of grief. The risk, of course, is that the tail wags the dog; this is why I make such a point of keeping the focus on the end game and not being too bothered about intervening noises off.



Markets themselves are telling us that it is far from cut and dried. While equities have bounced credit spreads have remained stubbornly wide (that is the premium yield on corporate debt over the comparable gilt, the premium reflecting the perception of higher credit risk). The equity and fixed interest markets cannot both be right.

The oil price gave me a scare recently, flipping back up to \$120 on the war-ette in Georgia and usefully reminding us that the economics of supply and demand can be trampled by geopolitical risks. Happily neither the flip nor the episode lasted for long. Actually for the game plan to be right oil does not have to fall to my \$95 target; merely by not carrying on up it would bring headline CPI gently back down. Quicker and much more entertaining at \$95 though. Behind all of that lurks another interim risk to the script; asset prices do not usually change trend in one quick turn, they usually mess about a bit and bounce around before settling into their new direction. With the slowdowns in the Emerging Economies (notably China) seemingly to date less severe than some had postulated (and their equity markets had flagged) demand for oil may surprise to the upside. So I don't rule out another flurry of excitement in the oil price – though seeing how close we are already to that \$95 target I breathe a little easier each day.

I'm also depending on an end – or at least a pause – to food price inflation. This has felt a pretty safe bet: the harvests look good, especially in China (where, did you know, there's 3 years' worth of grain in stockpile). But recent forays around the UK have revealed disturbing sights; the harvest looks a cracker but it's standing in water with the land too soft for machinery. A week or so ago it looked as though we could lose the lot but by now about 25% is in. Never before have I been so glad to be stuck behind a tractor and a full grain trailer.

News from the real economy is a bit mixed depending where you look. Falling house prices catch the headlines (and, yes, are more dramatic than I had expected) yet in Scotland where it was my good fortune to be last week (working, sadly) prices continue to rise. Retail sales are weak though as ever there is a disparity between the official data and word from the CBI. Mortgages are now available only to credit worthy borrowers with a sensible equity participation; this may be painful for those whose access to credit has vanished but a return to sanity in lending is another encouragement that black clouds do have silver linings. I think all the Monetary Policy Committee here in the UK needs to see before the start of what will in all probability be an aggressive series of rate cuts is a clear change of direction in the headline CPI. With oil at \$103 and petrol prices reluctantly following it down that time cannot now be far off.

But I'm anxious not to come over as though this is some kind of quick fix. Developed world economies ended the long up-cycle generally operating above their potential and it takes more than a few dull months to put that right. Policy settings in the UK and Europe have been geared to take economies off the heat; thus far the Bank of England and the ECB have done pretty well in propping up the banking system without pumping liquidity into the wider economy. But even if (when) declining inflation allows policy to ease we'll still be battered by what Charlie Bean at the bank calls grenades going off in the financial system.

This matters; talking with an accountancy firm in Edinburgh last week I was told (politely but oh so firmly) that I didn't appreciate the extent to which the banks are effectively closed to all but the biggest companies. This isn't going to get any better until confidence and liquidity is restored to the banking system and for that to happen we need some months without grenades. Here so far as I am concerned the timing is frankly in the lap of the Gods. This global slowdown was never going to be easy or quick. The fact that it has generally been consumer rather than company led makes resolution that much slower, never mind all those grenades. But meanwhile it's nice that so much is currently panning out according to plan. With the end game in mind I stick to my view that risk assets should still be accumulated and you should avoid the temptations of that wilful seductress, cash in the bank.



Bonds

So last time I did something extremely rare and said something vaguely flattering about bonds. Yields would fall and in effect this made for a tactical asset allocation call. As noted, yields have now fallen faster than I'd have dreamed so how far might they go? In the past today's yield just under 4.50% has proved something of a barrier though last March it did take a look at 4.28%, albeit briefly. With headline inflation falling but still for some time well above the 2% target it might seem a tad ambitious to be looking for further progress. But I think we can.

The UK Gilt yield curve is unusually flat but when managed rates start to fall this should pull the front end of the curve lower, just as we can already see in the USA where the curve slopes up in classic textbook manner. Whoa there – too much jargon; explanations required.

If you plot the yields of all the gilts in issue, from the shortest date to the longest what you get is what we call the 'curve'. Usually the curve slopes upwards, after all it is intuitively obvious that if you lend to someone for a longer period you would require a higher rate of interest to compensate for the additional risks inherent in the time lapse before you get your money back. The commonest risk, of course, is inflation; even at the UK official inflation target of 2% p.a. the value of money halves in 35 years.

Yield curves become distorted for many reasons and for several years the UK 'curve' has been almost flat, sometimes even sloping downwards. This is not always puzzling but it is far from ideal. If long yields are suppressed this increases costs and inefficiencies for those with long liabilities to match, pension funds for example. And if there is no incremental reward for lending long the process of credit creation gums up. The banking system, for example, needs a time related spread in order to live.

In the UK just now we see this pattern: the yield for a 2 year gilt is 4.37%; 5 year 4.33%; 10 year 4.45%; 30 year 4.38%. There is nothing here to tell you whether any individual yield is right or wrong but the relationships are clearly distorted. In the US the comparable yields on Treasuries are 2.29%; 2.99%; 3.74%; and 4.36%. In the light of what is going on in the US economy these yields may seem somewhat low but at least the slope makes economic sense.

Back to the UK. When base rates fall they will drag shorter dated gilt yields lower but it is unlikely that longer yields will come down too. Thus the curve will start to assume a more normal appearance. This is a necessary – though unfortunately not sufficient – condition for recovery in the banking sector. But that doesn't answer the initial question – how much lower can yields go and, as a secondary consideration, whereabouts along that curve should you be to get the most benefit?

On this side of the fence we tend to think of 10 years as a neutral place to sit, hence it is so often the 10 year yield that gets quoted as a proxy for the market as a whole. But when the curve is changing shape 10 years is often the pivot point, not an exciting place to be. Our gilts specialist here thinks this may again be the case; as short yields fall (and prices rise) the 10 year yield may struggle to get much lower. A target of perhaps 4.25% which I have mentally pencilled in may, then, be quite ambitious enough.

In which case we can come to three conclusions. 1. The earlier call in favour of gilts was a good one but most of the gains have already been made. 2. To squeeze the best remaining upside from curve steepening, stick to medium dated (5 – 8 years, roughly) issues. 3. Consider (very carefully) the alternative attractions of high quality 'Investment Grade' corporate bonds where a yield premium of 200 basis points will in time prove excessive.



Infrastructure - and choices

For my foray north of Hadrian's Wall last week I chose to drive, an odd choice, perhaps, given the near 400 mile distance and the apparently obvious alternative of taking the train. Not so odd, though, when the direct travel cost was roughly half the train fare and the journey time should have been much the same. And the train included the dubious delights of an hour's wait on Crewe station; no disrespect but it doesn't exactly galvanise one towards the public transport option.

Driving back south on a Friday was of course asking for trouble and the M6 duly obliged, giving me an extra 2 hours to ponder why UK infrastructure seems always to be so far behind the demand curve and, just to improve my mood, why we make such bizarre choices.

I'll admit I've forgotten how much of my money was frittered away on a glorified tent in the middle of an old gasworks on the Thames, time being a great healer, but its contribution to the national infrastructure, to future economic growth potential, to anything remotely related to improving the daily grind was clearly zero. Worse, by diverting resource from elsewhere it was negative. I have better recall of the cost overruns on the West Coast Main Line but after all that pain we have at least made an investment that will pay back for decades to come. Why oh why cannot people who have power of decision in these areas make rational choices?

It's about to happen again, this time in spades. OK, when people are feeling warm and fuzzy about medal success in the Chinese spectacular it may come over as a tad curmudgeonly and non-PC to gripe about 2012 but the facts don't go away just because they may be unpopular. We're committed to spend an unknown but ever increasing amount of cash on a 2 week shindig and for what? Photo opportunities and a monumental ego massage for a bunch of not very memorable politicians with, if we're lucky, improved transport links to places no one has any reason to go and a few hundred acres of derelict land tidied up for houses where no one really wants to live. Brilliant.

I can understand why it might have looked different in China, with reserves accruing too fast to be possible to spend and the (huge) bill for the Olympics a mere drop in the overall infrastructure investment ocean. But here? Surely not. The true final cost will of course be kept from us for our own good but you can bet it will be enough to have made a real difference where it's needed: to our railways, our power supplies, even the wretched M6. Oh for an iota of common sense...



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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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