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Viewpoint

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

Viewpoint

Viewpoint is 100 today and feeling mightily pleased to have got this far. In one sense I'm just faced with yet another blank screen challenging me to fill it with stuff; in another it does feel a bit special. Viewpoint first saw the light of day in October 1995, which seems aeons ago; actually it's about a quarter of a million words, give or take a few, and at this end of the production process that feels like a lot. Along the way there's been some good stuff and some not so good; what's been astonishing is the support from you all, thank you. Who knows what the future will bring but as for the past, it's been (mostly) fun.

Free Trade

The good folk of Kirkcaldy, all 48,108 of them apparently, have much of which to be proud though I confess that my on-the-ground research has to date been conspicuous by its total absence. '*Lang Toun*' boasts Europe's longest street fair – I take it we are talking distance rather than time here – and had the dubious honour to be the home of lino. Well we all have our crosses to bear. What really puts *Cathair Chaladain* on the map for me, though, is the birth there in June 1723 of Adam Smith, the granddaddy of much that we take for granted today in terms of economic theory.

Adam Smith came up with the intellectual bases for free market capitalism, the division of labour and free trade. To be fair, free market capitalism isn't exactly flavour of the month these days and Mr Smith himself recognised that dividing labour might be all well and good but the cost might be that we all end up terminally bored with our lot. Neither concept, though, is under serious challenge even if down Gogarburn(*) way some may harbour doubts.

Free trade, on the other hand, is a more fragile flower, one much more at risk from the crowd-pleasing madness of myopic politicians. Free trade might just fall victim to the urge to 'do something'; it lacks popular advocacy and thus it behoves all thinking people to make its case – as often and as loudly as we can. So this is my contribution.

David Ricardo has popped up in Viewpoint before; I went through a phase of rabbitting on about the theory of Ricardian Equivalence a while ago (relax, I'll spare you a re-run). Ricardo refined Smith's basic thinking into the mighty fine Theory of Comparative Advantage. Each of us is better at some things than at others and since we are all different those things are not the same for all of us. There is no activity that cannot be done well by somebody; there is nobody who can do nothing well – at least that's the theory. Everyone has a 'comparative advantage' in something. Some kindly say I can write quite well; certainly no one would say the same of my efforts in plastering a wall.

(*) Gogarburn is the grand and expansive/expensive home of the RBS, by Edinburgh airport.

It makes sense for us all to concentrate on doing what we do best, drawing on the expertise of others for our other needs. Being good at what we do, we are more efficient than if we all did everything ourselves. This works on an individual level, indeed it works on any level right up to global. This is why we have money; money means that our exploitation of each other's comparative advantages can be indirect.

Trade is the key driver of economic growth. Never mind all the theory, empirical evidence shows irrefutably and abundantly that for just about any sensible economy the growth in exports and in national incomes are indivisible. You grow exports, of course, by doing whatever it is you do best, outsourcing what you do less well to others; these become your imports. It's funny, then, that when an economy comes under a bit of pressure imports are stigmatised as a bad thing. If imports to country A (exports from country B) are a bad thing then so, logically, must be exports from country A (imports to country B). Neither A nor B wants to reduce their exports – after all to do so means doing less of what they do best – but if each sets out to reduce their imports then that is exactly what they will achieve.

Since October last year global trade has collapsed. IMF data for the period July 08 to February 09 show that world exports have fallen by over a third; this is a catastrophic event and it will be a calamity for all of us if it is not sorted. The worry is that just now the signs of sensible pragmatic solutions are about as evident as my researches in Kirkcaldy.

Trade stops for either (or both) of two reasons. The stupidest is the first over the horizon in every cyclical slowdown – protectionism. For an example, look at the 'Buy American' clause in the US fiscal stimulus package. According to its warped logic, sourcing everything from home rather from where it is better, more efficiently or cheaply made will 'protect jobs'. Piffle; just ask any US exporter, already feeling the heat of 'country B' getting its own back. And let's do some logic of our own: if it makes sense for the US to ration its trade with other nations it presumably makes sense for Oregon to cut back its imports from Texas. But if that makes sense, shouldn't every town keep itself to itself? How about every street, every household? Madness; all those idiots who think restrictions on trade are a free lunch should be sent for re-training. Sadly, they have loud voices and they tend to get elected.

Happily, that lunacy is not the prime cause for the collapse in global trade this year. Everyone's trade (in and out) has fallen, all at once. The key this time lies in the banking crisis and the sudden disappearance of trade finance. If banks will not lend against letters of credit, the associated trade movement cannot happen. The goods don't move, the ship stays in dock, the workers who produced the goods get laid off, and so on. This is exactly what has happened.

The banks are out of casualty but are still in intensive care. They don't feel very well, poor things, and they don't have the stomach for anything at all risky – like lending money. This will change but until it does we're stuck. And the longer global trade is hamstrung, the longer, deeper and more intractable the recession will be. This is critical and it is urgent. And it is easy to fix.

Governments have committed unimaginable sums to supporting the banking system, with even more in the form of contingent liabilities (guarantees). So here's a plan: why not go one step further and offer guarantees for letters of credit? The actual costs should be buttons in the overall scheme of things and the prize, an immediate recovery in world trade, a treasure beyond price. That's what the G7/8/12/whatever should have been sorting last week, not exchanging T shirts.

Global trade is poorly, suffocated by systemic failure. Sending it a 'get well' card might be nice, micro surgery to fix the problem would be better. Governments should think a bit laterally about this; fingers crossed someone, somewhere, is listening.

Markets (again)

The last two Viewpoints have been pretty positive about the prospects for risk assets in general and equities in particular. I've not been looking for any dramatic upside but felt that the rally we had enjoyed since the March lows was rationally based and broadly sustainable, albeit maybe a tad overcooked at the recent highs. With so many investors still so sceptical and with such huge amounts of cash sitting idle in money market accounts (some $4tr at the peak) it was likely that on any signs of weakness there would be plenty of buyers – 'capitulating bears' – ready to perform. If there are enough 'buyers on dips' what you usually get is no dips. Last month's piece even ventured to comment on the technicals; the FTSE chart looked as if it might be about to be bullish. Mistake: never read into a chart what you hope it might be about to do, let it do it first.

With all of that in the background June hasn't been the happiest of months. Markets have not collapsed, we are nowhere near a descent to the lows of this Spring, and we are still comfortably within the previous trading range. But the index has irrefutably come down and it would be churlish not to accept that this does indeed constitute a dip. Disapppointing.

Disappointing but not, I'm thinking, a disaster. The world has not suddenly stopped following the script but, undeniably, attitudes have changed. Markets rallied – just as earlier Viewpoints had suggested (!) – on a dawning realisation not that life was getting better but that it was starting to get worse rather more slowly. From that seed grew a more solid expectation that improvement was on the way. It may be that markets got a bit carried away with themselves though I can't say I noticed much in the way of enthusiasm at the time. More likely, participants took a reality check not so much on their expectations as on the downside should they to turn out wrong.

So the mood has shifted from 'I believe' to 'prove it'. The markets now want evidence to support those expectations. As some of my more academic colleagues like to put it, the focus has shifted from the second derivative (the change in the pace of change) to the first (the change itself). Actually that kind of jargon goes down a storm in meetings and it's a fair description of what is going on; we can let it pass.

This is the tricky bit; opinions about the economic and corporate outlook differ on a truly galactic scale. Most of us go with the notion that we have years of slow growth ahead (that 'most of us' rings a little alarm bell, more anon) but otherwise there is not much common ground. Given that some of the postulated outcomes are very much on the bleak side, it makes sense for markets to lose patience with the soothsayers and look for hard tack.

I think they'll get it, perhaps from the most surprising quarter – corporate earnings. We're now in to the second quarter results season which is proving a pretty mixed affair accompanied by the customary analytical frenzy. What all this tends to forget is that this is a backward-looking exercise; results may bump the markets around from day to day but will not give it direction. Last time, I chatted about the silver lining to the big black cloud of unemployment, making the point that companies have been quick to slash costs. Friends have made me understand this has been true in Germany too, the effects simply being hidden by the KurtzArbeit system of employment support. Memo to self: must be less bearish about Germany in future.

Flatter (rather than falling) demand, some degree of inventory accumulation and a collective sigh of relief all round coupled with hammered costs should mean something rather nice for margins. With the gradual, painfully slow, improvement in the macro numbers set to continue and a potential wild card from earnings, markets should soon accept that progress has become provable rather than just wishful thinking.

'Most of us'

Anyone who has had the tenacity to have been with Viewpoint throughout its life – or even a half or a quarter of it – will know all about my predilection for a non-consensus view. Indeed it's an article of faith for me that the consensus is (almost) always wrong. This may seem flippant but actually it makes sense; not only is it empirically provable, it has to be so otherwise markets would never be surprised and would never move. And there would be no point putting in all the mental wear and tear of thinking, of trying to distil exactly how the markets will turn out to have been wrong.

So this consensus about the post-recession outlook (leaving aside the shape of the initial stuttering recoveries) is worrying. True, we do have some people on the lunatic fringe like those looking for a metronomic 3.5% annual growth from 2011 (guess who…) and there are still a few depressionistas out there. Most of us are stuck in the middle, looking uncomfortably at each other. This could be one of those times when that's the right place to be; the logic that gets us there feels pretty robust. And yet the doubts remain.

It is easier to align with the depressive lot than the lunatics. Historical precedent is discouraging and it is still not clear that the flow of credit through the system is yet restored; there is a long way to go despite everything that has been thrown at the problem (and, actually, because of some of it). The legacy imbalances were huge and to be honest most of us were at least a tiny bit guilty of crossing fingers and hoping the rebalancing would be someone else's problem. The scope for petty minded policy errors ('Buy American') remains uncomfortably large. The risk of stagflation may be small, even minimal, but it's there.

Yet it could go the other way, not as those fantasists at the UK Treasury have it but still less miserably than I'm suggesting. Policy stimulus is unlikely to be pulled prematurely even though central bankers will be at pains to prevent second round inflationary outcomes. The improvements in household finances, the reductions in the excess savers' trade surpluses (and the fall in the US trade deficit) are well on track and sometimes surprisingly quick. 'Green shoots' may be a tired joke but the trend changes in the data are coming sooner than many had expected, even if they remain inevitably fragile.

I think we'll get bits of both as, inevitably, the data ebbs and flows; this will give us some volatility in markets around what is likely to be a broadly flat trend for some time. If I'm pushed to get off the fence and without walking away from my central forecasts have a view on the error in the current consensus then my hunch is that in a couple of years' time we'll find that I (and 'most of us') have been too gloomy.

By the way, did I mention we're 100 today?

Peter Bickley

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