

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.

Happy New Year (?)

So much for hitting the ground running in 2009; hitting the ground coughing is nearer the mark. Whether it was mere 'man flu' – that scourge of mankind that somehow women shrug off, leaving them able and willing to storm Tesco, cook dinner, do the laundry and muck out the gerbils – or the real McCoy I can't really be sure but after 3 weeks of it I know just how the UK economy feels. Wobbly, weak-kneed, jaded and clearly functioning below potential; key indicators fluctuating wildly from cooking to freezing; seemingly resistant to all attempts at treatment – this human and this economy are clearly out of sorts. What I do know is that each is probably at or near a low point and each will recover, though downside risks remain; grappling with a frozen motor car at half past five this morning was not, in hindsight, a great idea.

Looking back to last January's Viewpoint is salutary and depressing, 2008 has been so much worse than I – or any of us – ever dreamed. I expect to be feeling better soon but it will take much longer for the economy as a whole and these days there are no prizes for over-optimism. Prediction is today dodgier than ever and visibility, as they say, is extremely poor. But that, of course, is a classic characteristic of low points and that's why – even after the mental and financial battering of the past year – it is so important to try to keep a clear head.

Meanwhile, something of an aside. Now and again I hear the odd grumble that Viewpoint is maybe a bit – er – partisan, perish the thought. To set the record straight, Viewpoint does not do party politics; indeed it doesn't need to, the economic facts speak for themselves. Thinking about the last issue (pre budget report), though, the economic arguments I put forward were logically and factually impeccable but on reflection maybe some of the rhetoric was a touch o.t.t.. Which is shame if it then came over as less than objective.

Maybe too I could restate my general position on current policy responses where – with significant reservations – I am rather more in sympathy with the Keynesian line being taken by Government than with the more orthodox monetarist thinking of HM Opposition. It's just a shame that we are starting from here rather than where, fiscally speaking, we should and could have been.

At least stock markets made good use of what for most of us was an extended holiday break (or sick leave...) by staging something of a rally. This is normal for the time of year but these are abnormal times so anything that looks familiar is especially good for morale. It seems highly improbable that this marks a fundamental turning point but it is a timely reminder that prices for risk assets can – and do – go up even while the background looks grim. Indeed, the very asset mix that has caused me so much grief since Lehman collapsed is going a storm so far this year – Hang Seng up 8%, Bombay up 7%. Keep up the good work chaps!



2009 – coping with new realities

The world did not change when the US housing market began to crumble; nor did it when all manner of clever stuff started turning to dust in banks' (and some other, rather unexpected) hands. The world did change when Lehman Brothers was allowed to go bust and it changed again – another turn of the wrench – when preference shareholders in Freddie Mac and Fannie Mae were left blowing in the wind. It is understandable that in unprecedented times policymakers will make mistakes but these were blunders of epic proportions, leading amongst other things to the effective collapse of the UK retail banking system. It took a little while for the penny to drop and by the time it did – for most of us that is – asset prices were in freefall and liquidity had vanished.

Thus while the first 8 months of the year were something of a struggle, albeit well within tolerance after the long bull market, the last few months were simply terrible. With markets melting down the option of throwing in the towel was not really available; just as well since doing so is almost always a big mistake. Indeed major markets have already recovered more than half their post-Lehman falls and the Emerging Markets may too have made an impressive start on recovering lost ground. However, even ignoring the setbacks that are certainly still to come, life will not return to what we used to regard as 'normal'. The new realities are indeed different.

All the rhetoric suggests that throughout the developed world the key policy objective is the re-creation of the status quo ante but behind closed doors it is hard to believe that anyone really thinks this either achievable or desirable. In both the UK and US household savings ratios had been squeezed down to extraordinarily low levels, unsustainable once the music stopped. This isn't something new, constrained consumer demand was always part of the sluggish recovery story even before the financial world went mad. The real problem is managing the transition, a problem hugely magnified by the continued malfunctioning of the inter-bank markets. There are two aspects to the immediate crisis, the first lying within households' budgets and the second in the corporate sector.

Simplifying this a bit, if every household has inadequate savings it makes sense for every household to save more. But if every household actually does so, all at the same time, the resultant hit to final demand and then to incomes is so great that it is in fact impossible to save more, the so-called 'paradox of thrift'. Fleshing that out a bit, if the savings ratio were to return to the levels of the early 1990s – a reasonable benchmark – the net economic effect would be a 6% reduction in total GDP. From what they say, politicians seem to be trying to prevent any such adjustment; the reality, though, must be that they are trying to spin it out over a period of years rather than crunched in to just a few months. This may offend the purer principles of good housekeeping but under the circumstances it makes sense.

If a collapse in bank lending to individuals may be more a matter of lack of demand than of supply, the same is clearly not true for companies. It might seem odd that there is a problem here at all given that the corporate sector came into recession pretty soundly financed but that reckoned without a mass withdrawal of routine bank funding. Balance sheet efficiency means that most companies finance work in progress through borrowings which, of course, they roll over regularly. Until, once again, the music stops – which here in the UK it has. This is a tricky one; it's not a case of big bad greedy banks refusing to lend, the poor battered banks just haven't got the cash.

Before we moved from economic discomfort into serious crisis I had argued that the bulk of the recessionary pain would be felt by households – by consumers – since this was where financial stresses were greatest. The corporate sector, by contrast, was in rude balance sheet health and should have been able to weather some P & L account strain without undue difficulty. It hasn't worked out like that; 2008 was tougher than expected in terms of rising unit costs versus



weakening sales. With an overlay of stickier credit availability, companies drew down internal funds to maintain working capital and they responded rationally to the strain on cash resources by aggressively cutting expenditure elsewhere – including investment and employment.

That shock within what had looked the most resilient part of the economy is now the biggest threat to the UK outlook. If – a big and critical ‘if’ – bank lending for routine corporate financing resumes in fairly short order, then with input prices now falling away and costs under control sluggish final demand will still make a mess of P & L accounts but companies should generally survive. But if it doesn’t then recession really will get a grip, which no amount of Government money will correct.

It is hard to tell whether policymakers in the UK fully understand the twin dilemmas. Efforts to coax consumers into spending suggest awareness of the paradox of thrift but sit oddly alongside alarmist – if possibly true – rhetoric about the gloomy outlook. Listening to Ministers, my own policy response is to batten down the hatches as tightly as possible. I’m increasingly convinced, too, that throwing £12.5bn at a cut in VAT is money down the drain. But on the banking situation, while Government has done a good job in staving off a complete collapse and recapitalising individual institutions, the decline in broad money growth suggests either a lack of appreciation of the immediate risk to the corporate sector or maybe a dearth of ideas in response.

Reading between the lines of the Chancellor’s interview with the Financial Times this week I’m inclined to give some benefit of the doubt; the Treasury does seem to be trying to get its head around measures to bring liquidity back into routine funding and to re-stimulate broad money growth. But one of today’s least palatable new realities is that the risks are skewed the wrong way and the tails, as they say, are very fat (jargon for ‘if it does go wrong, then it goes horribly wrong’).

Assuming that – as they have done before – policymakers succeed in pulling the right rabbit out of the hat and that these immediate crises are headed off at the pass, how does that leave the more enduring new realities? In short life looks pretty dull.

Never mind the paradox of thrift, the fact is that the household sector does have to sort itself out; consumer discretionary demand is going to be weak for some years to come. Unemployment has further to rise and will be sticky at its higher levels. Disposable incomes are benefiting from lower energy prices but these effects will dissipate later in 2009 even if oil stays down at the \$50 level. House prices seem set for significant further falls as affordability overshoots to the downside, weakening domestic balance sheets even more. Companies, as we have seen, are unlikely to be the locomotives for renewed economic vigour. Which leaves us with Government, already promising to let the fiscal deficit explode and talking airily of hundreds of thousands of new jobs. Hmm.

On the plus side, there is a general – albeit not universal – acceptance that neo-Keynesian responses make sense right now, conditions being so extreme that conventional policy restraints have to be set aside. In the UK context, though, there are several worries. Most of those jobs are likely to be in the public sector, increasing the size of the client state and adding to the burdens on the productive economy. Creating non-jobs is the bureaucratic equivalent of paying people to dig holes and fill them in again. Our record on managing big public sector spends is poor and with everyone in a bit of a panic there are few grounds for thinking we’ll do any better this time. And unless we are going just to print money (which, actually, might not be too mad an idea short term) it all has to be borrowed from someone. With gilt yields as low as they are, flogging a cool £100bn or so of new paper may not look too daunting but I’m not sure I’d want to depend on it. Eventually, of course, it all has to be paid back.

Structurally, too, we have to pay the price for past decades’ excesses. Banking and financial regulation will tighten and probably go too far, the effort to curtail speculative and inventive



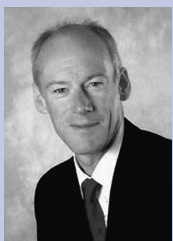
excess likely to crimp entrepreneurial vigour. The banking sector has to shrink and credit will remain tight. We're going to have Government getting under our feet in all manner of irritating ways. Drab.

The UK has its own self inflicted problems in all of this but the general picture is common across the developed world. In the US the initial imbalances were significantly worse but the policy responses have been – and continue to be – much more aggressive than our own. When your currency is the world's undisputed reserve currency you do have rather wider policy options and the US may indeed be the first economy to stop deteriorating. In Europe households were not over-borrowed and with a few exceptions there were no housing bubbles. Policy, though, has been slow to respond and recession is likely to be unnecessarily prolonged. Japan, of course, is still Japan and need not concern us. Happily the Emerging Economies – for which at the moment generally read Asia – stand out, not as totally immune to our travails but as beacons, nonetheless, of strong relative performance.

This was headed 'coping with new realities'; despite all the gloom investors can do better than just coping, there are plenty of opportunities out there for brave and cautious alike. Equity markets are universally cheap. Agreed, conventional valuation metrics feel meaningless just now but when all else fails look at tangible cash returns on investment. Even allowing (quite aggressively) for cuts in dividends in 2009 many stock markets offer yields significantly higher than local (sovereign) bonds. When equities are soaring people forget the powerful impact of compounding income; in today's conditions it's paramount.

Risk aversion has distorted value everywhere. Spreads on good quality Investment Grade corporate bonds have widened hugely and despite growing investor interest are still far too high. Got a specific returns target for your portfolio, 7%? 8%? – you can match it here. While emerging stock markets were collapsing last autumn so too were commodities. Many now trade well below their production costs and output is being mothballed. I should not need to remind you what happens when falling supply hits recovering demand (remember China's 4 trillion Yuan infrastructure spend). At some point this year commodities are going to fly. And if everyone secretly wants their currency to weaken then that old barbarous metal – Gold – must be worth a look.

And this is the point. The outlook is pretty dismal, come to think of it the last 4 pages haven't been exactly jolly, but that is no reason to throw in the towel. The flip side of all the pain that many investors (including me, honesty compels me to admit) have endured is that prices for risk assets are not just discounting dismal, they are discounting Armageddon. No one has a good word to say for risk assets these days; the conclusion is obvious.



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