

# Viewpoint

Regular research bulletin for private investors



## Worries...

Peter Bickley

I'm writing this with the FTSE 100 up a smidgeon over 100 points on the day, a cool 2%. The screen is a sea of blue and that squeeze I've written about before, the year-end pressure on those who have missed the bus to dress up their portfolios, is very evident. The markets are on a roll and who knows how much further they can run? At the moment it doesn't look as though they feel like turning tail. Recent Viewpoints have evolved; earlier in the year I was deploying the megaphone to try to get people to accept that economies – and stock markets – could and would turn for the better. Latterly I've changed the tune, arguing that we should continue to enjoy the ride but start to keep an eye on the exits. This edition takes another step in the unfamiliar direction of bearishness.

Looking around, there are plenty of reasons to worry but then there always have been. My gripe with the bearish camp to date was not with the facts so much as their interpretation; we all know about household debt, fiscal deficits, tightened lending standards and so on but none of that meant the economy had to keep on falling

out of the sky. Markets were grossly over sold and as soon as you put on a contrarian hat it was blindingly obvious they would rally and the bear market would be over. But it was not obvious that we would rally so far and so fast; that's been a very pleasant surprise. The consensus has travelled a long way from the slough of despond and it's now breathlessly bullish; not rampantly so but certainly making some pretty brave assumptions about what's next in the script. As so often, the consensus is probably the wrong company to be keeping.

I'll confine this analysis to home ground; things may be different elsewhere, probably rather better in the USA, perhaps rather worse in the Eurozone where naughty children are sent to bed with the threat of an ECB rate rise to frighten them to sleep. There is some good news. Households have knuckled down to repairing their finances and the savings ratio has leapt from near zero to 6%. As we know, the banks are not going bust any more and the money markets have returned to normality. Industry surveys have picked up and despite a set of



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Industrial Production numbers that would make a smack in the face with a wet kipper feel desirable it is clear that UK plc is doing a bit better.

Quantitative Easing is having some effects in holding down bond yields and generally freeing up the markets, though exact quantification will for ever remain elusive. Unemployment has risen but by less than I'd have expected; latest figures showed the rate of increase tailing off. 'Cash for clunkers' has stimulated activity in car showrooms, demonstrating that households who don't need to borrow can still be induced to part with large amounts of cash if the



propaganda is good enough. If this were a normal recession, all this would be consistent with the start of a sustainable recovery.

Sustainable recovery is just what some analysts are starting to pencil in. As the third quarter season for company results gets under way it looks as though we are in for a good experience, as a mix of cost cuts and slightly better sales sees margins widen out. Again this was predictable but that does not stop the more excitable commentators heralding it as a new dawn.

My predictions for the profile of recovery have evolved too. Once I had got to grips with the scale of the recession I argued that recovery – which certainly would come – would be fitful and slow. Then I did change my mind, thinking the initial bounce back could be more dramatic, albeit then still followed by an extended period of disappointingly slow growth. But my assumption that with the banks ‘fixed’ the normal flows of credit in the economy would resume now feels unsound.

Just because all the negatives are so familiar and were so grossly exaggerated last Spring it does not follow that they have gone away.

The recession emanated from private households, not from the corporate sector, and would inevitably be tough to turn round. Despite progress to date, households still have a long way to go; indeed the whole issue of global imbalances (between countries saving too much and spending too little and countries – like us – which have been doing the opposite) has barely started to be addressed. Quantitative Easing is working, slowly, but is no magic bullet. Government is running out of ammunition; the markets will not tolerate further expansion of the UK fiscal deficit. Companies have little incentive to invest.

Above all, banks are doing what comes naturally after such a trauma, shrinking their balance sheets. The money supply – outside the financial sector – is not growing. Net lending to non-financial companies is falling. Companies to whom banks would be happy to lend do not want to borrow; others struggle to fund their working capital requirement and will, in increasing numbers, go bust. The turn in the inventory cycle, the impact of fiscal stimulus and monetary easing and simple relief that we are all still here will turn the economy upwards but not, I now think, with the impetus

for which I had started to hope. And there is always afterwards; my view on what happens next has not changed, it will be a long depressing slog as the emergency oxygen supplies get turned off.

I don't want to over-egg all this, nor to cause undue anxiety or a wave of spoilt breakfasts. What's at issue here is life after recession, not how to cope with depression. But we need to be realistic about the outlook and not get carried away by a soaring stock market. And this problem with lending and the money supply, this is really bothering me now. A renewed leg downwards becomes more and more probable by the day.

The FTSE is up 50% from its lows yet it can thump in another 2% in a morning. This doesn't feel right. My caution may be premature; we can get more of this but it makes me uneasy. How you respond is really up to you. I tend to take the long view and just get myself mentally prepared to ride out some stock market turbulence. 2008 did, therefore, hurt. Nimble souls and those of a more nervous disposition might think about banking some of this year's gains. Whatever, keep your seatbelts fastened.

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