

The Oval *Slant* — July 2009

Time to take a bath Mervyn?

There is currently much talk about 'green shoots' and whether this is accurate or just the triumph of hope over reality. Inevitably, all of us and our clients are wondering what will happen to stockmarkets and the economy over the next 6-18 months. As the well known economic forecaster, J K Galbraith said "there are two types of economic forecaster – those who don't know and those who don't know they don't know"! With a regular diet of Robert Peston on the evening news and the doom and gloom in the daily newspapers, the recent stock market rally may not have done enough to persuade people that we are not all going to hell in a handcart!



2008 – World financial system nearly falls over

Both the UK and US financial regulatory bodies had stress tested many different models dealing with the failure of a major institution. However, no model seems to have been considered whereby the whole banking system implodes. The result was widespread panic and a single week in October 2008 saw World stockmarkets fall by 25%! We all remember Hank Paulson (the US Treasury Secretary) promoting the TARP (troubled assets recovery programme) as the way forward, but this was very much policy on the hoof and not much more than an initial 'back of a fag packet' calculation. It seems the important thing was to be seen to be doing something and the correct actions could be developed and refined later. The decision to let the iconic firm Lehman Brothers go belly up sent the desired signal that not all firms could be saved; but the law of unintended consequences meant hundreds of billions of dollars of counterparty risk was suddenly exposed. To his credit, Gordon Brown did take some swift and confidence building steps to do more than put a finger in the dyke and helped to create some stability in the UK.

Of course, the financial markets are driven by two emotions – fear and greed and the latter was very much in the ascendency. Traditional valuation bases were thrown out of the window as people didn't want to be left holding the parcel when the music stopped. Inevitably, the pendulum swung too far and many valuable and profitable companies were savagely marked down indiscriminately. (For example, Barclays share price plummeted along with the other banks but then tripled in just a few weeks). Since then some poise and confidence has returned to the markets and the rally between March and May 2009 was most welcome. But where do we go forward from here?

Sustainable green shoots – the good points

Signs are emerging that Government intervention is working. Early days for quantitative easing and the disparity between LIBOR and Base Rate has considerably reduced. Risk indicators such as credit spreads are easing and bank margins are growing. The global economy is still in recession but the rate of decline is reducing; as it is with commercial and residential property values. Many companies are still making decent profits and various surveys indicate greater optimism (such as the Purchasing Managers Index).

And the bad points

Massive issuance of gilts and attendant overhang of Government debt. Severe shortage of mortgage offers for all but the lowest risk. Large increase in unemployment and insolvencies (but these are both generally viewed as lagging indicators). Corporate credit lines removed or reduced and cost of borrowing markedly higher; despite close to zero base rates. Inflation worries. The huge millstone of consumer debt, both in Europe and the US.

Mervyn v Alistair

Perhaps Mervyn v Gordon is more accurate as the Chancellor often seems little more than a glove puppet, for the ex-chancellor seems convinced he occupies both No 10 and 11 Downing Street. There is clear tension between the Treasury and the Bank of England with Mervyn King obviously not feeling he is being 'kept in the loop' and also expressing concern over the huge gilt issuance and the cost of servicing this. However, this time bomb is going to have to be dealt with by the next government; which is unlikely to have the 'red flag' as its anthem. Nevertheless, the cost of managing and eventually repaying such debt will impede the UK recovery; as confirmed by both the European and World banks – there is even some talk of a possible downgrading of our Sovereign debt which would be bad news indeed and raise the already horrendous servicing costs. There is no doubt Alistair and Gordon are between a rock and a hard place, but a more united front with both the Bank of England and industry leaders would be helpful.

It's a recovery Scotty, but not as we know it

The general consensus would seem to be that the good points outweigh the bad and that the market lows of October 2008 are unlikely to be revisited. Most economists have indicated (or perhaps wish for?) a typical 'V' shaped recovery and that the recent market rally was indicative of this. Others (perhaps more pragmatic?) suggest a 'W' shaped recovery and that we are already experiencing the second down leg before the recovery proper can begin. A third opinion is gaining traction – that of the 'bath' shaped recovery. This reflects the view that, even if the recovery is underway, it may well be long, slow, erratic and uneven. There may well be a number of rallies followed by troughs; but if the latter are not as much as the former then it is the all important trend we should be concentrating on. The battle between good and evil, referenced by some of the points mentioned above, is likely to continue for some time and so the fairytale ending of us all living happily ever after has been deferred; at least for the time being.

Where do we go from here?



This is not to say good times will not be here again – they will be; we just don't know where, when and how long. As Mark Twain said "history doesn't repeat itself but it does have a habit of rhyming". All previous recessions have eventually come to an end and it is easy to overlook the fact that many companies are still making decent profits and severe cost cutting and reorganisation strategies mean the survivors are leaner and fitter to profit more as the recession ends. Put simply, perhaps the light at the end of the tunnel is no longer a train coming in the other direction; as looked the case at the end of 2008!

As they say in the City, "the only things that pick bottoms are monkeys" and hence we shouldn't try and time the markets. A better option is (for existing money) to remain invested and (for new money) to gradually phase investment over a 3-12 month period. If it is a bath shaped recovery we are already bumbling along the bottom and even with 'V's or 'W's the worst is likely to be behind us. So, a sensible investment strategy is more important than ever; as well as ensuring that existing portfolios correctly reflect client risk profiles. With such uncertainty and volatility, expert investment knowledge and research is more important than ever. What good news that we now have the skills and extensive resources of 4 quality discretionary managers to call upon to look after our clients' investments and allow us to concentrate on the financial planning strategy and advice.

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