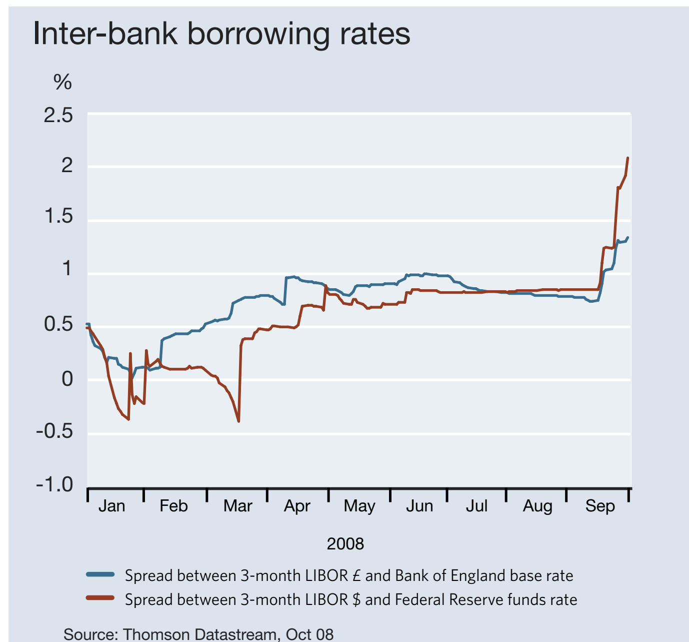
Investment comment
October 2008

Economic and market background
Not since the 1930s has the world's financial landscape changed as dramatically or as rapidly as it did during the third quarter of 2008. The crisis in global credit markets, which began just over a year ago, developed rapidly in September from a crisis of liquidity into one of solvency, causing panic in financial markets (which aggravated in turn the forced deleveraging of financial companies) and engulfing some of the largest financial institutions in the world. In a less challenging setting, the precipitous decline of commodity prices (and, notwithstanding Russia's belligerence towards Georgia, a lower oil price in particular) might have been succour to investors, but events in the financial arena eclipsed all else.

As financial sector strains mounted, equity markets slumped and credit 'spreads' widened. Inter-bank borrowing rates rose sharply (with the overnight dollar rate in London briefly touching 10%) amid intense shortage of credit, and a clutch of money market funds fell below their 'par' value or began to wind themselves up. In the course of a global 'flight to safety', government bond yields fell steeply (with the yield on the three-month US Treasury bill falling to 0.02%, its lowest level since the early 1940s) and the price of gold rose strongly.



Source: Thomson Datastream, Oct 08

Source: Bloomberg, Oct 08

Amid almost unprecedented alarm in credit markets, the destinies of some of the behemoths of the financial world appeared to be determined in September in a manner not dissimilar to a fireside game of *Monopoly*. In a ten-day period alone, Fannie Mae and Freddie Mac, the two vast US mortgage entities which provide or underwrite half of the US mortgage market, were placed in conservatorship (nationalised), Lehman Brothers, the fourth largest investment bank in the US, filed for bankruptcy and the US government became the majority shareholder in AIG, the world's largest insurance company, at a cost of $85 billion.

As the predicaments of major financial institutions worsened quickly, hasty acquisitions of once-illustrious institutions formed part of an astonishingly swift redrawing of the financial sector map. Among a raft of banking acquisitions, Merrill Lynch was bought by Bank of America (whose chief executive was depicted almost as having uttered '*eeny, meeny, miny, moe*' before eschewing a similar opportunity to acquire Lehmans). Elsewhere, JP Morgan acquired Washington Mutual, Wells Fargo agreed to buy Wachovia, and the UK government encouraged Lloyds TSB to buy HBOS, the UK's largest mortgage lender. Goldman Sachs and Morgan Stanley remained independent, but their change of

status to 'bank holding' companies divested Wall Street of its last remaining stand-alone investment banks.

Policymakers have intervened to try to ease the sense of crisis, although not yet with the interest rate cuts which seem (in Europe at least) to be inevitable. However, there has been real fear in markets that policy responses will prove inadequate in restoring order to the financial sector and in averting a protracted recession in the developed world's economies. Much hope now rests on the ability of the US government to use its salvaged $700-billion rescue plan to cleanse banks' balance sheets of the 'toxic' debt that is hampering 'normal' lending practices and to restore order to credit markets.

In addition, the Federal Reserve has orchestrated an enormous injection of dollar liquidity via other leading central banks to try to ease credit conditions. In Europe, governments have stepped in to support a number of ailing banks (Bradford & Bingley, Fortis and Dexia being among them). In many regions, authorities have instituted temporary bans on the 'short-selling' of financial stocks, an activity that was deemed to have exacerbated the woes of financial companies.

Aversion to risk and the appeal of 'safe-haven' assets afforded healthy gains to **government bond** investors, whose earlier fears about rising inflation were trumped by growing concerns about the outlook for global financial markets and economies. The FTA Government All Stocks Index (of gilts) returned +4.7% over the third quarter (to reverse losses earlier in the year and to record a nine-month return of +2.3%) and the JPM Global Government Bond Index (ex UK) delivered a currency-enhanced quarterly return of +9.1% to the sterling investor (+14.8% over nine months). However, with corporate spreads (the additional yield premia over government equivalents) continuing to widen amid worsening credit conditions, **corporate bond** prices retreated and there were precipitate falls in bank debt.

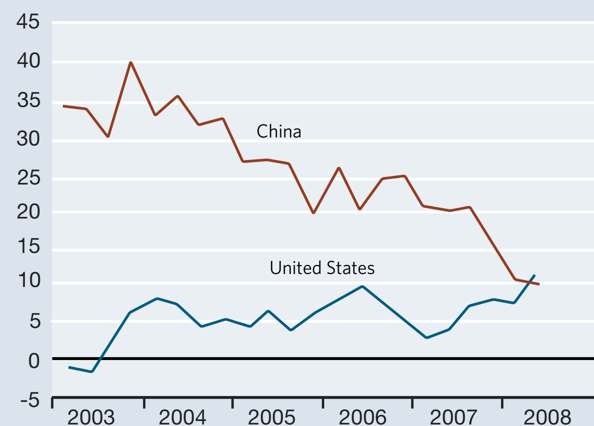
Equity markets were weak universally during the third quarter but, in keeping with the effects of a hurricane, they were disturbed more on the periphery than in the eye of the storm itself. Thus, while North America, where financial-sector concerns have been greatest, actually recorded a (dollar-flattered) gain of 1.4% in sterling total return terms (-9.3% over nine months), emerging markets slumped collectively to a loss of 18.3% (-27.8% over the nine-month period). Elsewhere, the UK returned -12.2% (for a nine-month return of -22.0%) and, to the sterling investor, Europe (ex UK) returned -11.2% (-22.1% over nine months), Japan returned -7.8% (-12.4%), and the Asia-Pacific region (ex Japan) returned -16.3% (-27.2%).

The **US economy** grew respectably in the second quarter of the year, owing to record export volumes (which have been growing faster than China's) and rising government spending. However, with the dollar having strengthened and overseas trading partners' economies having weakened, the US economy has appeared more recently to succumb to the effects of its burgeoning domestic troubles (not least malfunctioning financial markets and a continuing housing slump). The respective fortunes of the world's oldest and second-oldest professions appear to capture plainly the extent to which those difficulties

US dollar
Trade-weighted index

Source: Thomson Datastream, Oct '08

US exports
% change on previous year



Source: Thomson Datastream, Oct '08

are already taking their toll on economic activity. While revenues at houses of ill-repute are reported by the Nevada Brothel Owners' Association to have fallen by between 20% and 45% since the start of the credit crunch last year, America's pawnbroking industry is said to be doing well.

Events in the financial sector and in housing are the greatest sources of concern. House prices have continued to decline, with Las Vegas experiencing the sharpest falls (-30% in the year to July) and with one house in Detroit selling reportedly for $1. Moves by the government to place Fannie Mae and Freddie Mac in 'conservatorship' and to establish a banking recovery fund are not quite a case of 'Las Vegas or bust', but they will amount to significant drains on the public purse. The government hopes,

via its largesse, both to restore confidence in the mortgage market by placing a floor under falling asset prices and to shore up overseas investors' faith in US assets.

The dollar strengthened markedly during the third quarter, not least because of the greater concerns about economies outside the US than about the US itself. However, near-term currency strength belies the greater precariousness of public sector finances and America's growing 'funding gap' is likely over the longer term to deter foreign holders of US assets and to be negative therefore for the US dollar.

With enormous uncertainty surrounding the outlook for both economic growth and inflation, the Federal Reserve has kept faith that a slowing economy will reduce price pressures and vindicate the preservation of interest rates at 2%. Following commodity-price falls, and given the muted nature of growth, central bankers may feel less vexed about keeping policy 'loose'. Inflation pressures appear likely to ease but, with consumer price inflation (at 5.4%) still at its highest level since the early 1990s, the Federal Reserve may be wary of the threat that governmental policy will cause inflation to rise.

In the **UK**, policymakers (apart from the prime minister, whose 'economic re-launch' offensive has been blunted by all around him) appear to have been engaged in a doom-mongering contest. The governor of the Bank of England warned in August of the UK economy's 'painful adjustment' to the combination of the credit crisis and higher energy and food prices; Chancellor Darling opined that the country was facing its worst economic times for 60 years; and the OECD forecast (erroneously it would seem) that the UK economy would be the only economy of the major seven economies in the world to enter recession this year.

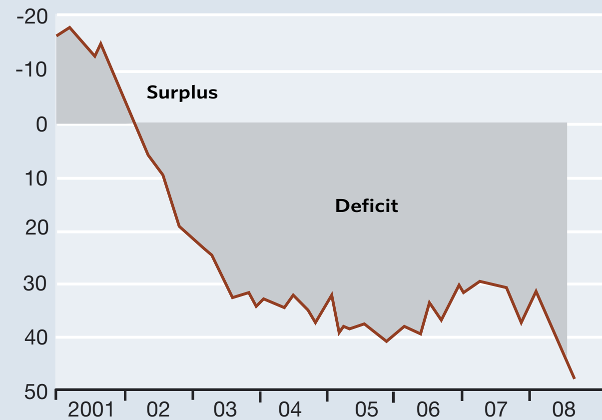
The outlook for the UK economy has indeed worsened and interest-rate cuts may be closer than previously anticipated. Flat 'growth' in the second quarter of the year brought to an end 63 successive quarters of expansion and, during the third quarter, economic activity appears unequivocally to have weakened. The housing market has continued to deteriorate (with net mortgage lending in August down by 98% from a year earlier and house prices falling faster than during the housing 'crash' of 1990), consumer confidence has fallen to its lowest level since the early 1970s, industrial output has been diminishing (despite the recent weakness of the pound) and inflation has risen towards 5%. If a bleak winter lies ahead, it may be compounded by the fact that the cost of a hot bath is estimated to have risen to 96 pence (from 41 pence four years ago).

The sterling performance of British athletes at the Beijing Olympics was not matched by the UK's currency. As 'Team GB' enjoyed its largest haul of gold medals since the year the Titanic sank, the chancellor pondered which parts of the family silver he might sell to plug the widening hole in the public finances. With news that public borrowing over the next three years may be £65 billion higher than the chancellor had advised in March, and with Treasury officials apparently hatching plans to change previously cherished rules on government spending and debt, sterling fell to its lowest trade-weighted level since the mid 1990s. Government ministers appear increasingly to resemble loose cannons as they seek ways to prolong their continuing recklessness.

The **European economy** has been running out of steam in recent months. It shrank in the second quarter for the first time since the launch of the single currency in 1999 and surveys have pointed firmly to continued weakness during the third quarter. With exports weakening, it is conspicuous that domestic demand, sapped by rising food and fuel prices and by higher interest rates and tighter lending standards, has failed to take up the slack. Sharp falls in retail sales, in business confidence and in industrial production suggest that Europe is not immune to the effects of the US-centric credit crisis; and European financial institutions remain precariously exposed to the US housing

UK public sector net borrowing

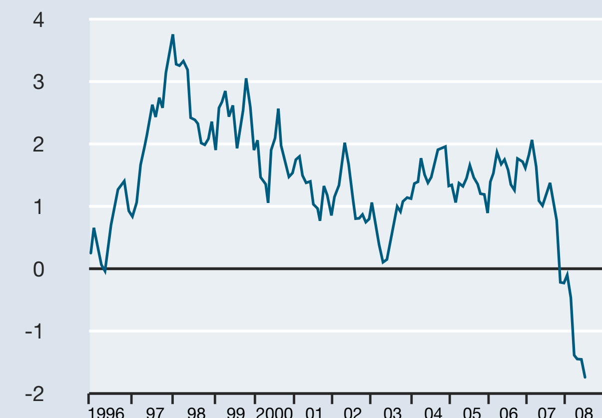
Sum over previous 12 months (£bn)



Source: Thomson Datastream, Oct '08

Eurozone retail sales volumes

% change on previous year



Source: Thomson Datastream, Oct '08

market (not least because the Continent's politicians do not appear, as yet, to share their American counterparts' appetite for a publicly funded sanitisation of banks' balance sheets).

Rising inflation has elicited a range of responses across Europe; Spain has decided to halve the number of traffic lights it operates and Nestle has chosen to cut costs by removing the ('last') Rolo from each packet of the renowned confectionery. Most significantly, however, the European Central Bank responded to the rise of consumer price inflation to 3.6% (down from a peak of 4.1%) by raising interest rates to 4.25% and rebuffing calls throughout the summer to lower them. The ECB has softened its rhetoric a little recently in recognising a 'materialisation' of risks to growth, but it appears to want to see clear evidence of falling prices (and of wage restraint in particular) before cutting rates. Inflation seems likely to fall, but the demand from IG Metall (Germany's largest trade union and traditionally the bellwether of European wage-setting) for a 7-8% pay rise for its members will do little to placate Europe's central bankers.

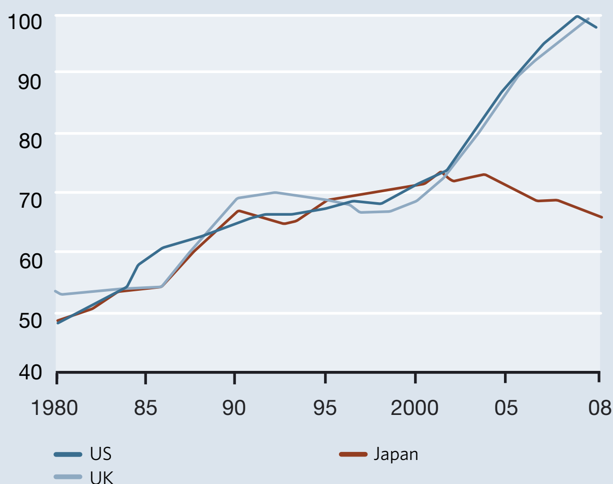
In **Japan**, the economy was reported to have contracted between April and June; and, given signs of continuing weakness in the third quarter, the theory that Japan would continue to prosper while the rest of the developed world slowed appears to have been disproven. The country has suffered little from the direct effects of the global credit crisis but, with export growth and the capital expenditure it spawns being critical to economic wellbeing in recent years, Japan has remained vulnerable to deceleration beyond its shores. It experienced a rare trade deficit in August as growing shipments to emerging markets such as Russia and the Middle East failed to counteract the impacts both of deterioration in the US and Europe and of rising input costs.

Japan's downturn should, however, be tempered by its relative frugality in recent years. Japanese households' debt is much more modest than that of their counterparts in the US and the UK, the country's housing market did not 're-inflate' following the collapse in house prices during the 1990s, and Japanese financial institutions' losses on securities linked to US sub-prime mortgages amount so far to just 3% of the global total. Following 20 years of 'deleveraging', Japan's consumers and corporations are relatively sheltered from the fallout of the credit crisis.

It may be fortuitous that Japan has less immediate policy challenges to tackle than other major economies, given the political uncertainty that seems perpetually to plague it. After less than a year in office, Yasuo Fukuda resigned in September and has been replaced by former foreign minister Taro Aso (Japan's third prime minister in as many years).

Elsewhere in the **Asia-Pacific region**, the rate of economic activity has generally slowed, owing chiefly to weaker export markets and prompting policymakers to switch attention from rising inflation to slowing growth. In China, in particular, the authorities have appeared keen to prevent a post-Olympics hangover and the central bank cut its benchmark interest rate in September for the first time in six years to support the domestic economy.

Across Asia, consumer price inflation has been falling, with strong competition in the manufacturing sector seeming to prevent the diffusion of fast-rising producer costs to 'downstream' prices. Having opted over the last year for measures to control inflation (such as raising reserve requirements, subsidising prices and deploying substantial foreign-exchange reserves to bring about local currency appreciation), Asian policymakers appear now to have greater latitude in promoting economic growth. Lower oil prices should prove a particular (short-lived?) boon given Asia's heavy reliance upon imported fuel.



Source: Goldman Sachs, Oct '08

Source: Thomson Datastream, Oct '08

US 30-year Treasury yield

Source: Bloomberg, Oct 08

Bond spreads

Source: Thomson Datastream, Oct '08

As Asian authorities contend with the impact of slowing economic growth, their decisions may have important (and adverse) implications for the rest of the world. Coupled to the recent breakdown of the Doha round of global trade talks, changes in Asian competition law hint that the region's commitment to free trade may be weakening. New legislation in India, for example, means that a merger filing in the country will trigger a waiting period of up to 210 days (compared with a typical period of 30-60 days in Europe and the US). It is desirable that Asia foster growth in its domestic economies, but not that it do so at the cost of its economic relations with the rest of the world.

Investment implications

Investors in **government bond markets** endured wild swings in fixed-interest prices during the third quarter as they grappled with conflicting concerns about the global financial crisis and inflation, and about how central banks would respond to those twin threats. In contrast with earlier in the summer, when inflation concerns were predominant, sovereign bonds performed well during the third quarter owing to widespread risk aversion elsewhere. The US 30-year treasury yield dipped in September below 4% to its lowest ever (intra-day) level and, amid concern about the safety of bank deposits, the yield on Treasury bills fell close to zero.

Developed-world government bonds should continue to find favour in the course of economic slowdown around the world, but investing in them appears to resemble a game of 'dare'. In the near term, interest rates should remain stable or fall and slowing global demand should serve to alleviate inflation concerns. However, the rapid increase in government liabilities associated with nationalisation of parts of the financial sector may presage higher yields in the years ahead (and weaker currencies) on both sides of the Atlantic. In the US, in particular, the ballooning of the budget deficit may be forbidding to overseas investors, whose support hitherto has been so critical to the underwriting of low government bond yields.

Corporate bond spreads continued to widen during the summer, exceeding levels seen both at the height of the US 'savings and loans' crisis in 1990 and in the aftermath of Enron's demise in 2001. With Lehman Brothers' default ranking as the largest ever corporate debt failure (being more than five times the size of WorldCom's default, the previous biggest), counterparties have grown increasingly paranoid about conducting business with one another. The deleveraging of the global financial system has accelerated, and the prospect that economic growth will be hampered by dysfunctional credit markets has grown, affecting not simply financial-sector debt, but the credit of companies more widely. Investment-grade bonds look inexpensive and markets appear to account generously for the likelihood of mounting default rates. However, in such a challenging environment, investors should be judicious about the companies whose debt they finance because the bond prices of economically sensitive businesses may weaken further.

Despite the significant challenges facing the US economy and its financial sector, the **North American equity market** delivered the least weak return of the major regions in the third quarter (-8.8%); and, to the sterling investor, dollar strength converted that return into a remarkable gain (in the circumstances) of 1.4%. Volatility was pronounced, however, with Wall Street indices experiencing their worst ever points fall on 29 September and enormous swings in share prices accompanying great uncertainty about the outcome of negotiations in Washington to steady credit markets.

The outlook for the financial sector is extremely uncertain and it remains appropriate to take a highly cautious approach to investment in banks. The agreement in Congress of a $700 billion rescue plan should stabilise markets by assuaging fears of a systemic collapse, but the plan is economically focused and

Source: Bloomberg, Sep '08

should not be seen as a green light to shareholders to buy bank shares. Where equity in banks survives the ravages of government intervention, its value will be susceptible to the diminished revenue and profits that seem certain to characterise the financial sector in the aftermath of the credit crisis.

In the wider market, significant concerns about the financial and economic outlook seem at odds with consensus forecasts of strong US corporate earnings growth in 2009, but investors should take some comfort that the 'bear' market in equities is well-established, with North American equity prices standing almost a fifth lower (in dollar terms) now than at the start of the year. Moreover, relationships between economic activity, corporate earnings and share prices are far from linear, with stock markets serving to discount future prospects rather than to reflect them as they occur. In 1991, for example, when the US economy was coming out of recession and earnings fell by 25%, equities rallied nonetheless by 27% over the course of the year.

Volatility in the **UK stock market** in recent weeks has been extreme, and in the banking sector in particular investors have struggled to attribute a value to future earnings streams. Shares in HBOS fell by 50% on concerns about the bank's solvency, before they doubled as news of an approach from Lloyds TSB emerged. All of this occurred in just the first 90 minutes of trading on 17 September.

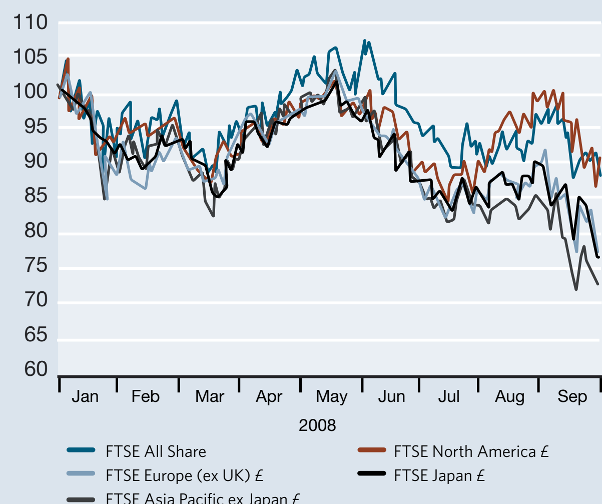
The pressures faced by the UK's financial sector and continuing falls in house prices represent considerable headwinds to financial markets, but share prices have fallen in acknowledgement of those difficulties. The collective price-to-earnings ratio of UK equities has halved since 2001 and the dividend yield has doubled over that period. Even taking into account the inevitable dividend cuts by banks (which paid 30% of total market dividends last year), the prospective yield available on shares is roughly equivalent to the yield on UK gilts, historically an indication of future share-price gains.

Amid the deleveraging in financial markets, the support of the 'private equity bid' has diminished significantly this year. However, listed companies appear to have come out from the shadows, with 68 companies a month during 2008 going 'under offer' (as defined by the Takeover Panel), compared with an average of 58 in 2006 and 2007. The strength of inter-company merger and acquisition activity to date, which has been boosted in part by the fillip of a weaker pound to overseas buyers, implies a greater degree of support for UK equities than might have been supposed.

Equity markets were weaker in **Europe** than in the US during the summer. Whereas European market capitalisation (including Russia and Turkey) exceeded that of the US stock market by more than a trillion dollars in May, recent upheavals have led to the US regaining its status as the larger of the two equity regions.

European indices have been shackled by their large weightings in financial companies and industrials and they have been dogged by both the slowing of the eurozone economy and the ECB's steadfastness on interest rates. The outlook for Europe's companies is undoubtedly challenging, given that corporate indebtedness is actually higher on the Continent than in the US and given that the region's banks have written down assets almost to the same degree as their US counterparts. In the absence of a federal government intent on implementing a banking rescue plan, Europe's credit-related difficulties may actually be harder to resolve than those of the US.

Financial sector cleansing will not take place quickly and the weakness of economic activity in Europe illustrates that the contagion of the credit crisis is already being felt in the 'real' economy. Nonetheless, in every industrial sector in Europe there are companies that resisted in recent years the trend to imbue balance sheets with debt and that have opportunities now to acquire distressed rivals, to build market share and to invest in order to increase their earnings. With valuations becoming



Source: Thomson Datastream, Oct 08

increasingly attractive and dividend yields exceeding those available on government bonds, a discerning approach to European equity investment should be profitable.

In **Japan**, a rising yen has continued to protect overseas investors from some of the tribulations associated with holding Japanese shares. The -7.8% return ‘enjoyed’ by the sterling investor was almost 10% better than that which was suffered by local shareholders.

Japan’s companies have shed much of their excess debt, labour and capacity in recent years, but their parsimony continues to be unrewarded by stock-market performance. However, the relative health of ‘Japan Inc’ appears to be borne out by the increasing covetousness of Japanese businesses. With cash apparently comprising 11% of their balance sheets, Japan’s companies have almost doubled their outlay on overseas companies since 2007. Most striking have been purchases by leading financial companies of stakes in (or assets of) their crisis-hit US peers (for example, Mitsubishi UFJ taking a stake in Morgan Stanley, Nomura buying some of Lehman’s assets and Sumitomo Mitsui planning an investment in Goldman Sachs).

Sentiment among domestic investors remains poor and it is doubtful whether the government’s appeal to its citizens to take more risk will improve matters significantly. However, Japanese investors have been repatriating capital from abroad, suggesting that being awash with cash and facing rising inflation, they may finally accede to participation in their own stock market. With valuations undemanding, balance sheets strong and corporate share buy-backs and dividend payments escalating, selective investment in Japanese equities may have merits.

The stock markets of the **Asia-Pacific region** fell extensively during the third quarter, and in China they did so deeply. Shanghai’s main stock market lost about two thirds of its value, illustrating pointedly that China’s one-party state (whose ‘Weather Modification Department’ was charged with warding off rain at the Beijing Olympics) is powerless to control the Republic’s share prices.

It might have been hoped that Asian stock market investors, who had been perturbed by rises in commodity prices earlier in the year, would benefit from the precipitous declines in raw material prices occurring over the summer, but Asian equity markets took their cue from other factors. In particular, the deleveraging of the global financial system has been detrimental to Asian markets, with the effects of capital flows proving more important than fundamental economic conditions or the virtues of companies.

Asian companies face challenges, with their terms of trade having worsened (notwithstanding recent falls in commodity prices) and the economies of their trading partners having slowed. However, the region’s financial sector has been relatively unscathed by the global credit crisis and corporate balance sheets are generally strong. Most of Asia’s growth derives now from domestic demand (with trade contributing just 2.6% of China’s 11.9% growth over the last year); and slowing commodity prices should allow authorities to adopt ‘easier’ monetary policies that enhance the prospects for corporate earnings growth.

Conclusion

Changes in the global financial landscape have occurred with extraordinary speed in recent weeks, but it would be folly to think that the challenges to which those changes testify will be resolved as quickly. The erosion of confidence in the financial sector has had, and will continue to have, profound implications in a number of areas for the foreseeable future. With governments and central banks broadly united in finding solutions to the financial crisis, confidence should be restored and credit conditions should stabilise, but heightened volatility will persist in markets in the meantime and it is important to recognise that the ‘new order’, whenever it is established, will be substantially different from the old order.

As the deleveraging process continues, in developed economies at least, a protracted period of ‘sub-trend’ economic growth seems unavoidable. With less plentiful and more costly credit, there will be strains on capital spending, on consumption and on asset prices. How great a force these trends exert on the world economy will depend in part on how resilient the less indebted (mostly developing) areas of the world prove to be in the face of the ‘mature’ economies’ travails, particularly in bringing about growth in domestic activity amid less favourable trading conditions.

The actions of authorities to surmount challenges should be supportive of economies and financial markets. Although the flooding of the world with liquidity might typically risk stoking inflation, it seems unlikely that ‘looser’ policy will impinge seriously on the tangible supply of money in economies given the necessity for banks in the months (perhaps years) ahead to seek and preserve capital rather than unleash it on their customers. Policymakers should be liberated, therefore, to take ameliorative action.

If the economic landscape appears uninviting, investors should take comfort from the fact that financial markets have moved swiftly to reflect many of the challenges that lie ahead. With markets having fallen sharply over the last year, investors should be rewarded more highly now for the risks that they take. Those risks are plentiful, but so too are prospects for lucrative, long-term investment in high-quality businesses. Opportunities are most profuse when sentiment is at its weakest.

“Prosperity is not without many fears and distastes;
And adversity is not without comforts and hopes”
Francis Bacon, Essays (1625) ‘Of Adversity’

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