

A view from the USA



By Trevor Robinson
Associate AEIA

Over the last few months, my colleagues at AllenbridgeEPIC have tolerated benignly my pontificating about the equity and bond markets. To me, and as I have spent the last few weeks in the USA, this seems an appropriate time to review the last twelve months and to look forward for the next twelve.

Overall, my view is that in the USA, we are about half way through the "financial" stage of the crisis, but that we are still only at the beginning of the "economic" stage of the crisis.

On the **financial** side, I believe that we have now seen the worst of the "sub-prime" crisis and its effect on financial institutions and their balance sheets, but we have not yet seen the worst from the "Alt-A" mortgages, where most of the "liar's loans" are held, nor have we seen the worst from the "Option ARM" mortgage sector (interest rates will reset to higher levels from low "teaser" rates later in 2009), nor have we seen the worst from mortgages in the supposedly "prime" sector, nor from the Commercial Real Estate (CRE) sector. I fully expect the problems in the CRE sector to bring about the collapse of hundreds of regional banks in the USA in the next 18 months. In addition, I expect massive defaults on car loans and credit card loans – and any securities created on the back of them.

On the **economic** side, unemployment, for example, will grow dramatically over the next twelve months, GNP will shrink and corporate profits will be decimated. The UK has similar problems, yet starts 2009 in a slightly worse economic position than the USA, certainly in terms of debt per

capita, debt to GNP and economic dependence on "The City".

My analysis still starts from the principle that the US & UK consumer is dead. He is massively over-borrowed – a feeling that he liked when his house price was going up and when he felt that his job was secure, but neither of which is now occurring.

Now he feels that the best use of his cash is to pay off his credit card bills and stop paying 15-30% interest on those bills. He does not want to spend – full stop!

The cutback in his spending has obvious knock-on effects on corporate profits, corporations having themselves over-borrowed, over-leveraged their balance sheets, often at the behest of the investment bankers who are now truly shown to have feet of clay.

Into this morass step the world's governments to try to resolve the crisis. Unfortunately, the mistakes made by Japan in the Nineties do not appear to have been learnt by these governments. Put simply, the best way to resolve this crisis is to permit a "market-clearing" price for all assets to be established as rapidly as possible, to allow companies to go bankrupt in that process, then to move forward into the next economic upturn, albeit with a greater caution. Until that market clearing process takes place, the crisis is merely being prolonged, rather than resolved. Of course, to politicians with their focus on four or five year terms in office, this may be quite sufficient. However, personally, I do not think it is a sensible way to run modern economies.

In my opinion, the next twelve months will show us just how impotent the worlds' governments are in resolving this crisis.

It does not matter whether the government uses fiscal stimulus - tax cuts - to put more money into the consumer's take home pay, nor whether it uses monetary stimulus - reducing interest rates.

The consumer no longer wants to spend and he certainly does not want to borrow to spend. There has been a complete U-turn in mindset. He has moved from "risk taking" to "risk aversion" almost overnight. We can argue as much as we like about whether the various measures of "money supply" are expanding or contracting and whether this will lead to deflation or inflation. The vital fact is that there is no "money demand" from the consumer; there is no money demand from the corporation which sees the collapse in consumer spending. There is no real desire on the behalf of banks to lend money as they wish to rebuild their own balance sheets and can do so, albeit glacially slowly, with a positively sloping yield curve. Moreover, they have sufficient bad loans on their balance sheets already, while their confidence in their own ability to make new, better loans in the current economic environment is shot to pieces.

What happened to the idea that by creating instruments that could spread the risk around the investment and banking communities, each individual investor could take a small hit and therefore protect the wider system? This was great in theory, but the egregious use of leverage by investment banks (over forty to one, compared to a pre-2004 limit of fourteen to one), their hiding investments off-balance sheet, their deliberate and manipulative deception of regulators and investors, has made the problem much worse than was foreseen when the original "risk spreading" theory was presented.

Recently, bonds have gone up in price, not because investors fear deflation; bonds have gone up in price because there is a flight to quality. No investor wishes to own shares, so he sells; he does not wish to deposit his cash in the bank, as he does not trust the banks to survive (indeed if the banks do not trust each other, as evidenced by the lack of inter-bank lending, why should any depositor trust them?); so the result

is that the money goes to the safe haven of the government and its bonds and bills. Hence the zero interest rate available on US Treasury Bills at the moment. Savers are more focused on the return **OF** their capital rather than a return **ON** their capital.

What does history have to tell us about such previous crises?

I generalise wildly, but the sequence is something like this:

- Equity markets fall as investors fear the future economic outlook
- Investors put their cash in deposits or government securities ("flight to safety")
- The economy turns down
- Governments reduce interest rates to try to restore the economy, maybe adding some Keynesian stimulus
- Bonds increase in price as interest rates fall along the yield curve...
- ...but only up to the point where bond investors start to believe (a) more than (b), where (a) is that the government will issue more bonds and bills and that these cannot be sold at current prices; and (b) is that there is safety in government paper.

This last point is the next stage in the bond market that we are yet to see. Please note that this is not an argument for believing that we are entering an inflationary, or indeed hyper inflationary period, it is simply discussing cash flows based upon fear and greed.

- The stock market forecasts an economic recovery and itself starts to recover.
- The economy recovers, but the government is stuck with paying higher coupons on its debt for the future; taxes may have to rise.

The problem, of course, is how long it takes for the last two bullet points to take effect.

It is my opinion that this will take a long time in this economic cycle because we have not seen any attempt at finding "market clearing" prices for assets. The rules which would, if implemented, lead to a rapid clearing of the asset markets are simple and are as follows:

Cont'd on Page 2

- Complete transparency with regard to risk and leverage/gearing in all financial contracts and financial instruments
- The marking to market of all financial instruments and assets at the close of the trading day
- The banning of all "off balance sheet" accounting
- The banning of all "mark-to-model" accounting
- The banning of all "offshore" accounts for all financial institutions
- The strict enforcement of existing regulations across all financial assets and all financial institutions
- The banning from the financial services industry of the individuals and firms that created these problems (potentially including jail sentences)

Any alternative strategy will continue the pain for longer. How do you remove a "Band-Aid" - slowly, dealing with the pain as best you can, or swiftly, creating a short sharp shock which may be much more painful but is over with quickly?

For too long we have paid "lip-service" to transparency, mark-to-

market and the strict enforcement of regulations of all banks, broker-dealers and other financial institutions. In practice, we have not implemented any of them in sufficient detail and with sufficient thoroughness. Time to do so!

At some point taxpayers will start to ask themselves:

- Why are the many being asked to benefit the (rather rich) few?
- Why does the US Government, for example, wish to bail out imprudent bankers, imprudent car loan providers, imprudent credit card providers, imprudent borrowers of all of the above, rather than let them take the pain that is an intrinsic part of the classical capitalist free market system?
- Why should the prudent individual who deliberately avoided the "buy-to-let" insanity, who avoided taking out a mortgage at six times his salary, who kept his credit card balance in check, who did not use his house as an ATM machine, why should he pay through his present and future taxes for those who were imprudent?
- Why should the prudent saver now

be punished by artificially low interest rates?

Greenspan and Brown were supposed to have presided over "years of plenty", produced by their top quality economic management. Taxpayers/voters will come to see that this was merely a debt-fuelled mirage.

Some final thoughts:

Inflation or deflation? I remain firmly in the deflation camp. If the consumer is dead, retail prices will have to fall to try to entice him back into the market. He will quickly learn - indeed may already have done so - that by delaying his purchase, he will get a better price tomorrow, next week, next month. This is a classic deflationary spiral. This forecast does not require decreasing energy prices, nor decreasing commodity prices, it is simply based upon the delaying actions of the consumer and the natural economic response of the manufacturer/retailer. Moreover with unemployment increasing, I cannot see wage demands increasing, which has in the past led to a classic wage/price inflationary spiral.

The impact on equity markets?

A long slow painful decline as "the

worst is over" yields to yet another piece of bad news.

The impact on housing markets? ...as above!

My two biggest worries for 2009?

- 1) Protectionism.** In the name of "protecting American jobs" I fear that President Obama will restrict competition within the US economy, favouring "national champions". This is a system that has been tried and seen to fail on many occasions. I fear that it will be tried again and will fail again. One of the biggest side-effects is that it will seriously annoy the Chinese.
- 2) The abolition of the mark-to-market requirement.** There is already massive distrust between financial institutions based upon the fact that they have hidden certain assets and liabilities off their balance sheets. Allowing "mark-to-myth" will only increase that distrust. Why would any investor buy shares or bonds in - or lend money to - a company or financial institution that deliberately mis-values its assets and/or liabilities?

Implementing either of these strategies will prolong the crisis, deepen the recession and lengthen the time to recovery. **February 2009**

A > AFFORDABLE CONSULTANCY

At AllenbridgeEPIC we charge set fees. Everything is clearly costed before you commit to our consultancy. You can buy as much or as little as you require. But you can be very sure you are unlikely to receive such excellent value for money from any other adviser.

E > EXPERT OPINION

At AllenbridgeEPIC you will find the widest range of expertise on tap and advisers who have worked both in the investment fund and pension fund arenas. All have distinguished, enviable track records and you'll be hard pushed to get access to such expert advice anywhere else.

I > INDEPENDENT THINKING

At AllenbridgeEPIC we have access to the independent research source within Allenbridge Group plc. This allows our advisers to offer uncompromised advice based on their own independent thinking and backed up by research that banks and institutions pay a premium for.

A > ACTIONABLE OUTCOMES

At AllenbridgeEPIC we won't leave you feeling 'what exactly, did I pay my consultants for?' Our prime objective is to deliver a clear step-by-step set of 'actionable outcomes' - in response to your objectives - ensuring you know the results of any recommendation.

Contact AllenbridgeEPIC Investment Advisers

London Office
17 Hill Street
Mayfair
London W1J 5NZ
020 7409 1111

Glasgow Office
180 Hope Street
Glasgow
G2 2UE
0141 564 1638

Lancaster Office
PO Box 785
Lancaster
LA1 9DB
01524 389326

E-mail
info@allenbridgeepic.com

Web
www.allenbridgeepic.com