

OIL & THE BALANCE SHEET!

With widespread talk of the credit crunch being over, the most topical question I keep getting asked is “**when will all this turmoil come to an end and financial markets recover?**” Money and the credit markets have yet to return to normal and in my view, this could take several quarters. It is evident that the levels of debt within financial and household sectors are in need of reduction, which in developed economies is inherently deflationary.

It is not expected that commodity prices can continue increasing at the pace that we have seen of late. My view is that commodity prices are simply the “last throw of the dice” by speculators and will follow the bubbles in housing, credit and equities. I believe the overall weakness in the recession of developed economies will reduce global demand and will act as a catalyst to undermine the commodity bubble. Wage inflation importantly needs to be kept under control to avoid a repeat of the 1970s. The economic downturn that we are currently witnessing is likely to be long and protracted, for two main reasons:-

1. Balance sheets need to repair.
2. It is the largest two sectors (household and financial) that are affected, which are also the most intertwined with the rest of the economy.

Recessions and slowdowns are generally caused by Central Banks creating cashflow into the system, which ignites inflation and then the banks begin to “slam on the brakes”. In my view, conditions are different this time, as this crisis is caused by excessive amounts of debt, all held specifically by the household and financial sectors and as such, this is primarily a “**balance sheet crisis.**” Before we can see a recovery, balance sheets will need to be repaired and to put this into perspective, the US ratio of household debt to disposable income at the end of the first quarter of this year was 138% - in the case of Britain, this was 160%. Banks are also loaded up with debt and it will take time for them to restore their balance sheets to meet capital adequacy ratios. As I said, repairing the balance sheet to a less leveraged position will take some time, as there are only three ways in which this can occur:-

1. You can raise capital, which may be feasible for financial institutions such as those we have seen recently with HBos, RBS and Bradford & Bingley, but households cannot raise capital in this way.
2. The householder can sell assets and use proceeds to pay-down debt, but the problem is that no-one wants to sell property or securities in a falling market and so they tend to procrastinate and put off the evil day.
3. You can earn your way out! For householders, this means increasing their savings rates and cutting consumption; for institutions it means increasing their margins which is clearly why the “swap rate” at which banks borrow money over terms like two or four years or more, and determine the kind of mortgage deals that are offered, are increasing, despite Central Banks having held rates. This itself places more pressure on the debt-laden consumer, which when combined with indirect growth tax from higher energy and food costs, is going to be damaging for western economies going forward and cause widespread deflation in discretionary goods and services (i.e. those companies producing goods that the consumer does not have to buy – typically luxury goods).

What is widely anticipated is that the surge seen in the last twelve months in commodity prices is unsustainable and as the major economies weaken, leading to a slackening off of demand, commodity prices will fall back. It is also widely expected that the oil price will fall back to below 100 USD per barrel later this year, creating the opportunity for Central Banks to cut interest rates as deflationary forces rise to the surface. This will be very positive for equity markets and high quality fixed interests. Commercial property will lag equities and fixed interests because even though many property companies’ share prices are trading at significant discount to the net asset value, they are still largely dependent on banks repairing their own balance sheets, sufficient for swap rates to reduce, before normal lending conditions are restored.

In markets where prices are still rising, as with oil and gas, there is evidence that consumers are starting to change their behaviour. For example, the consumption of gasoline in April was down 4% on last year and a number of major airlines have signalled their intention to cut their flight schedules by 20%. One further disincentive for commodity price hikes is that the US authorities are investigating market manipulation which should fire a clear warning shot across the bows of commodity speculators. Asian economies such as Taiwan, Malaysia and Indonesia which have provided heavily subsidised oil prices to consumers, have finally decided to cut fuel subsidies, resulting in sharp price rises for the end consumer, further eroding final demand. The Indian and Chinese economies are all set to follow suit.

Whilst I anticipate equity and fixed interest markets to rally towards the end of this year, it is important that defensive sectors within portfolios dominate – such as utilities, telecoms and pharmaceuticals. High quality corporate fixed interests are now yielding over 7% per annum and offer excellent value for the medium to long term investor, as well as providing the opportunity for capital appreciation as inflation begins to fall away.

When excluding commodity related stocks, blue chip equities are now trading on single digit price/earnings ratios, last seen in the Spring 2003. The indicators that we will continually be looking for, that the credit crisis is reducing, are as follows:

- The bank borrowing rate needs to be considerably lower and much closer to Central Bank rates. The difference is currently 0.8% and should ideally be at 0.2%.
- We need to see bank balance sheets restored to normality and the only visible indicator will be when they are more willing to lend, giving further stimulus to investment markets generally and particularly commercial property.

As always, a diversified portfolio will help to reduce overall volatility but it is still my view that patience is the key in these challenging difficult financial conditions. Patience will be rewarded if investors are prepared to take a two to three year time horizon.

I have taken the opportunity to enclose our Summer 2008 bulletin, which I hope you will find of interest.

Yours sincerely

A handwritten signature in black ink that reads "Gary". The signature is stylized with a large, sweeping initial 'G' and a trailing flourish.

GARY BOND – APFS
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(NB: Past performance provides no guarantee of future returns and any views expressed by us do not constitute advice as each client's circumstances differ)