

14 November 2008

FROM CREDIT CRISIS - TO LIQUIDITY FREEZE - TO MARKET OPPORTUNITY

As if the volatility of the third quarter 2008 was not bad enough, the beginning of the fourth quarter began with further bank failures, daily Government bail-outs and some of the sharpest falls in world equities since 1987. The intensification of the market downturn reflects the transition from a credit crisis, where primarily leveraged investors saw access to credit being frozen, to what is now a full blown liquidity crisis, where normally solvent institutions find it difficult to fund their day-to-day operations. Indeed only some months' ago, investors focused their attention on the security of their bank deposits and were eager to secure a return *of* their money, rather than a return *on* their money!

The crisis of confidence gripping the global banking system means normal market mechanisms have turned dysfunctional and nowhere is this more evident than in the money markets, where the London Interbank Overnight Rate (LIBOR) remains stubbornly high. Central bank intervention has been strong, albeit some would argue, late. **Nevertheless, there are indications that the liquidity freeze is now finally beginning to thaw.** Central banks are moving to directly takeover dysfunctional parts of the banking system and act as a shadow payments agent for the entire economy. Led by the UK, there are the first signs that policymakers are moving from a piecemeal and ad hoc bail-out approach to co-ordinated "system-wide" solutions that are directly targeted at improving the solvency of the entire financial system. Indeed, the "futures" market is now suggesting **90 day LIBOR rates around the World could fall substantially by March of next year.** Australia set the example, in early October by cutting interest rates by a full percentage point (the most since 1992) twice what economists were forecasting and clearly set the precedent for further co-ordinated moves by other major economies who have since followed.

It is my view that the rate cuts we have seen to date are only the beginning. Against a backdrop of sharply slowing global growth, **inflation dynamics have clearly improved.** In the UK for example, the inflation picture (as predicted by the implied yield on index linked gilts) has fallen from 4.15% to 2.63% giving "strong cover" for a retreat by the Bank of England on its rate cutting policy.

In addition, we have seen extraordinary falls in prices, with the main CRB index falling by 48% since its peak (02/07/08) with corn, oil and natural gas all falling significantly since their peaks seen in the Summer. Central banks now have the opportunity for rate reductions of a similar magnitude and as such, they should now repeat their radical and now unlimited intervention into money markets with a similar determined approach towards lowering official interest rates. As I write this piece, this process is now well underway but there will be much more to follow!

Equities

In Equity markets, many Blue Chip dividend yields are now well above Government gilt yields and the bulk of the Blue Chip index is now trading on earnings multiples of single figures. This is ironic because throughout the entire crisis, when we have seen a freezing in credit and all asset-backed mortgages, **global equity markets have remained liquid which in the short term has been their greatest weakness.** This is because quoted stocks have provided the only liquid exit for distressed hedge funds, seeking to offset their risk in the fixed interest and commodities markets. What this essentially means is that forced sellers, such as the hedge funds, have dragged down the only market that has been "open for business". Whilst this means equities may yet overshoot on the downside, large global companies can offer liquidity, dividend flows that can still grow (against deposit rates that will tumble as interest rates fall) and what are in most cases, balance sheets that are now far stronger than that of their bankers –all at unprecedented valuation lows. Investors holding **equities** via regulated investment funds also have daily liquidity and extra-ordinary levels of diversification and as banking conditions normalise and Central banks provide system-wide support, **these are the assets that will rally first!**

Whilst it is accepted that the UK economy specifically is facing a very difficult couple of years, it is my view that UK share prices are now priced for a depression rather than a recession. Part of the reason why shares have fallen so sharply is that the stock market is a discounting mechanism – i.e. investors anticipate potential bad news and factor that into prices long before the actual event. This means that the market often hits its low point well before the economy hits its low, and equally, share prices often start to rise again before an economic recovery begins. More importantly for long term investors, it means that share prices become extremely "sentiment driven" and prone to over-reaction and as such, companies with considerable long term strengths can suddenly find themselves being heavily punished along with everything else. **It is important that investors**

look beyond the extremely volatile, irrational movements that are expected over the next few months and see the significant potential on a two to three year view.

Fixed Interests

The Fixed Interests market (i.e. high quality corporate bonds) also offers compelling value, in my view. There is a time in the economic cycle when it makes good sense to invest in fixed interests and that is when economic growth falters and markets expect a downwards turn in the interest rate cycle. The current turn in credit cycle has been exacerbated by pressure on hedge funds to offload positions they took on with borrowed money. This has led to a wave of forced selling in the fixed interest market and in the absence of buyers, falling asset prices have triggered a vicious circle of further selling. **As a result of this, many good quality corporate bonds are now available at “bargain basement” prices.** It is my view that there is incredible value in bond markets, more than there has been for many years. Although there may be no early rebound, yields that are now on offer, some would argue, are more attractive than equities. **Investment grade corporate bonds at the end of October were yielding nearly 5% over Government gilts, which implies that one in four investment grade bonds will default on their interest payments over the next five years.** To put this into context, default rates peaked at 2.4% in 1986 and even after the technology bubble burst, the default rate only reached 1.4%, not 25% as is currently being priced. Even through the 1970s, the default rate remained below 1% and finally, even during the Great Depression and the pre-war year that followed, the default rate never got above 5% for investment grade bonds. In summary, we are seeing a credit market driven by technical factors rather than fundamentals, driven purely by forced sellers in the market. Those investors who have the luxury of being able to buy and hold, will be well rewarded over the next two to three years.

Commercial Property

The final asset class I would like to cover is that of Commercial Property which has also been punished. Valuations have now fallen to such a level that the rental yield on prime (highest quality) commercial property is now at 6.5% - the highest it has been since the 1950s. When comparing this to the ten-year gilt yield of around 4% this asset class is now beginning to look attractive again. We can all accept that commercial property is not the most liquid of investments, indeed those banks with a high percentage of their loan book in commercial real estate will be looking to reduce their exposure to shore up their balance sheet at the earliest opportunity. As such, I expect commercial property to appear later in the recovery process – i.e. behind stock markets and fixed interests. Property shares are more liquid than physical property and when looking back in history, the following data is thought provoking – from 1973 to 1974, property shares fell 75% and recovered 119% in 1975. From 1989 to 1992 global property shares fell 58% and recovered 122% in 1993. From 2007 to the present day, property shares have fallen 64% and so 2009 and 2010 should see a strong recovery if history is to be repeated! (source: Datastream)

Let's not forget that western economies have an ageing population and investors desperately need income. With Cash rates plummeting, high quality equities, fixed interests and commercial property are the only places where these needs can be met! More specifically, as I have already stressed, the yields on high quality corporate bonds now offer long-term redemption returns that would in a stroke, satisfy the goals of many final salary pension schemes and retirement programmes.

I have enclosed the Autumn Financial Bulletin which I sincerely hope you will find of interest.

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