

## A FEW LESSONS LEARNT.....

Looking back over the quite extraordinary two years that followed the collapse of Bear Stearns and Northern Rock (the starter guns of the global credit crisis) and almost every investment and economic record seems to have been broken; first to the downside with the largest market falls since the Thirties, the highest market volatility ever recorded and the largest drop in global trade ever seen. Little more than a year later, we are recording similar records but this time to the upside; 2009 saw the largest commodity rally since 1987, the sharpest rise in global equity markets since 2003, and almost certainly the biggest fall in equity volatility ever. Whilst the resulting turmoil left public finances in tatters and much of the financial sector on government support, the damage to global investment portfolios, although very painful at points in the crisis, was ultimately for a “steadfast” investor, thankfully modest.

**So having survived this extraordinary chapter in investment history, what can we learn that will help us with future investment strategies today?** Let’s start with the experts: Bill Gates, now the world’s greatest philanthropist, quotes in his annual foundation letter the extraordinary prescient words of John Maynard Keynes, as he surveyed the economic carnage caused by the ‘Great Slump of 1930’. *“This is a nightmare that will pass away with the morning. For the resources of nature and men’s devices are just as fertile and productive as they were. The rate of our progress towards solving the material problems of life is not less rapid. We are as capable as before of affording for everyone a high standard of life – high, I mean compared with, say twenty years’ ago – and will soon learn to afford a standard higher still. We were not previously deceived but today, we have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand”* Source: *The Great Slump of 1930* by John Maynard Keynes (1833-1946).

**Funding risks still remain for the weaker financial institutions....** This time our “colossal muddles” and “blunderings in the control of a delicate machine” have been inflicted by mortgage-backed securities, collateralised debt obligations and other creations of the shadow banking system. While much of the short-term costs of these positions fell on the Central Banks, many of these toxic assets or the lending behind them still remain on the balance sheets of global investment and commercial banks. Unsurprisingly, Regulators are responding by steadily tightening their capital requirements, possibly very substantially if the unexpectedly tough Basel Committee proposals announced in December are adopted. The impact on some banks would indeed be penal and for the UK, the problem is exacerbated by a simple mis-match between borrowers firmly addicted to super-low short-term interest rates and depositors who are starting to ask for a higher risk premium to provide funding to UK banks.

**The lessons for Central Banks....** Is that whilst it was relatively easy for them and their national treasuries to write the cheques to intervene in troubled asset markets, it will be much more difficult to reverse the process and exit. Central Banks will need to execute a four-stage process:–

- i) End existing purchase and quantitative easing programmes
- ii) Drain excess Bank reserves
- iii) Start to lift short term interest rates
- iv) Finally, sell assets outright (this is very difficult if you are the Bank of England and already own 30% of your own gilt market).

The consensus is that they will be slow to act and that money will remain loose, real asset prices will continue to rise and through the fog we will start to see a gradual and persistent rise in inflation. This is, and will continue to be reflected in an improvement in real assets (equities, commodities and commercial property). In such an environment, the inflation risk will be embedded into fixed interests and cash products.

**So can Governments grow out of their debts?.....** By looking back in history, it was clear that the UK had to escape its debt burden after World War II but also the dilemmas it later posed. Back in 1945, the debt burden was 240% of economic output (GDP). By 1965 the National debt was only 96% and by 1980 it had been halved again down to 48%..... the reason of course was not that the debt itself had declined, by the growth of GDP was significant. In other words, as Keynes had put it in 1934, by looking after economic output and employment, the budget could look after itself (echoes of Downing Street today?). For Governments with the freedom to “look after growth and economic output” the ability to grow out of this crisis certainly has historic precedent – but it does imply higher inflation (UK inflation rose from 0.8% to 15.2% from 1945 to 1980). In an environment where inflation is being engineered, this would be negative for fixed interests but hugely positive for equities which over the longer term have demonstrated strong inflation protection. By contrast, the economies with structural and demographic rigidities (Japan stands out), that allow debt-driven deflation to take hold, face an inexorably mounting real debt burden – ironically, this environment would be supportive for fixed interests and negative for equities. The dilemma today however is worst in peripheral Europe, with deteriorating national income and expenditure balances. A strong Euro, political fragility and labour immobility will undoubtedly weigh heavy on the Euro and as such, currencies will play an important role within portfolios going forward. The US by contrast, started the crisis with a strong Government balance sheet and still holds all of its vast foreign borrowings denominated in its own currency and remains a strong, autonomous democracy. This will undoubtedly lead to a stronger Dollar.

**Remember the “old fashioned” investment principles.....** Finally, investors have had to re-learn from the crisis what might have been considered “the old fashioned” concepts of liquidity, transparency and progressive income (dividend) growth across equity markets. This would imply that the large capitalised global blue chip companies will continue to be re-rated upwards as we move through 2010, as investors move from fixed interests to equities in the face of the rising inflationary risks and the deteriorating sovereign risk. As always, asset allocation is key in managing risk effectively across portfolios and it has never been more important than it is today.

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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)