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# Investment Overview and Strategy

## Overview

When the history books are updated, one of the key contributors to the collapse in investment markets in recent weeks will undoubtedly be seen to be the bankruptcy of Lehman Brothers on 15th September. With US Treasury Secretary Hank Paulson keen to avoid accusations of creating moral hazard, his decision to allow the demise of Lehman created unintended consequences. Firstly it raised the spectre of counterparty risk - financial institutions refused to deal with one another for fear of default. Secondly, the huge number of unsettled bargains had a negative effect on already poor liquidity. Thirdly, it triggered the crystallisation of credit default swap obligations - with many CDS's held by cash-strapped financial institutions. Confidence crumbled, markets went into meltdown and the economic slowdown which was already underway has now accelerated into a recession.

## Current environment

There are three major factors influencing behaviour in markets at present:

a) **Crisis in the financial system;** The crisis in the financial system revolves around the risk of systemic meltdown in the global banking system. This was certainly a major risk at the beginning of October, but the coordinated recapitalisation of the banks by central governments in the UK, Europe and the US has significantly addressed the critical issues of solvency, liquidity and funding. Evidence of the success of this is the gradual reduction of LIBOR rates over the last two weeks.

b) **The prospect of global recession;** Economic activity ground to a halt in September, pushing the developed world from anaemic growth into recession. Business and consumer confidence levels have tumbled, but the authorities have now recognised the problems and are addressing them through a combination of interest rate reductions and fiscal stimulus. It is too early to gauge the likely severity of the recession but optimistically one can point to a quicker response now by governments than in previous downturns and economies that are less constrained by high and embedded levels of inflation.

c) **Consequences of deleveraging;** Sixteen years of economic growth has been accompanied by an unprecedented credit bubble, the puncturing of which will have pervasive effects on governments, businesses and individuals. The unwinding of leverage is having a major impact on investment markets with equities having borne the brunt of forced or distressed selling. The global economy is facing a credit contraction. This has deflationary consequences and in order for the recession not to develop into a slump, the authorities will stimulate economies through monetary and fiscal easing. Under these circumstances, inflation is not an issue over the next two years, as evidenced by the collapse in commodity prices.

## Markets and investment strategy

### Fixed interest

Inflation rates are set to fall sharply over the next year aided by much lower average oil, commodity and food prices. Central banks will lower interest rates to mitigate recessionary effects, with rates in the UK likely to fall below 3%. Against this background, conventional gilts of less than 10 years duration look more attractive than index-linked. Issuance to finance the bank bailout is likely to be concentrated at the short end, however, given the lower financing costs and the expectation that the government stakes will come back into the private sector in around five years time.

Corporate bonds, especially investment grade, are implying historically high default rates. Risk aversion and the current opacity of future profits from the financial and manufacturing sectors will likely keep spreads high for now. However, when market volatility reduces, there will be attractive opportunities in the corporate bond arena. Junk is best avoided.

### UK equities

At its most recent closing low on 27th October, the FTSE 100 was down 40.3% in the calendar year to date and over 44% from its all time high. By most conventional valuation measures, equities have moved into the realms of being historically cheap, or at the very least discounting an enormous amount of bad news. The current historic price/earnings ratio is 8x and compares with the long-term average of 12x. Hence a 50% reduction in corporate profits would only take the market back to its average p/e. The trailing dividend yield of 6% would have to see company dividends slashed by 25% to get back to the current yield on a 10-year gilt. Both of those scenarios would be much worse than in previous economic recessions. The recent 15% decline in sterling/dollar has given a boost to UK companies reporting or trading in the US currency. 42% of the FTSE by value reports earnings and dividends in dollars, including BP and Shell who, between them, provide 20% of the market's dividend. As more companies warn on dividends, the hunt for yield will continue, especially with interest rates coming down. Oils, utilities and pharmaceuticals offer a defensive earnings profile as well as reliable cash flow and dividend yields. Lower interest rates may also give a boost to financials and consumer cyclicals, but avoid the balance-sheet stricken. Corporate bankruptcies often come late in the recession, or even after economic recovery has begun.

### Overseas equities

The US equity market also looks historically cheap and the economy has the benefit of huge economic and financial stimulus packages. A weak pound also boosts the attraction for UK investors. Europe, by contrast will continue to suffer the lingering effects of a strong euro as well as knock-on effects from problems within the EU enlargement area, particularly eastern European countries. The Japanese economy faces recession again and the outlook for the stockmarket remains uninspiring. Asia and emerging markets look oversold, however, given huge recent falls. A combination of low valuations and stronger economic fundamentals than in the previous crisis in the late 1990s, suggest that these regions are now better placed to withstand the downturn.

## Conclusion

The problems in the financial sector are being addressed through the recapitalisation of the banking sector, while the recession is being targeted through a combination of lower interest rates and expansionary fiscal policy. Extreme volatility in markets is acting as a major deterrent for potential investors, however. Fear and forced selling has created potential mis-pricing in several asset classes, notably equities and investment grade corporate bonds, both of which are arguably discounting an overly bearish outcome. Evidence that the volume of forced selling is receding could lead to a sharp and extended recovery in share prices from current levels.

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**31st October 2008**

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