

America Panics

Doubtless, you will not have escaped the news about the stock markets in the past 2 weeks. I thought it might be useful to summarise the views of the economists and fund managers that I have read. As usual, there are the optimists and the pessimists. The pessimists tend to be in the USA & UK, the optimists in Asia. This tends to reflect the difference in the state of the western and eastern economies.

The main thing is not to over-react. Although it may not feel like it from all the hype in the media, it is a good time to be investing now for the medium to long term. I have set out some options below.

1. What happened?

On the weekend of the 19th January George Bush announced tax cuts and incentives to try to prevent the USA going into recession. This possibility has been hotly debated for a month or two and markets saw this action as confirmation that it was likely. If the economy slows down, so do company profits, bringing down the price of their shares. Therefore investors sold shares on the Monday. The USA was closed for Martin Luther King Day and so the rest of the world took the initial brunt of selling and saw their worst one day fall since the planes crashed into the World Trade Centre on 11th September 2001 with drops of over 5%.

Before the US market opened on Tuesday 22nd, the Federal Reserve announced a 0.75% cut in interest rates. The biggest single cut in over 20 years. This just served to prove the US has a serious problem and caused the US stock market to drop and caused even more selling in the rest of the world. Common sense kicked in on Thursday and Friday and the markets rallied and the US ended the week higher and emerging markets recovered most of their losses. It was a massive roller coaster ride and doubtless some fearless traders made a lot of money.

There is some debate that the unwinding of equity positions of the rouge trader in Societe Generale, who had incredibly placed \$73 billion of unauthorised equity market trades, amplified the magnitude of the market fall on the 21st. Societe Generale sold his positions into the market over 21-23rd just as the markets were falling anyway and their action would not have helped the markets. Selling into a falling market caused their loss of \$7 billion and controversially, they did not tell the French Central Bank until the 23rd.

The US Commerce Department reported yesterday that gross domestic product -- essentially a report card on the economy -- showed growth falling to 0.6% in the fourth quarter. That was the lowest growth rate since 2002 and far below the 4.9% growth of the previous quarter. Economists had expected 1.1% growth. This is what prompted the Federal Reserve to cut rates by another 0.5% yesterday to 3.00%

2. Analysis

Last week's events came on top of a gradual sell off since the start of the year. Since January 1st, the developed markets are down by around 10% (up from -18% last week) and the emerging markets are down 14-16% (up from -25% last week). The worst hit are India & China. Bonds have rallied and gold has risen to over \$900 per oz.

The US economy is slowing fast and for a Central Bank to react the way the Fed have done is a sure sign of a problem. It will take at least 6 months for the effect of the rate cuts and stimulus package to filter through to the consumer, so there will be uncertainty and volatility in the markets for much of this year.

Banking

As I predicted in my December newsletter, there have been more write downs due to sub prime mortgage losses and more investments by sovereign wealth funds in the banks. The impact on the banking system has been considerable. It has spilled over now into the companies that insure debt issuers against default, the so-called monolines. Bond insurers typically insure the safety of municipal and corporate securities and have been a quiet but key player in the growth and collapse of the sub prime mortgage market. Without bond insurance, securities backed by mortgages will be difficult, if not impossible to sell. There have been an unprecedented number of claims on bond insurers, raising the possibility they may not be able to meet their obligations unless they can raise more cash. If bond insurers are downgraded, their ability to attract new business is threatened. Bond insurer FGIC was downgraded yesterday by Fitch Ratings after it failed to meet a deadline to raise new capital. Fitch Ratings cut the company's rating to AA from AAA.

There is some good news in this area which could signal an end to the crisis. One of the little reported announcements last week is that the US insurance regulator has called the larger Wall Street banks together to structure a support package for the monolines. If this works, then confidence will be restored.

This would not mean that we have seen an end to bank write downs of losses, or worse, but the liquidity and confidence needed to oil the financial sector's wheels would flow again

East vs West

The US economy has felt the impact more than any other economy as their property market has imploded and lending has been severely restricted, having a negative impact on jobs, consumer spending and confidence. There is a real danger of America talking itself into recession, as confidence plays an important part in consumer spending and investing. Hence the more talk about recession, the more self fulfilling it becomes.

Opinion is still divided about whether the US will slip into recession, but the weight of opinion is tending to predict there will be a short, shallow recession.

However, there is not too much cause for gloom. Global economic fundamentals are strong, even though oil prices have caused some inflation in food and fuel prices. Companies around the world are making good profits and balance sheets are strong and equities are trading at reasonable prices. This was not the case 7 years ago when equities were over-priced and balance sheets weak.

The sell off in Asia and the emerging markets was a “knee jerk reaction” precipitated by the fear that if the US goes into recession, they will see a dramatic fall in their exports and that would drive them into recession as well. This is the subject of a massive amount of debate. There has been an argument for a year now that Russia, India and China in particular have done much to balance their economies and stimulate domestic demand. They all have an emerging middle class with money to spend. This is one reason why commodity prices are so high.

Another factor is that the USA is massively in debt to the oil producing countries, Russian and the Middle East, also to China. Unlike 7 years ago, all these emerging countries have huge reserves which can be called into play to stimulate their economies if necessary. In the past, the emerging markets have suffered badly whenever the US slowed down as their export markets eroded. The developing world is much better placed than ever before to weather any downturn in the USA.

This debate will only be resolved as the year unfolds. It is obvious from the market falls this month that even if the economies of east and west are becoming decoupled, their stock markets are not. For those of you that live in Asia, you may have noticed there is no liquidity problem, banks are lending, property prices are rising, companies are profitable and investing. It is inevitable that emerging market exports will slow this year as the US economy suffers and this will have an impact on emerging economies. However, interest rates are low in these countries and whereas Asia in particular has supplied liquidity to the rest of the world, this could now be directed at their domestic assets.

As reality sets in amongst investors, the emerging market stocks could recover much faster than the US stocks.

3. Don't Panic - What to do now?

The majority of our clients are investing for the long term in funds of funds or diversified portfolios. A common mistake for private investors is to buy high and sell low. The funds that we have been recommending will all recover over time. Collins Stewart have remained fully invested and so will take the growth as it comes. Lanson moved over half their assets to cash before the crash and so have not suffered so much. The BRIC fund (Brazil, Russian, India and China) is also fully invested with a weighting towards China and these larger emerging economies are better placed to withstand the effects of the US slowdown. We are not recommending that you make allocation changes at this point.

This is the third period of heavy volatility in the past year and will not be the last this year for sure. It is an excellent time for monthly savers as you will be buying more units on the dips, which over time will see a greater gain. It is a mistake to stop contributing at this time and is in fact a good time to increase monthly contributions. You can continue in the equity funds as these always show the best long term growth. Alternatively there are other low risk alternatives as for lump sums below.

For those of you with lump sums to invest, there are several possibilities:

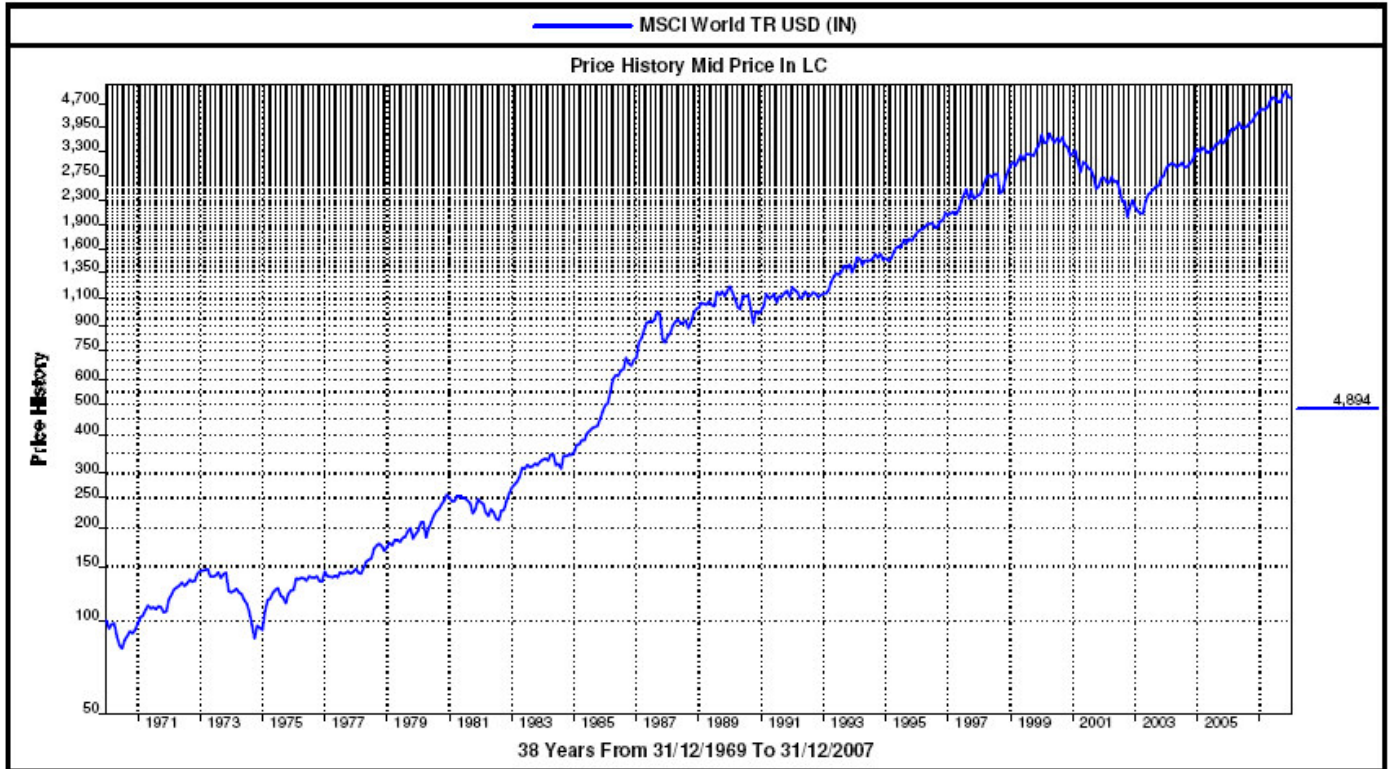
1. You can invest into the funds of funds we recommend – Collins Stewart & Lanson – as they will manage the asset allocation for you. Also, the BRIC fund is dynamically managed across the major emerging markets.
2. Alternatively to avoid timing problems, you can deposit the money into a low risk fund and drip feed it into your chosen equity funds over the year to reduce the risk of investing on a peak.
3. For lower risk investors, the Ground Rent Fund will not be affected by any downturn in UK property markets as it has a fixed income. The fund returns a consistent 9-10% per annum and should continue at this rate, unrelated to equity markets, property prices or interest rates.
4. Hedge Funds tend to perform well in volatile markets and there are 2 good low risk fund of hedge fund available: Momentum All Weather & Thames River Mainstay. These have risen in price over the past weeks.

New FPI fund with profit lock-in.

Friends Provident are launching a new fund next week run by Black Rock Merrill Lynch that invests in world equities but with a difference. They have linked up with HSBC to **provide a profit lock in of 80% of the highest price the fund reaches**. This enables you to participate in the full growth in world equities but minimise your risk as the fund cannot drop more than 20% below its highest ever price. This fund will also be available as a mirror fund and I will send out more details next week.

4. Interesting observation on market dips

One observation I would make, but it is dangerous to apply it too rigidly, is that if you look at the MSCI world index graph (on a log scale to make the past clearer) then generally the market dips are symmetrical. That is, they take roughly the same time to recover as they did to drop. Last week was an example, we saw a 2 day drop then a 2 gain recovery. We had a 3 year bear market from 2000 – 2003 and then 3 years to recover. There are exceptions of course, for example, “black Monday” in October 1987 saw a 1 week drop and then a year to recover. The main thing to note from the graph is that markets do recover over time and over the medium to long term, they see very good returns. Nobody can time a bottom or a top, but investments made whilst markets go into or come out of a bottom obviously see greater long term gain.



If you would like to top up or have any questions, please let me know.

Clive A Ward

Director
Affinity Consulting Group Ltd