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Global Commentary **20 March 2009**

Ben and Merv Get Serious

All over the world central banks are beginning to print money so that they can inject more liquidity into the monetary system. Fundamentally central banks are using their own balance sheets to buy bonds from the markets so that more cash is available in the money markets. These purchases increase the money supply and reduce interest rates, which should encourage more lending thus helping to ignite a recovery.

So far the Federal Reserve, the BOE, the BOJ and the Swiss National Bank have all made positive starts in this direction. They have stopped talking and have started intervening in the markets in a substantial way. It is now clear that considerable work has been done by advisers at the central banks and most probably a pooling of information and research, so that they could start this new process being as informed as possible.

It is significant that at the recent meetings of the Monetary Policy Committee in the UK and the Federal Open Market Committee in the US, the members voted unanimously for the current low level of interest rates and to action a programme of substantial quantitative easing. Quite frankly we should either be very impressed or rather frightened!

Both committees noted that credit is still extremely tight and that considerable caution has re-emerged in the inter-bank market. What is clear is that the central bankers are sufficiently concerned not to wait for any further political guidance or approval. They have acted decisively to build upon the current optimistic rally in the capital markets. Recent statements from Citigroup, Bank of America, J P Morgan, and Barclays all emphasised that the banks have traded profitability in the first two months of the year.

In normal times such statements would not be met with expressions of relief, but the money transmission system in the developed western world is not functioning well. Those who have money are not that keen to lend it and those that are considered a good risk are not that keen to borrow. Most economic players have a minimal risk appetite.

Markets are now concerned about the shape of future possible bail outs. The Americans have handled each rescue differently. This has meant there has not been a standard template which affects different parts of the capital structure the same way on each occasion. Consequently investors do not understand where the greatest risk lies across a financial institution's capital spectrum and this has continued to erode confidence. Many investors feel that Mr Geithner needs to show a keener grasp of the situation and clearly state his policy goals.

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Nonetheless global bond issuance by corporates has so far this year exceeded $350billion. This marked improvement shows that borrowers who are prepared to pay the going rate and usually have a high credit rating, can now access the corporate bond markets. The central banks are concerned that those lower down the food chain are still being denied access to credit for simple items such as cars and for most people the limit on their credit cards has been cut. Small businesses are still at risk all over the world and the central banks hope that quantitative easing will not only reduce the cost of borrowing across the risk spectrum but also go some way to providing smaller players with extra liquidity.

These moves are quite important since they underline the determination of the above central banks not to repeat the mistakes of the Great Depression. Hence their clear intent of providing extra liquidity which in the USA is equivalent to 8% of GDP and in the UK corresponds to nearly 10% of GDP. These measures are in addition to the other programmes announced to insure toxic debt in the UK and provide considerable assistance on both residential and commercial mortgage backed securities both in the UK and in the USA.

It is possible that the determination of the central banks to protect the world economy will encourage the leaders of the G20, who are meeting in 10 days time to also adopt a bold approach. It could be that as the first quarter of 2009 finishes, the capital markets find themselves quite close to “the end of the beginning” and that from here we could gradually build on firmer foundations.

Make no mistake; the first two quarters of this year will be dreadful. This recession is shaping up to be the worst downturn since the Second World War, but it is not a depression and it is clear that the authorities are determined to do all they can to prevent a deflationary spiral. The capital markets are still working. Bond issuance has been massive so far this year. Across the world companies are raising considerable amounts of equity as well, so there is cash available at the right price. As usual one needs a willing lender as well as a keen borrower.

We feel the next stage of this process will be a gradual rise in M&A activity. The current valuations of quoted businesses are now very cheap. It is true that they are not as cheap as in the 1930s and that is because we are not in the midst of the Great Depression. In this climate strategic acquisitions can be made at historically low prices and the strong corporates will be able to offer stock or cash (from a bond issuance or internal resources) or both to clinch any deal. So provided we do not see a severe deterioration from here, we expect a lot more corporate activity.

Finally, there are a number of clear differences to the 1930s:-

1. After the Lehmans debacle no major financial institution will be allowed to fail, but the shape of rescues must start conforming to a clear template.
2. In most developed economies fiscal stabilisers are already operating and helping to cushion the effects of the rapid downturn.
3. Central banks are tackling the lack of regular credit.
4. The determination of the Chinese to support their economy will benefit the rest of Asia in the second half.
5. Government measures in the USA and UK will succeed in promoting a better housing market and help to slow the rate of decline in house prices by the end of the summer. However, the UK housing market could easily continue falling into next year.
6. Inflation should slowly return within the next 18 months because of the large amounts of money being pumped into the system, however the current high level of surplus capacity within the world economy will mitigate against a resumption of high inflation for at least the next three to four years.
7. The mild inflation which we expect to see towards the end of 2010 will be helpful to the world economy and should prevent the dreaded deflationary spiral.

This scenario suggests the following investment conclusions:-

A. There is still scope to make money by buying government bonds but this will be a tactical call as investors will need to watch carefully for any expected rise in inflation which will raise yields and therefore hit prices.
B. The convertible market may reappear towards the end of this year and clients should consider some exposure to this area during the second half of 2009.
C. The dollar should not fall substantially from here as most other countries will also be using considerable measures of fiscal and monetary easing.
D. If this scenario is correct then investors may have three to six months to start making a clear commitment to sensible equity exposures.
E. At first this will just involve a rotation out of the defensives and into the consumer cyclicals. It stills seems a little early for this move but it is something that should be under constant consideration.
F. The current volatility and political uncertainty still favours holding some gold.
G. UK Real Estate is both an inflation hedge and currently provides a high yield by historic standards. The price of property assets should also benefit from the increased availability of finance at lower interest rates. Consequently investors who are of a sufficient size should consider buying prime commercial property in the UK since the fall in the pound also serves to underpin the current cheap prices in the eyes of foreign buyers.

Finally a note of caution. We are by no means out of the woods yet, the volatility readings are still extremely high by historic standards. There will still be a lot more pain and some nasty falls in the capital markets, but it does appear that the healing process has definitely begun and provided the leaders of G20 reinforce this modest confidence with a sensible summit communiqué we could look back at the first quarter of 2009 as marking the bottom of financial markets. This would then be followed by some positive economic growth during 2010.

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