

# Strategy Overview

## The Crash of 2007/09 Act 3 Scene 2

### The Fourth Horseman

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Meridian Investment Consultancy  
Strategy Overview  
The Crash of 2007/09: Act 3 Scene 2

## The Fourth Horseman of the Apocalypse

It's over four months since we last produced a strategy paper, and people have been asking why we have nothing new to say. The easy answer is that nothing much is happening, the recession is deepening, and we just have to be patient.

But now we have a totally new threat, in the form of swine flu. The other three horsemen of the apocalypse, war, death and famine are always with us, but pestilence on a global scale is a bit less frequent, although we've had the odd scare with SARS and bird flu.

Swine flu somehow sounds more serious than bird flu, doesn't it; a bit "weightier". And then you read that the usual response to swine flu epidemics is wholesale slaughter, which seems a bit drastic. But apparently there are other responses to human versions, which is a relief.

When the first paper in this series was published in August 2007 we were accused of being apocalyptic, and what's happened to the banks since then might suggest that was the right word. To have a global pandemic on top of all our other troubles may seem like a bad joke. But viruses like this can't be vaccinated against, although there are drugs to help those infected.

It's much too soon to see how bad this will be, but it has already had adverse impacts on travel firms, and the unfortunate pigs.

[Biblical sidebar. Pestilence was actually the first horseman mentioned in the Revelation of St John the Divine. There are many interpretations of the whole of Revelation, including the meaning of the Four Horsemen]

### Paranoid Suggestions

This flu has gone from unknown to an expected pandemic in record time. There are various theories about this. Readers of Tom Clancy's "Executive Orders" (published 1996) will remember that in that story a Middle-East country created a new virus based on Ebola, and released it in the US. This attack fizzled out because Ebola kills its victims too fast, so the virus doesn't propagate well. This isn't complicated science, the ways in which the flu virus evolves is well known, and it's not hard to construct new viruses in a simple laboratory. The book includes a good explanation of a lot of the science of viruses.

The paranoid are suggesting that this pig flu has shot to prominence just because the authorities are aware (or worried) that a terrorist group could create such an attack.

### Crisis, What Crisis?

For those of us still in work (still the vast majority, after all) it's sometimes difficult to see what the fuss is about. The streets, trains, restaurants and shops may be a bit less full, but there are no riots, the streets are as clean as they ever were, and mortgage payments will be a lot lower for most. But the banks seem to be in trouble, shares nearly halved in value, houses seem to be going down in value (that can't be right, surely), and the Prime Minister is saying it's all under control, and none of it is his fault anyway.

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In that sense this is an invisible crisis for most of us, and that may be affecting our financial judgements. In the insurance world most investments are fixed interest, and things in that market have actually been pretty good. Yields on UK gilts and US Treasuries are probably at record low levels, certainly at the short end of the market. Credit spreads have widened a lot, and there are worries, but apart from Lehman Brothers all your bonds have matured on time (so far). Surely this will all blow over, and in a year or two we'll all be asking what the fuss was about?

Unfortunately some of the things being done to fix the problems of the financial system will be with us for years. Governments are having to borrow on an unprecedented scale, and having to print vast amounts of money. The UK's government debt, as a percentage of GNP, will double or treble before the banks are finally sorted out. With a bit of luck the government will eventually be able to sell off its stakes in the banks, but not for a while, and in the meantime the taxpayer will be picking up some very hefty bills. Taxes will have to go up, spending will have to be trimmed pretty ruthlessly, and we'll all have to put more money into our pension schemes.

Life's going to be a bit grim for most of us (Sir Fred Goodwin is the exception) for several years. One of the challenges that investment committees are facing this year is to make sure that all the present gloom isn't overly affecting the decisions which need to be taken if investments are to be managed efficiently this year and next.

It's one of the challenges for investment strategists (which we all have to be at times) that the best time to invest in any asset class is just when the outlook for that asset class is at its worst. The same applies to selling decisions, of course, you should be selling just when the asset class looks cheap and there's lots of good news to come. The reason for this strange logic is that markets always overshoot. Investors get too optimistic at the top of the market (just look back at the technology boom), and get too pessimistic at the bottom. The big problem, as has been pointed out, is that nobody rings a bell at the bottom (or the top) of the market. That has always been true, but it doesn't mean that there are no signs at all to guide the watchful investor, or committee of investors.

### **Market Timing Matters**

That's actually not quite correct, because the real truth is that asset allocation matters, and market timing is just a part of asset allocation, although an important part. Academic research has shown that asset allocation can explain 98% of your investment return. In other words what your investment manager does with the money you allocate to bonds is responsible for 2% of the variation in returns; the asset allocation decision is responsible for the rest. Investment committees probably don't realise how much responsibility they carry, and that may be just as well if they want to sleep soundly (at night, not actually in committee meetings).

In 2009 there are some very difficult decisions to be taken. Sticking to short government bonds will give returns of about 1% in the US and UK, and soon also in Euroland. As interest rates start to rise government bonds will do even worse, at least to start with. So there is great pressure to find ways of adding extra return, even though that will mean taking extra risks. But where should that risk be taken? And, even more important, when

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should risk be added?

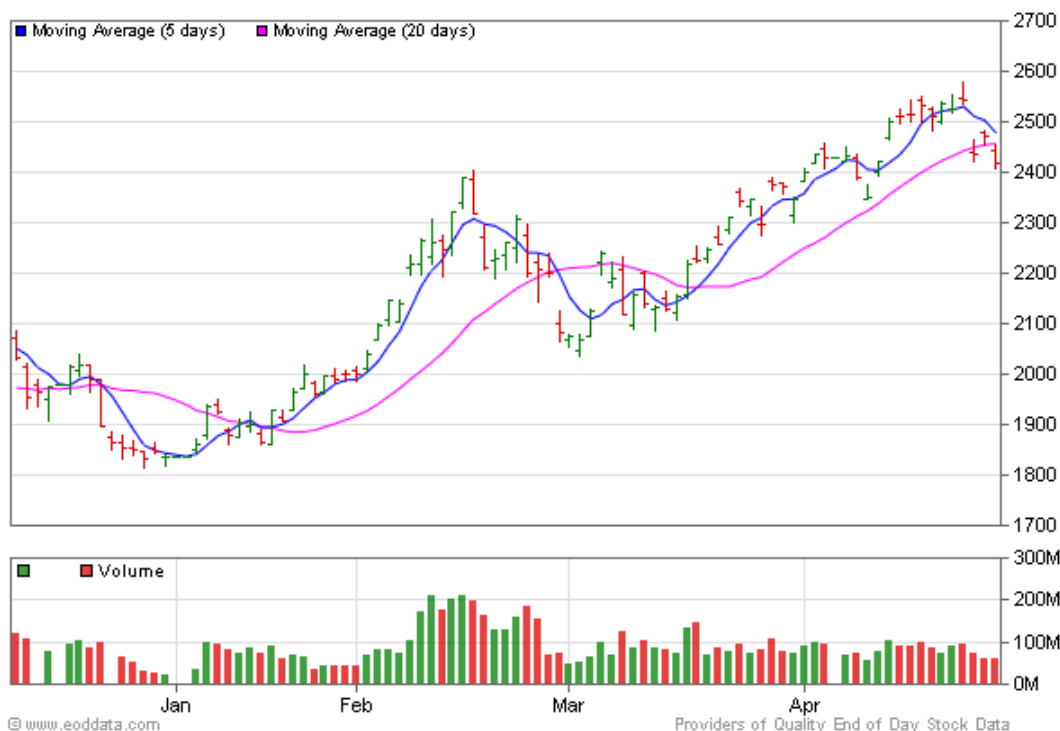
Our response so far has been that we'd much rather be late into riskier assets than early. If the recession ends quickly and 2010 is a year of positive growth, and the crisis is behind us then fine, that's good news, but the FTSE 100 won't suddenly be at 6,500 again, and credit spreads won't suddenly be wafer-thin again. At present equities do seem to be expecting that the worst is over, but bond markets don't seem to be agreeing. We think bond markets are more likely to be right.

### Current Events

Let's just look at what's been happening in 2009 so far. It's been a mixed bag, and that's interesting because it's not all gloom at all. We start by looking at some good news:

China was badly hit by a slump in export demand, and decided early on to subsidise local consumers' purchases of durables, in order to keep factories working. There has already been a lot of money pumped into the local economy, and China was running a budget surplus, so can afford to keep on spending its way out of recession.

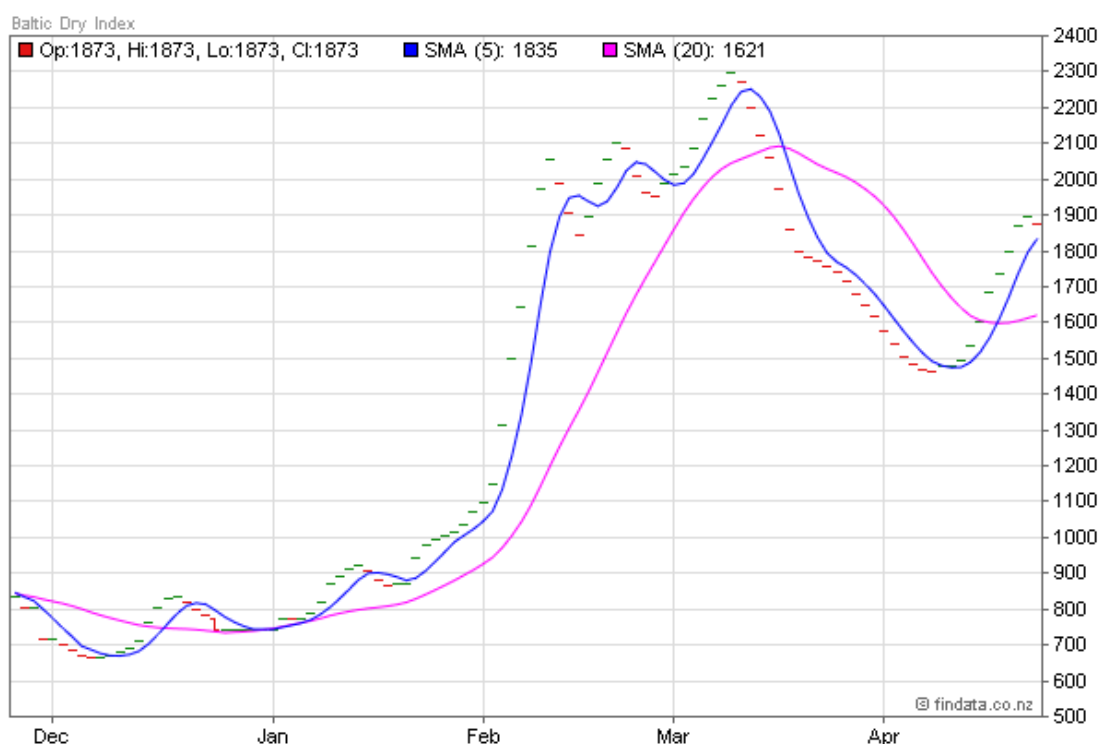
As a result, perhaps, the Shanghai stock market is up by a third from the lows it reached last year.



This may partly explain another piece of apparent good news, the Baltic Dry Index of freight rates:

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Rates have almost tripled from the lows of December, suggesting that shippers are beginning to move goods around again. The Baltic Dry Index has been used by hedge funds and others as a speculative tool in the past, so we don't want to put too much weight on just one factor, but someone, somewhere thinks that more goods will need shipping quite soon. This fits in quite well with another factor, for which there is no hard data yet, but where there is some anecdotal evidence.

That third factor is de-stocking. When economies start to slow beyond a certain point almost every business starts to reduce stocks. This is driven by two main factors, which are the need to cut borrowing, and the realisation that sales are slowing, so there is less need to keep stocks, whether of raw materials or of finished goods. Even in these days of just-in-time manufacturing (and retailing) the effect of de-stocking can be considerable for a month or three, but once stocks have been cut trade starts to flow again as people run out of stuff and need to order more. The movements of shipping rates we show above could well be a reflection of a steep fall in demand, as orders are halved or cancelled, followed by a recovery once stocks have been run down, and orders start to be placed again.

The hard data to back up this thought will come from Purchasing Manager data. These are the people who will be increasing their orders, and their intentions are tracked carefully by statisticians. The next three months will make those indices worth watching.

We'd be very careful not to describe any of these factors as green shoots, but there is a possibility that the extraordinary drops in industrial output that have been seen in South Korea and Taiwan, for instance, could be reversed quite soon.

Then we have some less good news, of various sorts, and mostly to do with market

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behaviour, rather than with economics.

Let's just go back to a point we made earlier. The time to buy any asset class is when everyone is selling, and the class is totally out of fashion. Technically this makes us contrarians; we want to be doing the opposite to the crowd, at least at key market turning points.

So we were worried to hear that there has been considerable retail buying of high yield bond funds. Inflows this year have been in the \$ billions. To some extent this is a reaction to very low deposit rates and low returns on money market funds. But junk bonds are a long way from either in terms of safety and volatility, so some of that buying must have come from genuine interest in high yield as an asset class, and the man in the street shouldn't be buying such a dangerous asset at this point in the cycle.

Next we're worried about the lack of panic and fear. At the bottom of the last bear market, in early 2003, even the more sophisticated of our clients were worried about a repeat of the 1973-1975 market crash, and we had some trouble convincing them that the 1970s were far, far worse in terms of damage to the economy. This time around there's no sign (yet) of real fear and doubt, although the economic situation is actually worse, in many ways, than the 1970s.

So we'd like to see more panic, more fear, and more forced selling of equities and other risky assets. At the bottom of the market last time pension funds were selling all their equities to buy corporate bonds, at exactly the wrong point in the cycle. Life insurers were pushed into selling equities by the FSA, which was very worried about their solvency. Aviva recently produced figures showing they could withstand another big fall in equities (when the FTSE 100 was around 3,500), so we may have to fall further before we get the panic selling.

Not with a whimper, but a bang, seems to be our view at present. We'd like to see more blood shed before buying risky assets like equities, commercial property or junk bonds.

### ***Who leads Whom?***

Traditionally the main equity indices have begun to recover from their lows some months (six months, on average) before the economy turns up. There's been a general assumption that clever economists and financial analysts can see early signs of recovery before ordinary mortals, and thereby manage to start buying equities long before there appears to be any reason to do so. We'd like to consider an alternative theory.

Economists talk about something called the "wealth effect". This is quite simple, and just says that people will spend more when they feel more affluent, even if their income as such hasn't risen. So a rise in house prices, or in share prices, will eventually persuade people to spend more because they feel better off, even though they have no more money in their pockets. This effect has been studied for some time, and there's no doubt that it exists.

So we'd like to consider the idea that at some point in a recession a bear market rally on the stock exchange can actually help pull the economy out of recession, through the wealth effect. If people stop worrying about the recession because their assets are going up in price they may start spending more, and thereby help end the recession.

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We doubt whether this thesis is provable, but it's an interesting thought that perhaps the Bank of England should be buying shares, rather than bonds, with the £75 billion it's spending on quantitative easing.

#### **To-do List**

We don't think there's any rush to take more risk at present, we expect at least one more crisis before economic recovery starts.

A lot has happened since we looked at the investment outlook in January this year, and to discuss recent events we plan to hold a strategy seminar towards the end of May to update everyone on what's happening.

There are now seven of us at Meridian working on investment consultancy, and it's a crucial part of our business. We are working for a wide range of clients, and we think we've helped all of them to avoid losses during the last 18 months. If we're not already advising you then please do talk to us about how we might be able to help. 2009 is turning out to be just as difficult as 2008, as we expected.

DWO

May 2009

Earlier overviews can be found on our website:

<a href="http://www.mips.co.uk/doc/Crash1.pdf">http://www.mips.co.uk/doc/Crash1.pdf</a>	August 2007
<a href="http://www.mips.co.uk/doc/Crash2.pdf">http://www.mips.co.uk/doc/Crash2.pdf</a>	November 2007
<a href="http://www.mips.co.uk/doc/Crash3.pdf">http://www.mips.co.uk/doc/Crash3.pdf</a>	January 2008
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<a href="http://www.mips.co.uk/doc/Crash7.pdf">http://www.mips.co.uk/doc/Crash7.pdf</a>	October 2008
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