



Strategy Overview

The Crash of 2007/08 Act 2 Scene 2

In the eye of the storm

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The Crash of 2007/08: Act 2 Scene 2

It's not universally realised that the eye of the hurricane is a relatively quiet place. The first half of the storm has passed over, and an eerie calm descends. The water is still rough, winds still blow, but for a while things are more peaceful. But never be fooled. The second half of the storm is still to come. This is a time for repairing damage, taking stock and getting ready for the winds to blow again.

The second quarter of 2008 has been such a deceptively quiet time, after the storms which had been blowing since last summer. The Fed and JP Morgan had rescued Bear Stearns, and there would presumably be support for anyone else deemed too big to fail. Everything was going to be OK, and the worries went away.

In fact new warning signs began to appear at the start of June. Inflation reared its head again after a decade of sleeping peacefully. Investors started to worry that interest rates might have to rise. Credit concerns began to grow again. News from the US and UK economies began to get worse.

The second half of the storm is coming.

Update

The UK banks are busy raising new equity capital, although it's not been easy. New losses are still appearing at banks all round the world, but the worst of the bad news from home loans and structured credits may already be past in the US. The UK is probably lagging 6-12 months behind the US in house prices.

However, there is a new threat, from the monoline credit insurers. Both MBIA and Ambac raised substantial new funds in Q1, which deferred the problem, but in June Moodys downgraded MBIA Insurance to A2, and MBIA Inc to Baa1. Ambac Assurance went down to Aa3, and Ambac Financial to A3.

S&P now has MBIA Insurance at AA, and MBIA Inc at A-, Ambac Assurance at AA and Ambac Inc at A.

A financial guarantee insurer is only as good as its rating. It's hard to see how Ambac or MBIA will write much new business. They aren't in run-off, but with little new business coming in they might as well be. The Ambac share price has fallen by 98% in the last 12 months, MBIA by 93%.

This brings enormous problems in the credit default swap market, where both have been big players. All the banks and others who bought protection from (then AAA) insurers are now having to decide whether they need to go out and buy more protection. Uncertainty about counterparties has been the root cause of the credit crunch. It hasn't gone away yet.

But the worst threat comes from the real economy. Inflation (see below for a longer discussion) has reached levels not seen in the last ten years in most leading economies. In second-rank and developing economies the situation is far worse. A long list of countries have inflation at over 10%, and 20% is becoming more common. Food and energy prices are the headline cause, but all raw material prices have been rising. Australian iron ore companies are negotiating near 100% increases in their prices to China.

The worst nightmare for central banks, and even more for finance ministers (and retired Chancellors) is stagflation: inflation combined with economic stagnation. That's where we

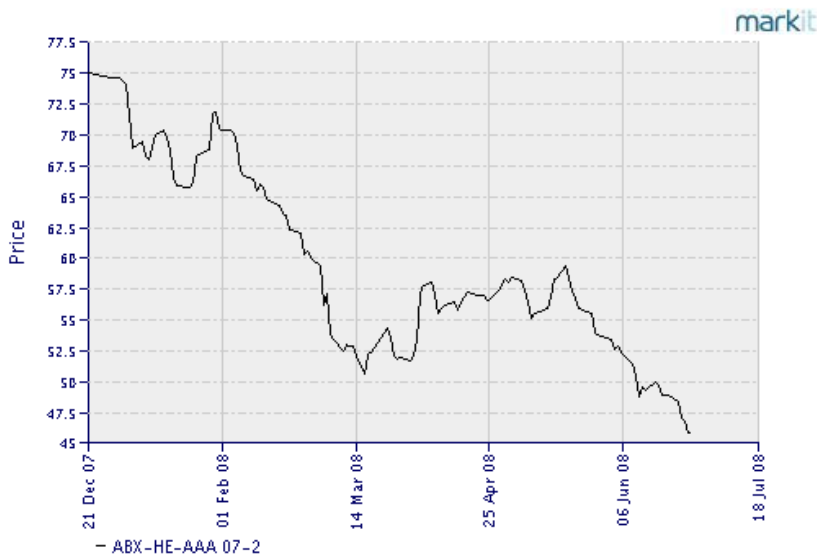
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The Crash of 2007/08: Act 2 Scene 2

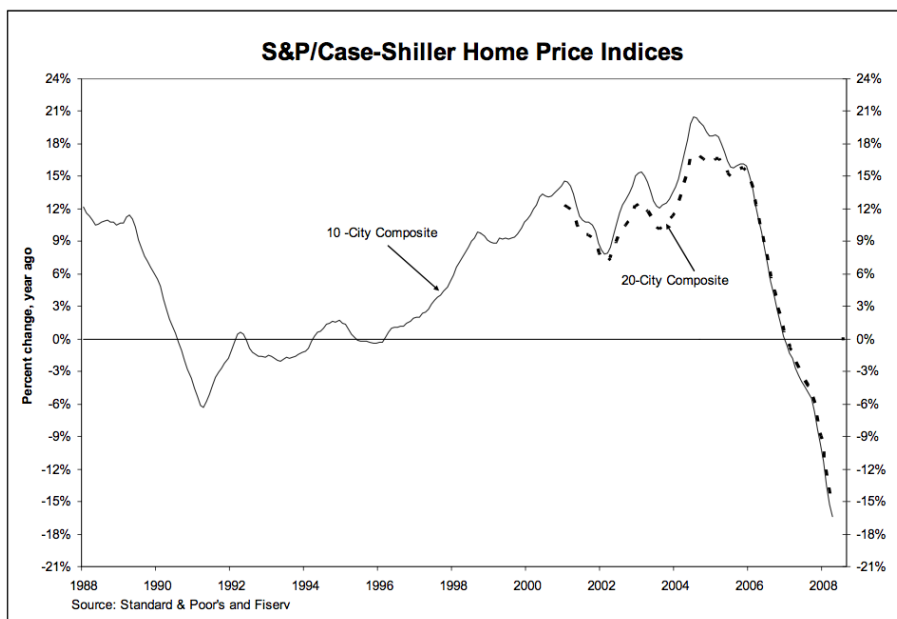
seem to be heading, unless commodity prices turn down before the end of the year. If oil falls to (say) \$100-\$120 a barrel then things would look a lot less gloomy.

Continuing Collapse – Sub-prime

In our second paper on the crash, published in November 2007, we used a couple of charts from <http://www.markit.com/information/products/category/indices/abx.html> which has some very useful illustrations, effectively of asset-backed bonds linked to mortgages. Here's a newly updated version of one of those charts:



The index recovered strongly in April and the first half of May, but has since begun to fall quite rapidly, and is well into new low territory. The continuing fall in US house prices is the main cause of this, of course. Here's the main US housing price index:



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Strategy Overview

The Crash of 2007/08: Act 2 Scene 2

The fall in prices seems to be accelerating, if anything. No wonder spreads on non-guaranteed mortgages are still widening. The Case-Shiller is a 3 month moving average, and the full article can be found here:

http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_Release_062418.pdf

Economic Outlook

This is a very odd crisis, because we're used to the economy getting into difficulty, for whatever reason, and companies earning less, perhaps becoming bankrupt, and a credit crunch following as a result. This time things are the other way around. The credit crunch has come first, on a grand scale, and now we're beginning to see greater economic weakness, particularly in the middle ranks of UK high street companies.

Some very odd data at the beginning of June suggested that UK consumer spending had risen quite sharply. Possibly, overall, but the rate of bankruptcies in the retail trade continues to rise. Two names in particular stand out; ScS and Land of Leather are both going to struggle to meet some rent payments, and while they may manage to raise new capital it would be a brave banker (not many of those about) who'd lend money to either.

In the US the continuing rise in fuel prices has finally started to bite in the vehicle markets. Hummer sales have halved, and SUVs and pickups are becoming very hard to sell second-hand. This is quite probably going to kill off GM and Ford, who only make serious money out of these gas guzzlers. No great loss, perhaps, but a real shock to US perceptions.

Inflation

Twenty years after it seemed to have been killed off for ever inflation has come to life again, driven by rising food and fuel prices, but helped along by rises in the cost of almost all raw materials.

Inflation is the most corrosive of all economic ills. Free market systems depend on clear price signals to work properly. At a certain level inflation destroys those signals, and it becomes very difficult to plan more than a few months ahead.

4% inflation isn't enough to do that sort of harm, and in the G8 (or even the G20) inflation is mostly still well below danger levels. The worst problems at present are in the developing world, where food and raw materials are a much bigger slice of spending.

Russia is at about 14%, Argentina 25%, China 10% and India 8%. And in all cases these are economies which weren't of global importance 30 years ago, when we last had a global inflation problem. Their governments and central banks have no direct experience of dealing with it.

All solutions to inflation involve tough choices. Remember the UK under Mrs Thatcher in the late 1970s and 1980s? Massive unemployment, social unrest, strikes. How many newly developed countries have political systems solid enough to stand that sort of strain now, especially when they've come to believe that everything is moving in their favour?

The best known worst case at present is Zimbabwe, where inflation runs at somewhere between 10% and 50% a day. It's pretty hard to run a business with that going on.

Meridian Investment Consultancy

Strategy Overview

The Crash of 2007/08: Act 2 Scene 2

And the insurance industry needs to keep a wary eye open. What very nearly killed off Lloyd's in the late 1980s wasn't asbestosis and pollution and all those other issues. It was the total failure of most syndicates to realise that the inflation of the 1970s and 1980s had increased their liabilities enormously. At least Lloyd's survived. Look at the very long list of insurance companies that failed between 1980 and 1995 and you wonder how many of those had made too little allowance for the effect of inflation.

Inflation Hedges

There are very few investments which can protect usefully against inflation. Insurers need predictability in their investment returns, and most of the asset classes which might help just take too long to deliver.

Equities

The usual first thought is the equity market, but the evidence of the last time is that it doesn't work fast enough. The 1970s and 1980s were poor times for the FTSE and the S&P. Companies found it hard to plan (breakdown of the pricing mechanism), their customers were feeling poor and threatened. It wasn't until the 1990s when inflation had been killed off that the main equity markets really took off and caught up with price inflation.

And a long list of companies didn't survive at all. Look at the composition of the FT 30 share index in 1970, and again in 1995, and see how much had changed.

Bonds

Conventional bond markets suffer terribly in times of inflation. Interest rates go up to dizzy levels, and volatility goes up too.

Index-linked bonds may be a partial solution, but again volatility can be very high, and for an insurer they offer only limited protection.

Property

Residential property suffers as people lose their jobs. Commercial property suffers as tenants go bankrupt. Eventually both will provide quite good protection, but it will arrive too late to help some.

What next?

So what happens next and how should investors be placed to weather the second half of the storm?

Firstly by recognising that there is a problem. We still find managers who think that the worst is over, and that things will be better by Christmas. Hiding your head in the sand doesn't work for ostriches, and it doesn't work for investors either.

Things are made more complex because this crisis is happening backwards. Banks usually get into trouble after the economy slows down, when their borrowers start to default. This

Meridian Investment Consultancy

Strategy Overview

The Crash of 2007/08: Act 2 Scene 2

time the banks have managed to do serious harm to themselves before the economy started to slow. Going into a recession with the financial system already weakened by the credit crunch will make the problems of the coming recession that much worse.

Credit

Spreads have widened again in June. As borrowers start to default they'll widen some more. We've already been at very wide credit spreads in Q1 2008, at the same levels reached in 2002. This time spreads may get even wider. Credit is still a high risk area. Keep some powder dry for the bargains that will be available at the end of 2008 or in 2009.

Duration

Interest rates rose sharply in early June as markets panicked about inflation. It's impossible to tell which countries will choose to fight inflation rather than recession, but you can't use interest rates to fight both at once. Expect lots of volatility in bond markets. If you'd rather avoid that, and risk missing out on profit opportunities then being very short is probably the best way to be. If your investment manager is very smart (and lucky) then there will be profits to be made, but only at the risk of equal losses.

Equities

Already down 10% or more from the Q2 peaks, we'd expect equities to fall at least another 20% before hitting bottom, and the bottom will probably be next year, not this. Going into a recession with an already weakened banking system is a recipe for problems.

Hedge Funds

Lots of opportunities out there, but it is going to continue to be a bumpy ride. The best will do well, the worst will close down.

Outlook

Don't expect that this will all be over by Christmas. Things could be worse in a year's time, I'm afraid. But eventually things will get better, and there will be opportunities in equities, property, and credit. Just not yet.

DWO

3 July 2008

Earlier overviews can be found on our website:

<http://www.mips.co.uk/doc/Crash1.pdf>

August 2007

<http://www.mips.co.uk/doc/Crash2.pdf>

November 2007

<http://www.mips.co.uk/doc/Crash3.pdf>

January 2008

<http://www.mips.co.uk/doc/Crash4.pdf>

April 2008. This one didn't reach all our clients, due to a communications problem.

Meridian Investment Consultancy
Strategy Overview
The Crash of 2007/08: Act 2 Scene 2

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