

Strategy Overview

The Crash of 2007/09 Act 2 Scene 3

The Bears have a Party

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The eagle-eyed observer will note that the title of these papers has been changing. What started as “The Crash of 2007” has now become “The Crash of 2007/09”. It’s clear that things are still getting worse, and that the low point will come in 2009, not 2008. Even that may be optimistic; some observers are talking about reaching rock-bottom in 2010. It’s nice to feel there are some people more pessimistic than us.

When the first paper in this series came out in August 2007 we were accused of being apocalyptic. At the end of September 2008 we’ve lost Bear Stearns, Lehman, and Merrill Lynch, and the US Government has bailed out FNMA and Freddie Mac, along with AIG. I’m not sure that we weren’t being optimistic a year ago. It’s worth reviewing the summary advice we gave in that paper:

“What should insurers do with their investments? Some answers are easy:

- Raise credit quality. This is partly a function of which manager you use, but we’d want to ask managers to explain explicitly how they’d handle the sort of downgrades and failures that we expect to happen. If in doubt cut exposure to BBB and A rated bonds sharply (or completely).
- Reduce exposure to financial institutions. Investment managers have tended recently to invest heavily in corporate bonds issued by banks and other financial intermediaries. These now look threatened by all the risks we’ve outlined above. We’d suggest halving your current credit exposure to financial institutions. If you’re a real pessimist you might want to cut it entirely. Investing in government bonds instead will reduce your yield, but it will guarantee you get your money back.
- Sell equities. The equity market won’t be able to stand up to the sort of bad news we expect over the next two years.
- Hold hedge funds, and possibly use them as a home for money coming out of equities. The key points in hedge funds will be to have a professional manager in charge of the portfolio, and to be well diversified.

If your underwriting is exposed to claims from financial institutions do some pessimistic modelling and then grit your teeth and buy more reinsurance. Buy additional reinstatements on existing reinsurance cover, if you can, this will be lots of separate events, not a single catastrophe.”

We don’t regret any of that advice. Hedge funds haven’t made much money over the last twelve months, but they’ve done far better than equities, which are down 20% or more.

Update

The third quarter of 2008 has brought its own surprises. A small war broke out between Russia and Georgia, a government rescue of Fannie Mae and Freddie Mac, the failure of Lehman, a rescue of AIG and Merrill, and a plan by the US to set up a massive rescue funding package.

There’s some agreement that without the massive US intervention in the middle of September there could have been a catastrophic meltdown of the global banking system.

Even so some US-based money market funds seem to be in trouble. The Reserve Primary fund announced that it had been invested in Lehman paper, and that its nett asset value had

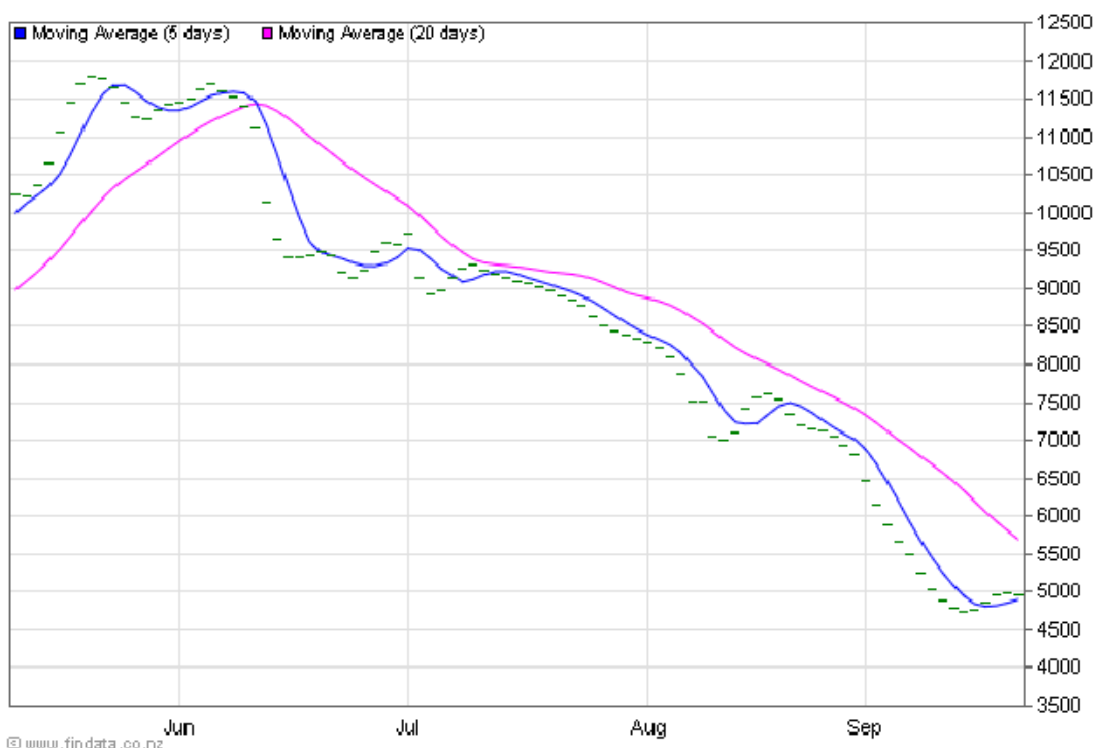
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The Crash of 2007/09: Act 2 Scene 3

fallen to \$0.97. Putnam suspended redemptions of one of its money funds because of large withdrawals. The 20th September Financial Times estimated that \$8 billion had already been spent to prevent US-based money market funds “breaking the buck”. Legg Mason alone has provided \$2 billion of loans and guarantees to support some of its funds. As a result the US Treasury has offered an insurance scheme to support US-based money market funds. No such scheme is envisaged at present in the UK, although the same problems probably exist over here.

Inflation

Our first chart comes from an unusual source. This is the Baltic Exchange’s index of shipping rates, known as the Baltic Dry Index:



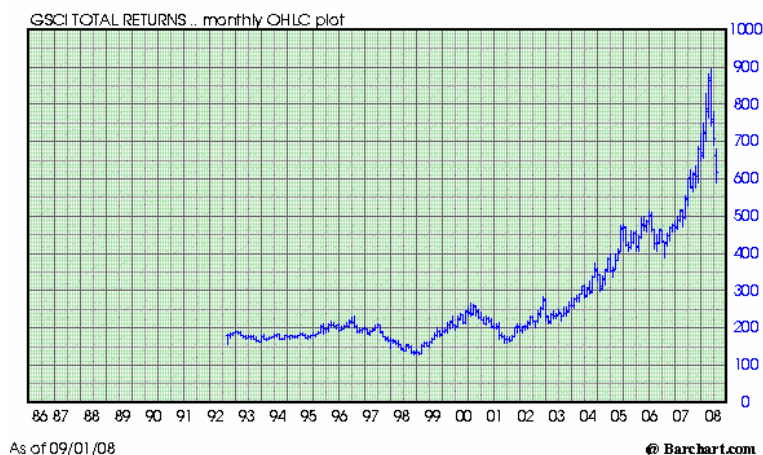
This is an index of dry cargo rates (not oil or gas), and typical cargoes would be iron ore and foodstuffs such as wheat or rice. The index has fallen by more than a half since early June. This suggests that China, who had been hiring ships like mad to import raw materials, have cut back sharply. The supply of ships is fairly fixed, so this index can be quite volatile, but this is a steep fall, and suggests that the Chinese may be facing a bit of a recession, which would soon impact on their suppliers.

A further indication of global slowdown comes from the oil price, which has also fallen sharply, although it appears to be rising again as we write.

The next chart is a Goldman Sachs index of commodity prices:

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The Crash of 2007/09: Act 2 Scene 3



For a long time (from 1992 to 2001) commodity prices just went sideways. The boom since then is mainly because commodity producers hadn't planned for the massive increase in demand from China, India and other emerging economies. Australia has (literally) mountains of iron ore, but it takes time and a lot of money to build the infrastructure to get it to ports and to ship it. The growth in demand caught everyone by surprise, but massive investments are being made to increase supply. The likely end result will be a further decline in prices, perhaps not back to 1992 levels, but over the next 3-4 years we wouldn't be surprised to see this index halve from its present level.

The good news buried in this is that inflation will become much less of a problem, which gives the ECB and Bank of England more scope to cut interest rates. Some are now forecasting UK inflation to fall to 1½% by the end of 2009.

What next?

Our last paper, at the end of June 2008, was very concerned that things would get rough again. They have, and probably rougher than we expected. The US is trying to get Congress to agree a \$700 billion rescue package for the financial system. That's a much bigger number than we've seen before, if it's an attempt to quantify the total problem. Unfortunately for the US administration it's an election year, and Congress is quite likely to fail to pass this massive bill before the election in early November, and maybe not even after that.

Credit

Banks probably now have some official support, as shown by the UK government's encouragement of the takeover of HBOS by Lloyds. But the decision to allow Lehman to fail shows that there are no guarantees. In the UK it's fair to assume that RBS, Lloyds, HSBC and Barclays are, effectively, too big to fail. A similar list in the US would probably include Citi, Bank of America and Goldman Sachs. Each central bank probably has its own list of local banks who will have to be rescued, and this list of "national champions" is the best place to lend money, if you need to lend to financial institutions.

There will be further failures. Washington Mutual and Morgan Stanley look vulnerable in the US. Smaller banks and building societies in the UK may be taken over, but

Meridian Investment Consultancy

Strategy Overview

The Crash of 2007/09: Act 2 Scene 3

shareholders may lose everything. In more exotic parts of the world like Russia and Kazakhstan there may be a big clear-out of banks, particularly those who have lent money to clients to speculate on stock markets.

If the US rescue package gets through Congress then spreads on bank paper will probably come down. Spreads on industrials will probably rise. We've said several times that this economic cycle is like no other. The banks have suffered first, and their unwillingness to lend will now push economies into recession.

Credit spreads are wide, but may well not get any narrower until at least the middle of 2009. For those prepared to take a gamble those spreads may be wide enough to cover the risks, but we hope that our clients aren't going to gamble.

Duration

Rates in the US are already very low. If the rescue package passes Congress then there's probably no need at present for the Fed to cut further, but we wouldn't rule out more cuts in 2009 to kick-start an economy in recession. Duration should be neutral at present.

In the UK rates have stuck at a relatively high level. If inflation comes down sharply in 2009 then the Bank will have room to cut quite hard (with the Chancellor and Prime Minister cheering them on). We've heard forecasts of base rates as low as 3 ½% by the end of 2009. Being long of duration by at least a year looks like a good move.

The Euro remains an enigma, but falling inflation should give more room for a cut or two. Being long of duration is probably the place to be.

Equities

It's been a volatile quarter, particularly in September, but we can see no reason for optimism yet. We'd not be surprised to see the FTSE 100 down towards 4,000 in 2009. The S&P could fall another 20% too. Markets in more exotic places could turn into disasters. The Russian RTS index fell by 6.5% on 15 September, by 9.7% on 16th, and 6.39% on the 17th. The market was then closed while the authorities tried to support it. The index has halved since the beginning of July, and a lot of investors have been using borrowed money.

Hedge Funds

The US and UK have banned certain forms of short-selling in financial stocks, which might cramp the style of some funds, but this is supposed to be a temporary measure. It may harm some specialists, but doesn't have a big impact on hedge funds generally.

It hasn't been a good year, and most of the indices are showing smallish negative returns. The squeeze on the banks has impacted liquidity, and markets have been very volatile. The rate of funds closing has risen slightly, but there have been few disasters. 2009 should be a better year, if things calm down a little, but there's probably no hurry to invest yet.

Outlook

September 2008 is probably the closest we've ever been to a total collapse of the global

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Strategy Overview

The Crash of 2007/09: Act 2 Scene 3

banking system. Repairing the damage and getting the banks lending again will take some time, and with a bit of luck they will be more careful who they lend to, at least for the next two or three years.

After such traumatic times it's hard to tell when the market turns. Our expectation is that there's a good chance that the bear market in equities ends with a bang, not a whimper. The big collapse in equities in 1973-74 ended in January 1975 when Burmah Oil collapsed. The last bear market ended in the UK with a selloff by life insurers, when the FSA stopped turning a blind eye to their shrinking free assets, and insisted that they reduce their equity exposure.

This time it may be pension funds who turn sellers at the bottom of the market. Those optimists who hung on to big equity exposures from 2003 to 2007, in the hope they would cut their deficits, now know that they've lost that bet. But so far very few big pension funds have announced plans to sell their equities and switch to liability driven solutions. As equities fall further the pressure will increase, and we'd guess that a big pension fund will announce its decision to shift strategy at the bottom of the market.

We'll still be encouraging clients to think about taking more risk in 2009, and deciding how much they might be prepared to increase their investment risk. Let's face it, nobody will be taking more underwriting risk in 2009, will they?

DWO

October 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.
http://www.mips.co.uk/doc/Crash5.pdf	July 2008.

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