



Strategy Overview

The Crash of 2007/09 Second Interval

The fire curtain is rapidly lowered

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Update

It's only three weeks since our last quarterly update, but these have been the most tumultuous and dangerous weeks in financial markets since the world began. Governments finally realised that we were standing on the edge of the abyss, and that if they did too little banks would have to close their doors, and credit cards and cash machines would have stopped working.

Led (surprisingly) by Gordon Brown, European and other governments have all agreed to put up big slugs of new equity to recapitalise banks, and most have added guarantees to all lenders, whether as depositors or bond investors. If this isn't enough then the same governments will have to dig deeper into our pockets.

This was all too late for Iceland, whose banks were too big for the Icelandic government to bail out. It will take some time for this episode to play out, but it's a fair bet that lenders to those banks will not see all their money back, and Iceland itself may default on its own debt.

After a 20% fall in most major stock markets between 6th and 10th October markets recovered a bit on 13th October, but that rally may not go far.

Back to the Real World

If we can assume that major world banks are now government guaranteed in Europe, Japan and the US then what happens next? Back to the real economy, I'm afraid, and it's not a pretty picture. The paper we sent out in the third week of September featured the Baltic Dry Index of shipping rates, which then stood at about 5,000, having already fallen from a peak of near 12,000. Today it stands at 2,000. See this web page:

<http://www.findata.co.nz/markets/Quote.aspx?e=INDEX&s=BDI>

for an updated chart. This index is notoriously volatile, and a large part of this fall is probably due to the unwinding of Forward Rate Agreements and the activities of hedge funds, but it still sees the index back to a level it hasn't seen since 2005. Ship-owners and their clients are expecting a big fall in world trade.

The big question is what lending the banks will be able to do under their new (government) owners. They'll have to be a lot more careful who they lend to, because most of that lending will have to stay on their own balance sheets. No investor in their right minds will want to buy structured securities, asset-backed loans, CDOs or any other sort of second-hand bank debt. Not for the next three years, anyway, until we get into the "greed" stage of the next upswing. So banks won't be able to lend very much, and they'll be a lot choosier who the money goes to, because it's their capital they'll be risking.

Credit cards will be harder to find, and all businesses will find their bank manager less accommodating. Banks will be trying hard to get loans repaid before their clients go bust.

The end result is likely to be a deeper recession than we've seen since the 1970s and 1980s. Most companies are more highly borrowed now than they were then, and defaults are likely to be higher by far than in the 2001/03 slowdown. Consumers will find it hard to get credit for anything, so house prices will fall further, and fewer cars will be sold. In the USA it's hard to see how General Motors and Ford can survive the fall in sales which has already started, for instance.

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Normally governments would attempt to alleviate the effects of recession by spending more and running bigger deficits. But after bailing out the banks they really can't afford to help the economy by spending money. Interest rates can be cut, and in the UK there's still plenty of scope for that, but the US is already down to 1½% Fed Funds, and that leaves very little room.

This is (excuse us) a depressing picture. With proper management it won't turn into an economic depression as such, at least in most countries, but unemployment will rise sharply, and not just from the banking sector.

So in terms of investment strategy nothing much has changed.

Duration

In the UK expectations are that base rate will fall quite rapidly to 3 or 3½% by next summer. In fact rates could well fall further for a while. In the US there's not much scope for further cuts, but we'd be surprised if the Fed doesn't go to 1%. The ECB has a problem because it's still worried about inflation, but if the global recession really bites inflation will go away, and they'll be able to cut as well, probably as far as 2%.

So staying long of duration is probably still the smart move, but managers will need to be agile.

Credit Risk

Buying bank debt guaranteed by your government must be the smart bet now, but you'll need to read the small print and be sure the government is actually guaranteeing the piece of paper you're buying.

But otherwise it's still much too early to take any more credit risk. Industrial and commercial debt should get cheaper still (it's already cheap by most standards) as the recession tightens. Just over a year ago we advised moving out of financial credits. It's time to move back.

Equities

It's too early to buy, other than as a short-term gamble. There are too many unknowns, and the recession hasn't really started yet. As it bites, and when GM and Ford close down, that will be the time for the brave equity investor to stick a toe (or even a foot) into the water. There's not nearly enough distress in equity markets yet, the real pain will come when pension funds sell their equities to buy bonds, and when regulators force life insurers to cut their equity portfolios.

Hedge Funds

Hedge funds have had a bad year, with the main hedge fund indices down between 5% and 10%. It's actually surprising those losses aren't bigger, given the global liquidity crisis and the degree of dislocation in markets. At some point markets will calm down a little, and hedge funds will be able to use their skills to make significant profits. But first they may have to survive some shrinkage as nervous investors ask for their money back.

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Property

Commercial property prices in the UK fell sharply at the end of 2007, but haven't fallen by much since. A recession will push prices down further. Banks won't be lending much money to commercial property investors for a while, and in the buy-to-let market things are likely to get quite messy.

In a year or two there will be some great opportunities in commercial and residential property. But there's absolutely no reason to hurry.

Insurance Industry Impacts

What will the wider impact of all of this be on insurers? AIG has already gone, probably, as has a Japanese life insurer, and others may follow. US and Bermudan insurers tend to have bigger weightings in equities and other riskier investments than their competitors in London. All that dodgy paper the banks were busy selling in 2005/2007 had to go somewhere, and the consensus is that US insurers (and others) have their share. Investment losses will eat into their capital base, and limit their ability to compete.

There's another big question mark, and that's over the whole Basle II process. The global regulation of bank capital requirements had already moved towards a Basle II basis. Since it's clearly totally failed to work under stress there has to be a big probability that Basle will have to be rethought before 2012.

Finally

Before the curtain rises on the next act of an epic that's beginning to feel like Götterdämmerung let's just say again that all this uncertainty and chaos hides some enormous opportunities. Massively wide credit spreads and fallen equity markets will one day provide big profit opportunities. Now is the time to start thinking about taking more investment risk. Not yet, perhaps not in 2009, but eventually.

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.
http://www.mips.co.uk/doc/Crash6.pdf	September 2008.

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