End 2nd Quarter 2009

The first six months of this year can conveniently be split and described thus; everything fell for two months, and rose for the following four. Whilst it is obviously more complicated than that, it does produce a V shaped picture on a graph, a symbol cherished by the optimists.

Given the massive falls in nearly all asset classes last year, it was inevitable that a point of maximum pessimism would be reached, and this happened at the beginning of March. The main beneficiaries have been equity markets in Asia Pacific and Latin America, the later boosted by an increase in the price of oil, up some 60% so far this year.

The background picture, however, remains confused. Interest rates in most economies have been cut as low as they can go, which is the traditional response. This has given a huge boost to banking margins, but there is still a general reluctance to lend. Quantitative Easing, a policy devised to unblock the credit system, would appear to have made little, if any, difference.

This is not a standard recession, and markets, if not politicians, are starting to take this on board. We are still in the early stages of this balance sheet recession; far from putting reserves aside, consumers, companies and countries entered this downturn with far too much debt, and this is now being unwound, wherever possible.

Consumers can cease all forms of discretionary spending, and have done. Empty car dealerships and kitchen showrooms stand witness. However, those that have a job, and a reasonable expectation of keeping it, would appear to be moving a notch down the affordability scale. Thus pubs such as Weatherspoons, which sells beer at low margins, are doing very well.

Companies, too, can act to help themselves. Rights issues can pay down debt, consolidation can cut costs, and the stronger franchises will emerge in a more competitive landscape.

Countries really do not have the same options, and especially so this time around. The collapse in the value of Sterling should make our exports more competitive, but most of these go to Europe, which is hardly enjoying boom conditions. Meanwhile, a collapse in revenues is met by an increase in demand for resources. Rising unemployment brings larger social security bills. These already outstrip the revenue from Income Tax.

America has a much less restricted economy, so it is worth looking at what is happening there. Last month, 467,000 jobs were lost, and the measure of time worked fell 6.9% from a

year earlier. The implication is that many are taking pay cuts to stay in work, an increasing trend in the UK. There are now thought to be 20 million US households in negative equity.

The month of April witnessed 342,000 foreclosures. Interestingly, sheriffs in Michigan and Illinois are reported to be refusing to enforce these orders. In an economy where 70% of GDP comes from consumer spending this is not a helpful backdrop.

One would expect this scenario to lead to deflation, perhaps the worst of all evils, and yet this seems to have been averted. Certainly, central banks have acted much quicker than the Japanese did in the Nineties, the latest practical example. With so much liquidity being injected in to the system, it seems inevitable that inflation will re emerge, as it always has done in these circumstances. The authorities insist that it will not happen, but it is a proven way of reducing debt.

Outlook

The full horror of the state of public finances in the UK was laid bare in the Budget towards the end of April and, at the time of writing, conditions are said to have deteriorated significantly since then. It is inevitable that there will be severe cuts in budgets, not only here, but across Europe.

Whilst China, India and the Asian Pacific regions are at different stages of their economic development, the growth they produce will not be, of itself, enough to reinvigorate Western markets.

We would therefore appear to be in for a prolonged period of sub trend growth, and there is no indication of for how long these conditions will endure. Eventually the background will improve, and economies will recover, albeit from a lower base. Along the way, there will be opportunities, and we will attempt to capture those. Our main focus, however, will remain one of capital preservation.

David Oakes - 6th July 2009