

Investors are finding it increasingly hard to gear up their portfolios thanks to market illiquidity and the tougher borrowing restrictions now in place. They are instead holding on to more liquid assets, anticipating a new non-sub prime credit problem



Heading for the rocks



BY DAVID OAKES, CHIEF INVESTMENT OFFICER, MERCATER CAPITAL MANAGEMENT

Minutes before the picture above was taken, the wind dropped to nothing and the tide turned. These yachts were actually sailing backwards, and those who did not act quickly enough hit the rocks. Yachts, like markets, are not designed to reverse;

forward momentum is all.

The rescue of Bear Stearns illustrates this point; as counterparty to some \$10trn of swaps, its failure would have caused havoc in the financial system too horrible to contemplate. Connectivity, or entanglement, is now the new doctrine. Unwinding the riskiest of these relationships, and the products they have spawned, is going to be a long and painful process. Further losses will not be avoided and the credit default swap market looks the most vulnerable.

When the dust settles, expect much tighter regulation. There have been warnings aplenty but only the Federal Reserve seems to be up to speed. Politicians will blame City

folk for the downturn, and there may be a degree of truth in that. But only a degree.

■ Debt-dependent

Here in the UK, it was only a question of when we were hit in the neck, rather than if. M&G estimates that for every £1 growth in GDP over the last decade, it has required £4.20 of debt. The longest period of growth in economic history is a consequence of the greatest expansion of debt ever and now the tide has turned.

Public finances are in such dire straits that taxes had to be raised in the latest Budget and will be again. All socialist governments run out of money

eventually, it is merely a matter of timing.

Cutting interest rates, as the Fed has done aggressively, has not yet freed up the credit markets, but enabled banks to widen margins.

Both the Bank of England and the European Central Bank remain fearful of inflation, yet high interest rates have no downward impact on the price of oil or wheat. Far better to concentrate on restoring the banking system than worry about the price of bread. Indeed, with nearly one-fifth of the workforce engaged in the financial services industry, the health of that sector is of critical importance.

To some extent, equity markets have anticipated

PA SUMMARY

The rescue of Bear Stearns shows the extent to which its own debt exposure is interlinked with that of other financial institutions worldwide.

Investors are still to see the full extent of mortgage foreclosures, credit card, auto loan and other non-sub-prime defaults before progress can be made.

One sign that normality is back in the credit markets is when buyers of high-quality corporate debt are rewarded, before gearing.

“All those wonderful mortgages offering 95%, 100% or even 125% of the value have been sent to the museum to join their self-cert cousins. Our children will gaze in awe. The restriction of credit, combined with its higher cost, can mean only one thing; house prices are going to fall – and quite a long way”

this new reality. Many share prices have more than halved – including banks, retailers and house builders – and only the beneficial effect of the resource stocks has kept the index from falling further.

■ The US situation

Back across the Atlantic, house prices continue to fall, with Goldman Sachs expecting a drop of 25% from the peak. The extent of the losses from mortgage foreclosures, credit card and auto loan defaults needs to be quantified before progress can be made. Some commentators have suggested that central authorities may acquire large chunks of mortgage-backed securities and so free up the system – and maybe that is a way forward.

The speed at which this crisis has bourned down on us means the implications are barely understood in the wider world. While everyone knows that inflation is running at a much higher rate than official statistics allow, asset price deflation has only touched commercial property, income funds and second-hand cars.

Next up is domestic property. All those wonderful mortgages offering 95%, 100% or even 125% (what were they thinking?) of the value have been sent to the museum to join their self-cert cousins. Our children will gaze in awe. The resulting restriction of credit, combined with its higher cost, can mean only one thing; house prices are going to fall – and quite a long way.

Here in Cheshire, the agents talk of “ten and ten”, by which they mean that prices are 10% below last summer and, if you want

to sell, “knock another 10% off”. Over the Easter weekend there were more sale boards sprouting than daffodils. Oddly, the price of farmland is going strongly in the other direction.

■ Charting a course

So what is it that investors are to do?

Back to the yacht race. The Mercater yacht is in the middle of this pack; we had sustained no more than cosmetic damage, and decided to retire to live to fight another day. Where mandates have permitted, we have been following much the same course for our investors. We sold down our exposure to small caps and mid 250 before the end of February 2007. By July, we had totally exited any bricks-and-mortar property funds and through the autumn we looked closely at our multi-cap funds, selling those we felt too exposed to anything other than FTSE 100 stocks. This took courage; asset bubbles continue to inflate long after logic has gone home and relative performance can

The credit crunch

The main losses sustained by major banks:

UBS	\$37.4bn
Merrill Lynch	\$22bn
Citigroup	\$21.1bn
HSBC	\$17.2bn
Morgan Stanley	\$9.4bn
Deutsche Bank	\$7.1bn
Bank of America	\$5.3bn
Bear Stearns:	\$3.2bn
JPMorgan Chase	\$3.2bn
Bayern LB	\$3.2bn
Barclays	\$2.6bn
IKB	\$2.6bn
RBS	\$2.6bn
Credit Suisse	\$2bn

Source: BBC from company reports, 1 Apr '08

PA IMF VIEW ON CREDIT PROBLEM

At its semi-annual meeting in Washington in mid-April, the International Monetary Fund (IMF) estimated the credit crisis losses could creep towards the £1trn mark across the various mortgage and other sources of debt. It estimates the total losses rising to \$945bn in the next two years:

- \$565bn on US mortgages
- \$240bn on debt backed by commercial real estate
- \$120bn on corporate loans
- \$20bn on consumer loans

IMF recommendations include:

- Companies to provide timely and consistent reporting of disclosures, particularly for structured credit products and other illiquid assets
- Undertake write-downs as soon as their size can be established to cleanse the banks' balance sheets
- Disclose strategies aimed to correct risk management failings that may have contributed to losses and liquidity difficulties
- Incentives that shorten the time horizons for senior management of deposit-taking financial institutions need corrective action
- Produce special stability reports to help reduce uncertainty and correct negative public misperception of hard to value structured credit securities

Source: IMF's Global Financial Stability report

look dreadful.

Since then, new investors have been held in cash. Through the year end, most model portfolios have been carrying 25% liquidity and we have continued to dis-invest from equity markets.

By the time you read this, we will have sold all unhedged funds, investing instead in corporate bonds. We have a clear view of where economies are heading and the implications. Our task is to maximise returns when conditions are favourable and minimise losses when they are not.

■ Turning tide?

The good news is there. The Fed is determined to stop the rot and, with the rescue of Bear Stearns, the odds on the financial system imploding



have lengthened considerably. At the time of writing, the FTSE 100 stands on a PE of 10.2, and a yield of 4.3%. Attractive, yes. Compelling, no.

Much of the returns, in whatever asset class you chose over the past decade, have been generated by the effects of gearing. This has now gone, maybe for a generation.

The pendulum always swings too far, so this summer will be difficult. Normality will resume when buyers of high-quality corporate debt are rewarded, before gearing. Before too long, equity investors will make a lot of money. But that time has not yet come.