3rd Quarter 2008

The first six months of the year proved to be a woeful time for equity investors, with much of the damage being suffered in June. This trend continued in to early July, but on the 13th, Indy Mac Bank, a California based mortgage lender, was bailed out by the authorities, and a semblance of confidence returned. The feeling was that financial institutions with problems would be rescued, albeit that the shareholders would suffer.

The balance of July and August was a fairly settled period compared to what had gone before, and in those six weeks, the American market gained some 15%, and many other indices turned positive. Whilst the underlying economic situation remained difficult, it was not as though these problems were in any way hidden; a recession was to be expected in America and the UK, but short and mild was the consensus.

This mood was to change dramatically in September. Against a background of falling house prices, the share prices of Fannie Mae and Freddie Mac plunged; given that half of all US mortgages originate from these institutions, there was little option but to nationalize them, albeit that this process was to be called conservatorship. Investors began to think the unthinkable, confirmed just a week later when Lehman Bothers filed for bankruptcy protection; both shareholders and bondholders were wiped out.

This was the point at which it turned really ugly, and when the history books come to be written, this will surely prove to be the biggest policy mistake. The theory was that if every bank in trouble got bailed out, this would create “moral hazard”, and there was little sympathy for those who had grown rich in the good times, at the expense of others. Thus began, in earnest, the Wall Street verses Main Street debate. Taxpayers and their representatives did not see it as their duty to rescue financial institutions, not pausing to consider the ramifications of failing to do so. Chaos ensued.

By the following morning, the value of a share in the Reserve Primary Fund fell below one dollar, due to loses on the Lehman Brothers debt; suddenly cash on deposit was no longer “safe”. In the second half of September, Merrill Lynch, AIG, HBOS, Washington Mutual, Fortis, Bradford and Bingley, and Dexia all needed help of various sorts. The trail of destruction did not conveniently end with the quarter.

Confidence was shattered, and equity markets suffered severe reversals. Governments on both sides of the Atlantic, for so long behind the curve, rushed out plans to restore credibility to financial markets, but so badly drawn up was the American one that it got rejected on the first vote, sending equity markets in to freefall. As the quarter closed, the authorities were examining plans to take equity stakes in banks, modeled on the Swedish system of 1992, and these have subsequently been put in place.

House prices continue to fall in America, the UK and many parts of Europe. The price of this asset class, in particular, supported the huge expansion of credit to consumers over the past decade. That prop has disappeared, and the availability of credit will be substantially curtailed. In normal times, such a backdrop would lead to a reduction in spending habits, both on consumables and capital expenditure. Yet these times are not normal. Banks have been going bust almost daily; the real sense of shock when Northern Rock collapsed has been replaced by a weary acceptance, which is wrong. Huge damage has been done.

A recession is now upon us, the length and depth of which is unknown. Most importantly, it is not possible to gauge the extent to which company profits will be impacted, although they most certainly will. Unable to judge future earnings, we cannot say whether markets represent value at current levels; there remains the distinct possibility that the growth exhibited by the corporate sector over the last decade is nothing more than the logical outcome from the huge expansion in credit; which has now gone, and will not be returning anytime soon.

We remain cautious.

David Oakes

30th October, 2008