



More please, Hank

The much vaunted bail-out of Wall Street's banks with \$700bn of taxpayers' money seems to be going off the rails. Last week, US Treasury Secretary Hank Paulson announced that he was changing the rules as to who would benefit from his Troubled Assets Relief Programme (TARP) which originally had been set up to buy-up the banks' 'toxic' or sub-prime loans in an attempt to give the financial system a much needed transfusion to clean it up. Now it seems the plan has changed because, as **The Financial Times** reported, only \$300bn is to be used to buy up toxic mortgage assets with the remainder being used to re-capitalise banks, with the US government taking equity participation – much like the UK approach. And there is no shortage of potential recipients queuing up for a handout. As **The Times** discussed, amongst others, ailing motor giant General Motors has asked Paulson for an infusion of cash, firstly \$10bn to support a merger with Chrysler and when that was turned down the company said it was likely to run out of cash by next year. The plight of Detroit's motor industry is self evident – car sales have crashed and shares in GM trade at their lowest levels in 62 years after an analyst from Deutsche Bank, Rod Lache, said they could be worth nothing within 12 months. "Even if GM succeeds in averting bankruptcy, we believe that the company's future path is likely to be bankruptcy-like" said Mr. Lache.

This poor background set the scene for the week, unsettling investors as they fretted once more about the outlook for the financial sector and the credit markets struggled to digest the vast increase in supply of government debt that will be required to return the sector to health. Not that the markets needed reminding as to the parlous state of US institutions, but for good measure the US government was forced to rush to the rescue of AIG for the second time in two months, agreeing a \$150bn bail-out for the insurer last week. The US Treasury said AIG would have to comply with tough restrictions on the pay of its top executives as part of the TARP plan. Another 'Hero to Zero' turned out to be Freddie Mac, the US mortgage giant – also a TARP beneficiary – which announced last week that its net worth was less than zero after it lost \$13.7bn in the third quarter and begged for another \$13.8bn in rescue funds. The plea came just days after Fannie Mae reported a \$29bn loss for the same period and warned that it was haemorrhaging cash so rapidly it might need more Federal aid by the year end.

So unsurprisingly, stock markets went into reverse last week as investors' appetite for risk waned, with not even falling crude oil prices – US crude fell below \$55 per barrel – assuaging their nerves. Confidence was also undermined by news that American retail sales fell at their fastest rate for almost twenty years – down 2.8% against expectations of 2.1%. And as mentioned, car sales have collapsed, falling some 34% - caused by a complete dearth of finance for large ticket items as the banks withdraw from unsecured lending. Unemployment too is on the rise with about half a million Americans losing their jobs every week – but a phenomenon not peculiar to just the US.

The Butcher, the Baker . . .

And 17,000 others lost their jobs last week as the ripples of recession spreading across the UK led to a raft of companies announcing a swathe of job cuts. Large companies such as BT, Virgin Media and RBS said they plan to cut thousands of jobs over the coming weeks as they batten-down the hatches for what is likely to become a long haul to recovery. "This week is turning out to be the week when the recession really started to bite" commented Brendan Barber, the TUC General Secretary. His comments were echoed, albeit more mutedly, by Bank of England Governor Mervyn King who said "It is very likely the UK economy entered a recession in the second half of this year . . . Confidence has been badly affected. All this will restrain demand into next year. The impact of the 'multiplier' effect means of course that other, unrelated jobs are at risk in the supply chain.

Evidence of a deteriorating economic environment was apparent too in the already struggling housing market. News that home sales plunged to a new low last month were coupled with comments from the Nationwide Building Society which said that its net mortgage lending had fallen by 70% over the past six months. The latest survey from the Royal Institution of Chartered Surveyors showed that estate agents in England and Wales had sold an average of just under 11 properties per firm in the last quarter – the lowest level of sales since records began in 1978. The Nationwide's CEO, Graham Beale, challenged the Treasury's claim that lenders were obliged to maintain mortgage availability at 2007 levels. But hope is rising that the recent cut in interest rates may help boost buyers' confidence, with some evidence that 'vulture-buyers' are being tempted back into the market. There are hopes too that following sharp falls in the price of factory goods the BoE will, because of the deflationary impact, be able to cut interest rates further next month. Factory gate prices fell 1% in October – the largest decline since records commenced in 1986.

Leading the Way

Against this backdrop of a sharply slowing economy, Gordon Brown led the call for co-ordinated tax cuts by the leaders of the world's wealthiest countries as a solution to prevent the global economy falling into recession. As **The Sunday Telegraph**

reported, the Prime Minister intensified calls for a concerted programme of interest rate and tax cuts at the G20 summit in Washington this weekend. Mr. Brown said he believed the leaders would agree on “quick action results” as a way of preventing a severe and prolonged slowdown in the world’s economy. The PM’s plea received a mixed response, with George Bush appearing to distance himself saying “One of the dangers during a crisis is that people would start implementing protectionist policies”. On the other hand, German Chancellor Angela Merkel appeared more hopeful, motivated perhaps by news that Germany had just announced that it had fallen into recession.

This all coincided with a downbeat forecast from the Organisation for Economic Co-operation and Development (OECD) that all three of the world’s key developed economies will enter a “synchronised downturn” for the first time in 30 years. So clearly the pressure is on for a concerted effort by the G20 to announce a package of reforms and fiscal stimulus packages. The IMF is the first port of call for countries who fall into difficulties and so far a few East European countries have been forced to ask for help, but it too needs funding from supporting nations. Japan took the opportunity of announcing at the G20 Summit that it is preparing to offer \$100bn of its foreign exchange reserves to bolster the IMF’s coffers. The Japanese government is hoping that its actions will prompt other nations with large foreign reserves – such as China and Middle Eastern oil producers – to make similar offers.

Investors’ Choices

The recent sharp and unexpected large cut in interest rates has caused many investors to review their current investment strategies as cash returns begin to fall as a consequence of the Bank of England’s aggressive new monetary policy. **The Financial Times** said that the era of cash savings is now over as providers embark on a programme of sharp rates cuts on their savings products. Experts say that the era of accounts paying rates above base rate will end as LIBOR (the rate at which banks lend to each other) continues to fall, meaning the banks will no longer be so reliant on savers’ deposits and will be able to access wholesale funding again. The paper pointed out that, after taking account of both inflation – even allowing for a fall next year – and tax, the net real return for many savers is likely to be zero. These changes have caused investors to think about diversifying some of their cash into other less risky [than equities] investments such as gilts and corporate bonds where yields are now higher than many cash accounts.

The Financial Times discussed the merits of both these asset classes and whilst the underlying security of government bonds is ultra safe there is a degree of risk with corporate bonds – effectively IOUs issued by companies where capital and income are not guaranteed. Corporate bonds are rated according to the risk of the issuing company going bust, so the most secure will have *investment grade* status whilst others will rank as *sub-investment grade* where yields are likely to be higher. During most recent times corporate bonds have been through a tortuous time, swept up in the credit crisis and leading to declines in capital values. However, analysts point out that prices are so low that credit spreads – the difference [premium] between corporate and government bond yields – are at unprecedented levels. Put another way, dollar and sterling corporate bond prices are implying a default rate of 39% against an average of 0.8% since 1970. The paper concluded that, whilst you might not be impressed by the most recent performance figures, there is a good reason to think future returns are likely to be significantly better. As Paul Read of Invesco Perpetual put it “We can buy bonds often trading in the 60s, 70s and 80s that we think will redeem at 100 . . . equity-like returns, without taking equity risks”.

In the Hot Seat

As we all know, recent events have been unprecedented and created huge volatility in the financial markets but what have they meant for professional fund managers who have to work in both calm and difficult markets alike? John Hodson of THS Partners has almost 40 years of experience and whilst accepting current conditions are serious, thinks there are still reasons to be cautiously optimistic. “October saw a frenetic sell-off in global equity markets with levels of volatility unseen in recent years. We felt the measures announced were substantial and that many of the elements to allow banks to start lending again are now in place. We feel that equities offer good long-term value at these levels despite there being many signs of recession and forecast earnings downgrades to come. We started investing some of our liquidity through programme trades at the beginning of the month. Latterly, volatility has tailed off and LIBOR rates have softened, suggesting remedial measures taken by the authorities in the banking market may be starting to work.

Alongside continued evidence of recession we saw runs in many Emerging Market currencies and oil and other commodities fell in the face of slowing demand – this will act like a tax cut in most economies. We topped-up some holdings, such as HSBC and added three new holdings: McKesson, a pharmaceutical distributor in Canada, US and Mexico; Nintendo and Hennes & Mauritz. Overall, the Japanese element of the portfolio has held up well with the yen rising 16% against sterling in the last few weeks. But with a fragile economy we are taking a more cautious view and are reducing our overall Japanese equity position. So we continue to maintain our thematic strategy, adding to the portfolio whilst stocks are at depressed levels and then one has to be patient”.