Where Now for Markets?

December 2008

It is two months since Lehman Bros went into administration and I sent out my last newsletter. How the world has changed! There is a massive process of reducing financial sector debt (de-leveraging) while governments are desperately trying to maintain liquidity.

In the 1980s it took just $1.50 of debt to generate $1 of economic output: by early 2008, a staggering $3.50 was required. This is why governments are so concerned and billions of dollars, euros and pounds have been allocated to keep the economy moving.

The numbers are mind boggling: by 2013, the UK is likely to have debt of over 50% of GDP - the Maastricht annual limit is 3%. There are only two ways out of this corner - substantial inflation or years of higher taxes.

The possibility of inflation can't be ignored. The easy way for governments to pay back the debt is to engineer inflation through printing money and devaluing the debt they've taken on. Investors who've been in cash and gilts in recent months have to be vigilant that inflation doesn't erode their capital: look out for this in 2010/1.

Recessions have a momentum of their own and to try to kick start spending with taxpayers' (our) money at the *beginning* of the recessionary cycle is misguided: far better to cut unnecessary public expenditure now and use the funds as we near the bottom. This way, we reduce the debt built up and use the benefits at the best time, but it doesn't fit in with the electoral time cycle.

In my June newsletter, even before the Lehman collapse which presaged the current crisis, I described that banks, individuals and companies would face a period of rebuilding their balance sheets: Copies of our past papers are on our website at http://www.martec.org/archive.htm

As they rebuild their balance sheets, the last thing that families will want is to borrow money to finance new expenditure, so the pump priming will be to little avail.

I have spent some time analysing the recessions of 1929-33, 1972-74 and 1980-82. We can draw some interesting parallels and use the research to try to forecast the future.

In the 1930s economic activity fell by around 13%: a depression is loosely described as GDP falling by over 10% hence it was called the 'Great Depression'.

The next worst recession was 1980-82 when GDP fell by 3-4%. This was a fraction of the Depression but there was not the banking crisis of the '30s and now.

In my view, we will be lucky to escape a GDP downturn of 5% which is a most severe recession: so the economic and stock market outcome is likely to be as bad as we've experienced in our life time.

If we look at stock markets, the Dow Jones index fell by over 80% between 1928 and 1932, and in 1973-5 the UK stock market fell by over 70%. In 1982 the value of the S&P (Standard & Poors) 500 fell to just its book value. What do I mean by this?

If we compare the stock market value (market cap) of a company with the break-up value of its assets, the long term average on the S&P is 2.4: now it is 1.7.

So, in order for the S&P to fall to the book value of assets, it would have to fall from its current level of ca 880 to about 550. Not only are 550 consistent with a price to book ratio of 1 but also a price / earnings (P/E) ratio of 10 compared with the current 15.

The price earnings ratio compares the market cap with the profits generated. In bear markets the P/E historically falls to under 10: The anticipated average 2009 profits on the S&P is $55. Q.E.D! I have concentrated my research on the US market because there is more information and as the saying goes, if Wall Street sneezes the UK catches a cold.

I appreciate that all of this is quite technical and I am also looking at the performance of individual companies during past recessions to try to assess the outlook at a micro level. I may make my findings into a seminar early in 2009.

My last newsletter in early October was written when the stock market was 5000 and I speculated that the FTSE wouldn't fall below 4000, but this level was tested within 7 days. I am now much more concerned.

UK investors have to consider the possibility of the FTSE 100 index falling below 2003 levels to around 2700, a further 35% drop from here.

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We may experience a bear market rally in the next few months and this would be entirely consistent with previous stock market crashes: the secret for investors is to use it to position their portfolios ready for the fall-out.

So what strategy should you adopt to prepare your investment portfolios? We adopt a two stage process.

The first is to re-assess your appetite for risk and check if it has changed in the light of current events. We use a profiling program to provide an objective assessment.

Having established your profile, the second stage is to review the equities and funds you hold, whether they are risk appropriate and how resilient they may be to further market turbulence. In doing this, we look for funds which have high alpha and low beta. What does this mean?

Alpha is a measure of whether the manager is achieving a better result than a passive fund would. It reflects their added value compared with their peers.

Beta measures how the return of a fund is correlated to the benchmark. If the beta is zero, the fund is not at all correlated and if it is one it will move in line. If markets are going to fall further, a fund with a low beta is going to fall by less. Conversely if the market rises, then the increase may not be as good as in a high beta fund.

It is normal to adopt a strategy of diversification with your assets mixed between UK and overseas equities, bonds, cash and property etc which normally might have cushioned the portfolio falls.

However, in the last 3-6 months all asset classes, with the exception of government bonds (especially overseas where there have been currency gains) and cash, have fallen. This does not mean that diversification is no longer relevant: possibly it is more so as assets recover at different rates.

For example, corporate bond funds are currently discounting company failures at 1930s levels. It is possible to buy the debt of leading companies, such as Siemens, at a cost of only 75p for £1 worth of bonds. Because they are difficult to price at the moment, some fund managers are adopting manual pricing, so it is probably too early to invest.

I hope I am wrong and am being too pessimistic, but the strategy described above is going to stand you in good stead even if stock markets don't fall so far. Whatever, it is unlikely that significant equity investment will be attractive until three conditions are present.

- The margin on 3 month LIBOR over treasury bills has reduced to less than 30 basis points.
- We have two consecutive months when house prices do not fall.
- We have seen the earnings generated by global blue chip companies for the 1st half of 2009

We will be happy to provide you with a review of your portfolio. This would assess your risk appetite, comparing it with your asset mix and then reviewing each investment individually: we would then make suggestions for your future strategy.

We also plan to arrange some lunchtime seminars in south England during 2009 and possibly also have a fund manager presenting. If you would like to be invited or receive future newsletters, please send us an email to info@martec.org

May we take this opportunity to wish you and your family a happy Christmas and a Prosperous 2009.

Martec Associates

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Please contact us for a confidential discussion

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