



## International Economic & Financial Overview

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Such was the extent of deterioration in the financial system that Treasury Secretary, Hank Paulson, had no choice but to bail-out the financial system with a rescue package that is unprecedented in terms of cost and scope. The social and economic consequences of a complete collapse of the financial system would be so calamitous that such a course had to be avoided at all cost. To the international observer, coming hard on the heels of America's failure to make its mark on the international political landscape, the financial fiasco is another sign of America's waning global power. The next President will have an unenviable task of strengthening an economy whose financial system is greatly indebted, under increasing foreign ownership and whose political standing overseas has been greatly weakened by the wars against Iraq and Afghanistan. The fact that the Democrats are not sweeping all before them is an indication of the low esteem with which politicians are currently held.

### *Possible Changes to the Financial System*

The shifting tectonic plates in the financial sector will take a long time to settle down. The new roles of financial institutions will have to be established and the inevitable increase in regulation formulated. All this is known, however. Identifying future trends is most helpful at this juncture. In the hope of being roughly right rather than precisely wrong, to quote Maynard Keynes, here are some broad pointers to possible financial consequences of the crisis.

- The end of leverage. This is almost certainly a fact. Financial leverage was a major reason for the extent of the crisis whether it was consumers being offered loans they could not afford or financial institutions leveraging their capital for speculative gains. The quick fire change in Goldman Sachs from investment bank to commercial bank is a sure sign that leveraged proprietary desks being significant generators of earnings is a thing of the past.
- Previous articles discussed the return of principal-based banking rather than agency banking. The distancing of lender and borrower was one of the fundamental causes of the sub-prime credit crisis. Wachovia's announcement that it would end offering mortgages via brokers and instead meet the needs of clients who had a relationship with the bank marks the start of the new trend.
- Banks will merge because big well capitalised banks will be trusted by depositors. Small banks will be bought out. This is not a new trend but this crisis will give it a new momentum over the coming months – especially as Morgan Stanley and Goldman Sachs seek to expand to establish a franchise to diversify their source of funds.
- Investment banking is also likely to go back to its traditional role of advising companies. The reduced availability of capital, however, means they will have to bring in partners to the deal who can provide capital such as hedge funds or sovereign wealth funds.
- The number of hedge funds will shrink but the remaining ones will become financially powerful. This will be a positive development for the sector as there are far too many small funds around. There will be attempts to regulate the activities of hedge funds but they will adapt. Surviving this crisis will integrate them into the financial architecture.

- Financial assets will become more pure and understandable. It will be a long time before investors seek to buy complex derivative products. This will also include the arcane world of credit default swaps as it is now apparent that in the event of multiple defaults the institutions that offered the protection become vulnerable themselves.

### *Economic Consequences*

The US economy has performed remarkably well but the long awaited recession seems certain to arrive as a result of the deep dislocation in the financial system. The Federal Reserve has little scope to ease monetary policy, although if necessary they will reduce interest rates. This will not, however, stimulate the economy as there are very large structural changes at work which will depress domestic demand in the US. US consumer spending, weakened by slowing real income growth and rising unemployment, will remain weak for some time. US profit growth is declining and companies will be conserving cash flow because of the shortage of capital.

A source of strength will be the shrinking trade deficit but this reflects falling imports. Export growth, which has been strong, will be under pressure because of falling demand in the rest of the world. Even China's growth rate appears to be declining under the pressure of a rising currency and rising inflation in china.

In the short term the pace of inflation will ease off. However the suggestion that the US is entering a deflationary period is unlikely. The US is not heading for a depression because the US company sector is sufficiently robust and flexible, unlike its Japanese counterpart, to make such comparisons misleading. However, the pace of capital spending since 2000 has been very weak, less than the rate of depreciation. This suggests that the non inflationary growth rate of the US economy has fallen from 2.5%. The same is also true in Western Europe and Japan. The pressure on resources as a result of global population growth will abate but not disappear. The inflation risk will prevent long term borrowing costs from falling even if the economy enters a recessionary period.

Long term borrowing costs are also likely to be under upward pressure from the colossal increase in Federal borrowing over the next few years. Projections for the fiscal deficit have to be re-done as a result of Paulson's actions but already some forecasters are suggesting that the borrowing requirement could be as much as 10% in a single year. The total size of outstanding national debt is projected to reach 70% of GDP. These are worrying trends for future administrations to deal with.

The most visible sign of the deterioration in the fiscal balance will be an unstable US dollar. Recently its long period of depreciation appeared to be coming to an end. The fiscal cost of the financial bail-out and the large proportion of US assets held by foreign investors suggest that the weakening trend of the US dollar is not yet over after all.

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