

SPECIAL FEATURE

INVESTMENT REVIEW



THOMAS MILLER INVESTMENT
TRADITION WITH INNOVATION



2007: A SUB - PRIME YEAR!

By midway through 2007 the economy and financial markets were performing as anticipated. Global economic growth was rapid and inflationary pressures were continuing to build up slowly. Commodity prices continued to rise as a result of China's insatiable demand and Central Banks were cautiously tightening monetary conditions. Financial markets were in their comfort zone and apart from the occasional hiccup equity markets were making decent gains and fixed income markets were languishing.

In August everything changed because of an instrument that had insidiously been introduced into the global financial system to the tune of \$1.2 trillion; US sub-prime asset backed securities.

2007 will be remembered for the crisis in the US sub - prime asset backed market and the financial chaos it caused outside of the US. The market for sub-prime asset backed securities was created in an environment when interest rates and government bond yields were low. Investors sought assets which offered higher yields and this meant purchasing the assets that were of a lower credit quality. Credit spreads collapsed dramatically as investors seemed to believe that the combination of strong economic growth and low inflation would help even the weakest of businesses. The creation of a single financial instrument from high and low credits in sufficient quantity to ensure that it qualified for a top notch rating by the credit agencies was a natural extension of the credit trade.

The US housing market had been a source of growth for the US for many years. Some of the growth was based on solid foundations of rising immigration, increase in single family unit homes, low interest rates and a high level of employment. However, mortgages were also being offered to people with little or no income. Application forms were being completed with false information which meant that the detailed analysis on expected default rates was erroneous. The downturn in the housing market intensified in the early part of 2007, partly as a result of an increase in borrowing costs. The default rates on sub-prime mortgages rose far higher than anticipated and this undermined the credit worthiness of the high quality assets.

The crisis broke in August and the speed and extent of the fall-out caught the Central Banks by surprise. The whole saga, including the differing policy responses by the Central Banks, will be the topic of study for years to come. For investors, these developments caused a see-saw in the financial markets. Credit risk was re-priced overnight and investors now sought security at any price. Products such as money market funds offering returns above cash rates were shunned as some of the funds were closed because the managers could not sell the asset-backed holdings. Even the banking system seized up as the banks refused to lend to each other. Suddenly government securities, especially treasury bills, were in hot demand even as their yields plummeted. Equities in the OECD markets lost all of their gains of the year. Even the emerging markets registered heavy losses from their peaks.

By the end of the year the critical question remained unanswered. Was the sub - prime crisis going to be contained within the financial sector or would the real economy eventually succumb to the inevitable tightening of liquidity? The equity markets snapped upwards in late November in the hope that the US Federal Reserve would pump liquidity back into the economy in order to limit the fall - out. An additional positive development was the fact that asset prices had moved extremely sharply providing investors with many potentially very profitable investments for 2008.

2008: A YEAR OF EXTREME OPPORTUNITY

Investment analysts' crystal balls will be cloudier than usual for 2008 because the economic ramifications of the sub – prime crisis are impossible to predict. A key determinant of economic developments in 2008 will be whether the financial system can generate sufficient capital to finance economic expansion as well as repair balance sheets. One thing is sure; a high level of uncertainty will be a key feature of the investment climate in 2008. This is good news for investors as it means the rewards for investing correctly will be high.

Casting aside the crystal ball the following macro trends will influence financial markets

- Economic growth in the OECD area will be significantly less than in 2007. The profile of growth is likely to be noticeably weaker in the first part of the year. This means interest rates in the OECD area will fall. The US Central Bank will take the lead in reducing rates if growth falters. The European Central Bank will resist cutting rates but the Bank of England will cut in early 2008. Having been one of the strongest growing economies in recent years the UK economy will be one of the weakest as its key growth areas, financial services, housing and public sector employment, will be under pressure.
- Economic growth in China will be unaffected by slower growth in the OECD economies because of the sheer size of its internal development programme. The Chinese authorities will be keen to ensure that the economy is in good shape for the 2008 Olympics games. In addition, Shanghai is to host the World Expo in 2010 when 70 million people are expected to visit in 184 days. The implied infrastructure spend will keep the Chinese economy growing strongly and its demand for commodities will prevent any sharp decline in commodity prices
- Profit margin growth in developed economies will decline as a result of slower economic growth. Moreover, the faster rise in profits relative to wages over the past few years will come to an end as profit growth slows but wage growth stays constant or even accelerates in some economies. UK domestic profits margins will suffer the same fate although foreign earnings could be boosted by the anticipated decline in the value of sterling.
- Companies which have weak balance sheets will be particularly vulnerable to a liquidity squeeze. Private equity deals done in the last twelve months will be most at risk because they had the highest proportion of debt financing.
- The buoyancy of energy and commodity prices has resulted in an enormous transfer of income away from industrial economies to commodity producing economies over the past two years and this will continue in 2008. As a result the purchasing power of sovereign wealth funds will increase and diversifying out of government securities and into real assets.
- Concern about climate change became part of corporate culture last year and this will continue in 2008 and beyond.

Weaving the above themes together suggests the following investment opportunities.

Equity markets will struggle until the Federal Reserve reduces interest rates sharply. TMIL's in-house research suggests that, in an environment of initially weakening economic growth, the sectors which have historically performed the best have been health care, consumer staples and energy. As the economic slowdown intensifies and interest rates fall appreciably investors should switch into materials, consumer durables and financials.

The outlook for the UK equity market appears particularly unattractive given the poor macro economic backdrop. However, within the UK equity market the financial sector has suffered a huge downgrade and valuations would suggest that the worst has been discounted. In fact, it is not just the banks that have been badly affected but all high dividend paying companies. Those companies which have strong balance sheets and high dividend cover are trading at very attractive prices at present, including some banks, and they may perform well relative to the FTSE-All Share Index.

In a weakening growth environment fixed income instruments tend to provide better investment returns than equity. However, current yields on government securities have been depressed by the sub – prime crisis and are not attractive unless there is a global economic recession. A much more fruitful opportunity for investors will be credit, particularly securities of distressed companies.

The combination of slower economic growth and restrictive credit conditions means that the number of distressed companies will increase sharply during the year. Investment returns from managers specialising in distressed debt securities typically peak when the economy is at its weakest with annual returns above 20 percent. This is likely to be an area of particularly rich pickings. The presence of sovereign wealth funds might make this an even more attractive proposition as they seek to acquire real economic assets at bargain basement prices.

Profiting from foreign exchange movement has been difficult over the past two years. The yen carry trade has been one source of profit but the decline in US interest rates will make the yen vulnerable to appreciation. Investors are currently worried about a collapse in the value of the US dollar but this is not likely. Many holders of US securities, particularly Japan and China, have a vested interest in ensuring the value of their dollar holdings do not collapse. In any case the decline in the value of the US dollar is helping US industry to regain market share at home and abroad. In addition, US assets appear very cheap to foreign investors and 2008 is likely to witness a sharp change in the type of capital flowing into the US; away from government securities and into private sector businesses.

According to most measurements, sterling's current valuation is high against any currency, except for the commodity currencies of Australia and Canada. Given the weak economic backdrop in the UK and the likelihood that interest rates will be coming down faster than in Europe, sterling is most likely to weaken in 2008.

Investors will start 2008 with abnormally high holdings of cash. Amidst the entire uncertainty about the coming year, one thing is certain; cash will be invested as interest rates fall