

New Financial Order to Mould Economic Outlook and Investment Strategy

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As the credit crunch enters its second anniversary there are reasons to believe that the worst of the financial crisis is over. However, the trail of financial devastation left in its wake will result in significant changes in the financial system which will mould the economic growth profile of the industrialised economies over the next few years. Remarkably the credit crunch left the leading industrialising economies unscathed putting them in an economic and politically stronger position relative to the US and other industrialised economies. One consequence is that industrialising economies will be able to continue exporting inflation to the industrial economies where inflation is already at the highest rate for over a decade. For investors this backcloth requires a portfolio that is focussed on absolute return and investment themes rather than a generally diversified balanced portfolio of bonds and long only equity.

The Worst of the Credit Crunch is Over

The above statement is bound to be a hostage to fortune! However, given the scale of write-offs by the banks, the collapse of Bear Stearns a major US investment bank, the failure of IndyMac Bank, the second largest bank failure in US history and the litany of bank failures and closure of investment funds in the US and elsewhere in the industrialised economies suggests that not much else can go wrong. There are also concrete reasons to suggest that things are slowly on the mend. First the US authorities' decision to underwrite Fannie Mae and Freddie Mac was an important line in the sand. While there will need to be changes in the unique structure of the US mortgage market, the US Treasury has made it clear that failure of either of these institutions is not an option. Investors' recent willingness to purchase billions of new mortgages from these organisations is proof that these measures are working. Second, the Federal Reserve's actions of widening the type and number of financial institutions that can borrow from the Discount Window as well as widening the securities that can be offered as collateral also demonstrated that the financial system will not be allowed to fail. The rapid lowering of the Federal Funds rate underlined their intention to support the system. A third encouraging sign is that the banks have been able to raise almost \$200bn of new capital. Whilst more capital raising will be required and investors will be discerning (witness the failure of the HBOS rights issue in the UK) there is sufficient capital around if the price is right. The gradual narrowing of the spread between US Libor and the Federal Funds rate, as well as the spread between 10 year treasuries and 10 year swaps, is a healthy sign of a return to trust between the banks. The sharp rebound in banking shares in recent weeks is also a positive sign. However, the financial system will not be as we know it!

The 'New' Financial System

Regulators, policymakers and, most importantly, shareholders, will not permit financial institutions to operate in the same way as before, at least for as long as the recent experience stays in peoples' memories. The selling of units of mixed quality credits organised in a way that it is given the highest credit rating even though such assets are less than 50% of the unit will be severely curtailed. Securitisation will continue, however, as it is an important source of capital raising, risk diversification and broadens the asset choice for investors. Investors will now be far more enquiring of the quality of the assets they are buying and regulators will take pre-emptive action to stop excess leverage such as occurred in the mortgage market.

Another key change will be 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.

The importance of the non bank financial sector has already increased as the banks withdrew from lending and this will continue. The increasing concentration of large amounts of capital with sovereign wealth funds (SWFs) and hedge funds is a significant change to the financial landscape. The reputation of hedge funds has been enhanced by the credit crisis as not only did they survive torrid financial markets but they have emerged sufficiently strong to take advantage of investment opportunities thrown-up by the turmoil in the financial markets. Companies are seeking to attract both SWFs and hedge funds as cornerstone investors, often causing a clash of interests with existing investors such as the traditionally passive pension funds. The banks were the first to court the new investors but others are following such as General Electric. Hedge funds are providing important sources of capital to smaller and medium-sized companies in the form of asset based lending, aka 'old fashioned bank lending'.

The 'new' financial system is a blend of pre and post securitisation. In the early stages it is likely to provide a more disciplined and prudential lending environment which will be reflected in a better balance between the risk and reward for investors than in recent years. This will encourage more investors and re-build the pool of capital available to the US and other deficit ridden economies.

Outlook is for Weaker Economic Growth but Higher Inflation

Although the worst of the credit crisis is probably over, the economic downturn in the US and other industrial nations is not. The economic correction is most advanced in the US although the surprise to many analysts is that so far an economic recession has been avoided. The next six months, however, will be the most difficult as the stimulatory effects of the tax cuts wane, and the high pace of inflation means that further monetary easing is unlikely. Even once this period has passed, the changes in the financial system described above will limit the extent of any upturn as there will be reduced scope for economic growth based on financial leverage. The long awaited increase in the US rate of savings is now likely to occur.

The economies of Northern Europe are just beginning to weaken as a result of the credit crunch and the record high value of the Euro. An economic recession in the second part of the year is looking increasingly likely. The UK economy is set for a long period of stagnation for all the

same reasons as the US. However, with a less diversified economy the change in the financial landscape will hit the UK economy hardest of all the industrialised economies.

The leading pack of developing economies, including China, Brazil, India, Russia and Middle East, have been barely affected by the credit crisis. The wealth of these economies is based on commodities, an increasing middle class, substantial current account surpluses and large foreign exchange reserves. These strengths mirror the weaknesses in the industrialised economies and are resulting in an important shift in the balance of economic and political power.

One implication of this shift is that economic growth in the emerging economies has remained unsustainably high as shown by the sharp escalation of inflation in those economies. Since the economic priority of these economies is growth they are unwilling to control inflation by slowing the pace of economic growth which means that, in addition to the export of capital, they are also exporting inflation to the developed economies. Given the current strong economic position of these economies it can be expected that their currencies will continue to appreciate against the US dollar. Imported inflation will continue to be an irritant to the Federal Reserve, and other major central banks, by making its task of smoothing out the credit crunch, stimulating economic growth and controlling inflation difficult.

Investment Opportunities

The past fifteen years have seen financial asset prices boosted by the trend decline in nominal interest rates. Under such favourable circumstances almost any investment strategy provided absolute investment returns and therefore investors could focus on benchmark returns. Nominal interest rates are now on a secular rise due to the rise in inflation. Fixed income returns are likely to be poor. Equity returns will be depressed by slow economic growth, profit margin squeeze and rising interest rates. Investors need to focus on absolute returns and build a mix of investment strategies that can deliver real returns in an environment where average investment returns are likely to be subdued. Traditional long only equity portfolios are unlikely to deliver the scale of returns desired by investors. Instead, investors need to broaden their horizons and consider all available asset classes rather than focus on traditional or alternative assets. A blend of asset classes will be required in order to provide the appropriate combination of risk management and investment returns. Moreover, the investments need to be focussed on investible themes, such as asset-based lending, long term strategic investments such as those available in Africa and genuine alpha generating managers need to be sought. Understanding the aftermath of the credit crunch and its implications for the global economy will provide a map to an appropriate investment strategy.

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