A VIEW FROM THE BRIDGE

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Welcome to the second edition of 'A View From The Bridge'.

There have been two major political events since our last issue: the British General Election and the French referendum on the EU constitution. We reflect on the outcome and possible effects on European markets from the 'No' vote and put forward our view that Britain's relationship with Europe will now receive considerably greater media attention than during the Election Campaign.

Elsewhere, we look at some more 'behavioural' issues that can move markets and also take an initial look at the subject of cycles, short and long. Naturally, we continue to welcome any comments or suggestions which Nick Rundle, the Editor, will be glad to receive.

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Europe – All Not So Quiet On The Western Front

'Is there any point to which you would wish to draw my attention?'
'To the curious incident of the dog in the night-time.'
'The dog did nothing in the night-time.'
'That was the curious thing,' remarked Sherlock Holmes.

'Silver Blaze' – Sir Arthur Conan Doyle

The recent General Election campaign was certainly remarkable for the deafening silence that all three major parties maintained over Britain's relationship with the enlarged European Union. Yet now, with the Prime Minister due to take up the Presidency of the EU on July 1st, the importance of the 'No' vote in the French referendum on May 29th in determining the future shape and structure of the EU could hardly be greater. This result has thrown the political elites within the EU into turmoil and a number of issues – such as the debate over the accession of Turkey to the Union and the future development of trade policy – are now sidelined.

In many ways, though, it is highly convenient for Mr Blair, from a domestic point of view, for the French to have voted 'No'. A secondary vote on a text subject to slight alteration, as happened when Ireland inconveniently voted against the Nice treaty and when Denmark against Maastricht, is hardly an option; France is too large a force in Europe to be brought into line in this way. If this were to happen the new constitution would be viewed as still-born and all parties would need to reconsider the form that further political and economic harmonisation should take. The British referendum, promised for next year, would become effectively superfluous, and a potentially embarrassing rebuff for Mr Blair would no longer be an issue. **As investment managers, why is this political imbroglio of such importance?**

The main reasons are that we invest in European stocks and bonds and in UK companies with European exposure – Germany and France are our two largest trading partners. The 'No' vote from France is likely to have a number of consequences for markets. Firstly, it is probable that the euro will suffer some initial weakness as progress towards closer pan-European economic integration is halted. Secondly, some of the emerging markets in Eastern Europe, which have enjoyed good performance over the past couple of years as they adopted Western industrial practices and rapidly developed their capital markets, could suffer as full political and economic access to the markets of the Union is stalled. This is not just the case for the aspirant nations but also for those countries that became member states only last year: constitutional wrangles are hardly helpful for states seeking to establish the democratic stability and prosperity represented by Union membership.

Back, though, to the dog that did not really bark at all during the election campaign. Next month will mark the thirtieth anniversary of the referendum, promised by Harold Wilson's Labour government, which consolidated and validated Britain's membership of the then European Economic Community by a margin of two-to-one. At the time, it was thought that this decisive vote would bring an end to the sometimes bitter arguments that had surrounded the question of Britain's relationship with Europe. De Gaulle had blocked British membership of the Community in 1963; the Heath government had negotiated entry after de Gaulle had been succeeded by Pompidou, a more amenable French head of state, and finally the electorate had voted 'Yes'.

Nevertheless, over the last thirty years the perception of Britain within the Union has been of a reluctant and truculent affiliate rather than a whole-hearted member. Undoubtedly, the hardening eurosceptic attitude of Mrs Thatcher when Prime Minister was a key factor in this consensus view, heightened by her alleged penchant for hosting meetings with French politicians in meeting rooms graced by large portraits of Admiral Nelson and the Duke of Wellington. The opt-outs secured by John Major at Maastricht and the continued existence of sterling outside the euro-bloc reinforced the idea of Britain as a semi-detached partner, and the alignment of this country with the United States during the Iraq conflict appeared to many in Europe as a confirmation that de Gaulle was perhaps correct in his initial view.

All of these considerations conspire to make Mr Blair's position as EU President from July particularly uncomfortable. As a major trading partner and as a major capital market the nature of this country's relationship with 'Euroland' will substantially influence our own domestic currency, equity and bond markets, and it is probably no exaggeration to say that Britain is now seen as more detached from mainstream European political opinion than at any time since the late 1980s.

One of Mr Blair's predecessors as Prime Minister, Andrew Bonar Law, summarised his relationship with his party as: *'I am their leader – I must follow them.'* In European policy, as in a number of other areas on the domestic agenda, this route is far from clear. After a period of eerie silence, it is a reasonable assumption that we will be hearing from that dog again soon.

Crowds and Markets

One of the fundamentals of economic theory is the view that individuals will tend to act to maximise their own economic self-interest and that the interaction of all of these individual decisions forms a market. However, a more interesting question is to what extent individuals are influenced in their own decision-making by the perceived actions of others, or, in other words, can a rational person be persuaded to make an irrational decision simply by observing others taking the same course of action?

The answer to this question is undoubtedly that they can. Human beings, as social animals, are to a greater or lesser extent driven by hard-wired instinct to behave as part of the crowd. In some cases, the view of the crowd may be correct; at other times, it will pay enormous dividends to take a contrary view to perceived wisdom. As investment managers, it is our job to use our judgment to ascertain when a genuine investment theme has evolved into a so-called 'bubble' – a situation in the market where the price of a share or of a number of shares within a sector has moved dangerously away from any reasonable or logical basis of valuation.

One classic text – Extraordinary Popular Delusions and the Madness of Crowds, first published by Charles Mackay in 1841 – sets out in graphic detail the irrationality that gripped purchasers of tulip bulbs and shares in the South Sea Company in the eighteenth century. Enormous fortunes were lost in pursuit of unrealistic profit in an almost wholly unregulated market. The vast majority of those who lost money were, in retrospect, totally unable to account for their folly; they were just swept along with the herd-instinct. The parallel with the euphoria and subsequent hangover that beset internet and telecommunications stocks in the late 1990s is uncanny; slightly older investors will also remember a period of wild speculation in Australian mineral stocks in the late 1960s. Even an industry that has experienced enormous growth over the last seventy years, such as commercial aviation, has hardly rewarded the millions of optimistic investors who sought fortune from the skies. As Warren Buffett has noted, there were several hundred quoted airline stocks in America in the 1930s; by the 1990s the number was down to low single figures and of those that remained one had effectively been insolvent twice.

However a much more recent book – The Wisdom of Crowds by James Surowiecki – takes a different view. In many cases, the collective view of the crowd is more often correct than the view of an individual. One example is of a 'guess the weight of the cake' competition at a country fete. Given a sample of more than fifty people, the average estimate of the weight is (often) extremely close to the actual weight, and often closer than any individual's estimate. Thus, the crowd is smarter than the individual.

So perhaps we should, as investment managers, follow the crowd more closely after all, even allowing for the well-publicised sectoral booms and busts? Well, not really. The example of the cake is of a situation in static equilibrium. The weight of the cake will remain the same regardless of how many visitors try their luck. This is not the same as a market, which is dynamic in nature and can be affected by the view of each marginal individual when they choose to participate by buying or selling. The opinion of each investor can, therefore, be influenced by previous investors so the weight of the 'cake' or share can shift too.

Undoubtedly, there are many active participants in the market who seek to profit from herd-like behaviour - the so-called 'momentum' investors. The most profitable strategies of all are those where investment takes place before the herd has moved and then, by subtle or less subtle means, the herd is prodded into acting to the first investor's advantage. The growth of global telecommunication and of the internet has enabled information and opinion to travel more widely and with greater speed than ever before and so the herd movement may now be rather more unpredictable.

Benjamin Graham, one of the founding fathers of stock market analysis, conceived of such volatility in terms of 'Mr Market' – an emotional fellow whose job it is to provide stock market prices, all day and every day. Sometimes he is euphoric and quotes high prices, at other times he is gloomy and wilfully quotes low prices. However, his use is as a facilitator of transactions and not a guide to them; fall under his spell or be overly influenced by his emotional swings and there lies the route to some very expensive tulips.

In contrast to some of the wild gyrations of the past, market conditions in equities, fixed interest and currencies at the moment are generally a little subdued. Volatility has been somewhat greater in some commodity markets and in domestic property. It is here that perhaps there is some evidence of crowd-like behaviour at work.

In conclusion, therefore, it seems wise for an individual to be aware of the power of crowd psychology, to run with it at times but also to have the conviction to move away, or, in the words of the Sage of Omaha:

'An investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behaviour from the supercontagious emotions that swirl about the marketplace.' [1]

[1] Chairman's letter: Berkshire Hathaway Inc: 1987 Annual Report

Cycles, Supercycles and Long Waves

Various types of cycle, often with a short duration, can be relatively easy to identify. As a pattern emerges it tends to appear mathematically pleasing and exhibit a high degree of symmetry. Indeed, very precise timing accompanies many physical and biological cycles or particular points in cycles of this nature. Examples such as the lunar month, or the sun and earth's relative position, or frogs spawning illustrate this.

A business or economic cycle records regular fluctuations in economic activity over time. The business cycle is often said to have four distinct elements: recession, recovery, peak and slowdown and historic cycles have tended to be anywhere from five to ten years, peak to peak.

In the investment world certain stocks are often classified as cyclical. In broad terms, cyclical stocks are those most affected by economic cycles, such as property and consumer durables. Cyclical stocks are generally viewed to be riskier investments and carry a higher beta than non-cyclical stocks. A beta records how volatile and risky investing in an individual stock is compared with the risk of the equity market as a whole. Beta measures how much the individual stock's excess return (the amount it earns in dividends and capital gains compared with a short-term money market rate) varies in comparison with movement in the excess return of the market as a whole (usually represented by the market's benchmark index, such as the FTSE 100 Index). Therefore, betas for individual stocks can vary according to whether the overall market direction is upwards or downwards. As a result, a stock may be riskier in a falling market than in a rising market.

When considering periods of a longer duration, such as across generations, cyclical patterns are considerably less clear, timing can be much less precise or the symmetry rather less pleasing. The result is that it can be quite a challenge to identify or ratify the authenticity of certain historic cycles that a particular group may contend exists or may choose to endorse or promote, let alone to extrapolate and draw conclusions about the future.

By way of example, in 1926, Nickolai Kondratieff published a paper called "Long Economic Cycles". This paper was reprinted and published as a book in 1928 by the Russian Association of Social Science Research Institutes. In brief, Kondratieff determined that a long cycle of approximately sixty years was evident in capitalist economies, with the cycle being accentuated by two waves of approximately equal duration. One wave developed a burgeoning (and inflationary) advance and the other a series of deflationary contractions, punctuated by anaemic advances. He defined two and a half completed cycles and it has been contended that the rising wave of the third cycle began in 1896 and ends in 1920 and that the downward wave of the third cycle began in 1920 and ends in 1948, thus lasting 52 years. The contention from supporters of the theory continues with a rising wave of the fourth cycle that begins in 1949 and ends in 1980, whilst the downward wave of the fourth cycle begins in 1980 and is yet to be concluded. Kondratieff noted two principles, the first is that within individual countries, 'the cycles more or less coincide in time, although not completely' and secondly, that those cycles are 'international in character'. The current trend towards 'globalisation' would add weight to this theory.

The longer term inflation/deflation cycle has been linked to a confidence cycle beginning with characteristics such as nervousness, apprehension and apathy followed by caution but growing confidence and then extreme confidence, and even euphoria but which in the final stages of the cycle leads to despair, fear, concern and even panic.

Commentators and analysts have spent a great deal of time considering cycles and, more recently, the concepts of supercycles and the existence of numerous mini-cycles within a supercycle. There are many dangers in this arena, as conclusions extrapolated from trends of this nature are clearly open to over interpretation, or poor assumptions and misjudgements which could ultimately lead to major miscalculations of timing, influence or proportion. Deciding where one is in any given cycle can be key to the decision making process.

The dynamics of Commodity and Precious Metal markets and the interesting characteristics that they currently exhibit within the cycle and supercycle debate would seem to justify particular attention at present. An understanding of the existence of patterns and supercycles which provide historic context and lessons about credit inflation and credit deflation, savings ratios (as a proportion of disposable income) and many of the excesses that exist in financial systems and that frequently cause financial and economic strain, are worthy of deep consideration but will inevitably continue to trouble economists, analysts and commentators alike, with or without the existence of the supercycle. We hope to consider and examine the dynamics of specific cycles within future articles in this newsletter.

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