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Investment Management

A View from the Bridge

Nineteen years of paid enjoyment!

The title of the 12th edition of A View from the Bridge is what Alan Greenspan's recent memoirs, The Age of Turbulence: Adventures in a New World would suggest he achieved as Chairman of the Federal Reserve Board. Given the press coverage of recent events, "Turbulence" and "a New World" have a familiar ring.

This autumn has seen some very dramatic daily swings (and intra-day swings) in share prices and indices as the news of the knock-on effects of the summer's credit crunch hit screens. We also saw PetroChina become the first company to break the $1,000bn market capitalisation. Actually, three of the five most valuable companies in the world are now Chinese – PetroChina, China Mobile and Industrial & Commercial Bank of China and the other two are from the US, ExxonMobil and General Electric. Maybe China will once again become the largest economy in the world, rather sooner than many were forecasting.

But until that time the US remains number one and our first article reviews the memoirs of Alan Greenspan – the man who steered US interest rate policy for five terms. In our second article, whilst recognising the importance of the oil majors, we investigate why they have not benefited more from higher oil prices.

Our third article is perhaps closer to home for many of our readership and we comment on the Chancellor's pre-budget report – one or two surprises, some positives but certainly not good news for all.

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Alan Greenspan's The Age of Turbulence: Adventures in a New World

Two key rules for anyone retiring from a prominent position in public life are: 'Nothing is rolled up more quickly than the red carpet', and, when venturing into print: 'Get your retaliation in first.' Regarding the latter, the pre-eminent literary example is the history of the Second World War written by Sir Winston Churchill, which sought to set out for all time the definitive account of the 1939–45 conflict. Unsurprisingly, there was very little self-criticism and it has only been recently, with the publication of the diaries of people such as the Chief of the Imperial General Staff, Alanbrooke, that a different light can be shed on some of the Allies' setbacks. The campaigns in Greece and Crete, and especially the events in the Far East culminating in the fall of Singapore in February 1942, can be seen from a very different perspective.

Alan Greenspan's memoirs tick both of the boxes above. After a marathon nineteen-year stint as chairman of the Federal Reserve Board, this wide-ranging, well-written and impeccably researched book has hit the shelves within eighteen months of his leaving office. Not that the author has been entirely self-effacing in his retirement: two or three high-profile interventions during the course of the current year on the likelihood of recession in the United States and on the level of the Chinese stockmarket provoked swift

Alan Greenspan's The Age of Turbulence: Adventures in a New World continued

negative responses in global capital markets. It was not hard to see the focus of the remarks of the Governor of the Bank of England, Mervyn King, when he noted earlier this year: 'I'll only say that I am very grateful to Eddie George that he has not been on the radio commenting on what the committee are doing.'

Given the sheer tenacity that the author exhibited in his rise within the American financial and business arena, it is hard to believe that he would dwell too much on such coded criticism. Brought up by his mother after his father died young, his first ambition in life was to be a musician, and he does appear to have been a saxophonist and clarinettist of no mean talent. The lure of the business world and the discipline of economics took over, however, stimulated by the output of Ayn Rand, a writer whose works, derided during the era of 'big government' at the end of the twentieth century, are now coming back into favour. The message that governments are on balance unable to do much that is either good or useful, and have a high capacity to do harm, is an uncomfortable one for metropolitan elites everywhere. It appears to have been a profound influence on the young Greenspan, and his views on the unintended consequences of changes in fiscal policy made by both Republican and Democratic administrations have a great deal of merit.

Mindful of the second of the considerations referred to above, the author ably defends his record against two charges that critics of his long tenure level against him. The first is that the Federal Reserve ran an excessively lax fiscal policy during the years following 9/11 which encouraged an explosion in liquidity and risk appetite in capital markets. The second is that the Federal Reserve should have exercised more regulatory control over the area of sub-prime mortgages and given more attention to transparency in the area of structured investments and derivatives.

Greenspan's defence of the first charge is both economic and political. He believes that home-ownership is a social good in itself and that it should be promoted, even when there are risks that the disciplines of mortgage repayment for the long term may prove too onerous for highly leveraged borrowers. The loss of confidence that could have set in after September 2001 might have dragged the American economy into a mire resembling that of the 1930s, when protectionism and tariffs held back recovery for years. It was this worrying analogy that kept interest rates at 1% or so for perhaps too long – but, in hindsight, what was the alternative option?

On the second count, Greenspan's admiration for Ayn Rand is clear. He professes a 'libertarian opposition' to most regulation in the financial arena, commenting that 'Regulators can pretend to provide oversight, but their capabilities are much diminished and declining.' Not only in the United States perhaps; the recent events surrounding Northern Rock are an uncomfortable reminder of his argument. In some senses he sees their position as Bagehot saw the position of the monarch in the United Kingdom: having a responsibility merely to advise and warn. If equity traders do not heed his comments about 'irrational exuberance' or bond managers drive the yield premiums on junk bonds over US Treasuries to levels he called 'mind-bogglingly low', what can the Chairman of the Federal Reserve realistically do?

In fact, of course, the Chairman does have a great deal of influence over the economy given the policy options at his disposal, and Greenspan made full use of these during his tenure. In retrospect, perhaps rates were kept too low for too long after 9/11 and the internet bubble of the late 1990s was allowed to over-inflate, but everything always seems much clearer in a rear-view mirror and, at the time, critics of the Fed's policy remained fairly muted.

What shines through, above all, is the relish and enjoyment that the author took from his years as Chairman. To serve five terms under four different Presidents and not to relinquish the reins of power until nearly eighty years of age is a true testimony of his stamina and endurance. In another recently published memoir, the journalist Katharine Whitehorn reflected upon the career advice she used to give to young people starting out on their working lives. 'Find out what you enjoy doing most,' she said, 'and then find someone who will pay you for doing it.' Alan Greenspan certainly got that one right.

$100 Oil: good news for whom?

Oil may seem an obvious topic of discussion at the moment, with the price of Brent Crude reaching new highs on almost a daily basis and heading towards the $100 per barrel mark, which not that long ago seemed implausible.

One so often reads in the news that global oil is running out. This is factually correct but grossly misleading. Given the time involved in making oil – some several million years – it could and should be argued that it is a finite resource, so with circa 86.3 million barrels (13.7 billion litres) of oil per day being sucked out of the ground it is correct to say that supplies will one day be exhausted. However, it is also accurate to argue that there are still plenty of reserves left. What is more debatable is whether all the cheap oil (for which read 'easy to extract') has been found. When the price of oil was less than $10 per barrel (less than 10 years ago) it was not viable to explore the ultra deep waters of the world, nor was it worthwhile exploring the possibility of converting oil-

tar sands into usable hydrocarbons. (If the crude reserves derived from bitumen are included in the oil reserves, Venezuela has a larger pot than Saudi Arabia!) Yet with the price of oil at circa $95 per barrel, these once unfeasible projects become viable, and when these more expensive hydrocarbon reserves are factored into the equation there is a good argument to say there are plenty of reserves left.

And although some claim that oil is too expensive, we are still prepared to pay more for a bottle of sparkling water – which, let's face it, is not exactly finite – than we are for a litre of crude. Even at today's prices, one litre of crude oil costs only 30p. In fact, if one removes the UK government's tax from the equation, we pay more for supermarket water than we do for petrol. Based on scarcity value alone, this can't be right.

Looking briefly at the oil majors and their finances one could be forgiven for thinking that they have those elusive licences to print money. You will probably have noticed in recent times that the big oil majors keep reporting record profits, which should be excellent for shareholders – yet the share prices of companies in this sector have not only lagged the oil price but also the broader UK equity market. How can that be? The price of oil has risen ten-fold since the low point in 1998, yet the share prices have not even doubled in that time. The answer is to do with margins. Along with a rapidly rising oil price the industry has witnessed dramatic cost inflation.

Integral to all sea-based oil production is the requirement for an oil rig. There are two main types, deep-sea rigs and shallow (or 'jack-up') rigs. With the current demand for oil, the day rates for deep-sea rigs recently reached $550,000 a day. Even at $95 a barrel that requires a considerable amount of daily production before you start to make any profit. Furthermore, oil rigs are running close to 100% utilisation, meaning there are no spare rigs anywhere. Apart from a few nationalised oil companies, all oil rigs are owned and maintained by oil service companies. The oil majors hire them – at quite a cost. Clearly with the demand for rigs being so high the service companies get a chance to manipulate the day rates and the oil majors are very much at their mercy.

So what about the future? Demand for oil grew 4% in 2004, since when demand growth has slowed but is still growing. Perhaps unsurprisingly, Chinese demand growth accounts for the lion's share of this increase. With no viable alternative energy on the immediate horizon, demand is likely to remain firm. In the past when the price of oil rose too high for western pockets, the world turned to OPEC – and in particular Saudi Arabia – to increase production. However, Saudi Arabia is now pumping at full capacity, despite any claims to the contrary. Adding further to the woes, there is a shortage of refining capacity, so even if the producers could magically turn the taps any higher, the refiners couldn't do much about it.

By now you might be quite alarmed, given our dependence on the 'black stuff' for much of our energy requirements. However, as the oil price rises so too does the level of investment in alternative energy solutions, and whilst 'cheap' oil might be in decline there is still a considerable amount left in the ground that, with ever improving technology, becomes more cost-effective to extract. So for the time being, whilst the writing might be on the wall for cheap oil, which poses challenges for the oil majors, the oil services companies appear to have the upper hand.

Tax changes in the private client world

The Chancellor's Pre-Budget Report on 9 October 2007 contained significant changes affecting Inheritance Tax, Capital Gains Tax and the taxation of non-UK-domiciled persons living in the UK*. The Government has been reviewing the position of 'non-doms' for some time and an announcement in this area was not a surprise, although a further consultation will not help the uncertainty that long-term residents already face. The legislation is due to take effect from 6 April 2008, but non-doms will want to await further clarification before deciding their response. In moving towards a goal of a 'fairer' tax system, the Government must be very careful not to alienate non-doms, who could very easily leave the country, and also not to stifle the UK's economic growth prospects, which depend on the UK remaining an attractive place for foreigners to live and work.

The proposed changes to Inheritance Tax (IHT) and Capital Gains Tax (CGT) are welcome from a simplification point of view. The proposal to allow spouses and civil partners to transfer their nil-rate band for IHT purposes seems eminently sensible and for many will negate the requirement for creating nil-rate band trusts in their will. In the past elderly couples often faced a dilemma, wanting on one hand to ensure that they had sufficient capital to look after the surviving spouse, and on the other to maximise the value of their children's inheritance. The nil-rate band entitled them to transfer some assets without paying inheritance tax (£300,000 for 2007/2008). With the new changes, children can benefit from both parents' IHT allowances without the requirement for IHT planning (although IHT planning should definitely remain on the agenda). What is particularly helpful is that on the demise of the surviving spouse or partner, any unused IHT allowance can be utilised, so that someone who has been left everything by their deceased spouse and who themselves dies in 2007/08, can now pass £600,000 on to the next generation free of Inheritance Tax.

Tax changes in the private client world

continued

The proposed changes to CGT are more controversial, although few who have been involved with CGT calculations will shed a tear over the likely abolition of indexation and taper relief. The Chancellor seems adamant that he will introduce a single CGT rate of 18% but he may yet be willing to consider measures that would mitigate the impact of an effective CGT rate of 5% (for basic-rate tax payers) or 10% (for higher-rate), rising to 18% for business asset sales. Any increases in tax rates are generally unwelcome and the Government will not want to reduce the attractiveness of owning shares in the company an individual works for.

A move to a single 18% CGT rate would end the linkage of CGT rates to Income Tax rates (introduced by Nigel Lawson in 1988). For a 40% income tax payer, CGT at 18% will make increases in value through capital gain more attractive than a high income return. It may also be the case that if you have already realised gains in excess of the 2007/08 allowance of £9,200, realising losses to offset tax at 40% is more valuable than offsetting tax at 18% next year.

For assets that have been held for say 25 years and which are earmarked for sale in the near future, there are calculations to be done as to whether to sell before 5 April 2008 or after. For example, take two investments held since 31 March 1982 and today valued at £50,000 each. If one had a value of £20,000 in March 1982 and you assume inflation was 100% between March 1982 and April 1998 (actually it was a tiny bit more) then the taxable gain is £6,000 after taper relief. If sold before 5 April 2008, the tax – at 40% – would be £2,400; if sold on 6 April 2008, the tax – at 18% on a straight £30,000 gain – would be £5,400. If the other holding had a 31 March value of £2,000 then the taxable gain is £27,600. The tax at 40% is £11,040, but if sold on 6 April 2008 the tax is £8,640 – so sell next tax year unless it is going to fall in value between now and 6 April 2008!

We have said before: 'Don't let the tax tail wag the investment dog', and nothing is definite on the CGT front, but if the current proposals are actually introduced from 6 April 2008, then March 2008 will be a busy time for private client investment managers, as they liaise with clients and their other financial advisors in the run up to the end of the fiscal year. There will be some important CGT calculations to be made before we say a fond farewell to our CGT systems.

*Tax planning advice is provided by financial advisers. If you do not have a financial adviser or would like to be introduced to somebody new, then please speak to your Investment Manager.

Please send your views and comments on any of the articles above to Nick Rundle at:

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