



Bank lending – the different reactions of credit and equity markets

Our articles in this, our 14th edition of *A View from the Bridge*, continue two of the themes we wrote about in the 13th edition. Last time we looked at 'Debt in the Modern World' and this time two of our articles continue with this theme of debt. In the first article we look at aspects of the global credit crunch and how different markets have reacted. In our third article we look at specific company risk and suggest equity investors should recognise the credit risks in stocks with high levels of debt.

The second article of the last edition 'The Importance of Global Infrastructure Spend' summarised one of the presentations at our last Private Client Seminar. We develop aspects of this and related themes and argue that opportunities exist for investing in energy and agricultural-related commodities as a result of the unrelenting growth in demand due to urbanisation and global infrastructure development.

Last tax year presented many tax-related challenges to private clients and their practitioners so let us hope that the current tax year sees fewer changes introduced and that everyone can enjoy a well-deserved summer holiday.

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The credit crunch and afterwards

Since the late summer of 2007 there has been a great deal of media coverage of the so-called 'credit crunch' and the effect that a sharp contraction in bank lending is having on the economies of the developed world. Within capital markets there have been two widely divergent views. The credit markets have been predominantly very bearish, to the extent that the credit crunch would have posed a material threat to the integrity of the global banking system without massive co-ordinated central bank support. This has been forthcoming from the Federal Reserve, the European Central Bank and, to a lesser extent, the Bank of England, and for the moment the worst of the crisis – seen at the time of the near-collapse of the American investment bank Bear Stearns – seems to be past. However, banks still appear markedly unwilling to lend to each other and the Libor rate in the UK (the rate at which banks lend to each other) remains

stubbornly above base lending rates. This indicates that there is still residual fear of a potential default by a banking counterparty.

In contrast to the somewhat apocalyptic headlines emerging from fixed-interest and credit markets, the reaction of global equity markets has been significantly more muted. They have certainly tracked back from the high levels seen in the summer of 2007, with March 2008 being a particularly difficult month, but since then most major markets have staged a recovery and, most notably, volatility has dampened down considerably from the high levels seen in the early spring. It is too early to say that the turmoil in the structured credit markets is over, but, to misquote Churchill, we may be at the end of the beginning rather than the beginning of the end.

The credit crunch and afterwards continued

The differing reactions of credit and equity markets do perhaps reflect an idea that we have written on before in 'A View from the Bridge', a phenomenon related to the so-called 'wisdom of crowds'. Essentially, the idea is that the view of a large number of people will, on a weighted basis, converge on a more correct solution to a problem than any one individual. One good example of this is a 'guess the weight of a cake' competition at a village fete. Any one individual's view may be at wild variance with the actual weight of the cake; but if 100 participants are invited to guess, their responses are then weighted and a median number calculated, it is very often the case that this number is close to the actual weight of the cake.

Similarly, with investment markets the calculation and derived values of a large number of credit and specialised structured products are arrived at in a very opaque fashion, whereas share prices in global capital markets are the result of the interaction of a very large number of individual participants all over the world. It is thus reasonable to assume that on this analysis the more interaction and the more individual 'voices' that are involved in the derivation of the price of equities is likely to produce a better picture of the nature of the credit crunch than the variability of prices in thinly traded credit derivatives.

There may, of course, be a number of other factors at work. It is possible to argue that holders of equity investments take a longer-term view of their portfolios than investors in fixed-interest instruments and thus perhaps equity investors are more willing to 'look through' short-term volatility in markets for longer-term strategic reasons. In this case, one would expect equity markets to react less than credit markets to short-term events, which may be seen as fixable by central bank authorities. Alternatively, credit specialists may argue that equity investors have not yet appreciated the severity of the credit crunch and its lagged impact on the real economy. This would mean that a shock to the credit system would have reverberations over a period of time as patterns of consumer expenditure change in reaction to a significant tightening of liquidity in the banking system. The effects of this would not be seen for some time, given the quarterly and half yearly reporting cycle of most industrial companies, perhaps only beginning to show an impact later this year, when equity markets might correct in response to falling earnings.

It is certainly probable that corporate earnings numbers in most industrialised economies will drift down later this year and into 2009 as economic activity and world trade tends to slow. Corporate earnings may also be depressed by rising interest charges as companies find it more expensive to refinance corporate debt through the banking system. Indeed, one or two companies have now resorted to raising finance through rights issues. We certainly expect more of this to come and for some 're-equitisation' of the UK equity market to occur, in contrast to the 'de-equitisation' that has been a feature of the UK in the past two or three years. It is, however, our contention that the credit crunch is more of a monetary phenomenon than a real world phenomenon and the more appropriate response has come from the equity market rather than the fixed-interest arena.

What are the likely implications of the credit crunch for the banking system and global capital markets? One safe prediction is that collateral for loan finance will be much more carefully scrutinised than before. Another is that rating agencies will no longer assign AAA ratings to baskets of synthetic products created to mimic the returns and volatility of sovereign debt. The mathematical assumptions of some structured products have broken down in these times of severe capital market stress, leaving only sovereign debt to be seen as generally trustworthy. In fact, not all structured products warranted the sharp discount, and it is possible that some of the markdowns taken by banks and insurance companies may in time be marked back up.

Another lesson learned during the credit crunch is that of the perils of leverage within a credit portfolio. Given the demise of LTCM only ten years ago, it was a surprise to discover the extent of leverage in a number of failed hedge funds. Once again, the key lesson is that, in times of stress, markets do not trade in a predictably linear fashion; sometimes prices 'gap' and it may be impossible to buy or sell an asset without severe price discontinuity. This real-life factor is a key weakness of some modelling systems which, for mathematical purposes, assume a continual flow of prices whatever the market conditions.

After two such shocks within ten years, more recognition must be taken of the real-life conditions to which capital markets are subject in times of stress, and investors of all persuasions will surely be more sanguine in their evaluation and pricing of structured and synthetic capital market products.

Rapid changes on the global stage

An enormous amount of recent media attention has been focused on the effects of environmental, demographic and social changes, which are forecast to alter the way we live dramatically. The impact of these changes will have a strong influence on the investment themes which we seek

to uncover before they become conventional wisdom. However, comprehensive examination and analysis is required before investors sink capital into associated projects and schemes. The stakes are high and the speed of change arguably unparalleled.

Urbanisation is a good case in point. It has led to increased demand for infrastructure, along with the competing interests of feeding the population and, in many instances, using agricultural land to house them. In 1950, less than 30% of the world's population lived in cities; this rose to 46% in 2000 and is estimated to reach 60% in 2025. As a result, agricultural land is losing out. By 2040, the UN predicts that the urban populations of developing countries will nearly double. This will drive demand for a wide variety of associated goods, commodities and services. The consequences of a rapid rise in energy and agricultural commodity prices are far-reaching.

Today's international migration is believed to be at an all-time high, with some 2% of the world's population having moved away from their country of origin, and most of them seeking urban accommodation. Today, almost 80% of Europe's population lives in cities, compared to 39% in Africa and 41% in Asia. The most telling statistic is that the number of so-called 'mega cities' (those with more than 5 million inhabitants) is forecast to rise from 41 in 2000 to between 90 and 100 by 2015, with as many as 23 of these expecting to have populations greater than 10 million.

Global shortages exist as a result of failure to identify the extent of demand (although speculation in commodity markets has undoubtedly had a short-term distorting effect on some markets, such as rice). This is true in a number of areas, including China's water supply. Whilst China has 22% of the world's population, it is estimated to have only 7% of all fresh-water run-off, capable of supporting 650 million people on a sustainable basis – only half the country's population. Over the last few years, some 400 of the 600 major Chinese cities have suffered severe water shortages and many of the shortages are expected to lead to a limiting of economic development.

A fall in real prices for farm produce over the last two decades has led to under-investment in agriculture and this has exacerbated current shortages. The changing dynamics of biofuel technology and continued strong demand for transportation fuels have further distorted the tangled picture.

Closer to home, the UK is not self-sufficient in many resources and urbanisation is placing significant strain on their provision. For example, by decommissioning our own power stations, we are reliant on the Continent for energy. There is therefore a strong case for investors to examine the remaining 'trophy assets' in the UK, including National Grid, whilst also considering attractive new sources of supply in the global marketplace.

The arguments supporting the unrelenting growth in demand for hard commodities – as a result of global infrastructure development, housing and construction – are well rehearsed, and the super-cycle in commodity pricing appears intact. However, short-term pricing can be driven

by many factors, including speculation. Collective government action to curb trading through increases in margin requirement may be expected in the medium term.

The oil price and various soft commodity prices have also demonstrated major upward moves in the recent past and prospective investors should be encouraged to take particular care as fundamental prices becoming more and more stretched. Volatility remains high, perhaps reflecting the levels of uncertainty that surround markets which are venturing into uncharted territory. However, investment opportunities will arise through this volatility, particularly in some niche operations servicing increases in demand.

The emergency UN food summit in Rome reflects international concern regarding escalating food costs and a growing desire for global parties to act in a more co-ordinated fashion. Soaring food prices have led to social disorder and riots in countries such as the Philippines, Haiti, Egypt, Mexico, Tanzania and Morocco. Prices for staples, such as rice, soya and wheat, have risen by up to 83% in three years, making them unaffordable in the poorest countries, where the percentage of total income spent on food is considerably higher than in the developed world. Ban Ki Moon, the UN Secretary General, has stressed the view that we are paying the price for failing to invest in agriculture, whilst also calling for food production to rise by 50% by 2030 to meet increasing demand and inflation pressures.

Productivity gains remain a real option and many interesting investment opportunities result. Plant and machinery, chemical specialists and technical specialists provide ample opportunity to build up portfolio exposure. Potentially significant new sources of supply are available in countries such as Brazil and Argentina, which currently devote only around a fifth of farmland to crops. There is an aspiration, in a number of regions worldwide, to increase the protein content of diet and this is clearly evident in many local markets. Production improvement and the implementation of modern techniques and technologies in major regions like China are not expected to be sufficient to meet the predicted demand, and we expect to see land that is suitable for growing crops being acquired abroad, perhaps in Latin America and Africa, with a view to establishing long-term food security.

Overall, the outlook for agricultural products and food prices remains positive for the next 3–5 years, driven by rising world incomes, high oil and fuel demands, the developing biofuel market and low inventory levels. With record low stocks for many commodities, price spikes are likely in the event of supply disruptions. Whilst agricultural prices remain much closer to the lows of the last century than the highs when adjusted for inflation, potential investors must, as is so often the case, be cautious as to entry levels in this rapidly changing and volatile global marketplace.

The rationing of debt finance available to companies

A key question that has emerged in the wake of the credit problems that are now so apparent in the global banking system is whether limitations on credit will result in doubts over the value of equity.

Many market commentators question whether earnings forecasts are too high, but downgrades to profits in the current cycle have, to date, been limited. Retailers, housebuilders and financials have been some of the worst hit while at the same time market leadership is narrowing, and some other sectors are starting to follow a pattern of downgrades, albeit rather less severe. The market is looking to discount future events and work through these issues, trying to find a level that reflects the backdrop of current risk and reward.

It seems very likely that downgrades will increase and we would suggest that a catalyst will be a reduced capability to finance business at current levels because of companies' past dependence on easy credit. This imposed deleveraging may expose the fragilities in various business areas. We are looking to screen out those businesses that seem to be adversely structured and thereby manage specific risk, whilst the banking system muddles through this exceptional period.

Over the last few years we have witnessed a build up of leverage which is set to unwind rapidly and an extended period of debt retrenchment seems probable. There are a number of similarities with the 1990/1992 period, although it is important to remember that existing economic conditions, both domestic and global, are quite different to those that prevailed some 18 years ago. The expansion of

leverage over many years was bullish for risk assets, and contraction or deleveraging should have the reverse effect. We feel that low interest rates should provide a floor under markets, leading to specific businesses enjoying a relative out-performance when considered alongside other conventional assets.

The result of these dynamics is a wish to embrace equities that have low levels of leverage or are debt free, have solid long-term financing arrangements in place or have already completed sustainable re-financing. However, it is possible that there may be a somewhat greater appetite for leverage from private equity companies that are sitting on investible cash. With credit markets effectively moribund, one way of obtaining leverage indirectly is to buy into companies that are already indebted.

The cost of capital from conventional sources is not, as a general rule, falling despite recent cuts in base rates and the result is that individuals and corporate bodies are struggling to obtain credit. Given this background, we would encourage investors to look beyond earnings and to consider balance sheets, giving due consideration to any potential need for re-financing, leverage/debt reduction, or any prospect of a weakening relative situation. After a period of some indiscriminate selling in markets, the prices of equities may not truly reflect specific credit risks and from this emerges both opportunities and specific hazards. Thus investors should recognise the credit risks in stocks which have high levels of debt and low levels of interest cover. With these thoughts firmly in mind, so the valuation of earnings should reflect credit risk.

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

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