



# Where we've come...and where we might be going.

Welcome to the sixteenth edition of **A View from the Bridge**. 2008 has been an extraordinary year. The sequence of events which started with the credit crisis which first manifested itself in the summer of 2007 has led to extreme levels of volatility in equity, commodity and currency markets. As the leaders of the world's nations, both collectively and separately, seek to mitigate the negative effects, in a change of format, we show our views by taking a more in-depth look at recent events and also consider possible future implications.

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'If these things were so large, how come everyone missed them?' HM The Queen: 5 November 2008

Sometimes, it is the simplest questions that are the hardest to answer. One well-known politician admitted that having made a statement, the interview question he most feared was "why?" The question that the Queen asked at the London School of Economics this month is not easily explained. Some people would argue, with justification, that they **did** predict the savage downturn that has occurred in global capital markets but that their views were either ignored or sidelined. Certainly, it is fair to say that the dramatic events that have unfolded over the past few months have been unprecedented in their severity. The extent to which they have fashioned a re-ordering of the globalised capitalist model of markets that have held sway since the collapse of the Soviet Union is remarkable. In Great Britain, to find that a substantial part of the banking system is likely in 2009 to be owned by the State would have surprised even the drafters of 'Let Us Face the Future' – the radical Labour party manifesto of 1945. The small scale landslide in September 2007 that was the nationalization of Northern Rock became the avalanche that brought HBOS, Royal Bank of Scotland and Lloyds TSB as

suplicants to the state for support. How did everyone miss the big story?

To try and answer this question it is worth going back to fundamentals and looking at how markets actually function. Conventional theory tries to rationalize and explain the interplay and drivers of economic life through graphs, charts and equations. There is, over the long term, excellent empirical evidence to derive a broad range of conclusions as to how consumers behave in response to changing economic conditions. However, what is also undeniably true is that markets, over a shorter time period, tend to be dominated by emotional factors, given that the participants in economic decision making are, after all, only human beings and not rational automatons. A school of so-called 'behavioural' economic theory has thus come into being. A good way of thinking of this is in terms of 'chaos theory', or what the distinguished economist, Paul Ormerod, called in his book published in 1998, 'Butterfly Economics'.

The analogy here is with weather forecasting: although computer power has grown massively over the past

twenty or thirty years, such are the complexities and scale of trying to predict how weather systems will develop or change over relatively short periods of time that the, perhaps apocryphal, anecdote has been put forward that the unpredictable flapping of a butterfly's wings in South America could, through a series of events, somehow cause a devastating hurricane in some other far-flung part of the world. Life is just too irrational and unpredictable to try and impose short-term order. Yet this is just what economic strategists and theorists try and do. The excellent counter-example that Ormerod gives at a microeconomic level concerns the so-called 'must have children's Christmas present'. Marketing has become, over the years, an increasingly sophisticated affair: consumer focus groups, market research, age and demographic profiling have become major businesses for some well-known large companies. Almost every year, however, what parent with young children has not gone through the anguish in the week before Christmas of finding that 'the' Christmas toy – Buzz Lightyear, the Ninja turtles or the key Tellytubby – has mysteriously vanished from the retail shelves? Is it a dastardly plot on behalf of the manufacturers? Probably not, given the fact that demand for one key toy will generally substantially outstrip supply and that profit for the producer will not be maximized through frenetic auction activity on eBay. Yet it is a simple example of a breakdown in market intelligence that leads to completely irrational prices being paid for the sake of avoiding a wailing child on Christmas morning.

This brings us back to the question asked by the Queen. What was known and understood was that overall debt levels and leverage in the world had been increasing substantially since 2003 and that the use of derivatives – the so-called 'weapons of wealth destruction' in Warren Buffett's pithy phrase – had been rising exponentially as well. In pure economic theory, this should not have mattered since counterparty risk should not be a factor: for every 'loser' from a derivative trade there should be a corresponding 'winner' on the other side. Thus, funds and profits will tend to move around from the inept to the skilful but no overall capital should be lost.

However, and this is where irrationality makes its appearance, if there is default on one side of the trade, the so-called 'winner' will be unable to cash his winner's cheque. The extent of this disequilibrium was made abundantly clear following the bankruptcy of Lehman

Brothers in September when the counterparty positions on around \$610 billion of derivative trades had to be unwound. However, the key factor or the flapping of the butterfly's wings in chaos theory was the massive extension of mortgage credit in the United States to individuals who would be clearly unable under most circumstances to repay their debt, were interest rates to increase from the initial preferential terms or the value of the property on which the mortgage was raised to fall substantially. An important factor in this equation was that, unlike the position in Great Britain, a great deal of this credit was termed 'non-recourse'. This meant that were the value of the mortgaged property to fall below the level of the outstanding debt, the mortgage holder could simply return the keys of the property and walk away – the so-called 'jingle mail'.

The position became even more complicated by the fact that often the mortgage debt had been syndicated, so that even if the mortgagee was willing to enter into discussions about restructuring or repayment it was often unclear as to whom the ultimate owner of the mortgage debt was. The unwind of the substantial property 'bubble' began in earnest in the United States during 2006, particularly in areas that had been the subject of over-build and speculative development such as Florida, Nevada and parts of California. Prices tended to fall more quickly in areas where land was plentiful and so, cynically, some commentators have felt that both lawmakers in Washington and investment bankers in New York, where land is particularly expensive, tended to underestimate the seriousness of the issues that were developing in other parts of the country. Foreclosures gathered pace in 2007 and during that year some 1.3 million US properties were subject to repossession, up by around 80% on the figure from the year before.

Overall debt levels within the US also continued to rise. From a level of around \$700 billion in 1975, it has been estimated that total US consumer debt was around \$14.2 **trillion** in early 2008 with this total having doubled in about 7 years. Another telling fact was that in 2008 the average US household owned, between them, approximately 13 credit cards, and on those cards around 40% carried a trading balance. The comparable figure a generation ago was about 6%.

Worrying as these statistics are, it is the case that the housing market in the United States went into recession earlier than that of any other developed economy. By contrast, the markets in both the UK and Spain, two of the most over-extended areas in Europe, are now

perhaps less than halfway through a downward correction and in some areas like the Netherlands prices have hardly started to fall at all. These considerations are important in trying to evaluate where the economy and global markets might now be going and what the catalysts may be, over time, to allow growth to return.

Here we would tend to focus on two key areas: the corporate sector of the global economy and the importance of relative movements in the value of key currencies. Looking at data coming out of the corporate sector in the United States, it is clear that industry anticipated a slowdown in growth sometime back in 2007 and entered recession with balance sheets in sound shape in terms of cash and tangible assets as a percentage of market capitalisation, after allowing for the high profile distressed areas of the economy such as the mass car manufacturing companies. In Japan, a substantial number of well-run and well-financed global companies are trading at below book value. This implies that value might be created by breaking these companies up and using the capital released to build new companies in the same industrial space. What this argument does not address is the implicit brand valuation in corporate names such as Toshiba, which has advertised its products for decades and has fostered a considerable degree of brand loyalty and awareness amongst its global customer base.

Although merger and acquisition activity has slowed dramatically over the past year, it is feasible that well-financed companies are already at work evaluating picking off less well-placed competitors at valuations that would scarcely have been credible only a year or two ago. Whilst it is unlikely that consumers in the developed world are likely to be well-placed to increase their collective expenditure given the overall well-publicized levels of both secured and unsecured debt outstanding, a fall in global interest rates for the corporate sector changes the basis of evaluation for corporate activity. Of course, the corporate cost of capital in certain industrial areas will not come down nearly as far as sovereign minimum lending rates, and it was a salutary lesson in this regard to see such a well-regarded company as Philip Morris raising corporate funds at 6% above treasury rates. Nevertheless, as the initial financial and credit shocks pass through the system and the impact of the slowdown moves further out into the real economy, pressure from governments to get lending going again in the corporate sector should allow companies with solid balance sheets and good cash flow to take advantage of those in a weaker position who will struggle for some time to refinance at anything other than penal terms.

The volatility in the currency markets over the past six months could well mean that this takeover activity, when it starts to gather momentum, will be more international in nature than recently. This may have potentially significant implications for the domestic UK economy. It is hard to remember a time of fixed parities in currency markets but for nearly thirty years after the Bretton Woods agreement towards the end of World War II, it was incumbent upon governments to ensure that their currencies fluctuated within very narrow bands. Periodic step changes were permitted if capital outflows in the case of the UK, or capital inflows in the case of Germany threatened to become destabilizing. Devaluation was only a matter of last resort and an occasion of significant political embarrassment as was the case in 1949 when the £/\$ rate changed from \$4.03 to the pound to \$2.80 and again in 1967 when the rate moved further down to \$2.40. Austerity measures tended to accompany such moves: the notorious £50 foreign travel allowance even in the 1960s seem unbelievable to young people today yet the regulations concerning the disbursement of foreign currency to domestic sterling holders were administered with an authoritarian zeal.

At Taylor Young, we have felt for some time that the trade-weighted position of sterling against other major currencies was significantly too high, but only in the last year or so has its value started to fall in earnest. For a domestic investor, sovereign UK debt, or gilts, have seemed something of a safe haven in a turbulent world this year, but for an unhedged Japanese investor, for example, looking for a little more yield than on offer in the Tokyo fixed interest markets, UK gilts, let alone UK equities have, this year been little short of a disaster. Sterling has fallen by over 35% against the yen since January and still has no obvious support. Combining this fact with the fall in equity values this year, any Japanese company contemplating a UK acquisition last year will have seen a precipitate collapse in prices over 2008. Japanese banks, too weak since the 1990s to participate in the rounds of leveraging and securitization in the past few years that have blighted their American and European competitors, are, ironically, now relatively better placed to provide credit to corporate customers if required.

Tentatively, therefore, we can envisage that a number of domestically quoted UK companies might well become acquisition targets for international competitors during 2009. The highly marked imbalance that is noticeable every week in the UK between the purchases and sales made by UK directors clearly indicated that most boards believe that their shares currently offer sound value – international competitors with deeper pockets and stronger currencies may well take the hint.

Once analysts can see how trade buyers are evaluating companies, the so-called 'read across' valuations can then be made with greater confidence. However, if the longer-term result is effectively a 'garage sale' of quality UK plc assets to foreign buyers, with the concomitant issues of lack of domestic control over our economic future, then the current recession will have much darker consequences.

To conclude, it is hard to be too upbeat about the prospects for the UK in 2009. What is essential is that interest rates need to be reduced substantially even from the current level of 3%. Fixed interest markets are flagging deflation in 2009 so at 3%, real interest rates remain high. Tax cuts are also necessary, but it is important that these are seen to be lasting and not just

a tactical expedient. Consumers will not be encouraged by short-term moves if they anticipate tax increases after the next election. Infrastructure expenditure on public projects also needs to be brought forward to pick up the slack resources in the private sector. Where there are public/private partnerships, government must seek to set the pace to ensure that projects are not mothballed. The shock to confidence has been profound over the past six months, and economic news flow will undoubtedly continue to be gloomy for some time to come but, as we have noted previously, markets always seek to 'look over the horizon' and should resume an upward trend some time before recovery becomes apparent in published data. When that will happen is still unclear, but the simplest questions are, of course the hardest to answer.

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