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Offshore Holding Advisory

Sunday, 12th July 2009

## Offshore Holdings Advisory July 2009 Newsletter

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### Market and Currency update – 1<sup>st</sup> July 2009

(A Personal View by R B Skepper)

(For professional investors and businessmen/women only)

**FTSE 100: 4250 – 3<sup>rd</sup> July 2009**

#### Equities

Markets everywhere have rallied strongly from their March lows when the index here hit 3500, but resistance was bound to be met as they nearly all recovered from deeply oversold positions to their 200 day moving average level.

In order for a new bull market to occur this level has to be decisively breached on the upside.

Markets exhaust themselves by very big rises. The sheer size of the recovery needed from the March lows to get back to the long term 200 day moving average line would at the least suggest that there would be insufficient energy left to make the breach upwards as well.

This is what seems to be happening, and markets now appear to be in consolidation mode. However, taking the longer term, I am just going to quote here what Warren Buffet said back in October 2008 (when markets were just about reaching same low as March 2009):

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“The financial world is in a mess, both in the United States and abroad. Its problems, moreover, have been leaking into the general economy, and the leaks are now turning into a gusher. In the near term unemployment will rise, business activity will falter, and the headlines will continue to be scary.

So I’ve been buying American stocks. This is for my personal account, in which previously I held 100% bonds. My net worth will soon be 100% in U.S. equities.

## WHY?

To be sure investors are right to be wary of highly leveraged entities or businesses in weak competitive positions. But fears regarding the long term prosperity of the nation’s many sound companies makes no sense. These businesses will indeed suffer earnings hiccups, as they always have, but most major companies will be setting new profit records 5, 10, and 20 years from now.

Let me be clear on one point. I can’t predict short term movements of the stock market. What is likely however is the market will move higher, perhaps substantially so, well before sentiment or the economy turns up. So if you wait for robins, Spring will be over.

Today people who hold cash equivalents feel comfortable. They shouldn’t. They have opted for a terrible long term asset, one that pays virtually nothing and is certain to depreciate in value. Indeed the policies that government will follow in its efforts to alleviate the current crisis will probably prove inflationary, and therefore accelerate the decline in the real value of cash accounts.

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Equities will almost certainly outperform cash over the next decade, probably by a substantial degree. Those investors who cling now to cash are betting they may efficiently time their move away from it later. In waiting for the comfort of good news they are ignoring Gretzky's advice:

"I skate where the puck is going to be, not where it has been".

Warren Buffet - 18<sup>th</sup> October 2008

## **Sterling**

Sterling has made a substantial recovery from the lows of January when it hit \$1.33 and Euro €1.05. But the reasons behind this recovery are largely negated by the recovery itself, and that recovery now looks to be running out of steam.

The longer term prospects for STERLING look concerning.

I print below the Discussion paper on Sterling which I wrote on 1<sup>st</sup> December 2008, as I think the concerns expressed there are still very much in place.

**R.B. Skepper**

**6<sup>th</sup> July 2009**

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## What are the risks of a Sterling crisis in 2009?

**R.B. Skepper**

**1<sup>st</sup> December 2008**

The first question that has to be asked is:

Who will bail out the bailer outers?

There is of course only one answer: No one.

There is no supra national body so large in reserves that it is capable of bailing out half the world.

The IMF's own resources are a drop in the bath, and its supporters in times of need - the major economies - are themselves among those most needing help.

We are not yet in touch with an external universe with vast surplus resources that can swing in from outer space and rescue us.

So the huge credit bubble that we have allowed ourselves to create has got to be deflated entirely through our own resources, and retrenchment. All depends therefore on the effectiveness of the various government bailouts, or rather hand outs-in-advance of taxpayer's money.

It should be borne in mind that these bail outs are nothing more than extra money borrowed now against the assets and future earning capacity of each nation's taxpayers.

Equally those nations who are entering this credit bubble recession with the least debt, both at government and private level - those who fixed the roof when the sun was shining - have the greatest flexibility to deal with the problem, and potentially the earliest exit from recession.

On both counts U.K. P.L.C. starts from one of the least favourable positions.

That may now have been made significantly worse by the nature of the hasty and ill thought out package of measures the government has just announced.

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To simplify a highly complex problem, the bailouts will be judged on which do most to foster wealth creation - the only thing that can solve the credit bubble fallout.

Unfortunately for the U.K, the government have decided measures with the minimum of consultation. It also looks as if political advantage (rather than the nation's best interests) has swayed their choice of measures. This is in marked contrast to Obama's approach. He has not assumed that his party alone has the answers. He has set up a think tank, under the chairmanship of arguably the man in the world most likely to steer the right course, Paul Volcker. It will draw expertise from the widest political and economic universe. In Europe they have not gone for short term tax cuts, but focused support to bolster employment, mainly by creating substantially more work on European infrastructure. They are also taking a case by case pragmatic approach as (inevitably) further problems arise. Their locker is not being emptied in one go.

This is where there appears to be a marked divergence between the nature of the bail out that Brown and Darling have devised, and that being proposed in Europe and the U.S.

Here are some of the economic commentators' initial comments on the British bail out plan:

Damien Reece (Business Telegraph 25/11):

"The pre budget report marks a structural shift away from fostering wealth creation"

He goes on:

"The undoubted progress that the U.K. has made in the 34 years since Dennis Healey went cap in hand to the I.M.F. has now started to be undone. The pre budget report was a significant shift away from one fostering entrepreneurship and wealth creation towards one of chaotic public finances and yawning deficits paid for by those who, as Darling gleefully claimed, had done best from the growth of recent years."

Simon Heffer makes two points:

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“It was an aggressively sectarian set of measures. Labour has identified its people - the client state of public sector bureaucrats, operatives, and claimants sedulously created by Brown since 1997 and yesterday’s main purpose was to protect them. The notion that a piffling £5 bn of savings might be secured on a total public sector spend of £680Bn in a couple of years time says it all”.

(Public expenditure has risen under labour from £378bn to projected £680bn in 2010 - from 34% of GPD to about 55%)

Tom Clougherty, policy director of the Adam Smith Institute writes (in The Investors Chronicle):

“Priming the pump hasn’t worked in the past, and it’s not going to work now. Ultimately the chancellor’s only idea is to tax, borrow, and spend. This is the road to ruin.”

There appear to be at least four major concerns which could trigger a flight from Sterling:

1. The likelihood that the public sector borrowing requirement will turn out to significantly exceed that predicted in the pre-budget statement.

The tax take formerly arising from financial services and indirect taxes paid by its employees has been running at 30% of the total tax take. As much as 80% of this could vanish, indeed almost certainly will, bearing in mind the colossal losses of the banks- previously a lion’s share tax producer.

The Bank of England estimates total losses of the British banking system over the next five years will be around £120bn.

A sharp rise in unemployment will balloon welfare payments. The public sector deficit was £37.6bn in the first half of 2008 - 75% greater than the same period in 2007. £100Bn looks more likely than the \$78Bn predicted by the Treasury for this year. For the next two years it will then exceed this figure both years.

Foreign exchange markets, like all markets at the moment, are febrile. Any unmet forecast causes quite disproportionate reaction.

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2. The U.K. will be perceived to have a bigger restructuring need than other European economies, as the financial services sector, disproportionately large here, will permanently downsize. A sizeable portion of its recent activities, since the repeal of Glass-Steagal and the Big Bang, have been exposed as not only unnecessary, but actually wealth destroying. As Vince Cable put it: "They were doing nothing different from that of pyramid selling." They were creating products and financial devices that had no meaning nor requirement for the efficient working of the financial system. The profits they made were illusory, and now have to be paid back by the rest of the economic system. This alone suggests that the U.K. economy will not begin to meet the optimistic projections of the Treasury of growth returning to the economy in early 2010.

3. Overstretched British consumers need to spend more like a hole in the head and the gist of the pre budget statement is to encourage just that. Savings have got to permanently rise from the -1% of 2006/7. This can only be achieved by more money in wage earners pockets and lower costs.

The projected rise in national insurance is a "smack in the eye" to this.

4. The public sector, here, has swollen to a level without commensurate performance, that has now made it an unbearable overhead on the productive part of the economy.

Aggressive pruning of its grotesque inefficiency, and elimination of the more than 1000 (pork Barrel) quangoes costing £25Bn a year, along with a host of other bloated public agencies is now essential for restoring U.K. P.L.C. to a position where it is solvent, rather than permanently insolvent.

Our overhead as a nation has got too large for us to bear - the very centralised command economy situation that brought all Communist regimes to their knees.

It looks now as if only the arrival of the I.M.F. will force this to happen. The present government have clearly ring fenced this sacred cow, which they have made their personal province.

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The Tories appear too frightened to tackle this growing tumour within the economy.

There is a CAVEAT: Sterling's future is as much a political issue as an economic one:

Should the current government collapse and a new administration pledged to a serious restructuring of our economy take power, then Sterling could recover strongly in anticipation of the eventual improvements. We still have much huge inherent strength as a nation.

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- Robert Skepper graduated from Cambridge in 1961 and was trained at Buckmaster & Moore, then a leading stock brokerage which is now part of Credit Suisse First Boston. He joined Brewin Dolphin in 1986 as a private client portfolio manager.
- Brewin Dolphin is a founding member of the London Stock Exchange and has over 250 years of experience in managing private client wealth
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