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Market and Currency Update – 1st May 2009
(A Personal View by R B Skepper)
(For professional investors and businessmen/women only)

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The defining feature of the decade of this Labour government has been the outright failure of its central planning via public sector expansion to achieve its objectives.

The aim may have been noble, but the results pitiful. We still have the worst health, education, and transport infrastructure of any E.U. country - no different from the outcomes of the 5 year plans of the former Soviet Union. These did not result in any increment to wealth or public services - merely a further massive accretion of bureaucracy and regulation. This effectively throttled what little enterprise there was around, dooming the Soviet Union to steady economic decline.

This is exactly what has happened in our own public services. Massive additional resources have yielded an infinitesimal dividend, and left an ongoing pile of costs and debt for the diminished non - state sector to shoulder. Worse still it has impacted collateral damage on the private sector. The C.B.I. now reckons red tape is costing industry £70billion a year, up a further £10 billion in the last 5 years.

There is in fact no economy that could be more easily turned round than that of the U.K.

£100bn could be cut out of the public sector tomorrow, if there was the political will to do it. This would have no discernible impact on the services we receive whatever. Probably they would get better, because those who actually do all the work would no longer be hampered by those who don't - the quango's, committees, regulators of regulators, box ticking checkers, and a host of other unproductive inanities.

The million or more "non jobs" that could be abolished would release these people to start producing something for the economy rather than costing it. Since statistically an employee costs between 3 and 4 times his wages in overheads, even if he fails to find a job and stays on income support, the economy would be substantially better off. Most anyway would seek to achieve some kind of creative activity.

"Destructive creation" which, as Schumpeter said, is the driving force of free markets, needs now to take place in the public sector, and on a heroic scale.

As the chances of this happening remain extremely slight, the medium term prospects for U.K. Plc. remain concerning - to say the least. Higher taxes for everyone, lower living standards, and an eroding currency as the relative impoverishment of the nation has to be re-aligned with the growing prosperity of others (though in the short term Sterling may rise - the devaluation having gone too far, and having helped the economy - but not changed the longer term structural weaknesses resulting from the overblown State sector).

This is the Brown legacy - the price of excessive centralised control on too large a portion the economy.

After two decades of economic success Britain nevertheless re-enters decline from a position of considerable wealth - albeit the British banks have knocked about a £200Bn hole in it. But U.K assets are nevertheless probably of the order of £5000Bn.
The repayment of bank losses will come in two forms: partly more taxation to pay back the debt taken on by HMG to bail out the banks, and partly by savers and borrowers being permitted to be robbed by the banks for some years to come until they have restored their capital bases - this robbery is already taking the form of negligible interest on deposits for savers, and excessive margins charged to borrowers.

Small businesses and small savers, having the least bargaining powers, will bear the brunt.

BANKING REFORM

Currently there are apparently as many as 300 think tanks around the world, either independent or set up by governments, producing ideas for the future regulation of banking.

In the U.K. the official body given this job by HMG is the F.S.A.

This is a rather odd decision, as you do not normally entrust the reform of regulation to the regulatory body that screwed up in the first place.

But of course to admit that puts the blame squarely on Brown. He changed the system here by setting up the tripartite supervisory body, and removing the Bank of England's exclusive authority for bank regulation.

Where the central banks had exclusive authority, as in South Africa, Canada, and Australia, the banks did not get into the mess they did here. We should take advice from them.

Clearly a massive limitation of the permissible business scope of deposit taking banks will have to take place.

Never again can they get themselves into the situation of effectively holding entire economies to ransom. This largely happened by using depositors' money for purposes for which it was never intended - the ringleaders being Wall Street investment banks.

Hopefully there will also be active encouragement for new blood to enter the banking universe - like Tesco, so that in future they will be forced to be as competitive as the supermarkets are now.

The big 5 high street cabal here has got to be smashed.

According to the I.M.F., the whole banking cabal in the U.S. has got to be smashed too.

It all started when Clinton repealed the Glass-Steagall Act. This was set up after the 1929 collapse to prevent retail banks from using the public's deposits for investment banking activity – i.e. speculating.

Since Glass-Steagall's repeal, the big Wall Street investment banks, most of which previously were partnerships only able to gamble with their own money (and how careful they were), teamed up with the deposit taking banks whose resources were 100 or more times theirs.

Once it was other people's money they were able to gamble with, caution and responsibility went out the window, and the money was used, not to lend to real creative enterprise but to create all sorts of unnecessary financial products (like Special Investment Vehicles, Credit Default Swaps etc: etc:) whose sole purpose was, not to make the capitalist system work better, but to generate ever larger fees for themselves out of the same heap of money.

This got to the incredible point by 2007 where the banking and financial service sector in the U.S.A. grabbed a whopping 40% of all the profits made that year in the U.S economy!

Before the Glass-Steagall Act was repealed the banking and financial sector averaged about 17% of all corporate profits generated in the economy. Bankers' salaries averaged between 97% and 105% of general corporate salary levels. By 2007 their salaries had risen to 180% of corporate levels.

With this skilful piece of robbery of the real wealth creating part of the economy, the bankers increasingly upped their patronage of Washington, ensuring their interests were put first. In particular the "light touch" of banking controls that enabled them to go on acting as highwaymen but with the blessing of the authorities.

In the 90's they started off this process by promoting endless unsuitable mergers and acquisitions for which they took massive fees up front before the chickens came home to roost in the subsequent shareholder wealth destruction.

According to a study carried by KPMG, as many as 70% of the mergers of the 1990's destroyed shareholder value - one notorious example was the Daimler takeover of Chrysler. This cost Daimler Benz $10billion - and the rump investment they were left is now itself worthless!

However this wealth destruction pales into insignificance compared with what they have done this time, in their ever soaring search for ways of paying themselves up front fees. The derivatives explosion – financially worthless products, which as Buffet warned, would turn out this time to be weapons of mass destruction. The world economy never needed these products. Historically its periods of greatest economic growth were actually when they never existed.

The real worry is that the bankers, with their influence throughout Washington, have managed so far to sway the authorities to use the public's money to get them off the hook rather than nationalise them, and once and for all ditch their power, influence, and fancy earnings schedules.

Lehman's excepted, they have got away incredibly lightly.

If this means that when the crisis is over once again they can go back to snaffling a disproportionate share of GDP wealth, that will be a new dark day for capitalism.

I have dwelled at some length on the banking system, as, for the world economy to stabilise, and for the recession to remain just that, rather than sink into slump, the banking system has got to be made to work again.

The authorities' chosen method has certainly left the bankers with more than they should have been, but it is beginning to work. That is what matters short term, and this explains the surge in the cyclical sectors of world stock markets since mid March.

It is the relief of someone facing the firing squad, whose sentence has been commuted to 3 to 5 years. But it could still be that long before a good level of growth resumes. Future growth will be slower than in the recent past. It will have to be real, not founded on rising credit.

The defensive sectors of most stock markets had of course held up well, and since March have moved little - they now look relatively good value.
A bull market cannot be declared until the recovery is stretched across the majority of the market.

From this point there seem to be a number of different possible outcomes:

1. Most markets have now got back to near their 200 days moving averages. They are thus facing strong resistance levels technically. The large rise from 3500 to 4400's has also made the markets technically overbought. Wall Street is up from 6700 to 8400.

2. There still remain almost overwhelming amounts of cash sitting on the sidelines, mesmerised into inactivity by the last 12 months of fearsome volatility. Now, fear of missing out, could start to move it. Also solvency ratios will have improved for institutions, which will enable them to allocate more to equities.

3. The savage de-stocking of Oct/Feb almost worldwide is out of the way so orders will pick up somewhat, but Western consumers cannot go back to their debt habits of the last decade. So consumption will not return to previous levels - that is until new wealth is created to enable it. That takes time.

4. The economies that could expand their domestic consumption - those economies holding the surplus side of the debts run up by the overspending West - have got to do so.

There are question marks over this. Their populations are primarily compulsive savers - particularly the Chinese and the Germans.
Habits of a lifetime don't change overnight - so dis-saving will in the first instance, have to be done by their governments.

The Chinese seem to have accepted this better than the Germans, though in their predominantly command economy the institutions by which it can be done are weak. Japan has been trying to make its compulsive savers spend for a decade without much effect.

The rebalancing of the world economy that now has to take place looks as if it will face a number of obstacles before it is achieved.

But “achieve” it must, before genuine world growth can resume.

There remain a huge number of uncertainties out there, but the worst should hopefully be behind us.

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10th May 2009
Brewin Dolphin Securities

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