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30th November 2009

Chronicle of a death foretold

"It is just as if [then Chancellor] Norman Lamont had personally thrown entire hospitals and schools into the sea all afternoon."

- Central Banking magazine, on the UK's defence of Sterling during the ERM crisis.

"When I was young, people called me a gambler. As the scale of my operations increased I became known as a speculator. Now I am called a banker. But I have been doing the same thing all the time."

- Sir Ernest Cassel, private banker to King Edward VII.

Last week we learned just how close we came to the brink. The Bank of England confirmed that both the Royal Bank of Scotland and Halifax Bank of Scotland – the Caledonian reputation for the prudent stewardship of money being perhaps modestly over-rated ? – came within minutes of closing down their UK banking operations in October last year. It also disclosed for the very first time in public the existence of a £62bn emergency loan extended to the banks as lender of last resort.

The impact, both in psychological and market terms, of two of the UK's biggest commercial banks simply shutting up shop doesn't really bear thinking about.

The RBS debacle of 2008 wasn't, however, the first time that the Scottish bank had come close to a colossal near-death experience. John Lanchester for the London Review of Books points out that during the 17th Century, Scottish investors watched the English charter companies accumulating gigantic profits in their trade with Asia and Africa, and wanted a piece of the action. In 1694 they set up the Company of Scotland, which the following year was granted a monopoly of Scottish trade with Africa, Asia and the Americas. The company then staked everything on a new colony in what ultimately became Panama - and lost.

The resulting crash, reckons Lanchester, destroyed a quarter of the liquid assets in the country, and was a motive force in impelling Scotland towards the 1707 Act of Union with England. The Act of Union bailed out the company's shareholders; a body called the Equivalent Society was established to look after their interests. That became the Equivalent Company, which later moved into banking and was incorporated as the Royal Bank of Scotland.

"In other words, RBS had its origins in a failed speculation, a bail-out, and a financial crash so big it helped destroy Scotland's status as a separate nation."

As Mark Twain said, history doesn't repeat itself, but it does sometimes rhyme. While Fleet Street's spirits were animated last week by the panic and confusion triggered by an ill-conceived press release from the Government of Dubai, the real story with relevance for today's investor began in the 1980s, and in Japan.

An abundance of capital within Japan's banks begat a property and financial asset bubble. As the phrase has it: the trend is your friend, until the end, when it bends. The trend bent after the Nikkei 225 stock index reached an all-time high of 38,957 on December 29, 1989. It now hovers around the 9,000 level. The Nikkei plumbed a 26-year low in October last year, at 6995 – a decline of roughly 82% from its high.

By comparison with the property market, the Nikkei got off lightly. Prime property prices in Tokyo's Ginza district in 1989 equated to approximately $1 million per square metre. By 2004, prime "A" property in Tokyo's financial district was changing hands at less than 1% of its peak value. The collapse of financial asset bubbles hurts. When those bubbles are conjoined with a subsequent banking crisis, the real economy, as Japan can attest, hurts for quite some time. The more far-sighted investors in the early years of the 21st Century were wondering aloud whether Japan might have been the dress rehearsal, and the rest of the world would be the main event.

They haven't had to wait long. The early years of the 21st Century also saw then Federal Reserve chairman Alan "I see no bubbles" Greenspan keeping US interest rates at abnormal lows, in part to soften the blow from a stock market collapse and a modest recession. With US borrowing rates at ultra-low levels the so-called Maestro struggled to rationalise very low bond yields. (The answer is not particularly complicated. When interest rates are close to zero, investors are impelled to seek out higher returns in financial markets. One inevitable by-product of that tide of liquidity is temporarily lower bond yields.)

As in Japan, an abundance of capital and animal spirits provoked the inevitable response across asset markets. Greenspan may have puzzled over US Treasury yields, but he was evidently less troubled by appreciation in the property market – a property market within which US lending institutions were also fraudulently allowing essentially destitute borrowers to speculate. We know how that story finishes.

In what will go down as the most expensive press release in history, last Wednesday saw Dubai, ahead of a public holiday, ask for (though not demand) debt restructuring at two State-related entities, Dubai World and Nakheel. With details sketchy at best, and financial markets globally having enjoyed an eight-month rally sanctioned by government interest rate policy, investors – whipped up by alarmist and variously informed journalists who can recognise a band-wagon when it rolls in front of them – panicked first and asked questions later. Not all Gulf region debt is created equal. This point may not be lost on bondholders of UK government-owned Bradford and Bingley debt which defaulted in May this year.

Happily, not every member of the fourth estate hits the 'Return' key first and checks the facts later. There have been pockets of more considered commentary out there. Jeremy Warner for the Daily Telegraph makes the following valid observations:

"More perversely.. the crisis in Dubai has caused a renewed flight to the ***perceived security*** [our emphasis] of G7 government debt. Money is being withdrawn from the periphery and reinvested in US Treasuries, German bunds, and even British gilts.

"But if the banking crisis is anything to go by, that's not where the story ends. There, too, the implosion began with smaller, obviously flawed bit-players, who had self-evidently grown too rapidly and overstretched themselves.

"Markets dashed to withdraw funding from Northern Rock, but in transferring the money to the likes of the Royal Bank of Scotland found that they had invested only in something even more unstable. The Rock, it turned out, was just an outlier in a systemically unsafe sector.

"..The credit ratings agencies are just itching to downgrade some of the big hitters, alongside the obviously more vulnerable, with Britain and America the first in line. If the markets start to demand a premium for their money, that's going to make the task of economic recovery and fiscal consolidation that much tougher. At the risk of sounding like a scratched record, this crisis is not over yet – not by a long chalk."

It has become a catch-phrase of the financial crisis that we live in remarkable times. One peculiarly disconcerting aspect of those times is that the concept of "security" in financial terms has become more than usually fluid. For most UK investors, the crisis started with terrifying uncertainty over the status of cash in the bank. Having attempted to resolve those fears with money it doesn't actually have, the British government has essentially bankrupted itself, but has certainly badly impaired its own ability to repay its debts. While the Dubai panic may have caused some investors to flee into "safe haven" assets like Gilts, they should consider looking before leaping. Look, not least, at the economic fundamentals and plain creditworthiness underpinning the world's sovereign bond markets, because they are most definitely not created equal. The spectre of sovereign default has now finally arrived at the feast. Before the bill comes, look closely at your fellow diners. They may not be quite as solid as they appear.

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30th November 2009.

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Ref 1084/09/JD