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Dancing near the door

“Banking may well be a career from which no man really recovers.”

- John Kenneth Galbraith.

How much of the bailout money is actually supporting companies that provide jobs? That was the question asked by entrepreneur Luke Johnson in his regular and typically outspoken column for the Financial Times last week. He answered it anecdotally, with reference to a “chilling conversation” with a senior banker, in which it emerged that **almost three-quarters of the taxpayer lifeline provided to support British banks has gone to property lending**. As Johnson sharply observes,

“A distorting addiction to real estate is part of why it all went wrong in the first place.”

You can give a banker money, but you cannot make him lend. Or at least, not to those causes most worthy of the aim. Gillian Tett, writing for the FT on Friday, pointed out that when Japanese bankers, mired in their own credit crisis, were ordered to lend to small businesses, they ended up directing loans to subsidiaries of Toyota – not exactly what their governmental overlords intended. If both bankers and politicians were constrained by appropriately powerful oversight, perhaps financial crises would be less infrequent. That suggests that there may be a fundamental problem with the democratic process itself.

Euphoria for those banks operating independently of the dead hand of government has been whipped up by their investment banking-led gains. It would be difficult even for bankers to lose money when it is being provided essentially for free, and all the resources of government are being deployed to ensure that the trading environment offers up a rich harvest of short term profits so that banking balance sheets can be laboriously rebuilt at the expense of small businesses, individuals and savers. Shareholders seem to be blind to the fact that trading profits, even when the game is largely rigged, are inherently cyclical. And to the fact that without those trading profits, most commercial banks, like their government-owned rivals, would be reporting colossal losses due to still deteriorating loan books. Whether banks are through the worst is largely conditional on the health of the broader property market.

On the basis of research from Deutsche Bank on the US property market – the epicentre of the financial crisis – optimism as regards the banks is premature. Analysts Karen Weaver and Ying Shen forecast that the percentage of US homeowners suffering from negative equity will almost double to 48% in 2011 from 26% as at the end of March. “We predict the next phase of the

housing decline will have a far greater impact on prime borrowers.” Prime conforming loans make up two thirds of the mortgage market. “For many, the home has morphed from piggy bank to albatross.” Weaver and Shen reckon that 41% of prime loans will be underwater by 2011 versus about 14% now. They foresee another drop of 14% in US real estate prices.

I am indebted to Tim du Toit of [Eurosharelab](#) and to [The Inoculated Investor](#) for the following viewpoints from some of the investment greats. These were originally referenced in June of this year but with the recent equity rally threatening to break, they deserve renewed consideration.

“I ask anyone to give me an example of an economy beefed up by huge amounts of quantitative easing that did not inflate tremendously when or if the economy improved. I think what we’re doing now will either fail, or it will result in unbelievably high inflation – and tragically, maybe both. That would mean a depression and explosive inflation, which is frightening.”

- Julian Robertson, interviewed in the May issue of Value Investor Insight.

“..my trust has been severely shaken in the Federal Reserve, the Treasury, the Congress and the executive branch of government in their collective judgment as to what is required and appropriate for a fundamentally sound long-term economic recovery.. Governmental programmes deployed to stabilize and grow the economy appear highly risky, especially those involving an unprecedented Federal intrusion into the private capital system. They have been implemented in an ad hoc fashion with little predictability and consideration for their long-term effects upon the economy.. My financial market outlook is rather cautious. I believe the recent stock market rally is nothing more than a bear market rally.. Many forecasters are forecasting an end to the recession by year end, and I have even seen one anticipating a “V” shaped recovery. If my previous comments about the stimulus plan prove to be correct, these forecasts will be wrong.”

- Robert Rodriguez, CEO of First Pacific Advisors, at a recent Morningstar conference. You can read the full transcript [here](#).

“But my sense is that we have had a terrific rally, we have had a vast amount of stuff – dollars, injections of all sorts of things into the economy, TARP and other new programmes – and the ultimate effect is hard to know entirely at this point. But my sense is that this will not change the course of what is going to happen very much: that the economy is weak; it will remain weak. Whether we have seen the weakest moment, whether we’re going to decline at a lesser rate - that may be true because the rate at which we were declining was so precipitous. But I’m not sure that’s good enough. And my net feeling is that this rally does not have all that much more to go and the dangers out there remain consequential.. The dangers in the economy are most everywhere.”

- Michael Steinhardt interviewed on Bloomberg’s ‘For the Record’.

Luke Johnson’s piece for the FT was entitled ‘Britain needs a national will to reform’. But while identifying the problem is comparatively straightforward, and advocating solutions is relatively easy, implementing those solutions may be beyond us:

“..too many of those who comment and advise are theoreticians and academics. I actually work every day with owners and managers who are in a life-and-death struggle to keep their companies going. The grand announcements of economists and politicians appear to bear little resemblance to the brutal realities of business conditions at the moment. By nature most are slaves to the state – what can they know of capitalism ? We face stagnant markets for an extended period, and must

rebalance our industries – and our principles – if we are to be properly equipped to meet the challenges ahead.”

The stock market is not the economy, although a still overpopulated financial services industry may be tempted to view it that way. The red and green digits that represent markets and stock indices on a Bloomberg display do not represent the real economic world so much as they reflect in real time the feel-good factor of a relatively small clique of economic agents. The improved confidence of those agents since the March lows may suggest that the world economy is powering back up. But as every facet of the banking crisis reminds us, those economic agents are entirely self-interested. They do not serve the real economy, only themselves. The picture of apparent health they paint is a grotesque distortion of a still troubled and badly unstable world.

There is a phrase often used in dealing rooms (at least it used to be): enjoy the party, but dance near the door. A stock market rally does not a recovery make. Julian Robertson’s words above point to two possible outcomes for the economy: deflationary ice, or inflationary fire (or conceivably both). The rally has lifted many stocks back to fair value, but given the macro backdrop they should really still be cheap.

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