



29th June 2009

What colour are *your* spectacles ?

“Bank failures are caused by depositors who don’t deposit enough money to cover losses due to mismanagement.”

- Dan Quayle.

What a mess. Still only part way through one of the biggest banking crises in history, yet having suffered grievous losses across multiple asset classes, we don’t appear to have learned very much. Relations between the UK’s tripartite oversight authorities seem to be deteriorating into acrimony and turf warfare even as the regulatory pendulum gains in weight and momentum. The banking and financial services sector is fast becoming a political football. Taxpayers deserve better. Maybe they will get mildly less incompetent treatment from the next government. Meanwhile, Wall Street firms that are only in existence due to the unconsulted largesse of US taxpayers are planning to boost executive pay. Citigroup (current share price: circa \$3, which makes it the equivalent of a penny stock), having received \$45 billion in “government” bail-out funds, now wants to increase some of its banking salaries by up to 50%. Did the events of 2008, during which the taxpayer rescued Wall Street and the City, never actually happen ?

Exactly how far we are through the banking crisis remains unclear. But it is unlikely to be all the way through and back up the other side, to those broad, sunlit uplands where nobody knew what CDOs or CDSs were, or cared. We have just completed our second investment seminar of the summer and one of our guest speakers, fellow Money Week contributor and Pali’s chief strategist James Ferguson, highlighted what we know about banking crises. From the recent Rogoff and Reinhart study of 15 developed nation bank crises, the following attributes are common:

- Government debt, on average, rises by 86% over the first three years
- Equities fall by 56% over 3.4 years
- The unemployment rate rises by 7% over five years
- House prices drop by 36% in real terms over six years
- GDP falls by 9.3% (cumulative) over the first two years.

Consider not just the data relating to economic contraction but also the typical **duration** of those contractions: three years; five years; six years.. Given the magnitude of this crisis relative to all that have gone before it, does it not seem intuitive to expect the duration of our current debacle to be longer-lived rather than shorter than some of the more localized banking difficulties of the past ?

James also cited the Bank of England’s own study of 33 systemic crises between 1977-2002, in their Financial Stability Review of 2003. Again, on average, system-wide financial crises had the following characteristics:

- Average duration of 4.3 years
- Average percentage of non-performing loans: 26.7%
- Cumulative fiscal costs of banking resolution 7.8% of GDP (**without** an associated currency crisis), or 17.4% **with** one
- Two thirds of all banking crises result in a currency crisis (-25% drop versus the USD)
- Median cumulative output loss: 23.1% of GDP versus the prior 10 year trend.

Again, the same suspicion applies: is our current debacle going to be better, on average, than those that economies have experienced before, or is it going to be worse, and longer lasting? The wild card, admittedly, is the extent of government intervention already committed, and pledged. The current consensus, however, would appear to be that the worst of the crisis is past – at least as far as Wall Street’s plans for executive pay are concerned, even though much of the Wall Street still left standing remains a ward of the US government, alive only through the sufferance of the taxpayer.

Merrill Lynch, one of my alma matres, made much last week of their latest World Wealth Report. (A word to the wise. The wealthy of the world may find better corporate role models than that of Merrill Lynch, a stockbroker that survived the last Depression but which this time round was forced into the arms of Bank of America, which is itself now a ward of the US government, and the recipient of a \$20 billion “investment” and \$118 billion in “asset” guarantees. Then again, just because a business impoverishes itself is no reason to believe it will automatically impoverish you.) According to the report,

“What started as a financial crisis soon expanded into the larger economy [in part through the actions of investment banks such as Merrill Lynch].. World equity markets lost a decade of gains.. HNWI [High Net Worth Investors – the curse of the uncontrolled acronym managing to transform discrete individuals into an anonymous corporate subset] began to lose trust in the markets, regulators and, in some cases, their financial advisory firms [that was bold !].”

So now HNWI apparently have 50% of their portfolios in cash and fixed-income instruments. The cash element is understandable, if not particularly remunerative, either for Merrill Lynch or for its clients. But the “fixed-income instruments” is somewhat troubling. If those instruments are akin to government bonds, then they will probably preserve investor capital in the event of a protracted deflation. But in the event of an upsurge in inflation, they will represent return-free risk, and the combination of guaranteed avalanches of future supply and deteriorating credit quality and the still real possibility of a currency crisis for multiple western currencies leaves us decidedly lukewarm on the asset class in question. The trouble is not just government bonds. Many investors have migrated to corporate bonds on the grounds of relative yield enhancement. In many cases, however, corporate paper offers insufficient yield to compensate for the very real risk of rising default rates and general balance sheet impairment – such as you get from a long drawn out consumer-led international recession. It would be ironic indeed if investors, having seen their portfolios largely crushed by the equity bear, now considered themselves safe sheltering in corporate bonds at just the time when the macro fundamentals for mediocre quality corporate debt were deteriorating sharply. Out of the frying pan, into the frying pan, so to speak.

Ultra-HNWI (what’s wrong with the word “rich”?), somewhat counter-intuitively, suffered more than the wealthy population as a whole, according to MLCG (two can play at this game). The plain averagely wealthy saw their portfolio values fall by 19.5%, whereas the super-rich incurred losses more like 23.9%. The super-rich, again, should question the value of the financial advice they are paying for, assuming they are paying for it. MLCG reckon that their target market will revert to growth as the global economy recovers. On the basis of the bank crisis data cited above, they may have a rather longer wait than they thought.

MLCG also believe that the US is “crucial” for global economic recovery. Well, they would say that, wouldn't they ? A more objective assessment from the vantage point of the emerging economies might suggest otherwise.

Exports as a percentage of GDP, various emerging markets

Exports % of GDP

Exports (% of GDP) - 2008	Exports (% of GDP)	Exports to US (% of GDP)	Exports to EU (% of GDP)
Singapore	240	17	25
Hong Kong	203	26	27
Malaysia	111	14	12
Czech Republic	80	1	68
Hungary*	79	2	63
Thailand	76	9	10
Taiwan	76	9	9
South Korea	57	6	8
Poland	42	1	18
South Africa	38	5	12
China	38	7	8
Indonesia	33	3	4
Philippines	33	5	6
Russia*	32	1	18
Mexico	31	25	2
India	24	3	5
Turkey*	23	1	13
Brazil	14	2	3

Source: EIU.

There is a myth circulating that China needs the US consumer more than the US consumer needs China. The table above would suggest otherwise: Chinese exports account for roughly 38% of its GDP, but its exports to the US account for just 7%; those to Europe for only 8% or so. Mexico, on the other hand.. So not all emerging economies are alike.

As for the so-called developed economies, and more particularly their supposedly now rescued banks, James Ferguson at our seminars offered a table in respect of them, too, which makes for somewhat grim reading:

Major global banks: Tangible Book / Asset Ratios

	Tangible Book / Asset Ratio		Tangible Book / Asset Ratio
Deutsche Bank	0.95	Unicredit	2.8
UBS	0.99	Bank of America	2.83
Northern Rock	1.07	Merrill Lynch	2.84
Barclays	1.28	Bear Stearns	2.89
ING	1.54	BBVA	3.22
Citigroup	1.56	Nordea	3.22
Lloyds	1.6	Monte dei Paschi	3.43
Wells Fargo	1.62	Washington Mut'l	3.66
RBS	1.63	Standard Chart'd	3.68
Credit Suisse	1.94	JP Morgan	3.76
PNC Fin'l Services	1.94	Santander	3.76
BNP Paribas	1.97	Morgan Stanley	4.35
Lehman Brothers	2.39	Intesa San Paolo	4.51
Credit Agricole	2.44	BB&T	4.75
SocGen	2.5	UBI Banca	4.82
HBOS	2.55	Goldman Sachs	4.86
US Bancorp	2.59	Northern Trust	5.42
HSBC	2.65	Mediobanca	8.35

Source: Bloomberg.

Tangible book value removes from the equation all the dodgy “capital”, the valuation of which the banks have been lying about. Most of a bank’s assets are its loans. So you can see at a glance that many large banks are effectively leveraged 100 times, with tangible book / assets at around 1 or less. They are, in other words, hugely undercapitalised, and are likely to end up under full government ownership (or on the scrap heap, but after last year, that outcome looks less realistic) in anything other than a more or less immediate and peachy economic recovery, with no further deterioration in housing prices or asset values. The alternative, suggests James, is that they contract the asset side of the equation (i.e. loans) to compensate for such a slender cushion of equity. So don’t expect necessarily to qualify for that new mortgage or small business loan any time soon. Just as worryingly, note the institutions that James has highlighted in blue. Those are banks that have already either failed or required emergency government support. They are not necessarily the most egregiously leveraged (note Deutsche Bank and UBS, for example, at the top of this list of shame).

So the conclusions: the markets have got wildly ahead of themselves in seeing an end to the financial crisis (the jury on stock markets is still out). The banks are not necessarily in any better shape than at this time last year – there’s just an enormous cushion marked “moral hazard” and “taxpayer support” separating them from the grave, and further economic slowdown is going to lead inevitably to further balance sheet impairment, emergency capital raisings, and most probably panic (remember that ?).. Unless you believe, on better evidence than ours, that the green shoots are back. That is probably not a bet worth taking. The monumental scale of government support already announced, in the meantime, underlines the requirement to be exceedingly selective in bond selection – and probably avoiding overmuch government debt. It would be lovely if the outlook were better, but since we’re not an investment bank, our spectacles tend to be transparent and colourless, rather than rose-coloured, conflicted, venal and stupid.

Tim Price
Director of Investment
PFP Wealth Management
29th June 2009.

Email: tim.price@pfp.co.uk

Weblog: <http://thepriceofeverything.typepad.com>

Bloomberg homepage: PFIG <GO>

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