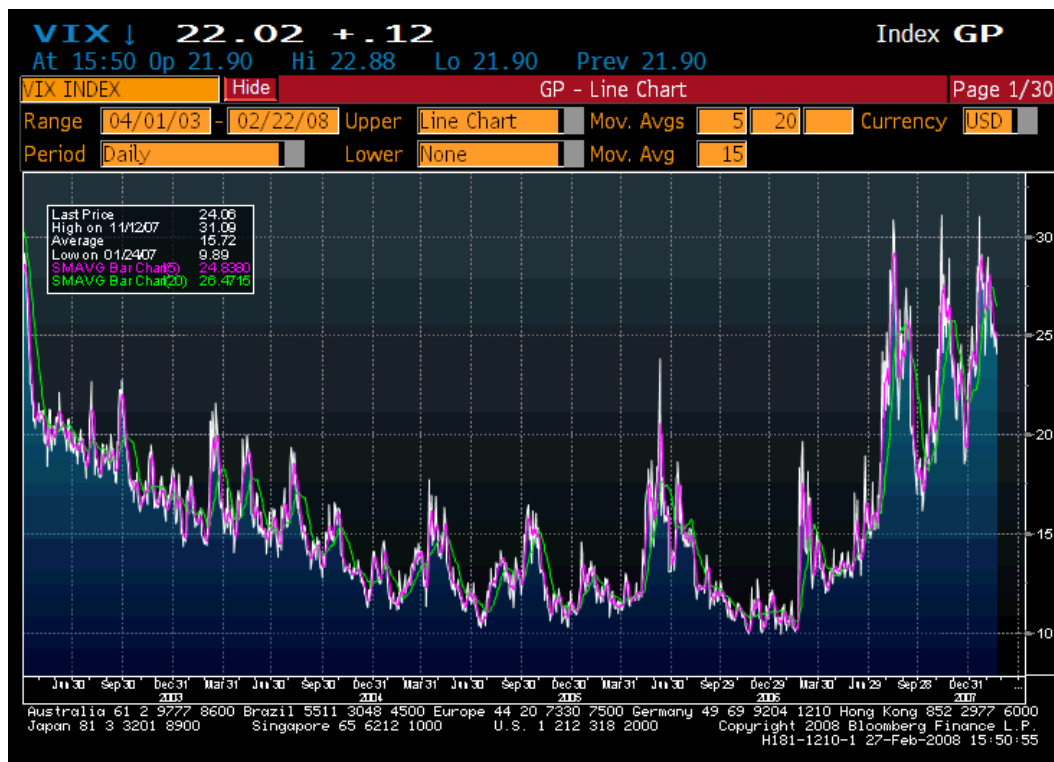


Squinting into fog

"A cynic is not merely one who reads bitter lessons from the past, he is one who is prematurely disappointed in the future." – Sidney J. Harris.

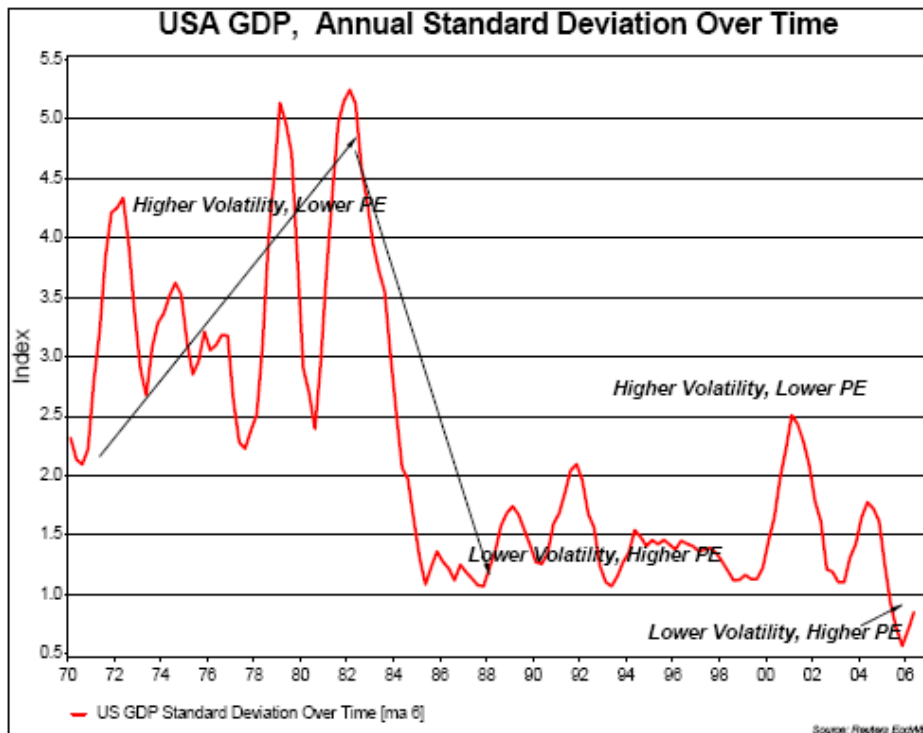
Pimco's [Bill Gross](#) calls them 'Old Maids'. Canada's [Eric Sprott](#) refers to them as UFOs from Mars. However one wishes to label the risks attendant upon structured products invariably linked to the health of the property and mortgage markets, the underlying reality is that leverage – throughout the financial system – continues to be aggressively unwound, that the "fair" pricing of those products remains opaque at best, and that supposed professionals are not necessarily any closer to understanding the dynamics of this market than otherwise uninformed observers. Bob Parker, vice-chairman of Credit Suisse Asset Management, told clients last week that the worst of the sub-prime mortgage crisis would be over within weeks. Perhaps so. This opinion would, however, have carried more weight had it not come from within Credit Suisse, which just a week after reporting decent fourth quarter 2007 earnings, suddenly announced that it would be writing down an additional \$2.85 billion because of unspecified "mismarkings" by a group of traders.

That so many storied members of a former global banking élite have been carried out on stretchers during the credit crisis perhaps suggests that we have seen a fundamental changing of the guard during this period of acute financial disfunction. One way of expressing this change is in the coinage used by a number of market commentators: that the days of 'The Great Moderation' may be over. The chart below, for example, shows the recent price history of Chicago's Vix index, a market estimate of future volatility for the S&P 500 stock index:

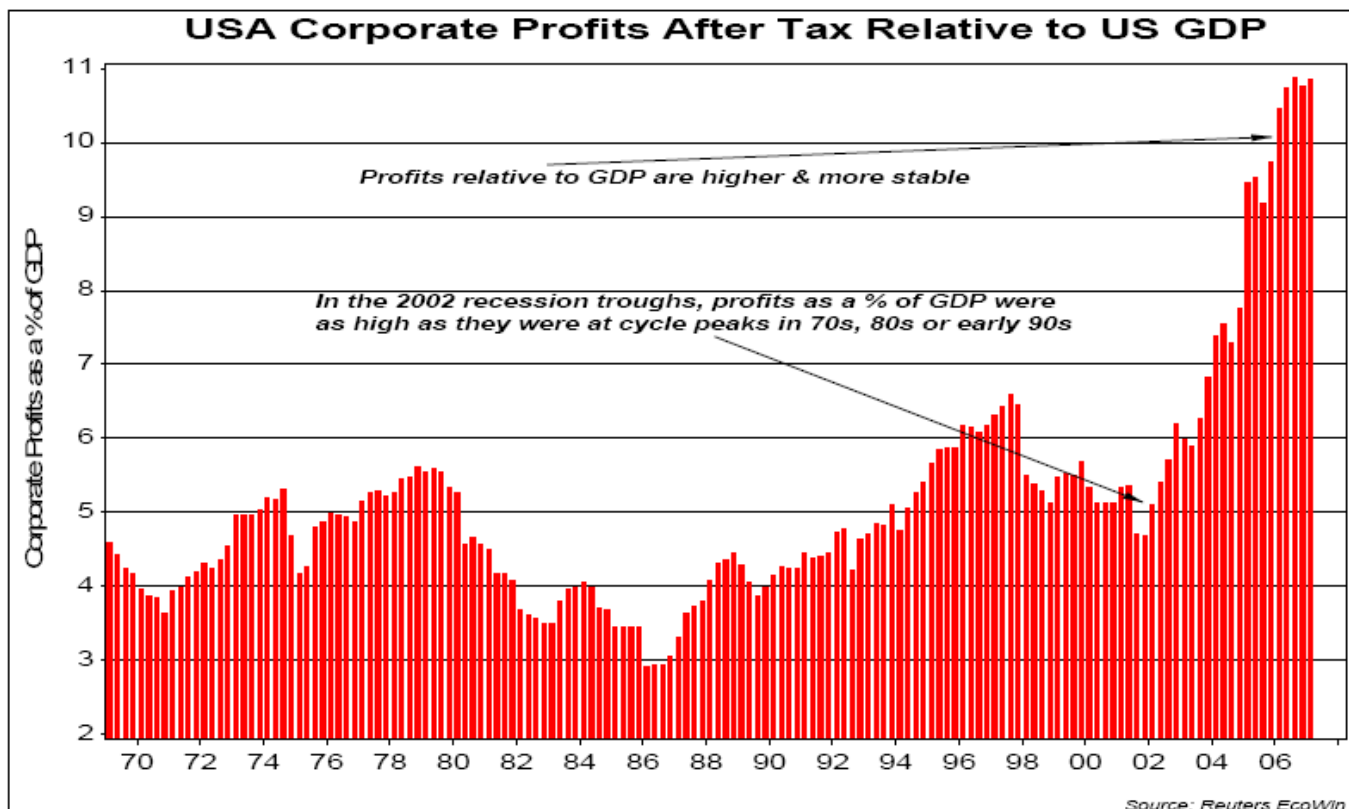


Notwithstanding a short-lived spike during the summer of 2005, the Vix's longer term trend pointed to "the death of volatility" – until subprime-related concerns progressively set in last year, with a vengeance. Credit Suisse may believe that the worst is passed. Others, including former Federal Reserve chairman Alan Greenspan (who now seems tragically unable to keep his trap shut), believe that the US economy has stalled and may well take longer to recover than normal: "As of right now,

US economic growth is at zero." Bank of England Deputy Governor Rachel Lomax warned last week that in the light of the credit crunch, central banks internationally face their "largest ever peacetime liquidity crisis," as "each week seems to highlight some new dimension of the ensuing disruption to core financial markets." Consultancy [Gavekal Research](#) may have been among the first to elaborate upon the theme of "The Great Moderation"; as their chart indicates, the last forty years have seen a marked decline in the volatility of growth.



The companion chart shows that with lower volatility to growth has come higher profitability:



But the trillion dollar question is whether either of these trends is **sustainable**. Corporate profits in the US, relative to US GDP, had never been higher than in 2007. In the light of a softening property market and a wounded financial sector, it seems reasonable to assume that analyst expectations for corporate profits growth in 2008 are simply unrealistic. Similarly, the thesis that 'permanently' low economic volatility can justify sustainedly high price / earnings ratios looks like being stress-tested to perfection this year. If the financial sector over the last 12 months is any guide to the broader market, the 'p' can easily get crushed, with the 'e' shortly to follow.

Tony Jackson, writing in last week's Financial Times, took a withering view of the [Pension Benefit Guaranty Corporation's](#) decision, as an itself indebted federal protector of pensions for nearly 44 million Americans, to 'bet the ranch' by switching the majority of its assets from bonds into equities. Nobody disputes that equities are likely to perform better over the longer run, but the longer run can be longer than you or I can remain solvent. Mr. Jackson made specific mention of the Asia effect, which is surely playing a significant part in the across-the-board rise in the prices of both hard and soft commodities:

"The China effect is crucial. In contrast to the shock increase in the world's labour supply, which for some years proved disinflationary [that Great Moderation again], the acceleration in per capita incomes points the other way. It produces a multiplier effect on consumption of raw materials, to say nothing of strains on the environment. The result – too much money chasing too few resources.. The result.. will be a hoovering up of investment by resource sectors generally, including water, waste disposal and alternative energy. In such a world, diversified portfolios may no longer make sense. In the 1970s, resource-based portfolios were alone in producing real returns.. Meanwhile, equities in general will suffer from the higher risk premium due to economic instability, and bonds from higher inflation.."

We wrote last week of the remarkable surge by soft commodities prices. The exquisite challenge of investing across multiple asset classes today is that innumerable investment sectors with solid longer term fundamentals are almost effortlessly taken "there", seemingly overnight, by more speculative capital. Contrarianism used to be about bucking the trend by buying out of favour investments at revulsion lows. Contrarianism in 2008 might be about, effectively, endorsing the speculative trend - but keeping the faith for the longer term. Shorter term price action, in other words (wheat, anybody ?) amounts just to **weather**; longer term, secular, sustainable and fundamental trends amount to **climate**. (In commodities markets, even more than in stock-picking, buy and hold may come to trounce trading strategies, and the recent article by Bloomberg's Andy Mukherjee, "Food is a great asset – minus the fund manager" also points in that direction.) Tony Jackson, we hope, is wrong in suggesting that portfolio diversification could be redundant (to be fair, he concedes as much himself). Whether he is correct or not, no rational investor would surely choose to allocate 100% of their liquid capital to commodities and nothing else. But he could be half right – in that investment right now into every distinct asset class requires extreme selectivity and care. Given the heightened volatility of the resources sector at present, and the marked disconnect between the level of equity indices (borderline euphoric) and the tone of credit markets (borderline suicidal), that seems like an eminently reasonable conclusion.

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