

Not waving but drowning

"The national budget must be balanced. The public debt must be reduced; the arrogance of the authorities must be moderated and controlled. Payments to foreign governments must be reduced, if the nation doesn't want to go bankrupt. People must again learn to work, instead of living on public assistance."

- Cicero, 55 BC. (Note: Edward Gibbon dated the actual fall of Rome to AD 476, over five centuries later.)

If ludicrously overblown press headlines were a definitive contrarian guide, the financial crisis has reached its nadir. *Fortune* went last week with 'The end of Wall Street as we know it'. If only. *The London Evening Standard* billboard, long a source of gaudy amusement to weary commuters, went with 'BANK CRASH: LONDON PANICS'. (The Standard, of course, has some form here. Previous measured coverage of topical events from the paper that never discovered lower case has included 'TOXIC CLOUD HITS LONDON TONIGHT'; 'THAMES FLOODS: PREPARE TO FLEE'; 'TOOTHPASTE CANCER ALERT'; 'EXPLODING LAPTOP COMPUTER ALERT'; 'KILLER FOG TRAVEL CHAOS'; 'AAAAAARRRRRRRRGGGGGGGGHHHHHHHHHHHHH!' (this last entry looks suspiciously like a fake – judge for [yourself](#)); 'IPOD HEALTH ALERT'; 'EUROPE: IT'S WAR WITH FRANCE'; 'INSIDE HORROR PUPPY FARM – PICTURES'; 'SUMMER KILLER WASPS ALERT'..) Other coverage was more nuanced. *The Financial Times* on Tuesday led with a somewhat baffling photo from the Chicago Mercantile Exchange of someone arms akimbo who may just have been ordering a cheeseburger. *The Daily Express*, admirably meeting its journalistic responsibilities in addressing the biggest markets crisis since World War 2, led with a headline about Princess Diana.

With the fifth largest US investment bank having been repackaged and sold at distressed valuations to what is now the largest, and with several UK banks now optically at least yielding over 10%, it would be redundant to say we are living in extraordinary times. But we are, and as Citigroup's Patrick Perret-Green points out, desperate times require desperate measures:

"It is time for Federal involvement no matter how distasteful the issue of moral hazard is. There are times when only the public sector can halt the rot. I believe that this is one of them. GSEs (Government Sponsored Enterprises, namely Fannie Mae and Freddie Mac) and munis need to be guaranteed and the White House needs to exercise its executive muscle. If it means that you have to replace your Treasury Secretary to enact the equivalent of a "surge" then so be it..

"Equally significant is that it is time for the other firefighters (central banks) to become much more involved. The fire may be centred in America but the sparks are floating on the wind and too little has been done to prevent it spreading.."

From a behavioural perspective, one of the *slightly* more positive straws - as opposed to sparks - in the wind is, perversely, the very failure of Bear Stearns: traditionally, the collapse of a major institution would have been treated as symptomatic of the low being *in*, or at least *close by*. It is a sign of the times that no sooner had Bear entered the welcoming arms of JP Morgan than the market sniper was directing his crosshairs at the likes of Lehman Brothers and MF Global. The difference this time round would seem to be that the crisis, like the financial system and the international economy, is properly global. So there are likely to be more Northern Rocks and Bear Stearns to fail before the worst can be said to have passed. Particularly in Europe, where the monetary authorities have been surprisingly grudging to offer the financial sector anything (other than simple liquidity) by way of meaningful emergency support in comparison with the Fed. One other, significant, observation: if we are entering a realm of much enhanced government (i.e. taxpayer-) funded support for the financial sector, that is occurring at a time when government balance sheets are already a disaster. Government bond yields run the risk of exploding upwards in an environment of further emergency bail-outs for badly run banks or near-banks.

But then these are extraordinary times. [RJH Adams](#), conversely, takes a less than charitable view of the Fed's energetic and creative intervention:

"And now the Fed has decided, post Bear Stearns collapse, that even more largesse is required for the troubles at hand – this time including non-banks and allied to terms of greater secrecy.

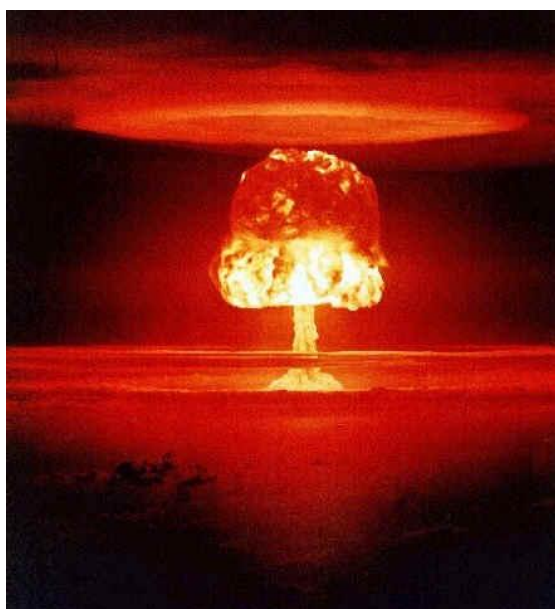
"This latter feature is both a sop to financials wishing to preserve their reputations which, for some curious reason, they collectively appear to believe are currently held in high esteem; and to stave off depositor / client scrutiny and exit.

"The secrecy is, viewed in these terms, a deception upon shareholders and a symptom of a weak banking supervision regime. Banks in difficulty are being allowed to hide and roll over their solvency issues (where they can) in the hope that their catastrophic losses on assets held prove transitory with the underlying security at some future point marketable.

"So far the opposite is happening and yet this behaviour is likely to continue until the Fed eventually comes up with a package soft enough to persuade the banks (and other financials who, like Bear, will find an indirect way to access Fed support) to take it up anonymously.

"Maybe the Fed just did that; but the opacity of the deal destroys confidence more than the fig leaf excuse of protecting banks' operations merits. Here is the point: it is currently impossible for investors to determine which banks / other financials are solvent. Allowing all and sundry to tap Fed offers can only turn out to be a drag on the broader economy and delay final settlement.. Banks need recapitalization. That requires transparency – and that someone takes losses. Just ask your average shareholders like Mr. (Joe) Lewis (whose Tavistock Group owns 9.4% of Bear Stearns) and Citic (a Chinese brokerage that agreed in October to invest \$1 billion into Bear Stearns). Buying time and pretending otherwise is wishful thinking."

"Our balance sheet, liquidity and capital remain strong" - (c) Bear Stearns' CEO, March 10, 2008



Not every debate last week was over the appropriateness of Federal Reserve support for broker-dealers and other members of the so-called shadow banking system. In a timely piece for The Financial Times, investment consultant David Roche wrote of the commodities 'lifeboat' being swamped in a rush to safety:

"In the current turmoil, there has been a rush into commodities.. the speculative element has grown sharply.. (but) global growth is declining fast. Recession will ensue and no region or asset class will be immune from its ravages.."

Roche suggests that as the Chinese authorities tackle domestic inflation (unlike their western counterparts), China's growth rate could easily fall by, say, 3% to 8% - which "would remove the ex-ante global supply / demand deficit from energy markets and push most industrial metals, including steel and copper, into significant surplus.. we can expect the price for refined oil to fall 30% and industrial metals by 20% to 30%. The big fall is coming."

Since commodities, and more particularly softs, have recently been the only game in town, Roche's suggested correction leaves investors with something of a quandary. Government bond yields are pricing in hell on earth. Equities and corporate bonds are trapped in a bear market, along with the US dollar and confidence in the international banking system. If commodities join them, where can despairing investors go - either in search of profits, or simply to preserve capital ?

One response would be that a commodities correction might be short-lived: limited, perhaps, to the extent that a Chinese slow-down takes some of the heat out of the market. If it turns out to be an altogether longer-lived correction, even that would be nothing that BMO's impressive global strategist Donald Coxe didn't foresee as far back as October 2003 ('Basic Points: A major investment sonata in a minor key'):

"Within months, this Movement will probably end. Whether it will come from disappointing economic news.. or simply because stock prices have gotten ahead of themselves, one cannot know..

"The Second Movement will mean further development of the [commodities] theme, but will be more stately, and will frequently be in a minor key. At each of those intervals, the miners will rediscover their primal fear: they must not be up dancing when the music stops."

Donald Coxe goes on to explain that the Second, or middle, movement of symphonies was historically a shorter movement that gave the orchestra a chance to cool down; "Since stock prices for the leading mining companies [and the prices of most commodities] will be up so hugely as this movement begins, there will be itchy portfolio manager fingers to take profits as the rest of the stock market encounters downdrafts.."

Again, given that Coxe was writing these words in October 2003, he deserves bonus points for prescience. As he then pointed out, in relation to the metals markets (but surely his words have a broader resonance for the entire commodities complex):

"..the demography of the market.. includes those too young to have seen a true bull market for mining stocks, and those who remember all too vividly the ghastly bear market of the 1990s, and the ups and downs of the 25 years before then. Within the mining industry, the aged players are battle-hardened and cautious. Youth doesn't understand, and age doesn't believe."

David Roche may well be right in the short term in relation to the overvaluation of commodities, but in the longer run his argument is up against some significant headwinds, including: a secular shortage of supply (40 year low inventories in the case of some agricultural softs); a multi-decade bear market before the most recent gains; the new ease of access into the sector, in the form of low-cost exchange-traded funds; the chronic underweightness of institutional investors (see, for example, our commentary 'All in the mind' of 7th March, which cited a Bloomberg report claiming that the Calpers pension fund, the largest in the US, having made its first investment into commodities in 2007, was considering increasing its investment **some 16-fold**); the demand shock represented by a newly emergent and newly wealthier Chindia; a US monetary policy regime that seems determined to sacrifice the dollar on the altar of banking system survival. Commodities markets are always going to be volatile, but rarely have there been so many fundamental reasons to be positive about their longer term prospects in an otherwise acutely unstable world.

Tim Price
Director of Investment
PFP Wealth Management
25th March 2008.

 01423 523311

 mail@pfp.co.uk

Email: tim.price@pfp.co.uk

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

Bloomberg homepage: PFP <GO>

Important Note:

PFP has made this document available for your general information. You are encouraged to seek advice before acting on the information, either from your usual adviser or ourselves. We have taken all reasonable steps to ensure the content is correct at the time of publication, but may have condensed the source material. Any views expressed or interpretations given are those of the author. Please note that PFP is not responsible for the contents or reliability of any websites or blogs and linking to them should not be considered as an endorsement of any kind. We have no control over the availability of linked pages. No part of this document may be reproduced without the express permission of PFP. Updated 25th March 2008 © PFP Group.

PFP Wealth Management
3 Windsor Court
Clarence Drive
Harrogate
HG1 2PE

Telephone 01423 523311

PFP Wealth Management
Lion House
Red Lion Street
London
WC1R 4FP

Telephone 020 7400 1860

Registered Office: 1 Hagley Court South, The Waterfront, Brierley Hill, West Midlands, DY5 1XE
Tel: 01384 361777 Fax: 01384 361785 DX 700621 Merry Hill

www.pfp.co.uk

PFP Wealth Management is a trading name of ProACT Financial Ltd which is authorised and regulated by the Financial Services Authority. Registered No: 4114354



01423 523311



mail@pfp.co.uk