

Power failure on Wall Street

"Doubt is not a pleasant condition, but certainty is absurd." – Voltaire.

Have there ever been bigger dislocations between the behaviour of financial markets and the likely fortunes of western economies ? Has the reputation of Wall Street and the City ever stood at a deeper discount to the actualité ? Does current market behaviour really tell us anything about the market's longer term prospects ?

There used to be a quotation above my father's desk; it may still be there:

"Finding the right answers is easy. It's asking the right questions that's difficult."

(This is only a variation on a theme: "Judge of a man by his questions rather than by his answers" (Voltaire); "Good questions outrank easy answers" (Paul Samuelson)). I used to find this quote trite but the longer I spend in the markets, the more pertinent it becomes. Which is itself a little like a particular Mark Twain quote: "When I was a boy of fourteen, my father was so ignorant I could hardly stand to have the old man around. But when I got to be twenty-one, I was astonished by how much he'd learned.."

One of the innumerable problems with Wall Street and the City is that they never do seem to learn from their mistakes. Property market bubbles; whichever hedge fund John Meriwether is associated with this week; the venality of quasi-monopolistic agencies associated with credit, housing or debt ratings.. Each generation seems obligated to re-experience the errors of its predecessors. There is little or no 'race memory' that might at least mean that this year's crisis is brand new rather than a tired retread of past embarrassments.

And while Wall Street typically shies away from overly intrusive questions, it certainly seems to have all the answers. Where is the oil price headed ? \$141 a barrel during the second half of 2008, according to Arjun Murti of Goldman Sachs. (Could Goldman Sachs possibly have any material interest in oil trading ?) Because Mr. Murti was also behind a prediction for higher oil prices in 2005, his apparent ability to foresee the future has led to his universal resource market canonization in the financial press. Actually, the target is \$150, says T. Boone Pickens, another presumably disinterested oil trader. The last time we saw this kind of easy momentum-chasing and price target leapfrogging was during the dotcom boom (Amazon.com – essentially impossible to value during its early hyper-growth phase, so easily justifying Henry Blodget's \$400 share price target even when it was overpricedly trading at \$242), and it did not end well. As the analysts at McCall, Aitken, McKenzie have suggested, welcome to "dot.oil".

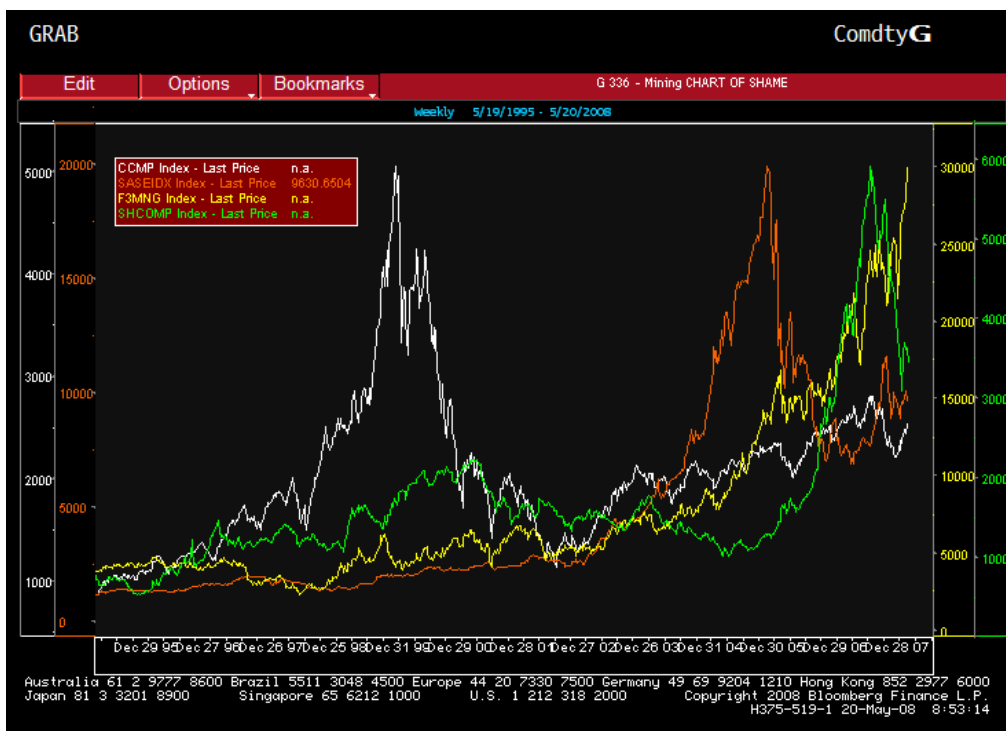
The difficulty with commodities prices, as Bloomberg's Caroline Baum recently pointed out, is that unlike more traditional financial instruments such as stocks or bonds, there is no fundamental yardstick of value:

"..metrics that allow us to quantify the degree to which prices have strayed from their fundamental moorings. Stock prices have an historical relationship with underlying earnings. House prices don't stray too far from their "earnings" stream, or rental value.. With commodities, no such quantifiable ratio exists."

So in assessing the valuation of commodities and natural resource prices, we are all left orienteering in the fog. Patrick Perret-Green of Citigroup has at least tried to square this circle using behavioural finance techniques. In his occasional 'Chart of Shame' he archly compares markets that have experienced classic booms and busts with contenders for the Emperor's new clothes. Back in January he cheekily overlaid a chart of the Nikkei (grotesque peak in 1989), Nasdaq (grotesque

peak in 2000), the Saudi Tadawul All Share Index (grotesque peak in 2006) and the Shanghai Composite (grotesque-looking peak in, erm, late 2007). Chinese stocks have obediently collapsed since then. One swallow, of course, doesn't make a Murti. Last week, Patrick somewhat ominously updated the 'Chart of Shame' but with the FTSE 350 Mining Index as the 'bubble' candidate (see below):

'The Chart of Shame': Nasdaq (white) vs Saudi (orange) vs Shanghai Composite (green) vs FTSE 350 miners (yellow)..



Source: Bloomberg; Patrick Perret-Green of Citigroup

As anyone who holds mining stocks will confirm, the sector dutifully collapsed, albeit in the short run. One can argue, as always, that "this time it's different", and that mining stocks trading on "just" approaching 20x p/e ratios and 1% dividend yields are hugely better value than internet stocks were in 2000 with p/e ratios approaching the infinite and no dividend yields, but the charts have a fairly compelling power, and anyone sitting on gains of the order of 200-300% or more is wholly justified in a spot of profit-taking.

What makes markets so intriguing today is that equities seem largely immune to a combination of \$120+ oil, softening housing markets and a likely collapse in western consumer spending. Arguing that several trillion currently either sheltering in money market funds or rapidly accumulating thanks to petrodollar wealth in sovereign wealth funds will ride in to support stock markets (a.k.a. *greater fool theory*) only logically goes so far in the face of such sizeable challenges. But some confusing short-term resilience on the part of stock markets does not invalidate the need for caution, it rather reinforces the need for patience. On a separate note, James Ferguson of Pali asks whether it might be time to commit heresy and talk, not of \$200 oil (or \$1000 oil, has anyone on Wall Street tried that yet ?), but merely **\$100** oil ? "The last three times, in the 7-year bull run that West Texas Intermediate (crude) has enjoyed, that the oil price got more than two standard deviations above trend, it precipitated an almost immediate profit-taking that resulted in an average -28% drop." Wall Street's venal salesmanship and management of subprime goes some way to underpinning its credibility in other markets, so its bandwagon-chasing on oil can be largely discounted on fundamental trustworthiness. The bigger question is how long equity markets can hold their poise in the face of the world's mounting unbalances, and that question touches on government bond valuations too in the face of the smoke of the battle around inflation.

Sir Francis Bacon once wrote:



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"If a man will begin with certainties, he shall end in doubts; but if he will be content to begin with doubts he shall end in certainties."

In the face of almost insurmountable doubts (over likely economic slowdown, the impact on consumer confidence of softening residential property prices, the robustness of Asian fundamentals in the face of the ongoing commodity rally, the impact of \$130+ oil, and the health of government bond markets given growing doubts over the under-reporting of inflationary pressures) it makes absolute sense to assume ongoing and substantial macro uncertainties. That argues, in turn, for nuanced and highly selective exposure to equity market risk, to capital preservation strategies in bond market terms, and to a healthy degree of 'absolute return' (quality hedge fund) as opposed to long-only market positioning, not to mention further asset diversification. Markets may not yet be flashing red, but there seem to be more than usually strong headwinds about. Unfortunately, an especially discredited Wall Street establishment now has peculiarly weak authority in either recommending appropriate strategies or taking advantage of the resultant dislocations in markets. Happily, evolutions in financial products and the rapid democratisation of more sophisticated investment vehicles make it easier for independent asset managers and private individuals to try and resolve these questions for themselves, rather than simply overpaying to engage with a mountain of conflicted interests.

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