



28<sup>th</sup> September 2009

## Still stuck in the woods

“Midway on our life’s journey, I found myself / In dark woods, the right road lost.”

- Translation of the opening lines of Dante’s ‘Divine Comedy’.

There’s a rumour going round that the financial crisis is over and that the world economy has recovered from the banking shock of 2008. Calm analysis of banking losses to date versus capital raised would tend to disprove the former thesis – see the table below (with a hat-tip to Eoin Treacy of [Fullermoney](#)):

### Global write-downs and credit losses versus capital raised, to date

	Total Loss (\$ bn)	Total Capital Raised (\$ bn)
<b>All Financial</b>		
Worldwide	1623.2	1340.8
Americas	1076.1	754.1
Europe	504.8	480
Asia	42.3	106.7
<b>Banks / Brokers</b>		
Worldwide	1137.5	1085.3
Citigroup	112.2	109.4
Wachovia	101.9	11
Bank of America	69.6	99.3
Merrill Lynch	55.9	29.9
UBS	52.8	39.9
HSBC	50.1	28.6
<b>Insurers</b>		
Worldwide	247.8	137.3
AIG	101.4	92.3
<b>GSEs</b>		
Freddie Mac	119.6	57.7
Fannie Mae	118.3	60.5

(Source: Bloomberg LLP, as at 21.9.2009)

As Eoin observes, one region alone stands out for having raised more capital than that required to replace banking write-downs and credit losses: **Asia**. Pretty much everywhere else, governments

and corporates are still playing catch-up with announced losses. Whatever cannot be funded through the bond markets or via already creaking government financing will have to come through rights issues – the overhang of which could start to pressure stock markets. A benign reading of the table above also assumes that the writedowns are over – rather than that there are further losses to come from, say, prime mortgages, student loans, auto loans, credit card loans.. It also presumes that the banks aren't lying about their real liabilities.

As regards the world economy, investors everywhere are seeing equity markets enjoying a powerful rally off their March lows and inferring that the battle is over. In a sense, the battle *is* over: Lehman may have been sacrificed along the way, but in all other respects the banks won, and everybody else lost. As Patrick Perret-Green of Citigroup points out, broad money continues to contract globally, and the likes of WPP's Sir Martin Sorrell plainly dismiss the green shoots thesis. In Patrick's words,

“it does look as if investors are far more optimistic than the managers of the companies whose equity they're buying.”

The equity rally has been, in Crispin Odey's words, a rational bubble. Investors have been presented with Hobson's choice. Faced with near-zero deposit rates and hugely manipulated government bond yields, equities look like the only game in town offering the potential for meaningful returns. We would only add that the requirement to be selective in stocks is even more pressing now, given the extent of the rally. Happily, what has lagged has been quality blue chip defensiveness. If the market does undergo a correction before the end of the year (and who knows for how long the rational bubble can inflate), the stodgy blue chips will almost certainly outperform their more speculative cousins, albeit on the way down.

But it is not just the stock market that offers the potential for meaningful returns in a financial environment otherwise hopelessly distorted by government fiat. As the bond managers at Stratton Street Capital observe, selected investment grade bonds from some of the world's most creditworthy borrowers can be bought with yields of 3% to 5% more than US Treasuries, whereas emerging market debt has never been so expensive by comparison with investment grade paper. How has this anomaly arisen ? In large part because most institutional bond funds are run by unthinking index-trackers: their managers allocate the greatest weighting within their funds to the most heavily indebted countries – which form the largest components of their respective index. This is exactly the opposite of common sense, which would focus on creditworthiness and fundamental quality rather than gross indebtedness. But this institutional navel-gazing represents an opportunity: the New Capital Wealthy Nations Bond Fund, to which Stratton Street are advisors, targets a gross redemption yield of around 8%, despite having an average credit quality of 'A', and despite having no exposure to sub-investment grade debt. Investors in supposedly “safe” investment grade corporate bond funds may be unaware of the risks they are taking on: under IMA (the Investment Management Association) regulations, Sterling Corporate and Strategic Bond Funds are permitted to allocate up to 20% of their portfolios to sub-investment grade debt. Such allocations may in turn represent 50% or more of the portfolio's entire risk. And as Stratton Street point out, amid some of the most challenging economic and credit conditions for decades, investors in sub-investment grade bonds (a.k.a. junk) run the risk of facing peculiarly high default rates and extremely low recovery levels on those junk bonds that default. In other words, the requirement to be extremely selective applies just as much to bond selection as to equities. The Economist has helpfully provided an interactive map of global government indebtedness [here](#). In both a literal as well as a figurative context, stay out of the brown stuff.\*

\*At the risk of appearing overly scatological, credit is also due to David Roche at Independent Strategy for a little plain speaking on CNBC last week. Contributing to the otherwise facile debate on precisely what letter of the alphabet the economic “recovery” will resemble, Roche commented as follows:

“You want to know my shape ? My shape is a toilet shape. Because I think that’s where 14% of GDP in terms of spending and central bank help will disappear.. The problem about the recovery (sic) is that none of the problems that caused the credit crisis have been resolved. Household leverage is worse than before, banking leverage is worse than before. The bad debts problem has not been dealt with and we have a new level of profligacy and leverage which is the government.”

Bloomberg carries a daily quote on its system. Monday’s was as follows:

“Givers have to set limits because takers rarely do.”

For “givers”, read taxpayers; for “takers”, read the governments of the west. Badly managed oversight of the financial system and a vilely uninformed capitulation to bankers have conspired to incinerate the public finances. Voting the UK’s clownish incompetents from office within months will be somewhat pyrrhic consolation: the damage has already been done.

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