Beyond the Crunch – Learn From History And Survive The Squeeze

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In our last newsletter we published the article "The credit crunch – Making sense of it" which explained the background to the credit crunch and some of the likely economic consequences. A lot has happened since then and this article now picks up from where we left off.

We have gone from the deepest recession in history to the start of the recovery in a few short weeks

A few months ago it was all doom and gloom and politicians, media and economic pundits were all queuing up to tell us how bad the economy was. Ed Balls, one of the architects of new Labours economic policy and one of Gordon Brown's closest allies and confidants, said in February 2009, "The reality is that this is becoming the most serious global recession for, I'm sure, over 100 years, as it will turn out" and this is a typical comment of that time. I am sure that this and other comments made by Ed Balls did not go down well with the Government as they have been busy giving us all the impression that the plethora of initiatives they have taken will save the UK and the world's financial system. Indeed, now spring is here and judging from the headlines we could be forgiven for believing life is fast returning to normal. Many newspaper headlines regularly state or at least imply that "Green shoots of recovery" are appearing and the stock markets worldwide have rallied from their lows in March. The FTSE 100 is up by over 20% with other markets up even higher. Stock market pundits are calling this the bottom of the stock markets. According to figures published with the late Spring Budget, many city economists and our Government are predicting that our economic recovery will start later this year, gain momentum in 2010 and recover strongly in 2011. Can they be right?

It may be a depression but not as we know it

If we are in the depths of a deep recession with unemployment in the UK at over two million (6.7% of the labour force), our gross domestic product (GDP) forecast to fall by 3.5%, corporate bankruptcies up by almost 60% to over 6,700 in the first three months of 2009, why is retail spending now rising? Between February and March of 2009, total sales volume rose by 0.3% and even house prices and stock prices are rising, although the data on house prices is mixed. Given that both retail spending and stock prices are leading indicators (in other words these figures tend to rise and fall first with changing economic activity), it is understandable why headlines of "green shoots" are everywhere. Yet these mixed messages can be deceptive - Why? Although we may be in a depression it is not as we have known it in the past. Today people are a lot wealthier than in the 1930's during the great depression. There is now unemployment benefit and other social security benefits and a lot more Government intervention in the early stages of a recession. Consequently, many people have a lot more money even in such difficult times. The base rate now at an historic low of 0.5% will add a big boost to people's disposable income each month for those with variable mortgages. Over time more will benefit as they come to the end of their fixed rate term and can get cheaper mortgage deals. All this in the short term can boost confidence and lead to an upturn. However, without a change in the fundamental causes that brought about the recession the current Government initiatives are unlikely to work. Indeed, it is likely that it will prolong the recession, because sooner or later the root causes that remain unresolved are likely to reassert themselves bringing about an even sharper down turn.

Lessons from history

If we compare and contrast our current recession which started in earnest last year to the 1930s, then we are still effectively in 1929 when Wall Street crashed and the great depression started. Then as now, well respected investors thought that their comments and actions could influence markets; sadly they did not. In 1929 Richard Whitney, Vice President of the New York Stock Exchange, acting on behalf a group of leading Wall Street bankers amassed their financial resources to buy US steel and other "blue chip" stocks at well over the then market price. It helped boost the stock market for about a day before selling began followed by panic selling on Tuesday, which turned out to be known as "Black Tuesday" when the Dow Jones index fell by 13%. This event came to mind in September 2008 when I heard reports that the legendary investor Warren Buffet was investing US$10bn into Goldman Sachs and that this was to be seen as a major vote of confidence in the US banks by him. Warren Buffet also said that US stocks were a good buy and he bought a lot through his company Berkshire

Hathaway. As news broke of these events The Dow Jones Index promptly rose but soon fell back. Berkshire Hathaway recently reported a 62% fall in profits and its share price has fallen by over 30%, the worst performance in 44 years. In his letter to shareholders Mr. Buffet said "During 2008, I did some dumb things". At least he is big enough to admit his mistakes!

By 1930 people believed that they saw the equivalent of "green shoots of recovery" as the US markets began to rebound. They bought stocks, hoping to recover what they had lost – only to get hit again even harder. The bottom didn't come until 8 July, 1932, when the Dow hit 41. The real news stories about the depression only started to appear in the mid 1930's. Both President Hoover and Roosevelt had not succeeded in bringing about a quick recovery. Even Roosevelt's new deal, (the basis of the Obama current recovery plan) did not lift the US out of the recession. That happened only once the US entered the Second World War.

The key message from history is that until the fundamentals which caused our current recession are resolved, no amount of tinkering at the edges and throwing money at the problem will make much difference; in the long term nature and market forces will take their natural course.

For many today, it still does not feel like a recession and as confidence returns and spending picks up it may seem business as usual, but it would be wise to remember the lessons from history.

Fundamentals have not changed

We need to remind ourselves of the basic problems that started the credit crunch. This was too many people borrowing too much money and living well beyond their means. The banks then fuelled this demand by creating vast amounts of unregulated and unknown quantities of paper assets against which they borrowed more money to lend. Governments aided this process with low interest rates. With the banking system awash with money, a lot of imprudent lending took place to people who could not afford to pay them back - "sub-prime borrowers". Meanwhile the easy money and loose lending policy created the credit and property bubbles. By the time the central Governments realised that this was unsustainable and tried to rein it in by tightening monetary policy and raising interest rates, the sub-prime borrowers were already defaulting on their loans in large numbers. This then set off a chain reaction whereby, as the value of the paper assets that institutions put up to borrow money on the money markets fell and also become harder to value, the lenders to the institution caught fright and stopped lending.

One of the high profile casualties was Bear Stearns which at one point was a solid investment bank being Wall Street's preeminent bond shop, taking on large volumes of sub-prime loans which were very profitable and seemed resilient enough to survive the crunch. The next moment, clients were pulling out their money and other firms stopped trading with them. Bear Stearns needed to borrow around US$75bn each day to fund its requirements and as the hedge funds that lent it money then stopped, they knew that Bear could not survive. To profit from this they took out a bet that Bear would fail, which in turn accelerated Bear's demise and within days the Federal Reserve had to step in and save Bear Stearns. The fall of Bear, the subsequent failure of Lehman Brothers (another blue chip US investment bank which this time was not rescued by the Fed) and the rescue of AIG (the largest insurance company in the world that had also underwritten much of the toxic debts) by the Fed set in motion more worries about the value of the assets in banks balance sheets and the insurance companies that insured some of their risks. The institution lenders feared that if they lent money to a failing bank they could lose their money as the value of the assets they were being offered could not be correctly valued. This situation has not materially changed even though trillions of US dollars have been globally pumped into the banking systems by the central banks.

Easing the credit flow is the route to recovery, but this is unlikely to happen until the toxic debts are quantified and dealt with.

Despite the recent G20 meeting in London and announcements made to support the economy during the credit crunch, no one seems to be addressing the root problem of the credit crunch, that of quantifying and dealing with the so called "toxic debts" (potential bad loans). The problem is that they are very difficult to value as there is no open market for valuing much of this paper and also it is not known who holds them nor how much they hold. The US Fed and UK's FSA are currently attempting to check the health of the balance sheets of the banks through a number of "stress tests". However, as these are the same regulators who failed to spot and act to stop the toxic debts developing, one has to ask how much confidence there will be in whatever they say or do.

There are no reliable estimates of how much potential liability there is in the global banks balance sheet but best guesses are in the tens to around $200 trillion. However, it is known that the balance sheets of the main UK high street banks are several times the size of the UK economy and even if a modest amount of those assets turn bad, the UK Government are unlikely to have the money to bail out these banks. But as many of our high street banks are now effectively nationalised, this now posses a significant risk to our economy as the tax payer is now liable for future bad debts of the nationalised bank. Given that a large proportion of these bank's assets are denominated in foreign currency, the UK government cannot print money to get out of trouble. There is also no guarantee that these banks could start to lend at the level which the Government is expecting unless the money markets ease. The outcome will depend on whether lenders have faith in the Bank's balance sheet.

There is a real danger of this downturn getting worse before it gets better
In this short article we do not have the space to develop the arguments regarding why things could get worse but nevertheless here are a few pointers. There are a number of Eastern European countries which are on their second and third IMF bailout and if these countries go bust and default on their loans this would put further pressure on the international banking system. This time it will be the European banks such as Sweden and Germany who would suffer early on but we the UK would not be immune.

Our Government's plan to borrow more, raise taxes, print money and spend to save our economy is unlikely to succeed if history is any guide. If excess borrowing and living beyond our means got us into this mess how can doing more of the same get us out? This defies logic and commonsense. Most of the tools used by our Government including reducing interest rates to almost zero and printing money were tried recently by the Japanese and it DID NOT WORK! Governments have a very poor record of spending large amounts of cash quickly in an efficient manner. The US lost billions of dollars which went missing in Iraq when it tried to stimulate their economy through spending on infrastructure. Even now Obama's plan to put $billions into the US economy is being held up because the money is not getting through to where it's needed fast enough due to the bureaucratic process required to ensure money is not wasted. In the UK we are not much better, the Government's flagship proposal announced in September 2008 to allocate £285m to help vulnerable people keep their home, "the mortgage protection scheme" has so far helped just one family across the whole of the UK some six months later.

The net national debt at the end of March 2009 was £743.6bn, the equivalent of more than half of the UK's GDP, and this does not take into account all the off balance sheet finance for which the Government is also responsible. Despite this the Government is planning to borrow more over the next few years than all successive UK Governments have borrowed in the past. This is likely to leave a legacy of debt for over a generation and interest payments which will require high taxation and public sectors cuts to fund. Against this background it is hard to see a quick economic recovery.

We need to cut public expenditure and lower taxes
The next government will have little choice but to cut public sector expenditure as the current trend is unsustainable. They also need to reduce borrowing and lower taxes. High taxes actually reduce the overall tax revenue as people take action to avoid it, typically by either not working as hard or even emigrating. We should also revisit our support for the banks and industries. Whilst politically this may be challenging, commercially it may ultimately be better to allow badly run or old industries fail so that new ones grow stronger in their place than to support lame ducks. This was the failed policies of the1970's. If done properly, letting banks and other weak companies fail need not mean economic meltdown. It will mean hardship for some who lose their jobs and savings but this is happening now anyway with the bail outs, therefore prolonging it for a longer period will only make matters worse. That is again a lesson from history!

Being unprepared for what follows could be costly but being prepared could be rewarding
No one can accurately predict what will happen in the future. All we can do is to assume what should happen from the analysis of events and the lessons from history. On this basis some of the likely events in the absence of a change in Government policy are:

- The stock markets may fall much further and could take several decades to get back to their peak of 1999. Nevertheless there should be considerable volatility giving an opportunity for traders to make good profits.

- House prices may fall even further, but this will create opportunities for those trading up or entering the market for the first time.
- The pound should remain under pressure and is likely to fall even further as switching to the Euro and Dollar accelerates. This may benefit exports but other countries may try to take action to prevent the UK benefiting from this through an effective devaluation of sterling.
- Both corporate and personal insolvencies will rise as a result of increased company failures and rising unemployment. The recent “Debt Relief Order” is likely to encourage many individuals to use this route to free themselves from debt burden.
- Although not an imminent danger, excessive printing of money is likely to lead to inflation in the future.
- Fraud and other financial crimes are likely to rise.
- Cash rich companies are likely to buy up distressed corporate debts and then use their powers to force the companies to shed assets, liquidate or restructure to repay their debts – this is called a “Vulture Fund”. This is likely to lead to more unemployment and destruction of capital if allowed to proceed unchecked.

In our future newsletter we hope to explore further how to take advantage of the opportunities that the credit crunch will present.