

HAMPSHIRE COUNTY COUNCIL**Decision Report**

Decision Maker:	Pension Fund Panel
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Title:	The Investment Outlook
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Report From:	The Independent Adviser

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1. Introductory

- 1.1. This report summarises the views of the Independent Adviser on the investment outlook for various asset classes as at August 31st 2011. It should be emphasised that the economic and financial situation is still appreciably more volatile than usual, and that September is likely to bring with it numerous unpredictable developments.

2. Background

- 2.1. At almost every moment since the end of July, it has been too early to try and discern what the future might hold as there was always some imminent event which could transform the outlook. And as one was resolved – default by the US Government was avoided; a further temporary tourniquet was applied to the Greek national debt; the free-fall in equity markets was, at least temporarily, stemmed – further question-marks were raised: what (if anything) do Ben Bernanke and President Obama have up their sleeves for later in September? Will the EU Zone finally get its act together, either for the next few months or in making progress towards some kind of common jointly guaranteed bond? And will George Osborne be compelled to reveal a Plan B (even if disguised as an always already available amendment to Plan A)?
- 2.2. One cannot indefinitely put off answering the question about what may lie ahead until it has been possible to look round the next corner, and I am therefore attempting to discern some solid shapes in the shifting murk. This is not an analysis, more some thoughts on our present discontents.
- 2.3. The main theme is what I would call optimistically pessimistic. Pessimistic because the general tone of expectations is gloomy, but optimistic because, after a long period of denial, it is now generally accepted that it is going to

take a long time for the current situation to improve and we can therefore discern the possible limits to the downturn.

- 2.4. Recognising the scale of a financial disaster may not merely make it harder to deal with, but also ensure that it spreads far beyond its initial cause. Thus, banks sold people mortgages they could not afford, but then parcelled them up (to 'spread the risk') and passed them on to investors (including other banks). To assist that process, they were given (highly exaggerated) credit ratings by the leading agencies, and insurance against default was widely taken out at rates which therefore failed to reflect the real risk.
- 2.5. As the loans duly turned toxic, default spread from bank to bank and nobody knew the value of what they held, what they owed and what they owned (except that in the last case what remained was close to zero).
- 2.6. The banks went rapidly from a liquidity crisis to one of solvency. To prevent a complete collapse of the system governments pumped unheard of amounts of cash into the banks – partly in exchange for assets of little or very dubious value.
- 2.7. This put increasing strain on the balance sheets of central banks – and in cases where the banking system was larger than the country in which it was operating (Iceland, Ireland and very nearly Switzerland) sovereign debt was forced up to levels at which doubts were raised as to their continuing ability to support the necessary payments. (The same rating agencies as had cheerfully endorsed the suspect mortgages as being on the same level (AAA) as international banks and the world's largest economies, now began downrating the banks because of the hit to their balance sheets, and then the governments that had been forced to plug the yawning gap in the banks' own finances.
- 2.8. Partly because of the long-drawn out process, holders of bonds issued by the governments which came under the greatest pressure (Greece in particular) refused to bear any share of the resulting necessary write-down in the value of those bonds. This was in spite of the fact that some bond issues had offered higher interest rates in some tranches precisely because they were exposed to greater risk. But, partly because much of the sovereign debt of most countries was held by governments and banks in other countries, heels were dug in and the burden of footing the losses transferred more or less in its entirety to the taxpayers rather than the bondholders themselves. Germany was particularly vehement in insisting that no 'haircuts' should be applied – arguing that this would destroy the Euro system, although Ireland did in fact impose a write-off on some of its securities.
- 2.9. The prolonged arguments about such issues led to the unfortunate experience of successive initiatives being put forward by Euroministers, each of which may have been relevant and appropriate, but all of which were too late and therefore too small so that the crisis continued to bubble more and more dangerously.

3. W(h)ither the Banks

- 3.1. Later this month, we will find out what the Vickers inquiry into the future regime for the banking system has recommended, after reconsidering its first thoughts, and, more important, what the Government intends to do as a result.
- 3.2. A tidal wave of opposition to any rigid separation of retail and investment functions has been building up, as has resistance by the industry to the idea of the UK unilaterally increasing the level of reserves to be held against assets above those laid down in so-called Basel 3.
- 3.3. The arguments against what Vickers is perceived to be about to propose seem to have a greater chance of success than those against the boosting of reserve requirements. Strangely enough, both sets are based on the same contention: that they will undermine the status of the banking industry and its contribution to the UK economy and Government revenue.
- 3.4. It is suggested that increasing the reserve requirements will diminish the level and variety of banking operations, and therefore lead to the loss of activity to foreign competitors and a reduction in profitability and therefore tax revenues.
- 3.5. Alan Greenspan recently queried whether more effective regulation of banks might lead to a loss of the ability to expend that would more than offset any gains from reducing the risks of a new financial disaster. Howard Davies calculates that the kind of restraints on the banks now being canvassed might lead to a reduction of 0.5 to 1 per cent in GDP after five years.
- 3.6. This needs to be put into context. While lax de-regulation of the banks clearly is not responsible for all the deterioration in the economy since 2007, it must have played a significant role. Currently, GDP is still 4 per cent below its level then, and the latest projections by leading analysts suggest that the 2007 figure will not be regained before 2013. Even if expansion after 2013 reaches 4 per cent a year, and is sustained indefinitely (it has never done so for even three years since the end of the war) we will not regain the GDP level based on the average rate of growth up to 2007 until 2021. To lose 1 per cent by 2015, and much the same again by 2021 would have seemed relatively very attractive.
- 3.7. As far as the banks' tax contribution is concerned, their share of the national revenue has plummeted since 2008, and the losses since then so far revealed and still to come ensure that a large hole in the national accounts is still to be revealed as these are set against profits yet to be made.
- 3.8. There has been much talk about banks which are too big to fail. Perhaps we need more banks which are small enough to be allowed to fail.
- 3.9. Obeying the rules can have perverse effects. Under Basel 2, less capital needed to be set against investment in sovereign debt because this was perceived as (virtually) risk free. But then governments were forced to underwrite the solvency of their own banks. Governments themselves had

to borrow to raise the funds. So sovereign debt lost some value, which weakened the banks, which then had to borrow more, starting a doomsday machine.

- 3.10. Another doomsday machine. The ratings agencies started cutting sovereign ratings because of the size of national debt. Countries then embarked on cutting back on state expenditure to reduce debt, and this resulted in slower growth. The agencies took the slower growth as evidence that the ability to pay down debt was also being reduced – and cut ratings again **because of** lack of, or slow, growth.
- 3.11. The five largest British banks, in terms of assets, each exceed the national gross national product. All the major US banks combined just about equal that country's GDP. It follows that Barclays may be mistaken in thinking (if it does) that its transfer to New York would be welcomed with open arms – still less that the much smaller Swiss economy would be delighted by its arrival.

4. Turmoil in Europe

- 4.1. Germany is beginning to look rather like Europe's version of China. It has an undervalued currency as compared to its fellow Eurozone members, while being able to hold its hand up and claim no responsibility for the consequent distortion of trade patterns, but also proclaiming its virtue in running an export surplus and impeccable financial record. But two-thirds of its surplus is with the rest of Europe, and two thirds of that with EU zone members.
- 4.2. Germany is also running a national debt of 80 per cent of GDP – as against a EU Zone target of 60 per cent – which is met by a much-maligned Spain – and a budget deficit of 3 per cent, while improvident Italy manages a primary surplus, although it also has a national debt of 120% of GDP. While insisting on the necessity for others to observe the ceiling on permitted budget deficits, Germany airily overlooks the fact that, in the early years of the Euro, she herself (together with France) brushed aside protests at its own repeated running of deficits of over double that figure.
- 4.3. While debt levels and budget deficits are eye-wateringly high in many of the smaller Euro countries, it is easy to overlook the fact that the Eurozone as a whole has a deficit of only 6% this year as against the US and UK which are both above 10%. (Next year the Euro budgets will collectively be running at 3% the US will still be, at best, on 9.1% and the UK at 7.1%).
- 4.4. While these figures do nothing, in themselves, to solve the problems of the Euro, they do at least demonstrate that looking at them together may make the prospect of a solution seem less forbidding.

Meanwhile

- 4.5. It can hardly be described as rising to the level of events for Finland to demand that Greece should provide collateral to support part of the Finnish contribution to the European bail-out loans, in the form of cash or other

assets. This effectively reduces the amount of support, as well as provoking other smaller countries to demand the same treatment.

- 4.6. But this also provides an international parallel for the British bank managers who have been making offers of loans to small businesses conditional on extracting personal guarantees from the directors and charges on their homes (as well as charges on assets worth two or three times the amount of the proposed advances).

5. Lessons from Re-Potted History

- 5.1. One thing that has been clearly demonstrated by the sudden return to chaos in markets last month is the difference between a recession triggered by financial collapse and the more usual recession that can be regarded as part of the normal economic cycle.
- 5.2. This follows from the fact that the full extent of the impairment to the banks and other financial institutions of a crisis in liquidity or of solvency (and doubly so for one that combines the two) only becomes apparent months or even years after the damage below the waterline occurs.
- 5.3. Banks can avoid writing down losses on loans advanced to struggling customers or impairment to mortgages and other property assets on their balance sheets while hoping that values will recover, at least in part, meanwhile, to keep the ship afloat, they engage in making a quick turn on funds made available by governments through central banks at cheap rates, and raising charges to customers, while scaling down the making of fresh loans, but continuing to pay often lavish bonuses, if necessary out of heavy losses, as with RBS.
- 5.4. Ironically, while this attracts attacks for failing to lend, the demand for new loans is itself depressed by the slowdown in the economy, and companies are not keen to invest in expansion while they are unable to see where the demand for higher output is to come from. (The exception is the small to medium sector of business and industry which, in general, has not built up cash reserves, and finds access to capital very difficult even when attractive opportunities to expand can be identified.)
- 5.5. It is rather surprising that the larger companies, who are sitting on at least £50 million of cash have not identified the opportunity to make loans, or acquisitions, rather than buying back their own shares. That is simply an acknowledgement that they cannot find a profitable use for their shareholders' money, but also a snare and a delusion for naive shareholders who think that it is an offer of something for nothing.
- 5.6. The bait is that the reduction in issued capital translates into an apparent increase in earnings per share because there are fewer shares. This is a delusion because what has really happened is that the individual shareholder who is mesmerised into retaining all his original shares actually finds himself having unwittingly increased his stake in the company as he now has a higher proportion of the reduced capital. He has coughed up for a rights issue without realising it.

- 5.7. But this can also be doubly expensive. Companies usually engage in buy-backs when share prices are high – and therefore overpay (in well over half the cases in recent years, shares fall in the aftermath of such purchases.) But the apparent improvement in earnings per share regularly boosts the rewards of directors and others who have arrangements for bonuses based, precisely, on this particular yardstick.

6. General Outlook

- 6.1. Market schizophrenia is rampant at the moment. As usual, we are told that this is not the time to panic – although I can find no instance of anybody saying that the right moment to do so has arrived. (Cynically, the signal to panic should be given only once you have disposed of your own holdings.)
- 6.2. Similarly, the advice to hold off any rush back into the markets until it has bottomed out, will in practice help to ensure that the bottom is indefinitely postponed if investors heed it. In practice, many people seem to have decided on a strategy of buying gold and gilts at the same time. This amounts to hedging bets simultaneously on inflation (with gold expected to offset a falling US dollar) and gilts to avoid risk while offering a minimal return that would become positive in real terms if the price level collapsed in a major recession. (it is not immediately clear how this strategy beats holding cash.)
- 6.3. The risks attached to holding gold were briefly illustrated in August, and the speed of the initial collapse was a good example of the volatility that can accompany the imminent bursting of a bubble. (There was also an uncanny echo of the timing – in the wake of authoritative pronouncements that gold was set to rise to \$4,000 within a year – to the publication of a book entitled 'Why the Dow-Jones is heading to 36,000' just weeks before the market collapse of 2000.)
- 6.4. Brief comments on various asset classes follow.

Equities

- 6.5. Having fallen almost 20 per cent, the FTSE100 has established some support by bouncing upwards three times from around 5000, This may well hold for some time, since most existing factors are now in the price, but any renewed fears about any significant part of the world economy could trigger a further sharp fall.
- 6.6. Similar considerations apply to most other developed markets.
- 6.7. While the drop in equity prices on most markets does of course, and by definition, make them cheaper, one traditional support for that argument seems to have been thoroughly undermined. This is the comparison between the earnings (not the dividend) yield on equities and the return on ten-year Government bonds. The latter is normally regarded as the 'risk-free' rate. So, with the consensus earnings yield on the New York S&P index for 2011 at almost 8.7 per cent, while 10-year Treasuries were returning just over 2.1 per cent, the orthodox calculation showed equities to be at less than a quarter of their 'proper' risk-adjusted level. You only have

to read that to realise it must be complete nonsense. (All the more so when the dividend yield by itself currently exceeds the ten-year return on bonds).

- 6.8. Equities are therefore cheaper – but not necessarily cheap.
- 6.9. The course of equities will, as always, continue to be mainly determined by the prospect for dividend payments and the predicted level of the price/earnings ratio. At the moment US equities are on a forward estimate of about 13 times earnings. The main problem is to guess future profits correctly. It is the case that profits generally have shown a big rise this year, but also that the recession will dent them in 2012 and beyond. If the market settles down, after the current rally, around 5 per cent lower, that would seem to be a sustainable level.
- 6.10. In the UK similar conditions apply but with less buoyancy; 5000 on the FTSE should prove defensible. If support at that level fails, then a further plunge of 5 per cent or more becomes a distinct possibility.

Bonds

- 6.11. Sovereign bond markets are sharply divided between those where default or recapitalisation is feared, e.g., Greece, Portugal – and less probably, Spain and Italy, and those where low rates are acceptable as a hedge against deflation, e.g., US and UK. But the ability of these countries to finance borrowing at a cost below inflation is not an undiluted expression of confidence as it also indicates disbelief in the likelihood of increased borrowing to finance expansion in the private sector – which would lead to higher lending rates.
- 6.12. The main support for bonds is the clear indication that most leading economies will make every effort to avoid raising interest rates until into 2013. This should put a floor under the capital value of fixed interest. The exception is likely to prove to be bonds issued by many developing countries if the inward flow of foreign capital continues to push up international inflation.

Emerging Markets

- 6.13. Although economies are expanding, inflation is an increasing threat – partly as foreign capital has been flooding in (some resulting from QE programmes in US and UK). Currencies in these countries are at risk of becoming overpriced and thus could affect investment prospects for local bonds, both governmental and commercial.

Property

- 6.14. There is a limit to the growth of property markets in terms of both capital and rental values in the context of low or nil economic growth. In the UK retail property outside large out-of-centre developments has seen rentals growing well below the rate of consumer price inflation over the past decade. Many banks are finding their loans to developers taking longer than expected to recover earlier losses in value against money advanced and write-downs are likely to increase. Older and less sophisticated office property will become more difficult to let.

Commodities

- 6.15. The most striking fact about commodities is the sea-change in their overall trend price that has occurred since the beginning of this century. In real terms both minerals and soft commodities became steadily cheaper (with interruptions) right through the twentieth century. That was in spite of a global population which, for much of that time, was rising at a faster rate than it has in more recent decades.
- 6.16. What has changed is that the so-called emerging economies have begun to generate effective purchasing power. It is not just China, but the rest of the developing world is now contributing significantly to global growth. The 'poorest' two-thirds of the world is now responsible for over half of the increase in output and trade. While this is exaggerated by the current slowdown in the developed economies, the trend is clear and will continue even if and when recovery occurs in the latter.
- 6.17. Against slowdown in the developed world, global population will rise by 400 million by 2015 and world GDP is likely to grow by 14-17%.
- 6.18. One side-effect of this that has not yet been widely recognised is that the upward trend in raw material prices will probably not take much of a knock from the current recession in Europe and the US, as effective demand for commodities may slow but will continue to grow. Thus, expectations that import costs will fall – reducing price increases – may well be disappointed.

7. Food for Afterthought

- 7.1. "The failure to end deflation is a by-product of a longstanding political debate about how to address overall economic problems. Comprehensive economic reforms will likely impose large costs on many, for example, in the form of unemployment or bankruptcy. As a natural result, politicians, economists, business people and the general public have sharply disagreed about competing proposals for reform. In the resulting political deadlock, strong policy actions are discouraged, and co-operating among policymakers is difficult to achieve." - Ben Bernanke, not about the US in 2011, but Japan in 2002.
- 7.2. The first decade of this century is the only one to show no net job creation in the US in the whole of its history.
- 7.3. The spending power of American employees has been sustained through the downturn in part by increases in social security payments in place of higher wages. This has had the double effect of helping to improve profit margins in much of commerce and industry while also boosting Federal and state expenditure – and paradoxically pushing up their budget deficits.
- 7.4. The pattern of British exports continues to show under-performance in the faster growing markets. Well over half of all sales abroad go to Europe and the US and, for example, only 1.5 per cent to China as compared to 2.9 per cent to Belgium and Luxemburg and 5.5 per cent to Brazil, India and Russia combined.

- 7.5. Real incomes in Britain have fallen in every month since June 2008 – the longest continuous trend on record. The pace of decline appears to have increased in August.
- 7.6. Over the past decade, hedge funds have proved a poor investment for American pension funds. After fees they returned an annual average of 1.9 per cent although the proportion of funds with exposure to hedge funds rose from 2 to over 40 per cent. Even so, American (and Canadian) pension funds outperformed the S&P 500 Index which lost an average of 3.2 per cent annually between 2000 and 2008.
- 7.7. Finally, an interesting hypothetical thought. If a further downturn in equities results in their falling one-third from their peak earlier this year, while other asset classes (supported by the fact that interest rates are unlikely to rise significantly for the next year and a half), fall by only 5 per cent, the overall value of the fund's portfolio would decline by just over a quarter. But this would significantly rebalance the fund, with the equity proportion falling from almost 60 to just under 50 per cent.

8. Recommendation

- 8.1. That the report be noted.

CORPORATE OR LEGAL INFORMATION:**Links to the Corporate Strategy**

Hampshire safer and more secure for all:	yes/no
Corporate Improvement plan link number (if appropriate):	
Maximising well-being:	yes/no
Corporate Improvement plan link number (if appropriate):	
Enhancing our quality of place:	yes/no
Corporate Improvement plan link number (if appropriate):	
OR	
This proposal does not link to the Corporate Strategy but, nevertheless, requires a decision because to accept the comments of the Independent Adviser	

Other Significant Links

Links to previous Member decisions:		
<u>Title</u>	<u>Reference</u>	<u>Date</u>
Direct links to specific legislation or Government Directives		
<u>Title</u>	<u>Date</u>	

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

DocumentLocation

None

IMPACT ASSESSMENTS:

1. Equalities Impact Assessment:

- 1.1. Equality objectives are not considered to be adversely affected by this report.

2. Impact on Crime and Disorder:

- 2.1. This report is not considered to have any direct impact on the prevention of crime.

3. Climate Change:

- a) How does what is being proposed impact on our carbon footprint / energy consumption?

No specific impact.

- b) How does what is being proposed consider the need to adapt to climate change, and be resilient to its longer term impacts?

No specific impact.