

October 2008

Dear Client,

**This note is a short summary of our thinking about recent events.**

### Investment implications

I think the word 'unprecedented' has been used more often than any other adjective to describe the events of the last seven weeks. And rightly so.

Three things have changed the financial landscape since the G7 met last week:

1. A coordinated and credible plan to recapitalise the banks of Europe, UK, and US has been presented;
2. The liabilities of banks are *de facto* or *de jure* guaranteed by the national governments;
3. Negative sentiment and price action in financial markets has been broken, at least temporarily, in nearly all measures (credit spreads, equity levels, volatility levels, liquidity).

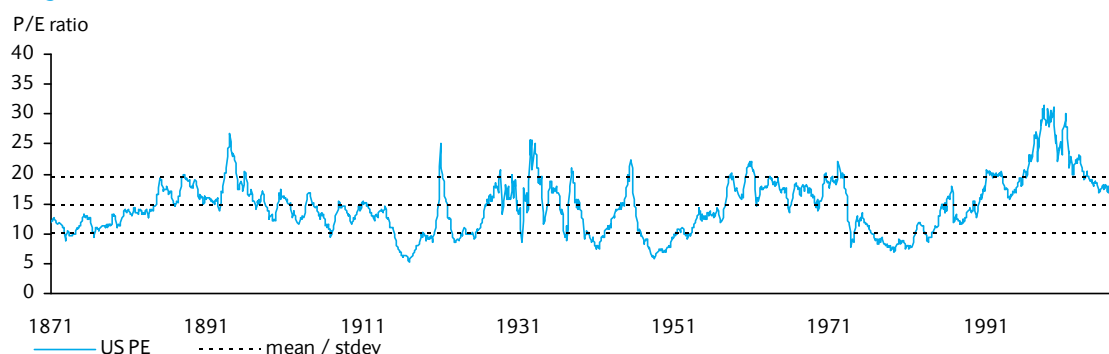
A more detailed summary is available for those interested.

### The case for equities

#### Valuation

As our colleague Tim Bond from Barclays Capital points out, equity valuations as measured by trailing price/earnings ratios are at once-in-a-generation lows<sup>1</sup>.

#### Long run P/E ratios for the US



Source: Robert Shiller, Thomson Datastream

Equity markets are pricing in a collapse of earnings of 45% or more. In its latest *World Economic Outlook*, the IMF has downgraded global growth for 2009 to 1.9%, down from 2.9%<sup>2</sup>. By

<sup>1</sup> Barclays Capital, *Global Speculations* (London: 10 October 2008).

<sup>2</sup> International Monetary Fund, *World Economic Outlook: Financial Stress, Downturns, and Recoveries* (Washington: October 2008).

comparison, global growth was 3.7% in 2007 and will be 2.7% in 2008. This indicates slowdown, to be sure, but not nearly as bad an outcome as equity markets have priced in. When price/earnings get stretched this far, Barclays Capital's *Equity Gilt Study* finds that the resulting 12-month returns are almost always above 10%<sup>3</sup>.

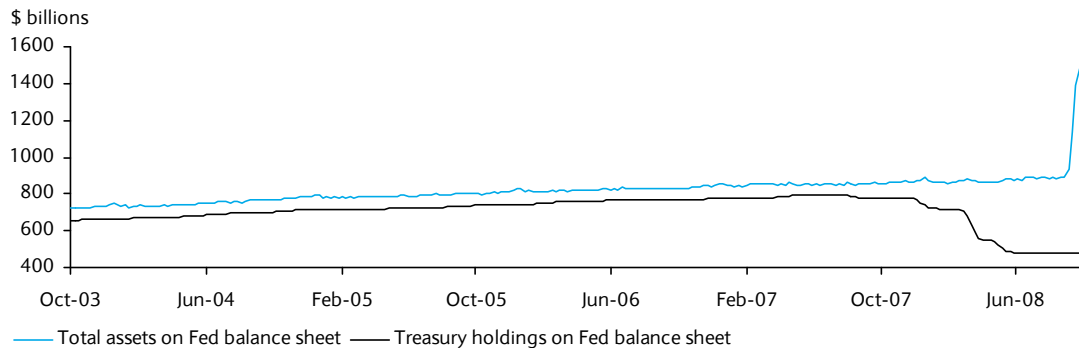
## Liquidity

The world's central banks are creating liquidity (money) at an unprecedented rate. This serves two beneficial purposes:

1. It quickly reduces stasis in the money markets and helps them function, allowing for the financing of households and businesses.
2. The money reflate asset prices (over time).

Federal Reserve chairman Ben Bernanke has written extensively about how the lack of liquidity exacerbated and prolonged the Great Depression<sup>4</sup>. An extensive array of tools has been adopted in the past months to help generate additional liquidity and prevent similar circumstances now.

## US monetary base growth

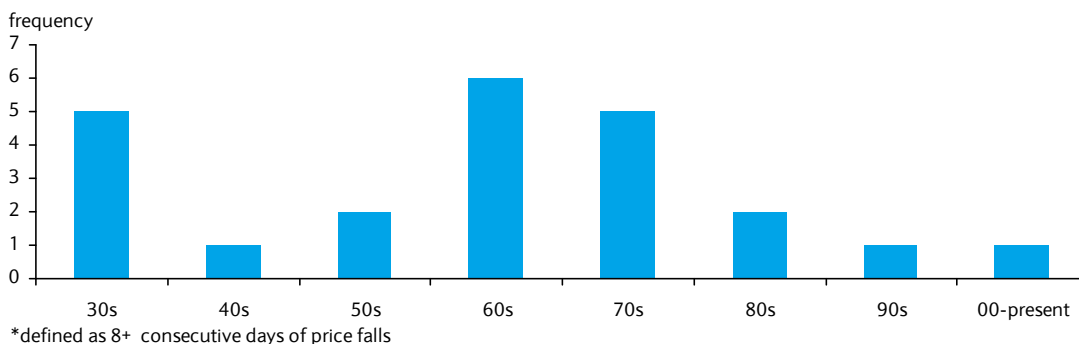


Source: Barclays Wealth Research, FactSet

## Momentum

Negative momentum has brought major indices to near the 2002/2003 cycle lows in a matter of weeks – how can momentum be a positive for stocks now? Indeed price action in the past seven weeks has been some of the most vicious since the 1930's. The S&P500 experienced eight consecutive negative days, something seen rarely since the Great Depression.

## Frequency of severe falls



Source: Barclays Wealth Research, FactSet

When sentiment gets this negative – when there are only 'bears' left, when all commentary is about doom, when all 'bulls' have quit – then by definition there are no more sellers. Many researchers have found parallels between stock markets and physical phenomena – gas diffusing through space, earthquakes, harmonics, fluid dynamics etc<sup>5</sup>. Momentum, to my

<sup>3</sup> Barclays Capital, *Equity Gilt Study* (London: 2008).

<sup>4</sup> For example, B. Bernanke, *Essays on the Great Depression* (Princeton: 2004).

<sup>5</sup> For example, D. Somette, *Why Stock Markets Crash* (Princeton: 2003).

thinking, is a bit like a hurricane. It builds force and fury and tends to self-reinforce itself. However, like a hurricane, it eventually exhausts itself too.

Markets can't stay negative forever. Which brings us to our final point.

### Dynamic processes

The world's economy and financial system have an incredibly powerful innate ability to correct and heal themselves. Over the last few decades, and accelerating in the past few years, technology, globalisation and investment in human capital have created a financial network that can quickly adapt and respond. Some would say that this creativity is what caused the credit problems in the first place – and they would be partially right. Credit bubbles and subsequent crashes have occurred in the past and will occur again. This time the world has a dynamic system – the financial system – that can respond and react and repair.

Additionally, policy makers are much more adept, knowledgeable and well-trained in the art and science of financial crisis management. And just as in the private sector, serious mistakes have been made along the way, but the public sector is now getting the response (mostly) right. This is not Japan in 1990 or the world in 1932.

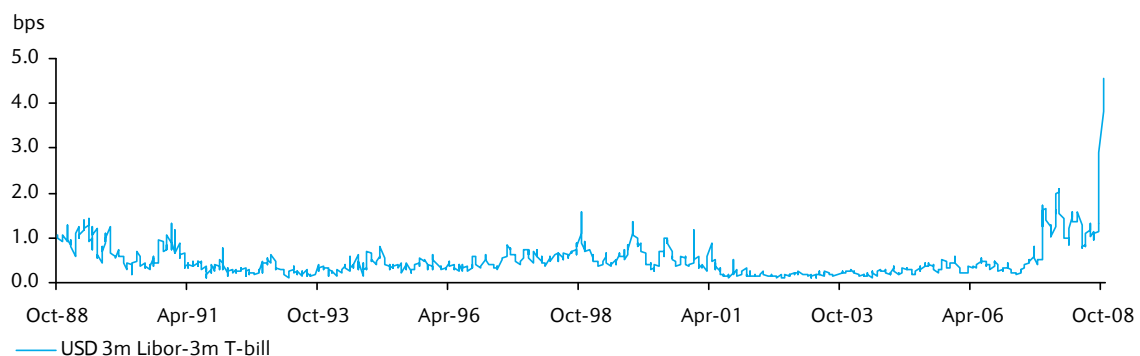
I call the ability of both the private and public sectors to respond to and repair the crisis the 'white blood cells' of the financial system.

### The case against equities

As our friend Anatole Kaletsky likes to say, 'This time is different' is nearly always a dangerous phrase<sup>6</sup>.

But maybe this time is different. The moves in markets have been exceptionally bizarre. The stock markets have actually been behaving less erratically than the money, credit and bond markets. Might the markets be telling us something about the future of the global economy that we can't see for ourselves?

### TED spread chart



Source: Barclays Wealth Research, FactSet

### Inflection point?

A simplified view of the world's financial history might encompass a number of cycles.

|                       |   |
|-----------------------|---|
| <b>Pre 1914</b>       | Unfettered capitalism & imperialism; gold standard; global trade, capital flows; private sector governance; limited regulation          |
| <b>1914-1932</b>      | Transitional mixed period; monetary experiments   |
| <b>1932-1970's</b>    | Autarky; limited international capital and trade flows; high regulation of industry and finance; manufacturing driven Western economies |
| <b>1970's – today</b> | Reduced regulation; innovation and liberalisation in all aspects of life; globalisation of capital, trade and information               |

<sup>6</sup> 'As they say in the markets, the four most expensive words in the English language are "this time is different".' Anatole Kaletsky, "The real reason why bankers feel so gloomy", *The Times* 17 July 2008.

Could we be at the end of this super-cycle, as some commentators have suggested?<sup>7</sup>

### S&P500 since 1970, with the channel being broken last week



Source: Barclays Wealth Research, Ecowin

I think the policy response by Europe and the UK to the banking/credit crisis may be this inflection point – but only time will tell.

By nationalising the liabilities of the major banks in Europe and the UK and by taking seats on the boards of major banks, EU governments now have considerably more power in the allocation of credit in society. If the governments resist the temptation to make state-directed lending decisions – often for political rather than economic reasons – and also resist making major changes about how credit is allocated in society, then economic growth will return and the bank rescue will be hailed as a massive success.

On the other hand, if governments direct the allocation of credit based on a desire to favour selected groups rather than as profit-maximisers, then capitalism as we know it, 141 years after the publication of *Das Kapital*, is over.

This is the risk.

### What to do now

We believe that the past several weeks have created unprecedented investing opportunities. Most important is diversification. Wealth creation and preservation is a long game. Private clients, almost uniquely in the world (along with sovereign wealth funds and investors like Warren Buffett), can take advantage of dislocations in the markets we see today. Others, like banks, insurance companies, pensions and hedge funds must worry about tomorrow's mark to market, not the inherent value of securities. Forced selling by the latter make great opportunities for the former – you.

**Stocks** are cheap (as highlighted above) but substantial risks remain, primarily around state intervention in lending. Markets aren't likely to rise straight from here; the damage to sentiment and balance sheets is too severe. We expect equity markets to be very choppy intra-day/week/month, but not fall much further from here. For those who are sitting in cash and have been waiting for an entry point, we suggest a program of methodical buying over the next few quarters. For those who've held on to their stocks through this turbulent period, now's not the time to panic.

<sup>7</sup> G. Soros, *The New Paradigm for Financial Markets: The Credit Crisis of 2008 and What It Means* (New York: 2008).

**Fixed income** also presents a tremendous buying opportunity in the corporate bond space. Unless you think we will enter a major depression (possible but not at all likely given the 'white blood cells') then switching out of government bonds and into a diversified portfolio of high grade makes excellent sense for many. For the first time in years, inflation-linked bonds offer excellent value – another example of distressed selling.

**Currencies** have also been turbulent of late. The dollar has strengthened significantly due to a dollar shortage and surging USD interest rates (Libor). While near-term (in the next few months) the dollar may give back some of those gains, we expect it to strengthen modestly in 2009 as the US economy responds more quickly to the bank bailout packages. The euro and the pound, in our view, will suffer both some political risk and a deteriorating interest rate position in 2009.

**Volatility** (option prices) in all asset classes is at or near record highs. Options do not offer good value for buy-and-hold investors, especially if one believes (as we do) that choppy but essentially directionless markets are the order of the day for the next few months. By the same token, there are a number of safe ways to sell volatility (options) in equities and foreign exchange. Puts can be sold at targeted levels in stocks or indices at levels you are happy to buy as well.

**Absolute return products** (hedge funds) have had a disappointing September, with most indices posting negative returns between -3% and -6%. Transparent Liquid Strategies (TLS) or algorithmic strategies have fared better, with results close to flat. The question for many hedge funds going forward is how capable they are in adapting to the new regime. Those that are intellectually flexible and adaptable, we believe, will make enormous gains in the coming years, while those that stick to old paradigms and ways of trading are likely to disappoint. We feel this is an excellent area in which to invest, but only with detailed assistance.

## Summary

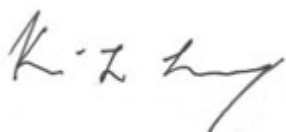
These past few weeks have been among the most tumultuous in financial history. There were some days it felt like the world was coming to an end. But it wasn't. And it isn't.

So long as the bank bailout package recapitalises banks, allows for the re-liquification of the markets and allows the system to heal itself, the world will recover fine through a soft economic patch over the next few years.

Remember that our global economy this decade has generated trillions of dollars of wealth for all segments of society in nearly all corners of the globe, has absorbed 1.5 billion people from China and India into the global workforce, has created life-enhancing medical care, has improved the diet of billions and has encouraged, through globalisation, better international relations among the major powers.

This powerful trend towards ever greater prosperity, globalisation, trade and commerce will not be destroyed by the credit crunch. Provided there are a minimum of errors by policy makers who want to direct capital from their newly-owned banks, capitalism will prevail and clever investors will enjoy excellent returns in the coming years from investments made during these dark days.

Warmest regards,



Kevin L. Lecocq, CFA  
Chief Investment Officer  
Barclays Wealth