



## CARTLIDGE MORLAND

### INVESTMENT UPDATE

23 January 2008

**The last few days have seen global equity markets sell-off, with some markets including UK and Europe, suffering their biggest one-day falls since 11 September 2001.**

So what has sparked the sell-off? The two main driving forces have been fears about a US recession and more bad news expected from the financial sector.

Moody's Economy.com estimates the probability of a recession in the US within the next six months at 52% – better than evens. In fact it is likely that the US is already in recession. Evidence for this can be seen in the December payroll report, which indicated a -0.3% increase in the unemployment rate. Moody's almost hit the nail on the head when they noted that "the last time the jobless rate rose by this much in a single month was in the second half of 2001, when the economy was in the teeth of a recession".

Last year, commentators were claiming that the emerging markets, such as China and India, had decoupled from events in the US. This gave rise to the belief that global growth would hold up in the face of a slowing US economy. But it should be remembered that the US economy dwarves the combined influence of China, India, Brazil and Russia in terms of dollar-based GDP. On this measure the Chinese economy is roughly equivalent to that of France and her overseas interests, less than half the size of Japan and barely a fifth of the US.

Problems in the global financial sector have deepened with the ratings agencies making public their concerns about the banking and insurance industries – the subject of many

warnings issued by Mervyn King at the Bank of England in the course of 2007, before the Northern Rock affair. Concerns are now more widely felt as corporate debt and insurers linked to guarantees on corporate debt are downgraded. A massive US fiscal stimulus package did little to calm investor fears in the short term and we have yet to see the full effect of the aggressive interest rate cut. Longer term, such actions will do much to boost equity returns and we expect further concerted action by the big central banks around the world to bolster the defences of the financial system from further fall-out from a credit crisis made worse by a slowdown.

But a US recession represents a big hole in the global economy. The Japanese equity market finished the year almost 20% behind the rest of the world in aggregate. There is little chance of Japan stepping forward to plug any gaps, after a great many years of stagnation, leaving Europe and the emerging markets with an impossible task in maintaining global growth at the current rate. Prospective equity market risk premiums must now rise if we are right about a US recession-in-progress. The quickest way for prospective equity market risk premiums to rise is for current equity prices to fall.

Fundamental indicators of value present a mixed picture for share prices. It is true that hitherto robust earnings reports from larger companies are translating into reasonable (although not particularly attractive) price/earnings ratios. Dividend yields, rising rapidly in the last few days, have been underpinned by an increase in the payout ratio. A word of warning however - those commentators that justified increasingly risky positions in 2007 on the basis of lower P/E ratios, based investment on a superficial examination of the capital markets. Earnings remain high and corporate balance sheets remain clean, but a cyclical slowdown in earnings will feed through in time.

We remain defensive in outlook, believing that the majority of investors should allocate to portfolios that are less aggressive than their long-run financial benchmark.

We believe that in the few years ahead the most successful investors will be those that mitigate risk in 2008 and we began taking steps

to reduce risks early in 2007. We have been consistent in warning of the damaging potential of an across-the-board re-evaluation of risk, at a time when implied risk premiums are narrow.

### **What Now?**

Equity prices are currently subject to considerable volatility within short trading periods. Prices are also falling when relatively thin volumes are being traded. There is also the likelihood that speculative 'short' selling is pushing prices artificially low.

Most Cartlidge Morland clients maintain balanced portfolios and invest on either a medium or long-term view. We have been consolidating profits earned since the current bull market began in March 2003 and have reduced risk in our portfolios.

Despite this, balanced portfolios will typically be 55% to 70% invested in equities – so asset values are significantly affected by the recent fall in prices. Losses are likely to be unnecessarily exacerbated by selling into current market weakness/volatility. Such action will only deny investors the benefit of recovery when it comes.

There are a number of unknowns currently undermining investor confidence. Not all banks have significant exposure to US sub-prime loans (for example), but all bank shares are suffering. Over the coming months, a clearer picture will emerge and when it does, investor confidence will return.

The economic stimulus provided by lower interest rates should not be underestimated, but neither should the inflationary dangers. Inflationary fears tend to favour equities. The point will be reached at which the prospective yield from equities makes them highly attractive – and prices may then recover quite sharply. For the medium term investor, there is little merit in crystallising losses now – whilst potentially missing the opportunity of recovery.

For those investors who hold heavy cash weightings and currently have light equity exposure, there will be significant opportunities.

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