

Reasons not to be Cheerful

A number of reasons to believe the FTSE 100 has further to fall beyond its recent low of 3300 are as follows: -

- World Debt
- Unquantified Risks in the World Derivative Market
- Pension Fund Deficits
- Liquidity of Life Assurance Companies
- Global Property Bubble
- High Levels of Consumer Debt and Spending
- Low Growth of Gross Domestic Product
- High Price Earnings Ratio

Some of the above reasons have been mentioned in earlier articles by this writer over the last 2½ years but, in view of the more recent optimism in the market, it may be of interest to visit them again as well as other ones.

In 2001 net claims on the U.S. financial system stood at an astounding \$28,000 billion, and Peter Warburton in his book *Debt and Delusion* in 2000 estimated that globally the aggregate was \$90,000 billion. His conclusion was that economic reality is destined to reach the terminus sometime in the reasonably near future. He considered for it to be delayed beyond the end of 2003 would take a miracle. Terry Smith in the Sunday Telegraph of 27 April 2003 gives a more recent estimate of US debt at \$31,000 billion and points out that this is just about 300% of GDP compared with a previous record of 264% early in the Great Depression - to him not a comforting comparison.

In his annual letter of March of this year to Berkshire's shareholders Warren Buffett, quoting his partner Charlie Munger's views as well as his own, stated that derivatives and the trading parties that go with them are time bombs, both for the parties that deal in them and the economic system. They also consider them as weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal. When men of that calibre speak so forthrightly we should all take notice.

An article in *Business Week* of 31st March 2003 explained that the worldwide market for derivatives is estimated to be \$105,000 billion and that the market is almost entirely unregulated. It said unless there is a replay of the Long Term Capital meltdown of 1998, no major change in the rules is likely. Not exactly the most reassuring way to sort out a problem!

Reinsurance is in many respects a similar business to derivatives. Reinsurance is currently the main part of Berkshire's activity. However, in taking on such contracts Buffett is very careful to make sure his holdings safely cover any subsequent calls that may be made on them as a result of claims. However, this is not always the case in that industry. In his letter, perhaps surprisingly, he draws attention to an unnamed company which he says is one of the world's largest reinsurers and which has all but ceased paying claims, including both valid and due. The company owes many billions of dollars to hundreds of insurers who now face massive write-offs.

The difficulties facing the pension industry and insurance industries in this country have been well documented. The pension industry is said to be facing a shortfall of £90 billion which will have to be met out of future profits or increased contributions from employees which in turn will lead to a commensurate drop in consumer spending and slowdown in industrial productivity.

The life insurance industry in this country has been caught out by its much higher level of investment in equities as compared with similar companies in Europe and America. Realigning their portfolios accordingly will inevitably lead to some further selling of equities beyond what we have seen already and downward pressure on the market.

A survey on the world economy in the *Economist* on 28th September 2002 drew attention to today's boom in house prices around the world which could turn out to be a bubble and then, with low inflation, house prices would need to fall more rapidly in absolute terms to bring the market back into balance. The consequence of such an event would be a fall in consumer confidence and spending.

The same article drew attention to the private sector balance which had shifted from a surplus of 5% of Gross Domestic Product (GDP) in 1992 to a deficit of 5% in 2002 as households and firms went on a borrowing spree; an astounding change after almost four decades where private sector never ran a deficit at all. The trouble is that the cure of a return to more prudent spending and saving would introduce the problem of a consequent reduction in industrial activity and profits. A no win situation?

In an article in the *Sunday Telegraph* on 8th December 2002, Luke Johnson gave 'twelve reasons not to be cheerful.' Five of these were:

- Japan, the world's second largest economy, seems incapable of the radical change necessary to escape from relentless decline
- US banks are steadily lending less to industrial concerns. This will reduce business growth and employment potential
- In the UK increasing government taxes and expenditure starves the private sector of investment and is invariably wasted.
- The cost of homeland security, climbing defence spending, and the war in Iraq for the two of the Western economies do not stimulate growth; they squander resources and lead to higher taxes and deficits.
- The unlimited Chinese workforce at \$100 a month is hollowing out the manufacturing based economies in the west with extraordinary speed.

Investors Chronicle on 11th April 2003 reported the chancellor has downgraded his forecast GDP growth for this year to between 2.0% and 2.5% but is sticking with a forecast of 3.0% to 3.5% for next year, against a consensus forecast of 2.4% and a Bank of England forecast of 2.25%. Roger Bootle of Capital Economics says the Government figure strains credulity. Tony Mackay in *Scotland on Sunday* of 13 April 2003 said that reliance on overoptimistic forecasts, because they are politically attractive, is not the basis of good economic policy

Even after its recent fall, the current PER of 31 of the S&P500 index is still double the long term average of 14 for the 47 years between 1948 and 1995.

The current Price Earnings Ratio for the UK market is 16 as compared with the 30 it was at its peak. Those who may think that 16 is a low rating may not be aware that at the bottom of the 1974 bear market the PER was around 5 and was followed by a market level in the order of 8 during the late 1970s and start of the 1980s. Comparing the global economic scene now with then, it seems that there are many more and greater uncertainties today and yet investors are giving the market a rating double what it was then.

The above is not to argue that there is no value to be found in the market at present, because there is. Rather, it is to put forward the view that the irrational exuberance at the end of the 20th Century has not yet been fully expunged and that there will be even greater value to be found in the not too distant future. Sadly, there will not be much else to be cheerful about at such a time.

Jim Steel
Edinburgh and WBW Sub-groups
20th April 2003