

## Reasons not to be Cheerful : 3

By Jim Steel

In April 2003 and January 2004 I wrote articles for Signet's Newsletters setting out my reasons for not being cheerful about investing in the stockmarket at those times. Even though the FTSE100 has not yet quite regained its level of seven years ago, given the substantial rises in the market subsequently, my pessimism then seemed unwarranted. The difficulty for me is that now, some three and four years later, I still feel the same way.

The main reasons given in my first article for my concern were: -

- 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

The main reason in my second article was the increasing American trade deficit.

In my opinion, most of the above concerns are still with us and in general, they have only got worse.

For example, Money Week of 24 Nov 2006 reported that since 2000 the global derivative market has almost quadrupled; this in a market that is still not regulated.

The emergence of private equity introduces another new uncertainty into the world of finance where large financial organisations buy out companies that are allegedly underperforming to turn them around and sell at a profit at a later date. Their charge of 20% of any profits seem excessive given that a significant part of their gain will have been attributable to leveraged borrowing, low interest rates and tax breaks.

*Money Week* of 10<sup>th</sup> November 2006 stated that the big Wall Street banks were about to reward their employees with \$36 billion of bonuses and 4,200 City employees would receive bonuses worth at least \$1.9 million. The inescapable question is whether greed in the financial world is again taking over those responsible for handling investor's capital.

The two countries whose economies I am especially concerned about are the UK and America. Taking our own first, one particular article in the *Scotsman* of 1<sup>st</sup> April 2007 summed up Gordon Brown's stewardship. It was entitled, 'The full horror of the Chancellor's Debt binge'. The figures quoted from the Treasury 2007 Budget were:

Government borrowing	£118bn
Public sector pension liabilities	£685bn
PFI liabilities	<u>£166bn</u>
	£969bn

The article's author Liam Halligan worried about how the Chancellor was heavily relying on our 'future' to secure his 'future'. He considers the Chancellor is chalking up massive multi billion liabilities, the vast majority of them hidden from the national accounts. He said: peer into Brown's "off balance sheet" liabilities and the numbers get scarier still. Chief among these, Halligan says is the future bill for the final salary pensions of state workers. The Chancellor's public sector recruitment campaign means the eventual cost of these pensions – all of which will be met by taxpayers – has ballooned in recent years. Halligan concluded, "He tells us a tax rise is a tax cut. He tells a deficit is a surplus".

Property prices have continued to rise some 35% over the last four years and borrowers are prepared to take on even more mortgage debt. Historically, mortgage used to run at something like three times salary. Nowadays five times seems an acceptable figure and these commitments have been taken on with variable rates at a time when the rates are very low. Needless to say, they will become more difficult to meet with rising interest rates.

Barry Riley writing in the April 2007 *Money Observer* said that the government has encouraged people to borrow on a huge scale to buy houses and consumer goods. Total personal borrowing has risen from £500bn to £1,300billion in the 10 years since Gordon Brown took over at the Treasury. Riley said we have turned into a nation of debt junkies, which means a traditional credit squeeze that would hurt ordinary people on a scale never seen before.

The debt position in America is on a much larger scale. Both countries, in private consumption and public debt continue year after year spending more than they earn.

*The Empire of Debt* by William Bonner and Addison Wiggin quotes an article in *Forbes* outlining how Americans are failing to save enough for retirement. In 2001 nearly 27 million U.S. households do not own a retirement savings account of any kind. The quoted median value of pension funds held by households headed by a worker between the ages of 55 and 64 was only \$55,000.

The book sets out the real scale of America's living beyond its means. One example given was the Government's gross accumulated debt excluding Medicare commitments as being \$7 trillion i.e. \$24,000 for **every American**. If items like Social Security and Medicare commitments and the money needed to be put aside for them the debt burden would rise to well over \$100,000.

The level of such debt was broadly in line with figures those given in another book *China Inc* by Ted Fishman which stated that in 2004 Americans collectively owed a staggering \$85,454 **per household** in mortgages, automobile loans, credit cards and other personal debts. The book also said on top of this, when future obligations are added in, each household's share of government debt is a staggering \$473,451.

With sums of such magnitude, one must question American's ability to continue to overspend, how painful a readjustment in spending and saving for retirement is going to be and what effect such a reduction in spending will have on the global economy.

America's insecure future is not going unnoticed and we only need to look at the fall in the dollar in recent years. At present China is holding around \$1 trillion of American debt mostly in American Treasury Bonds. They are cutting back on such exposure but must be careful as this could result in the dollar falling even faster and a reduction in the value of their investments. Further more, such action could reduce Americans ability to buy China's exports of manufactured goods.

China has impacted on the world stage over the last decade to an amazing degree. Fishman's book outlines just how. It is certainly on the road to becoming the world's greatest power later in this century with its effect being felt to an increasing degree every year, far greater than Japan ever did. One of the main differences is the way they are requiring and getting technology transfer from even the major manufacturers they are doing business with. This is so they eventually will be able to compete even in the biggest industries such as automobile and aeroplane manufacture. The undoubted cheapness of their labour means they are progressively hollowing out manufacturing in the West with all too ominous effects for the future.

However, their rise to dominance is not likely to be a smooth uninterrupted one. They are still a centrally controlled Communist run country with severe weaknesses of such a system which will have to be resolved before they achieve their full potential. A few of their difficulties were succinctly dealt with in an article by Will Durant in the February edition of *Money Observer* and titled, 'The writing on the Wall deciphered'. One of their problems is their four main state banks. Hutton said 'Of course the Chinese government wants the world to believe the bad debt problem is largely solved. However, according to a leaked reported from the Chinese Regulatory Commission, banks commonly ignore the regulations and understate bad loans, a practice that is made worse by bad accounting'.

Because of the above, this writer still sees much not to be happy about. The overriding reason for his pessimism is the increasing level of debt in its many forms which sooner or later will have to be addressed. It is difficult to see how this will be achieved without much pain. The real question is how private investors can be ready for a time when the financial world finally gives itself a reality check. No one can say when that will be, but even now it seems only prudent to hold a sizable proportion of capital in cash and progressively increase the amount should the current cheerfulness about the market continue to increase. After all, this is little more than the advice usually given by history's most successful investors. They simply sold when everyone else was buying and bought when everyone else was selling! To leave the last comment to Warren Buffett— it is only when the tide goes out you discover who has been swimming naked!

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