View from the Bridge an alternative look at the investment world

By Clive Hale - February 1st 2010

Would you believe it? -

The one good thing about breaking your leg (do let me know if there are any more…) is that you get lots of time to read those books you always meant to but never found the time. I have just finished Richard Dawkins "God Delusion" which naturally focuses on religion, a topic I am not going to discuss in this column, (however if you want a session under the hair dryer do give me a ring!) but many of his observations about "belief" are just as relevant to the investment world.

Although professing to be rational we will almost always hang on to our beliefs despite damming evidence to the contrary. In fact many of our beliefs are held despite have done little research to justify them – "I have a gut feeling" being a classic example. Consistently good investors have one thing in common. They interrogate the facts and spend a lot of time doing it. Being of a sceptical nature helps and they are often true contrarians.

The current "belief" is long Japanese equities and short Sovereign debt; US Treasuries and UK Gilts in particular. Japan has had a lost decade or two when viewed from the West, but their economy is managed to support social cohesion not the disciples of Mammon, so from their side of the coin their policies have been far from a failure; not something we *believe* from our perspective.

This is something that is gaining credence over here. Obama intends to levy a tax on the investment banks to get back the taxpayers support despite the TARP program being designed to turn a profit for the US Treasury…one fine day. The EU is wrestling with similar measures and the whole concept of Western capitalism is being questioned; capitalism is the worst form of economics apart from all the others to paraphrase the great man.

Meanwhile in Greece they are beginning to question whether their second *civilisation* is coming to an end and the ECB ponders the wooden horse in its back yard. Morality is also up for grabs. It is obviously wrong for the greedy investment banks to run their "Ponzi" schemes off balance sheet but not it seems for governments. As the Greeks put it "Democracy passes into despotism" (Plato).

So what can we believe in? Human nature seems to be a pretty constant factor when it comes to markets. The majority are greedy for success and fearful of failure. Charts are, to me, the only reliable way into that mind set and the major markets are dangerously close to another dose of fear.

UK – Voting with your feet?

Well at least the Chilcott inquiry has taken our minds off the economy. Tony Blair is now up for an Oscar and we have Claire Short and Gordon Brown to look forward to. The UK is now officially out of recession but only by dint of some statistical "fiddling". Our debt to GDP ratio is spiralling and either that gets worse, with a whole raft of unintended consequences, or we face spending cuts that will stop the "recovery" dead. McKinsey's report on "Debt and Deleveraging" puts the UK above Japan on the debt to GDP ratio. Does that worry anyone?

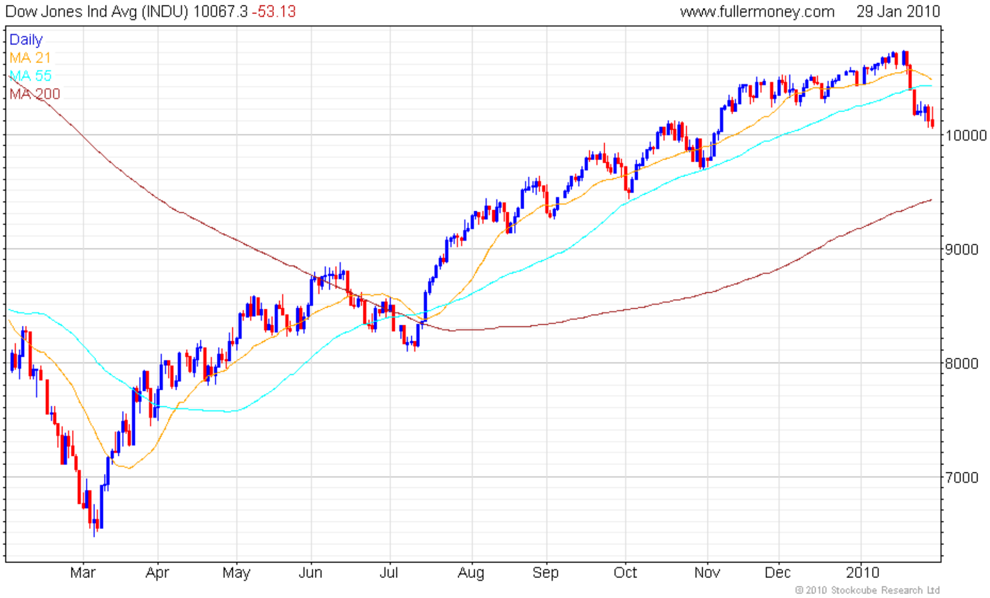
The market has caught wind of this and we are in the midst of the sharpest correction since the bounce started last March. We have fallen through support at 5200 which suggests we are going to test 5000 and probably the 200 day moving average currently at 4850. Because of the sharpness of the move we may get a bounce before the down leg continues. The best we can hope for in the short term is a sideways market bounded by 5500 and 5000.

We are due an election within the next 4 months, which maybe a closer call than the markets would like. An expenditure cutting Tory manifesto may also obscure the vote gathering process. Any "culling" of the banking franchise, without thought for the huge contribution the City makes to UK GDP, is also a negative, although "financial" GDP arrives mainly at the expense of the "widget" making variety. Financial engineering doesn't actually produce anything; it's a zero sum game.

Sell in February and go away?

USA – The home of the brave where nothing comes for free…

A similar chart pattern here with the 200 day moving average at 9400. Obama, and the rest of us, have realised that oratorical skills do not a complete politician make. Bernanke and Co continue to live in a world of make believe (well they believe it and that of course is the problem with belief systems…). "Easy money did not cause the housing bubble". Really? So it must have been the fault of the "greedy" bankers that you failed to regulate?



The main thrust of the McKinsey report mentioned earlier is that where debt to GDP ratios reach levels that the US has easily exceeded, the recovery process is a long drawn out (we are looking at 3-5 years) and anaemic affair, which can only be exacerbated by the withdrawal of Fed funding and/or higher interest rates. Higher rates seem out of the question given the escalation in debt service levels, (mind you when is that issue ever going to go away? Parallels with Japan?) but the Fed is committed to ending quantitative easing by the end of the first quarter, or is it?

GDP growth for Q4 2009 looks impressive but strip away the "bribes" and look at the unemployment data with a more than critical eye and stagnation looks more likely than a resurgent economy. Build America Bonds (BABs in the vernacular) have caught the patriotic imagination for state and local funding and receive up to 30% relief on the interest payments made by the issuers. This has taken some of the pressure off federal funding but the "Muni" market still looks like a Fannie or Freddie waiting to happen. The announcement of a removal of the funding cap on these two "institutions" last Christmas Eve has not gone un-noticed; despite the somewhat devious timing…

Europe – a Greek tragedy?

On the face of it 10 year bond yields in Greece of 6.6% (from a recent peak of 7.1%) don't look too racy when compared to (or is it with?) Australia where they are 5.4%. But remember that in a currency union interest rates are supposed to be pretty much the same. German yields (the benchmark) are 3.2% with Spain, Italy and Portugal (the PIGS along with Greece) are 4.1%, 4.1% and 4.4% respectively.

France and Germany have been adamant that there should be no bail out, but recently there has been a weakening of this view. They cannot afford a rapid unravelling that would put further pressure on the euro. If sterling wasn't in the same boat it would be marvellous to look across the Channel and gloat.

A "Greek tragedy" may well be containable but then Spain and Portugal become the centre of attention. Whither Santander/Abbey then? No fiat currency has ever lasted, let alone maintained its value, for long and the euro will be no exception; unless the Gold Standard makes a come back, Unfortunately there is just not enough of the yellow metal about for that to happen.

Meanwhile having just voted itself a pay rise the EU Commission continues to do what it does best as the following news item in the Metro illustrates only too well. A communist theme park portraying life behind the Iron Curtain is to be built in Bulgaria with a £2 million EU grant. The park, in Dimitrovgrad, will feature statues of toppled dictators, rifle ranges using Kalashnikov AK-47 assault rifles and "authentically grim restaurants". Borscht and tears anyone?

Japan – Is the sun is going down again

As mentioned in the introduction Japanese equities were the pundits' choice for 2010. So far they are on a losing trade and surprise, surprise you would be winning on US Treasuries and even UK Gilts (Bill Gross of Pimco suggests Gilts lie on a bed of nitro-glycerine – it may turn out to be nitrous oxide!)

One of the key drivers of the Japanese market is the banking index and in the short term this has pulled the main market back. Thus far the chart pattern of rising highs and lows from the November bottom is encouraging but needs to be watched closely. The BoJ has already stopped its quantitative easing programme and deflation is making a comeback. It has been suggested that they should just keep printing money until there is some sustainable positive inflation; shades of back home.

And like everyone else they are asking the same question. Having stepped on the loud pedal when do you go for the brakes and how hard? I almost can't wait to find out the answer. Almost…