Investment Commentary
by Roger Nightingale

The State doesn't just do big things badly; it messes up small ones as well!

John Kenneth Galbraith—the moral is:
don't let the scallywags get their hands on your money.

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The stock market is saying that there's a problem.

Financial markets are imperfect forecasters of economics developments, but much less imperfect than most other mechanisms. The comparison is not one that flatters humans. The latter tend to react defensively, therefore. Galbraith was not atypical. Presented with the evidence, he retorted petulantly that the equity indices had forecast eleven out of the previous eight recessions.

It's probably right.

He'd intended to disparage the stock markets; to belittle their predictive value. But what he actually did was to endorse them; unwittingly, to acclaim their track record. How many of those recessions, his audience had to ask itself, had professional economists forecast? Very few!

Europe's next cyclical downturn could be severe.

It's much the same these days. The markets continue to make mistakes, but fewer than economists. That's what makes the steep slide in valuations in recent weeks rather disturbing. The immediate outlook may be satisfactory, but that twelve or eighteen months hence might be grim; possibly very grim!

Banks are the spanner in the ointment again!

What's the problem? Nobody knows with any certainty, but the financial system seems to be short of liquidity. The authorities are pursuing highly expansive credit policies, but intermediaries—banks and investors—are reluctant to pass on the funds. Everybody is suspicious of the creditworthiness of everybody else.

Some may be teetering on the edge of oblivion.

The urgent problem relates to commercial banks. They got themselves into trouble in 2007/8 and, despite huge handouts from the taxpayer then, may be back in difficulty now. If so, there'll be no respite; they'll get no seconds. Investors no longer trust the authorities. They'll not buy the Treasuries that would finance another bailout. Instead, if the rumours were to prove well-founded, there'd be a systemic implosion.

In which case . . .

Greece demonstrates the problem. Nobody'll buy the securities issued by Athens; not locals nor foreigners. If Greece is to stay in the EuroZone, it'll have to be the Germans that finance the bailout.

. . . there'll be no salvation.	Spain is going the same way. There are rumours that many banks are unsound and, unsurprisingly, Madrid is now being treated in much the same way as Athens. Will Germany come to the rescue? No.
Systemic collapse is possible.	The denouement is obvious. Europe will have to change: the single currency being abandoned and a number of commercial banks being allowed to fail. Concurrently, economics activity will soften: unemployment rising and inflation falling. But how quickly? Will politicians and bureaucrats be helpful or obstructive? Will they opt for reality, or fantasy?
Britain is not much better placed.	The "likely lads" running Britain these days are no better informed than their European counterparts. At the Opening of Parliament, the Queen's Speech made it clear that they don't yet understand the magnitude of the problems the economy faces. Do they really think that a £6bn reduction in public spending is of any significance in the context of annual borrowings of £150bns?
Valuations falling before they rise.	They say they're prepared to take tough decisions, but their actions belie their words. Not until the public sector's DB pensions are abandoned and its retirement age lifted to 70 will action and rhetoric be aligned. In the meantime, the stock market is likely to be unrewarding. Dividends may rise and inflation dip, but capital values will suffer.

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Buckles Investment Services Ltd. Derwen House, Ffordd Derwen, Rhyl. Denbighshire LL18 2LS
Telephone 01745 345131 enquiries@buckles.ltd.uk www.buckles.ltd.uk