Newsletter

June 2007

SQUARING THE CIRCLE!

This may seem a funny phrase at first sight – surely a conflict in terms, but I don't want to pursue the semantics. 30+ years ago when I was reading economics at university, I remember the first rule was the law of supply and demand. This was then developed in macroeconomics to the multiplier effect where a virtuous circle of tax leading to government spending led to more consumption and therefore more taxes etc.

Now, I'm more interested in reviewing the effect of the price of oil. There have been three periods when the oil price has risen dramatically. Firstly, in 1974 when it led to not only excess inflation in the western world but also the first phase in the development of the infrastructure of the Middle East. We paid more for oil and they then used the money to sign contracts for a wide variety of infrastructure projects: a convenient circle.

The second occurrence was the fall of the Shah of Iran and led to a serious recession in the western world because it was still trying to shake off the effects of the inflation created by the first oil shock. This in turn led to a reduction in demand for oil and prices falling back. Infrastructure projects followed in the Middle East, though not Iran which had gone into purdah. Second line oil producing states such as Indonesia, Mexico and Venezuela began their long development, though being populous (like of course the other beneficiary of oil in the 70/80s, the United Kingdom) the impact on the countries' finances was not so dramatic as say Saudi Arabia or UAE.

Oil price shocks have contributed to all the global recessions of the post war era, with one exception and that brings us to the latest surge in oil prices, 2002 to now. While 1974-5, 1979-80, and to a lesser extent 1990-1, all were associated with a global recession, the oil price hike since 2003 has been dramatic and sustained, but the world economy powers on. One possible reason for this is that countries are less dependent on oil now: gas power stations have been springing up all over the world, but the abundance of gas has a limited time frame.

In everything concerning the global economy, one country looms large: China. Their insatiable demand for raw materials including oil has driven commodity prices upwards after decades of systemic recession.

Sustained growth in China of ca 10% pa has increased their demand for oil but the import cost has been more than offset by their income, primarily from exports of manufactured products to the US.

China, and previously Japan and Taiwan, have all built up large balance of payments surpluses, and therefore reserves, which they have used to purchase US Treasury bonds which were issued to finance their deficits: a convenient circle which kept everyone happy.

Companies and governments alike with cash piles look for somewhere to invest it: the former can return some to shareholders through special dividends or share buy backs, but governments build up reserves.

The news last month that China had taken $200bn from their influx of over $1tr dollars to invest in such vehicles as the largest US private equity player Blackstone is an interesting but possibly alarming development. Interestingly one of Blackstone's directors is the senator who has led calls for import levies on Chinese goods.

We now see a private equity circle that many speak of as the new paradigm to lead to sustained investment returns for all. The last time people spoke of a new paradigm was the internet boom in early 2000 and we know what happened there.

Next door to China, Russia continues to flex its oil muscle at an alarming rate: back to the cold war but with Russia having many of the trump cards.

Historically, stock markets used to predict the state of the economy a year ahead but that has gone out the window with the development of private equity (PE). If you strip everything aside, what PE does is to takeover companies with stable income streams and low debt to maximise returns for their investors. They substitute shareholder funds with debt which works fine providing the income stream covers the interest.

With the ready availability of capital as evidenced by the Chinese involvement, low interest rates and steady profits, there is no reason why this should not fuel continued merger and acquisition (M&A) activity. But what could derail this circle?

Firstly it should be said that this is money going round in circles and doesn't by itself lead to sustainable development like the infrastructure projects of yesteryear. Further there is significant risk that if something turns it could create a downward spiral that might be difficult to exit.

As PE engulfs larger companies, the latest example being Boots, the possibility of default would have more devastating effects. Either rising interest rates, lower economic growth and therefore profit streams, or a fall in commercial property could all lead to a turndown.

Whether this becomes a soft or a hard landing is difficult to tell at this stage, but as banks invest in ever more risky ventures as they search the massive fees associated with these takeovers, the probability of a hard landing when it arrives increases.

So what can an investor do? Well one option is to ride the wave looking for the next PE target or, like me, they can stand on the sidelines and wait for the something that might never happen. Selecting investment strategies has never been easy but now its nigh on impossible.

When you get such a weight of professional and fund manager opinion proposing caution it would be crazy to ignore them, but where can one go? If equities are risky, bonds show little value, with interest rates expected rise again before the end of the year. UK commercial property is becoming unbalanced with rental yields in London going lower than the yield on guaranteed 10 year government bonds.

Where will the oil money be invested if or when the crash comes? Where should the UK investor be putting their money? Here are some of my ideas:

- Countries which have sustainable domestic demand and low debt should be attractive. Germany, many parts of Asia and some of Latin America fall into this category. I believe that property in these markets through Real Estate Investment Trusts (REITs) offer good value.

- Defensive stocks such as utilities, food and health around the world should weather any storm even if they fall in the short term.

- Genuine market neutral hedge funds could also give cash ++ returns but these have less transparency than the unit trusts/OEICs which are in the main stream of the investor universe.

- Overall, I favour a large percentage of a portfolio in cautious funds with some overseas property and limited exposure to a well respected defensive equity income fund such as Invesco Perpetual High Income.

- Because the future of world growth is in Asia, specifically China and India as well as the other countries of Asia which have relatively low debt, I believe some small exposure to the region is desirable even though highly volatile

Obviously, there is no guarantee that these will be the best areas to invest in and the starting point for any recommendation must be your attitude to investment risk.

If you want to review your portfolio, please get in touch.

Enduring Powers of Attorney

In January, I referred to the Mental Capacity Act coming into force on April 1^{st}: like many new initiatives put forward in recent years, this was delayed at the last moment now to be implemented from October 1^{st}.

Since it has an impact for everyone, especially those over 50 with investments, I repeat the section below:

A new Mental Capacity Act 2005 comes into force on October 1^{st} and this will lead to the end of Enduring Powers of Attorney (EPA). These were a straightforward method of ensuring that in the event of mental, physical or other incapacity your nearest and dearest could look after your affairs, particularly financial, without the cost and complexity of applying to the Court of Protection.

EPAs will be replaced by Lasting Powers of Attorney, as introduced by the Mental Capacity Act, which will be more complicated to set up and also implement. A key difference is that, unlike now, the LPA would have to be registered at a Court (for which a fee is going to be charged) before it can be used. The whole process will be more complex and of course more expensive!

If you do not have, or wish to update your, Enduring Power of Attorney, you should do it now.

For more information on any of these issues, please feel free to contact us on:

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