



Preparing for a possible downturn 18 April 2008

The second Finance Panel seminar provided a timely look at the economic outlook, with a presentation by Mark Tinker of AXA Framlington and Eric Savill and Wynne Walters of Barclays'Commercial Bank's Business Support team.

Mark is an equity strategist and had spent the last 18 months looking specifically at risk reduction. His view was that the US downturn was likely to be less severe than economists and commentators anticipate, but the UK outlook was more doubtful.

Mark argued that the current situation was in part the result of an excessive supply of low cost money that followed the interest rate cuts by the Fed after 9/11. Coupled with the fact we operate in rules based systems - encouraging purchase of expensive assets to deliver 'correctly weighted' portfolios and conversely forcing the sale of assets at depressed prices - these reinforce spirals rather than preventing them.

On the positive side the US is still seeing huge sales and profit growth is strong: they are actually growing around 12% at a time when economist are talking in terms of 20% reductions. This confusion comes from sectoral differences - typically GE is growing strongly in all areas apart from financial services. Consumption is stable, corporates have strong balance sheets and do not need to borrow. Once the markets recognise this they could switch rapidly.

The current problem is not about borrowers, it is about lenders and in particular the fact that much lending product is seen to be 'contaminated', rather as a bowl of punch may be by the addition of some moonshine.

In the US about three quarters of home mortgages are fixed for 15 years or so. Sub prime mortgages count for less than 0.2% of mortgages and even if every sub prime borrower cut their expenditure by 30% (to the breadline) consumer spending in the US would still only fall by around 0.2%. Mark also said the claims that the US was not saving was nonsense. They have some \$53 trillion in net assets, and well over half that if real estate is taken out of the figures. Thus a slowdown is unlikely to come from the consumer. It is also why the Fed was putting so much liquidity into where it was required - the financial markets. Much of that excess liquidity will not be required in a year's time.

On the less positive side, recent growth in the US has been largely due to increasing utilisation, but the economy was now at the part of the cycle requiring capital expenditure. Failure to do so will act as a break on future growth.

In the UK, Ireland and Spain, however, large amounts of floating rate debt is more of a concern. [The Treasury has announced an injection of liquidity since the seminar, but the impact of that is unclear]. Sectors of the economy connected to consumer spending (and the related supply chains) will face tougher times and Mark anticipates no growth on the UK consumer side and parts of Europe for the next three years. Eastern Europe may also face difficulties since the rates on their largely Swiss floating rate interest rates have doubled.

The current exchange rates flatter 'Euroland', but if the ECB changes stance then even a drop of 0.25% in interest rates could alter exchange rates rapidly.

Eric and Wynne then turned to why commercial businesses run into trouble. Their area at Barclays looked primarily at mid sized corporates and they outlined the approach they took.

They broke problems into three categories: cash, trading and profitability and management. Cash is always king - and in the current market cash management is a particular priority. In terms of client approach they reported that planning and sales forecasting is often overly optimistic.

They outlined the typical decline curve - and the greater the decline the more rapidly the options decrease and the more rapidly discussions move from consensual to coercive. In simple terms, earnings decline leads to balance sheet strain, a cash crisis and, potentially, insolvency. So management need to be alert to a loss of competitive edge, which can be a signal of forthcoming difficulties. Beyond your own business, clients and suppliers are often areas of significant risk.

So if the messages from Mark were that excessive leverage is at the root of bubbles, the longer a period of stability lasts the more we are lulled into taking increasing risk, and we should be deeply suspicious whenever anyone claims 'this time it is different', then where is the next bubble rising while our attention is on the collapse of the previous one? Well there is a great party getting underway in the Middle East and Asia, with lots of cheap money and signs of inflation...

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