



Getting you there.



“Are we there yet?”

Back in February 2008 I wrote in this space how the theory of decoupling, that Asian economies generally could continue growing despite the slowdown in the US economy, was flawed. Since then we have seen a dramatic slowdown in the Asian region with, for example, the Singapore government predicting a decline in GDP this year of 5% with exports in December down 21% compared to a year earlier. This is by no means an isolated example. Singapore has often been called the canary in the global trade coalmine. During 2008 Asian stock markets fell on average between 40% and 50%.

In August 2008 I wrote that whilst the economic outlook was likely to deteriorate further at some point, equities would reach a level at which the gloomy economic outlook had already been discounted. Are we there yet, and if so what is the recovery likely to look like and what is the best way to take advantage of it?

I think it is fair to say that the current economic downturn is the worst in many respects since the depression of the 1930's. This should not be particularly surprising as the explosion in debt, especially at the personal level and the extreme amounts of leverage in the financial system, are at records. Indeed total US debt as a percentage of GDP is now at a level in excess of that last seen in the 1930's. As house prices and commercial property continue to decline the collateral value of much of the lending made by the financial system is severely diminished, impacting as we have seen on banks' capital ratios and consequently their ability to lend. What incentive is there for the banks to lend when the underlying collateral continues to decline, likely to result in increased bad debts, reducing capital further and consequently the ability to lend?

Considering the appalling economic news worldwide, just released US car sales for January are down by 37% as an example, then it is a little surprising that many commentators are still calling for the UK and US economies to end the current year at a positive rate of growth, albeit still negative for the year as a whole. I suspect they are being overly optimistic and basing their forecasts on previous recessions. As stated earlier this is unlike previous recessions and the contraction in consumer spending in the large indebted nations, particularly the US and UK, is unlike anything we have seen before. This is unlikely to be quickly reversed as consumers pay down debt and rebuild their

personal balance sheets, now consisting to a large extent of sharply lower house values and negative equity.

Of course governments everywhere are attempting to stop the contraction with enormous spending plans, financed by borrowing on an unprecedented scale. Could this treatment turn out to be worse than the illness itself? Government balance sheets are deteriorating rapidly as they bail out the banking system and put together large stimulus plans. Unfortunately little comment has been made on the likely huge shortfall in income from taxation as, both corporate and personal decline, the latter a result of sharply rising unemployment and lower investment income.

The market will at some point start focusing on the perilous state of many government finances, such as Iceland and Ireland already, in addition to the time bomb of underfunded pension schemes, both at a state and corporate level. How is this money going to be repaid? If it is through inflation then this will have very negative implications for bond markets, currently enjoying record low yields. If it is through higher taxation then this will have a very negative impact on the strength of the eventual economic recovery. In any event as the global economy recovers governments will incur substantially higher financing costs. In hindsight the very low interest rates orchestrated by the US Federal Reserve seven years ago resulted in many of the problems we are now seeing. Will in due course the exceptionally high levels of government debt being accumulated similarly result in problems a few years down the road?

In summary we believe that the economic news will remain negative for much longer than is currently anticipated and that the eventual recovery, and it will arrive eventually, will be a lot more subdued than expected due to the excessive levels of government debt being accumulated. Current turmoil will provide, in due course, an exceptional buying opportunity for patient equity investors who in the meantime must resign themselves to record low and declining interest rates.

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