

Strategy Matters

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Co-ordinated rate cuts and bank nationalisations

Three things need to happen before equity markets will calm down:

1. The authorities need to get ahead of events in the financial system.
2. The authorities need to get ahead of developments in the global economy.
3. Hedge fund selling needs to run its course.

Even then, it may already be too late to prevent a serious recession and further declines in equity markets, but it surely worth making the effort.

Equity markets are down by over 20 per cent since the beginning of September. Over the last six weeks the crisis in the US and European financial systems has deepened, the global economic outlook has deteriorated sharply and hedge funds have begun an aggressive unwinding of positions. All these events were not completely unanticipated, but very few can claim to have predicted the scale of recent events.

Financial system

Recent developments in the financial system have been well documented. In the US, Freddie Mac and Fannie Mae are in conservatorship, Lehman Brothers is no more, Merrill Lynch is now owned by Bank of America; in the UK Bradford & Bingley's deposits have been transferred to Santander and Halifax Bank of Scotland is expected to become part of Lloyds TSB; and in the Euro-zone Fortis has been part nationalised.

These developments, in particular the American authorities' willingness to allow Lehman Brothers to go out of business, have severely dented confidence in the financial system. Banks are unwilling to lend to each other and will only lend to the government. Treasury bill rates have plummeted; interbank rate have

soared. Money markets have become dysfunctional.

There are two problems: liquidity and solvency.

Central banks can solve the liquidity problem by pumping sufficient liquidity into money markets and they have been stepping up their efforts on this front. No bank is going to fail for want of overnight funding.

The bigger problem is solvency. Banks have written off substantial sums over the last year or so, and have raised rather less in new capital. As a result, they are under-capitalised and need to raise more capital. This they are unable to do in present conditions. The US authorities have tried to tackle the problem through their Troubled Assets Relief Program (TARP). This, in effect, allows the banks to swap 'troubled assets' for US Treasuries. The hope is that doing so will reduce uncertainty about the health of banks and allow them to go out and raise new capital. The two problems with this plan are first that it is taking a long time to implement and second that there is no guarantee that the banks will be able to raise the capital they need.

The UK authorities have gone for a more direct solution. They have invited the banks to accept an injection of capital from the government. £25bn is available for a list of eight large banks and another £25bn is available for other banks with substantial operations in the UK. Details are still sketchy because the plan had to be rushed out, but this looks to be the most radical step yet taken anywhere to address the current financial crisis. If any government is beginning to get ahead of events, it is now probably the UK government.

Global economy

The global economy has been weakened by the credit squeeze over the last year or so, but it

was brought to its knees earlier this year by huge rises in food and oil prices. These squeezed households' real incomes and led to cutbacks in spending on other items. At the same time, companies saw their margins squeezed at a time when revenue growth was under pressure. They responded by cutting back on spending and, crucially, cutting back on employment plans. This was a further blow to households and led to another round of spending restraint. The result is what Keynes called a 'paradox of thrift'. For individual households and companies, it makes sense to cut back spending but the result is a fall in aggregate demand that makes matters worse.

The UK, European and Japanese economies are in recession. The US economy is close to recession and would be in one too but for the tax rebates paid out earlier this year and the fact that interest rates were cut to 2 per cent in April. Even China is experiencing a substantial slowing in its growth rate.

Until today, the policy response to these developments was too slow. Central banks' inflation worries had caused them to hold back on interest rate cuts. Rates had not been cut in the UK and the US since April, and were raised in the Euro-zone as recently as in July.

Today's co-ordinated 50bp reduction in interest rates in the US, Canada, the UK, the Euro-zone and other European economies (together with a 27bp cut in China) is a step in the right direction, but central banks are still some way behind developments in the global economy and more will be needed. We now expect the Federal Reserve to cut US interest rates by another 50bp on 29th October, bringing them down to just 1 per cent. Rates are also likely to come down by another 50 to 100bp in the UK and Europe in coming months.

Hedge funds

Hedge funds are facing redemptions and cuts to their credit lines, so they have no choice but reduce leverage and close positions. Unfortunately, this is difficult to do in some markets – like credit – where liquidity is extremely low, so positions are being closed in more liquid markets, like equities and currencies. Because hedge funds tend to own similar positions this unwinding can produce some startling moves in financial markets. The

big falls in equity markets over the last three days are part of this phenomenon, as is the 20 per cent fall in the Australian dollar's exchange rate relative to the yen so far this week. There are other examples.

Unfortunately, there is little that can be done about this selling, other than to let it run its course.

Outlook

At best, the financial system is going to return to normal very slowly. The risk is that the US authorities have not done enough to stabilise their system with the TARP and that they will have to follow the UK's example and inject public money into the banking system. The political timetable in the US may make it difficult to act quickly, leading to a further draining of confidence. Meanwhile, the authorities in the Euro-zone have yet to act.

The global economy is already in recession, and it could turn out to be a serious one. Deleveraging is now in full swing and there is a risk that lower interest rates do little to arrest it. Inflation will fall and there may be a whiff of deflation by this time next year. Further interest rate cuts will be needed. Despite large budget deficits, governments may have to take fiscal action too.

Equities appear to offer value at current levels, they are clearly oversold in the short-term and policy-makers are, somewhat belatedly, taking action to support the system and the economy. This has led some to call the bottom in equity markets and to draw parallels with March 2003, when the last bear market ended.

The crucial difference between March 2003 and now, though, is that in March 2003 the global economy had emerged from recession and growth was picking up, while now the economy is just entering recession. Until the authorities have taken more action, it is too early to be sure that we have seen the lows in equity markets.

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