

Don't jump back in just yet

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For investors, fund managers and equity traders, it has been clear for a while that the UK economy was grinding to a halt. For those not involved in the workings of the City, however, the real severity of the economic downturn has been limited until now to rising food and energy costs – unless they have had to remortgage recently.

Which is why, in a bid to wake the general public to the seriousness of the situation, Charlie Bean, the Bank of England's deputy governor, delivered a very gloomy assessment of the economy last month (August). Likening the current slowdown to the 1970s was a clear attempt to warn the masses that the “Nice” decade of easy credit, soaring house prices, stable employment and low inflation had most definitely come to an end.

Mr Bean knows that most people are still in denial about the potential for trouble over the next 12 months. The slowdown in mortgage approvals is not as a consequence of some collective decision by the general populace to stop speculating on houses, but because banks have tightened their lending criteria significantly to try to weed out defaulters. According to the Council of Mortgage Lenders (CML), the shortage of mortgage funding has limited activity across the mortgage market including the buy-to-let sector, which has a significant number of lenders that rely on wholesale funding.

Banks themselves are still looking vulnerable and it is not clear that liquidity in the credit markets will return any time soon. The fate of Freddie Mac and Fannie Mae, the American mortgage finance houses which have been coming under renewed pressure as a result of the woes of the US housing market, is uncertain. Warren Buffett even went so far as to declare that the "game is over" for them and that shareholders are likely to see the values of their holdings wiped out. Therefore on a global level, putting money into banking stocks is still a high risk exercise.

On a positive note, however, the US has posted positive second-quarter growth levels, which suggests that being further on in the housing crisis means that there is some prospect for recovery, unlike Japan, Germany, Italy, France and Hong Kong which all reported negative growth levels.

So what does this mean for clients who are already invested in the market or looking for some pointers on when and where to invest? Only a steady and sustained rally in the equity markets is likely to draw nervous investors back. To achieve this there would need to be a fall in interest rates, easing of the oil prices (and as a consequence home energy costs), and increased liquidity in the wholesale borrowing market. This is unlike to happen in the short term.

Pessimists predict we are on the brink of a period of large scale destruction of personal wealth – through falling house prices, tumbling equity markets and rising living costs. Those of a more optimistic outlook argue that the significant pain will be felt within the retail sector with shops, businesses, houses and jobs all affected, but that the stock market itself is poised for recovery. After all, markets price in events expected in 12 months, rather than what is currently happening.

Clients who are looking for better returns than those available on cash (where real values are being eroded by rising inflation) could consider high quality corporate debt which is now yielding quite high values. On the equity front, technology stocks may be among the first to recover, but it is probably only the brave who will go bottom-fishing for some over-sold stocks with good long term growth potential. After all, it is still rather murky out there in the markets and no one is quite sure where the bottom is.