

Silos and boxes?

“Prediction is very difficult, especially about the future.” (Niels Bohr)

Virtually no economic commentator in March of last year foresaw a rise in the UK market of some 50%, even less that of Singapore’s 80%, even though prices were deemed very low at that time. Forecasts of house prices too have been random. The winner of the Financial Times house price prediction competition for 2009 was a fox who visits a journalist’s garden. (Next year +1%). Forecasts for the Footsie 100 index for 2010 vary from 6,748 to 3,980, which perhaps makes my forecast for the last 3 months of 2009 not too bad as I said it would vary between 5,400 and 4,600. In fact it varied between about 5,000 and 5,440, finishing just over 5,400.

Economic forecasts too have been wide of the mark. The Treasury has been too optimistic most of the last decade which has not helped the funding of UK debt. Economic forecasts should be easier than market forecasts but currently there is so much uncertainty that it is difficult, but the average forecast for UK economic growth for 2010 is 1.3 %.(The Economist)

There are many potential economic scenarios but all based on certain known important facts. Firstly, the UK, along with the US, Greece and Ireland has a huge budget deficit, and has to reduce public expenditure and/or increase taxes. If it were not to address this problem, then a serious reduction in the value of the pound would be likely and quickly. As you are aware politicians are not saying very much about how this problem will be addressed, and probably won’t until after the next election. My own prediction is that VAT will increase substantially. If it would increase massively and income taxes (especially National Insurance) reduce, then I believe a more dynamic economy would come through, but this time I fear it will be just the VAT increase.

Secondly, the Bank of England has been pursuing Quantitative Easing- essentially making markets more liquid. This has to stop sometime. It has never been done on such a large scale as this before, so nobody knows quite what will happen. Such a ceasing may affect stock markets adversely as one theory is that the reason for their rise has been this greater liquidity produced by the Bank of England.

Thirdly there is the great global imbalance between the U.S. and China. The U.S. believe that the Chinese should rebase their currency upwards as U.S exports are too expensive for the Chinese to buy and Chinese imports cheap for the U.S. citizens to buy. This leaves China with a huge trade surplus which they invest by buying U.S. Treasury Bonds so supporting the dollar. This will stop one day. What happens then? Does the U.S.Dollar plunge? This would create opportunities for U.S. exporters but create the difficulties of a reduced standard of living in the U.S as imports will be so expensive. It would also make trading difficult for those companies trying to export to the U.S.

Fourthly, have we sorted out the banks? Will irresponsible risk taking rear its head? Do they still work in silos, a danger pervading in Government circles too. By silo, I mean working within their own island without reference to what may happen outside. Lehman's for example had two separate departments pursuing completely different policies. They did not talk to each other. They just looked for their Department profit target and made sure all the boxes were ticked. An overall philosophy was not apparent except for attempting to make money.

This selection of economic problems makes predictions of stock and bond markets difficult, and this is before looking at possible political world events that may occur. The result of the UK election will be important for sterling in the short term, but higher taxes and a lower public expenditure will be inevitable whoever wins. My only prediction is that the turnout will be low, as disillusionment with politicians going to war on what turned out to be an unfounded basis, inefficient managing of the economy in the good times, and the expenses scandal has led to this. This is not good for democracy.

The lesson that should have been learnt in the investment world is that real proper diversification of risk is vital; that is planning for each possible scenario, be it inflation, deflation, political uncertainty and economic growth, and taking intelligent guesses as to where that growth will come from. At the same time, one should be ready to alter the weightings for each scenario quickly. There are still a lot of opportunities both for wealth creation and preservation, but just as technology makes it all a quicker world, the need for awareness and rapid reaction when required is vital. This is why we are making increasing use of multi-asset funds. These enable managers to vary percentages held in various classes of assets as they think fit to either to take advantage of those areas which are likely to make good returns in the short term, or to protect against downward movements. Indeed, given these uncertain economic times there is a strong need to use funds where capital preservation is an objective as well as those which pursue capital growth.

Food for thought

Universities offer a plethora of courses nowadays. Specialisation seems to increase. Thus one can study Econometrics, Statistics or Wealth Economics. Oxford University however offers a Politics, Philosophy and Economics degree. It has never had a pure and sole Economics degree. I haven't asked them, but presumably they feel that Economics by itself is not a sufficient subject; but needs to be seen in a wider context. Interesting.

A Happy New Year to you.

Andrew Roberts