

Confusing?

Economics has been known as the dismal science for some time, but it should have an additional description in its present condition - the confusing science. The old joke when I studied Economics was that in the exams, the questions were always the same - it was the answers that changed. Now it should be "which of a number of answers may be correct?" However, all do seem to agree that Government debt in all western countries is very high, but then that is because it is a fact. In the UK it is some 57% of the total income last year of the country. It is also rising because the Bank of England is printing money, the Government has not as yet cut any expenditure and tax receipts are falling off a cliff due to lower taxable incomes of companies and individuals. It will have to be paid back sometime, or else we will have an even greater falling currency and inflation. Thus this means Government expenditure being cut or taxes rising, or more likely a combination of both. How it will be done and how quickly depends on who wins the next election.

The two main opposing arguments of Economists are about whether we shall have inflation or deflation. Both camps get quite vigorous in their arguments and both claim Nobel Prize winners as supporters. The main argument concerns when this Quantitative Easing by the Bank of England (printing money) should stop. If it goes on too long, serious inflation will occur, if it stops too soon our very weak economic recovery will not only be halted, but go into decline.

Amongst the general agreement that economic output is likely to be sluggish for sometime due to the need for this debt to be repaid, thus lower demand for goods and services, there are various unknowns which have got more serious. The United States last month introduced a tariff on tyres imported from China at the rate of 35%. This is protectionism, and if seen as acceptable by others could lead to tariffs being imposed by other countries. A clue to the lack of serious intent by Governments to intensify international trade has been the dismal failure of the Doha round of talks designed to reduce tariffs.

The actions taken by Governments will affect how quickly and effectively we can move to greater growth and prosperity. Job innovation should be encouraged, taxes on effort should be avoided whilst taxes on spending, especially luxuries, is less painful and more of a choice for the consumer.

So, there is much uncertainty in the economic scenario that shall unfold over the next few years, so what about the uncertainty over where investment markets will go? That is after all what we are trying to foresee. What is the best strategy?

We have seen a big rise in Equity markets, here and abroad since March. I believe that this was lead by a belief by some, which became a belief by others, that the financial system was not going to collapse and that a depression would be avoided. Has this rally now petered out, will it carry on rising or will the FT index fall substantially again? We hear investment managers' views on this and we see completely divergent views. In other words nobody really knows.

My belief, for what it is worth, is that the FT index will trade between 5,400 and 4,600 until you get my next newsletter in January. It is likely to be that volatile. I could easily be wrong, but if it went outside those parameters then rationally it could only be sensible if substantial and believable estimates of earnings changed. Of course the markets are not always sensible. They certainly go too high and go too low. The psychology of human behaviour is an important element.

This is where diversification is so important. In 2008 nearly all conventional investments went down at the same time. This eventually included cash. Economic theory said this doesn't happen, but it did. Diversification for security purposes simply did not work. Will this scenario occur again? Nicholas Taleb's book "The Black Swan" says we just don't know - and he is right. John Kay in the Financial Times has criticised some Economists who seem to believe that there is a deep underlying structure from which the laws of economic behaviour that are universal in time and space can be deduced. This is not so. All we can do is note empirical regular occurrences which apply in particular contexts, and then see if any of those contexts apply now.

This sounds like all bad news, but it is not. I have said before that emerging economies are likely to perform better than the western ones for the foreseeable future, partly because they have less debt. I don't suppose Michael Geoghegan (Chief Executive of HSBC) read my last newsletter, but it is interesting that he is moving the head operational office to Hong Kong from London. He is unlikely to be the last. Some UK companies are likely to continue to do well because of their exposure to overseas markets. Some 40% of the earnings of the Footsie 100 companies are from overseas. Vodafone has 90% of its assets abroad. Both BP and Shell have more than 70%.

Even in a flat UK equity market money can be made. Even in a falling market it can too. This means genuinely diversifying which needs serious research to see what assets are not correlated, and not taking too massive a bet either way. Thus growth overseas and careful selection amongst uncorrelated assets could and should bring very good results this year and next. Thus it is important to have diversification of managers. Putting it in a UK tracker fund and forgetting, which is sometimes advocated, but not by us, is not likely to bring many smiles for the next two years.

In Praise of Women

Gillian Tett is the Assistant Editor of the Financial Times, and head of its Capital Markets team. She was one of the very few commentators who foresaw the problems arising in 2007. She has a Ph.D. in Anthropology, not Economics.

Stephanie Flanders is the Economics editor of the BBC. She wrote a superb blog on the inflation/deflation question, and is incisive and clear. She also has the unique ability to flummox Jeremy Paxman quite often when she explains the situation to him. He flounders. It is a joy to behold.

Best wishes,

ANDREW ROBERTS