



Holland Macro Views

Three different cycles and the dangers of driving at night

Stock Market Cycles, Economic Cycles and Political Cycles:

The 3 cycles listed above are very different animals but because they often overlap they are easily confused. The current situation makes a clear understanding of the distinctions between them very important I believe.

Stock (or Credit) Market Cycles

These happen relatively often, can occasionally lead to or predict an economic cycle but often equally do not. Their occurrence is as much about capital flows and sentiment of the participants as it is about genuinely underlying economic prospects (e.g. TMT in 2000).

Economic Cycles

Are quite certain in their ultimate likelihood of occurring to anyone that reads history but the timing of calling them is fraught with complexity, due to the interaction between credit availability, responses by central banks and the human nature of the wider public.

Political Cycles

These are something that we (as stock market investors) spend very little time thinking about. They can be incredibly long or short, are totally unpredictable and depend hugely on the will of domestic politicians or population, the circumstances in which the voter finds themselves and the alternatives (candidate or parties) they are offered.

That a stock market cycle and economic cycle are happening in tandem is obviously now clear for all investors to see. Those that felt this was just a stock market event (high % of commentators last summer) have been royally put to the sword. This has happened by killing off the contrarians. Such contrarians are often right to be bullish when all around are bears in a stock market cycle but in the early days of an economic cycle this mentality not only does not work, but actively causes such investors to throw good money after bad. Buffett has observed before that being a contrarian is fine, but you have to also be right!

Today all accept that we are in an economic cycle and a pretty extreme one at that. 'All' that is in the investment community NOT all in the population. The public awareness of the situation is far far better than it was at the time I wrote Credit Crunch Part 5 in March but the UK multi-generational love affair with Property and shares will take more than a few months to kill off or to be properly questioned.

A Political Cycle- Why is this important?

It is important because it may be a huge variable on what happens next. In December last year I wrote a piece entitled “Protectionism and interventionism the enemies of the free market”. I think these themes grow in importance as the Credit Crunch finds itself further away from balanced economic thinkers and more into the laps of politicians and the public at large. We must remind ourselves that politicians do not act whilst thinking rationally about the future of capitalism or the free market. Mostly they act as those that got them into power wish them to. With the real cost of Living in the UK now rising by 11% pa (and up much more in other countries) and with household wealth collapsing there is a real possibility that the stage can be set for a big swing in political will that the public will demand. New public/political opinion can swing in many ways but some easy to see examples are:

- Who cares about the free market? – It has not worked
- It was those idiots in the City/Banks that got us in this mess.. so tax them to get us out
- I don't care what the B of E Governor says in his posh speeches I need a pay rise to stay in my home and feed my kids

The likely list is endless and the permutations of where it can take us are pretty unforecastable. I repeat an earlier view that Capitalism and the free market could be forced to take a step backwards here, regulation and intervention will raise their heads high and a growth industry will be trade unions rather than fund managers.

Sadly the best example of a cycle such as this (much debt, huge free market, booming asset prices) that then saw big policy changes afterwards was the 1930's depression. Sadly then the clamour to “do something” after the failure of the 1920's New Era led to interventions that were not particularly helpful and in fact with hindsight exacerbated the situation. Taken to a simplistic level this is actually not that surprising. As the clarity with which one sees the future gets harder and harder to make out the effect of any decision made today will have a wider outcome. Maybe we should think of central bankers as drivers at night. Steering the car is pretty easy with lights on full beam on a Motorway, but now we only have side lights and we are on a country lane. The trouble is we are travelling at an even faster speed. The result of an incorrect decision or a lapse in concentration will be pretty severe.

Back to Today's Conundrum

That much of the excesses of a stock market cycle have been purged is now pretty clear and the contrarian thinking suggests, rightly to a point, that we should start to look for some bargains, but before we do that we have to be clear about where the economic cycle will go. There are many global forces at work obviously but for the minute we will constrain ourselves to the domestic level.

[My House price crash finally arrives and 'the' Ratio to look for at the bottom](#)

Long suffering readers of these rants kindly suggest that I should be thrilled that my housing predictions were accurate and of my early use words such as Crunch, Recession and Depression. I have no such feelings only of anger and resentment that so many people in positions of influence could be so selfish, ignorant, lazy or stupid enough to have allowed the wider population to be deluded for so long. My background is a pretty standard one. Dad ran a hardware shop, Comprehensive School, no University. As such those that are currently going to lose their jobs and houses etc. are my old school mates, friends etc. So whilst I take some pride in earlier analysis,

the social consequences of what was created are a little more important and to be frank I feel are all too often completely ignored by those that fiddle with their tip sheets and models in EC1-EC4.

[The mood changes, but denial rather than panic is still the current feeling](#)

The still upbeat mentality that prevailed on the high street before the simple arithmetic that gave us annualised house prices down 10% has since evaporated. Commentators are catching up fast and discussions of Depressions and house price collapses are no longer rare. As we are now clearly past the inflexion point all we need do now is estimate the likely length and severity of the current fall. I have written pretty extensively before on the contributing factors that suggested why this fall would be severe. All I will add today is:

- Comforting Commentary that observes housing may fall.c.10% is usually followed by a qualification such as “even if the bears are right and house prices fall 20% that will still only take us back to the levels seen in 2005. Hardly a disaster”. What this dismissal of big falls misses is the fact that a fall back to only 2005 levels does not really correct the excessive asset price inflation witnessed in the last 10 years. Yet in most other asset classes we are seeing a return to decade, or multi decade low prices. Why should housing be any different?
- The supply and demand argument on UK housing is still flawed, but yet still too often reproduced as evidence to support small falls. The fact that Land prices have now collapsed surely starts to disprove this already
- Housing was a classic momentum asset. George Soros’ recent book (which is worth reading) tries to stake claim on the term ‘reflexivity’. Despite his brilliance this is a little rich as Feedback Loops (higher prices driving more demand for that asset.) have been recognised for decades. They are probably better observed in housing than in any other asset (arguably due to the lack of sophistication of such a great percentage of the buyers). When those feedback loops work in reverse, Daily Mail Front Page “House Prices Crashing”, fear will replace greed in housing and the move that the general public dismissed at first as a correction will become an outright collapse. This day may have already arrived. Despite the 10% fall thus far, there is no volume of transactions which tells us current prices are wrong. Add to that widespread denial and the arrival soon of the forced buy to let sellers and negative momentum will soon be as persuasive as the positive variety once was.
- In previous pieces I have suggested that a fall of between 30-50% in UK house prices is likely. I see no reason to change that forecast and no reason to suggest that I (or anyone else) could be any more accurate than that.

[What does that tell us about UK Plc?](#)

Consumption has clearly dried up at exactly the same time the consumer finally accepted what a horrible state he is in. The state of family finances is highly unlikely to improve from here. The next likely step is that of admission that this is more than a temporary problem. At that stage consumption will either stay flat (on its new lower level) or collapse further still. This may seem alarmist but actually the latter of these two is the most likely outcome. Reason being a need to rebuild the Savings Ratio. In all post war recessions in the UK and US consumer savings ratios grew substantially during the period of slowdown as the consumer hunkered down rather than spent. Recent falls in the saving ratio to new lows shows that families are just living hand to mouth and hoping they can get through. Sadly it is most likely that they cannot. When that realisation sets in the savings ratio will start to grow and with it consumption fall further.

[This is the ratio to look for](#)

Interestingly this ratio has been clearly extreme in the US and the UK for many years now and it has been THE chart to clearly illustrate how exceptional the recent period of consumption has been yet many, many forecasters chose to ignore it. Only in recent weeks are they revisiting the

idea of its importance and again considering the possibility it needs to be re-built. The trouble is that it started falling in the US from previously normal levels (7-11%) in 1990. Rebuilding it to a similar point may take a very long time. I will not attach these charts again but do recommend you re-look at them for the US and the UK between 1940 and today.

As a result the time to look at UK banks, Retailers and house builders (if any are still left) is after the consumer balance sheet has started to be repaired. The UK Consumer savings ratio I suggest is our leading indicator of any future upturn in the same way that Credit spreads were the lead indicator of the top. Sadly we are currently a long, long way still from it being near such a level in many of the countries that saw it drop so far.

Returning to the Economic Cycle

My comments about central bankers and policy makers being drivers at night combined with my concern that the Economic cycle possibly generates the start of a political one I am afraid means that the range of outcomes from here become pretty large and few are positive. That said I make a few observations on Deflation and on how we look for signs that things have bottomed.

Inflation vs. Deflation

That inflation is rife is pretty clear. That the man on the street will soon want a pay packet that reflects the true cost of living is surely not far away. That said deflation cannot be ruled out either. Milton Friedman insists that the FED made the terrible mistake in the Depression in allowing money supply to contract. With a lack of trust between financial institutions and between those institutions and the consumer plus greater financial regulation it is perhaps no surprise that once rampant money supply has now stalled. I am no deflation expert. (Is anyone alive in the west?) but falling money supply, falling geared asset prices and job losses (50% of all jobs in the UK are in the financial, construction and retailing sectors) are the precursors of deflation I believe and most asset bubbles in the past have often ended up that way.

Again we come back to the poorly lit country lane, the car going too fast and the driver (central banker) who has to decide which way to turn. If they play the inflation card too hard the tip over to deflation will be hard to recover from (see Tokyo for details).

Looking for signs of a bottom... Either in sentiment or in some asset classes:

The bottom, or best chance to buy a certain asset, cannot just be about valuation or just about being a contrarian (see Buffet quote above). It is about finding the best risk adjusted opportunity. 3 points that suggest we may not be there yet:

1. Neglect: The sage tells us to look for amongst neglected shares or those “inherently unpopular on the street”. He does not say “look for those that have just fallen, but are still hugely volatile and almost unforecastable as they are bound to recover”. As a result I think the most interesting thing that could now happen to a bank, property company, retailer or house builder is....Nothing. The shares stop falling, become less volatile, the fundamentals become less surprising and they are no longer talked about. 6-12 months after they have stated doing nothing maybe they will be of interest.
2. Where are the un-leveraged buyers? Another classic sign that a share price has reached an interesting valuation level is when sophisticated prudent industry experts buy similar assets. This is not the same as leveraged, incentivised buyers. As such Private Equity interest in banks is maybe not as supportive as some may have suggested (TPG/B+Bingley has perhaps helpfully demonstrated this point of late). Also the idea that

an investment bank sells its mortgage book to a buyer whom it lent 70% of the monies to should not provide comfort either. Some recent trade transactions (e.g. Anheuser Busch) are possible signals of support but each, it must be remembered, are industry specific. Such deals also must reflect prudent assessments not ego fulfilments of CEO's. In other areas many recent entrepreneurs are still pursuing business models that are debt dependant for their returns (Property is a good example). A wider acceptance that these models are no longer appropriate would be a healthier sign. Sovereign wealth money is a tougher call as I think it is smarter than many suggest, but often it has not had a long interest in the industry it is buying in. Evidence of this theme I suggest is still pretty thin.

3. Admitting the problem would be a good start. Politicians need to start speaking the truth. I recently read the speech that Roosevelt gave on being elected, as President in 1933 (link attached). The language used and candour to which he addressed the parlous state the US economy was in at the time is fascinating to read. A hope for similar candour today is maybe too much, but if a bottoming in Domestic sentiment is to occur in the US, UK or other places with similar faults it is surely more likely after politicians have stood up and accepted the severity of a situation we are all in rather than telling us "we should be careful not to talk ourselves into a recession"
http://www.pbs.org/newshour/character/links/roosevelt_speech.html

Operational gearing at the macro level= No need to rush in

Personally I find much of the commentaries I read about the housing market, credit, stock market still very surprising as nearly all (up until very recently) have not been extreme enough. I surmise that many commentators and the public in general are like analysts faced with the prospect of making a company profit forecasts:

Really, really good analysts (the exceptions) build all forecasts from the bottom up and respect the outcome even it appears extreme at first sight. The vast majority just tweak existing assumptions and growth rates. Consider an analyst confronted with a big macro event (let's say £ appreciation!), which seems to result, on the face of it, in a 30% reduction in the profits a company will make. The analyst confronts the company. The company responds as follows. "Whilst I follow your logic Mr X I think you will find that due to plan Z which we are going to implement a hit of more like 8-10% maybe more likely". Mr X is an average analyst but a cynic also. He downgrades his forecast by 15%. Human nature is at work here. The company does not wish for events outside their control to be seen to hurt them to such a degree and the analyst derives comfort in not being too far away from his peers and having some blessing from the company. The next 15% downgrade happens a year later.

I suggest the recent views of many economic forecasters, Politicians and of the public at large is exactly the same. All groups now sense that things may get worse, but the authorities have suggested that "UK housing is not like the US" and "we should be careful not to talk ourselves into recession" i.e. "It won't be that bad". Against this backdrop commentators may forecast a mild 'technical recession' but stop short of outlining how bad it could really be. Similarly the population think their fortunes may reduce a little. I still hear: "but surely house prices won't fall more than 10-15% or stay down for very long and that will be great time to buy". That I am afraid is the mentality of denial, not panic.

Those in the investment community know this as operational gearing. Simply put. At extreme points (now) it works at the macro level too. A few months ago we had the first admissions of

trouble by the Macro commentators and the public. Like Analyst X they have yet to fully factor the extent of the downturn into their thinking. Many more downgrades will follow.

The points 1-3 above and operational gearing view suggest to me there is little need to rush back into buying what do look like cheap shares too fast. Faced with such a situation John Ritblatt once observed. "You cannot beat the markets when they are going down. The trick is just to sit it out. Dynamite won't shift them. Just go away and Ski or play golf". In the last few months I confess to having done both of these, not very well, but it does get a little boring.

Andrew Hollingworth

firstname@hollandadvisors.co.uk

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Contact:

HollAnd
Advisors

Holland Advisors London Limited
1 Berkeley Street
London
W1J 8DJ

Tel: (0)871 222 5521
Mob: (0)7775 826863
www.hollandadvisors.co.uk

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