

Economic Views for Investors

by Roger Nightingale

Is it a single real swallow or several imaginary ones?

Judging by the tone of media reports, the world economy is on the mend. We're told repeatedly that, though things were pretty grim in the twelve months to mid-2009, they're decidedly better now. And it's presumed, admittedly more by extrapolation than logic, that they'll be back to something close to normal in 2010.

In other words, does the recovery have legs?

Wishful thinking or reasoned analysis? Probably the former. Although some numbers are stronger, most are merely less weak. And such improvement as there has been is largely the result of inventory stabilisation—the liquidation that began last autumn having run its course by early summer. It's the *underlying* trends, those relating to final sales, that are giving rise to anxiety: in America, Europe and Japan, they're continuing to disappoint.

Final sales are unimpressive

Retail sales, for instance, are universally and chronically weak: employment levels are falling and wages moderating. Corporate investment, meanwhile, is in freefall: companies have too much capacity, not too little. It's only public expenditure that's rising, and that, possibly, for not much longer. Voters are getting increasingly restive: they recognise that it's they who'll have eventually to pick up the tab.

Public spending isn't popular

In the States, Obama's healthcare plans are now suffering the same fate as Clinton's were sixteen years ago. The public may approve the theoretical principles, but not the practical implications. The one, as soon as he recognised the psephological repercussions of his proposals, hurriedly dropped them. Will the other? Possibly.

A year from now, it'll be falling

In the UK, the picture is essentially the same. It's the bureaucrats, though, not the ministers, who are preparing plans to cut public expenditure. The former recognise (even if the latter don't) that there'll be a protracted period of austerity following next year's election. Budgets for education, transport, defence and health (politicians' denials notwithstanding) will be cut to the bone.

The recovery, therefore, looks fragile

So what, realistically, are the world economy's prospects? Not good. It's likely there'll be another two or three quarters of mild improvement, and then a resumption of deterioration. Inflation will stay low, going negative in many countries. Credit policy will remain accommodative, but overall borrowing will be subdued: those who can afford a loan won't want one; and those who want one won't be able to afford it!

That's why money policy will stay expansive

Fiscal policy will tighten: taxation rising painfully and expenditure falling severely. The Keynesian experiment will be seen once again to have been an expensive failure. Sadly, by then, the cabal who implemented it, *a fortiori* the clique who benefitted from it, will be long gone—beyond the reach of the law, but not necessarily beyond the censure of scribblers!

And that's why equity valuations are soaring

So why are equity markets on a roll? Because the current environment is perfect for them! They don't like rapid growth because that means that credit might shortly be restricted. They much prefer dull activity, so long as it's associated with reasonably buoyant corporate profits. Is that a sustainable proposition? Yes, but it requires the wage earner to take the strain: labour must accept a diminished share of the pie in order that capital take an augmented one.

Profits rising at the expense of wages

And that's precisely what's happening. In the US, it's employment that is being cut back. In Japan, it's pay levels. But the effect is the same in both: inflation that's low (or negative); interest rates that are negligible (and likely to stay so); profits that are rising slowly (but sustainably).

The indices will keep appreciating

The consequences for valuations are sizeable. Currently, most markets trade on multiples in the low teens. Actuarially, they deserve something closer to 25! Things are changing, though. Analysts are becoming bullish; investors are looking for higher beta (usually, equity in preference to fixed income or property).

Commodity producers trailing

And which geographical locations are likely to perform best in these circumstances? Not commodity producers, of course. They've had their run. They'll not have another for several years.

Tokyo and Geneva look good

Industrial countries are to be preferred—so long as they're competitive but not so competitive as to risk protectionism. Most EU members are vulnerable on the one front; China possibly on the other. Japan may be the safest of the majors; Switzerland the most attractive of the minors.

The DC pension deserves it—and more

In any event, it's reasonably good news for the pensioner. He's suffered agonies in consequence of the pitiless Brown and his gang of bullies. He deserves some respite. With luck, he'll get some: equity valuations rising more than 10% in the remainder of 2009; a further 25% in 2010.

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