

You will often have heard us say that past performance is never a guide to future performance. This is completely true, but past events and past behaviours can often provide some insight.

Savings & Loan

The current issues with banks are not completely unique. The "Savings and Loan" crisis in the US in the 1980s may not be that familiar to those in the UK, but has some startling similarities to today's problems.

Savings and Loan institutions in the US are similar to building societies in the UK.

A number of these institutions got into trouble after lending out more money than was prudent. Much of the lending was mortgages. The real estate market in the US then crashed, and many customers began to default on their loans. This meant the institutions began to fail and those with savings were at risk of losing them. Is any of this beginning to sound familiar?

In order to safeguard the savings of the ordinary man on the street, the US government set up the Resolution Trust Corporation (RTC). This bought those bad debts from the Savings and Loan companies, taking the liabilities off their hands.

This is remarkably similar situation to today, albeit today's crisis involves much larger institutions and has more of a global effect. Indeed, many commentators are calling the current US bail out plan "RTC 2".



The original RTC disbanded in 1996. It had gradually sold off all those debts it had inherited and a number of analysts believe that it actually made a profit from this sale.

The amended "Troubled Asset Relief Programme" (or TARP) that finally made it through Congress last week includes a clause that gives US taxpayers a non-voting stake in the banks they rescue. So if the banks recover, taxpayers may make a profit.

However, the US Treasury will have to pay above the market price for the so-called "toxic" assets. They will hope that there is more value in these debts than the market currently believes. Again, there is actually a possibility that a profit could be made, and this plan may not actually cost the US tax payer a great deal. The true cost will not be known for years down the line.

The Wall Street Crash and the Great Depression

Ben Bernanke, Chairman of the US Federal Reserve, is a student of the Wall Street crash and the events that followed it. He has even written a book entitled "Essays on the Great Depression." More to the point, he also feels he knows exactly what the Federal Reserve and the US Government did wrong in the 1930s.

This was another financial crisis that has some startling similarities to today.

The Great Depression was triggered by a crisis in US banks. At the time the figures in power had the attitude that the banks had got themselves into their own mess, they should get themselves out of it, or else go out of business. The feeling being that the economy would emerge stronger once those weaker businesses had fallen by the wayside, and the better banks should prosper.

This "moral hazard" argument is difficult to argue with on certain levels. Unfortunately, it ignored the knock on effect. Rather than emerging stronger after the Wall Street crash, the US economy was in the doldrums for more than a decade.

Bernanke's viewpoint in this current climate is "forget moral hazard". His insight into the events of the past make him much more determined to do the right thing today.



Media Spin

One recurring theme of our briefings and discussions with clients is the way the media portray financial events. Good news is not news, as they say, which means you're unlikely to hear when something encouraging occurs.



Monday 15 September was a terrible day for the equity markets, the day when they could first react to weekend events regarding Lehman Brothers and AIG.

As a result of the turmoil, many investors sold shares and bought government bonds in a "flight to quality". On that day, UK Gilts went up over 1.5% and US Treasury bonds went up by 4% (Source: M&G Investment Management).

This demonstrates the benefit of having a balanced portfolio. Even when most asset classes are performing poorly, there is usually something to lift the gloom.

And we would re-iterate that, if equity markets looked cheap last time we wrote to you, then by definition they are even cheaper now.

Bulls & Bears

On the subject of the media, there was an interesting article in the Sunday Times this week, presenting the views of various market "experts". Four of these views were positive, and four supposedly negative about stockmarkets. However, it was quite enlightening to read what the "bears" actually said:

"I'm waiting on the sidelines, but am not going to wait for long because when the market starts to move I think it will move rapidly," said supposedly pessimistic David Schwartz, a stockmarket historian. "We're near the end of the 2007-08 bear market. Investors should get ready to pounce," he continued.

This view actually appears pretty bullish, and another of the supposed bears was in our opinion relatively neutral.

Of the two who actually *were* bearish, David Kauders of Kauders Portfolio Management was particularly interesting, saying he only ever invests in government bonds and has done so since 1987. According to the article "... he said in the midst of the last bear market in 2002 that the FTSE 100 could lose 75% from peak to trough, taking it to 1,350 before it bottoms out. He stands by this belief today, saying it could even drop to 1,000..."

It is intriguing that Mr Kauders stands by this belief, despite being proved wildly inaccurate last time. The other bear was Hugh Hendry, from Eclectica Asset Management, the "neutral" was Darius McDermott of Chelsea Financial Services.

The "Bulls" included such investment luminaries as Anthony Bolton, former manager of the Fidelity Special Situations fund, Robin Geffen, head of Neptune Investment Management, and Peter Hargreaves of Hargreaves Lansdown.

We would suggest this article backs up two of the points we have been making, namely: **"Don't trust the headlines"** and **"be careful who you listen to!"**

If you have any comments, queries, or suggestions, please do not hesitate to get in touch.

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General Economic Overview

It is our view that inflation is likely to come down sharply over the next year or so. Interest rates will fall. A 1% to 2% drop in rates is not unlikely.

Recession is now looking highly probable and unemployment is likely to rise significantly.

Asset Class	Applewood View
<p>Equity Markets</p> <p>Despite the recent turmoil in the markets, equities still look very cheap compared to historical averages. Price earnings ratios of less than 10 times are the lowest for 20 years. Even though we believe company earnings are likely to fall, equities still look attractive at current prices.</p> <p>Yields are also very high and are currently greater than Gilt yields. The outlook for income funds and "value" based investment styles is positive, after a poor 12 months.</p> <p>We still expect high volatility for some time to come.</p>	
<p>Fixed Interest</p> <p>Corporate bonds look cheap compared to gilts, even those issued by high quality companies. The difference in the yield assumes that around one in three companies in the UK will go out of business, which we believe is very unrealistic.</p> <p>For example, one of our preferred fixed interest funds has a current yield to maturity of around 9%. This assumes no recovery in the sector, and is just the return built in based on current yields and capital returns. The fund in question has rarely suffered any defaults.</p> <p>With this type of yield and with interest rates looking likely to fall, double digit returns are possible. This would be an excellent risk adjusted return.</p> <p>We still expect some volatility in the short term as investors remain nervous that some companies may default on their bonds.</p>	
<p>Commercial Property</p> <p>We still believe property has some way further to fall, and we believe the markets will not start to look attractive until at least mid 2009. After that, we may see some reasonable returns.</p>	
<p>Residential Property</p> <p>The outlook for residential property remains poor and we expect further house price falls. Borrowing is likely to remain expensive and difficult to obtain for some time to come.</p>	

Key:

Positive Outlook



Negative Outlook



Neutral Outlook



These represent Applewood's views. There are no guarantees, which is why we usually recommend holding at least some funds in all asset classes at all times.