Fears, Francs and Frustrations

11 August 2011

After a day of relief, markets returned to panic stations yesterday and the FTSE 100 Index closed only just above 5,000 points.

Concern turned to France with rumours abound that they are about to lose their AAA credit rating. European banks suffered in turn, with Societe Generale in France forced to deny rumours about their solvency which saw their share price drop 15% yesterday and a further 8% today.

All three major credit ratings agencies stated that France was not in danger of being downgraded.

One concern is that, under the rules of the European Financial Stability Fund (which aim to stabilise peripheral European nations like Greece by providing them with loans), only AAA rated nations can guarantee the loans. If France loses its AAA rating, Germany would be left as pretty much the sole saviour of the other Euro nations, a position they will not relish!

A number of commentators believe that France losing its rating could lead to the breakup of the Euro. Of course, another possibility is that the rules of the EFSF are changed. Hopefully, this won't be required and the rating will not change, however what is driving markets right now is not facts or new information, it is rumours and fear.

There is now a lot more coverage of banking issues and references to a potential "credit crunch number two". With investor confidence so fragile I hope such concerns do not become tabloid headlines.

So-called "safe havens" such as the Swiss Franc and Gold continue to rise. Switzerland is so frustrated at the damage to their economy from their rising currency, they are threatening to peg it to the Euro.

Despite the high returns over the last 12 months, we are still not even tempted to buy at the current inflated levels.

This morning, the FTSE 100 was back up over 100 points before falling back, then recovering, and as I write it is currently at around 5,040.

Latest Actions

What hurt in the credit crunch was not just that equities fell, but that the normally lower risk assets on the other side of the portfolio fell as well.

We do not believe we are about to see credit crunch number two and have positioned our equity portfolio accordingly. However, we have no crystal ball and if we are wrong we need to be able to react. It is important that the lower risk assets we hold really are low risk. Fixed interest and property have held up well to date, but could see potential losses if the situation escalates.

We have therefore decided to reduce property and fixed interest still further and hold cash. We are doing so in discretionary portfolios by selling the Threadneedle Property Trust, the Standard Life UK Property Trust and the L&G Property Trust (where applicable).

We are also selling the M&G Inflation Linked Corporate Bond fund. Many of you will be aware that we are very concerned about inflation over the long term. However, this fund has seen the lowest falls and we could see inflation falling back significantly in the short term IF we are likely to see another recession. We are still concerned about inflation in the long term.

A typical cautious portfolio now holds circa 29% cash, balanced holds around 22%, and adventurous 20%. Unless things stabilise we may then sell a further fixed interest fund, which could create 3% to 4% cash. This is in addition to the cash that clients hold personally.

The portfolio cash is intended as a temporary position until things settle down. It will allow us to take advantage of bargains in any of the asset classes if they arise.

If markets move back up, we feel we are unlikely to miss out on great returns, however if markets move down we want to avoid the chance of significant losses in these areas and have the opportunity to buy back in.

Client Thoughts

We asked you whether you thought this was going to be a short or long term dip in markets, and where you predict the FTSE will be in 18 months time. Thanks for all the responses, the results are shown below.

80% of respondents to date thought this would be a short term dip (months rather than years).

The FTSE guesses were as follows:

- The average guess was 6,102
- The highest guess was 6,730
- The lowest guess was 5,000

Only one person thought the index would be lower in 18 months time. If anyone else would like to contribute to our survey, please do respond to this briefing.

If we take the average of 6,102, that is around 22% higher than we are today. If we factor in dividends of say 3% pa, that is around a 27% return in 18 months. This is an annualised return of over 17%, more than 50% higher than our standard assumption for equities of 10% pa. Based on our usual scoring system, we conclude that our average client would give equities the maximum +5 score!

It has been nice to see that our clients remain optimistic towards markets. What has also been welcome is the positive responses to our actions and to these regular updates, so thank you very much for your feedback.

We will continue to provide regular updates as and when things occur. We hope we will get to a point very soon where they will no longer be required!

The information in this briefing does not constitute advice. Please do not take any action without speaking to your adviser.

Colin Lawson
Managing Partner