

Get ready for the future

How deep will the recession be, and how will the investment landscape change this year? Shares asked three experts for their views

Russ Mould

Last Friday saw the FTSE 100 index slip briefly below the 4,000 level intra-day for the first time since late November and the UK's headline index is 10% below the peak it achieved on 6 January. Early hopes of government intervention, in the form of monetary and fiscal stimulus, could stoke inflation and boost the global economy are ebbing. The market debate now surrounds the depth and duration of the recession – whether it will be U, V, W or L-shaped – and what governments can do about it. The good news however is last year's heavy stock market falls look to price in a lot of the bad news, sterling weakness should help British exporters and falling oil prices should lower input costs and boost corporate profit margins.

The picture is not therefore far from clear cut and *Shares* has enlisted three investment experts – Sue Concannon of Halifax Share Dealing, Paul Howard of TD Waterhouse and Marc Spaelti of Dukascopy – SWFX Swiss FX Marketplace to address the big issues.

Bull or bear?

Shares initially asks the panel what their take is on market sentiment right now. Marc Spaelti swiftly outlines the big picture as he sees it. 'The answer is closely linked with the economic outlook,' says the foreign exchange expert. 'An economic recovery would certainly help equity markets, a deeper recession on the other hand is likely to trigger further weakness.'

'The financial crisis we've seen unfold over the past months strongly reminds economists of the deep recession of 1929. A look at the historical Dow chart during that time reveals, that the index lost close to 90% before bottoming out in 1932. Considering that the Dow

has roughly lost 30% in 2008, there is still a lot of downward potential for the current year'.

But before we start off on too bearish a tack, Spaelti is quick not to paint things too black. 'This said, there certainly are stocks worth buying now. With US president Obama's promise of a fiscal stimulus package, some sectors will most certainly benefit strongly'.

Paul Howard also seeks to look through the gloom. 'From reviewing recent trading activity by TD Waterhouse customers, especially new customers, they certainly seem to be bullish on equities for the most part, particularly in the banking sector,' he says. 'The government's latest bank bailout or 'insurance' plan as it likes to call it, coupled with news that **Royal Bank of Scotland (RBS)** will report a full year loss of between £7 billion and £8 billion, had a huge effect on the banking sector recently with speculation about the impact this may have on other banks.'

'The knock-on effect on bank share prices was quite severe, prompting our customers to trade heavily in the sector. The key indications are that they are hop-

Holdings (HSBA) – a stock that is not normally a regular trade for our customers. Overall we have seen a huge buy/sell ratio on banking stocks of around 5:1'.

Sue Concannon agrees banks have become a key arena for investors: 'From the perspective of our customers, trading in the shares of banks accounted for 24% of our total trades during August 2008, with 1.24 buy orders for every sale. By January of this year, transactions in banks has risen to 32% of total trades and the ratio of buys to sales stood at 2.75 to 1.'

'Over the same period we have seen overall trading volumes virtually double, with much of this activity driven by the shorter-term, speculative activity of our customer base. This is the result of the incredible volatility we've seen in the share prices generally'.

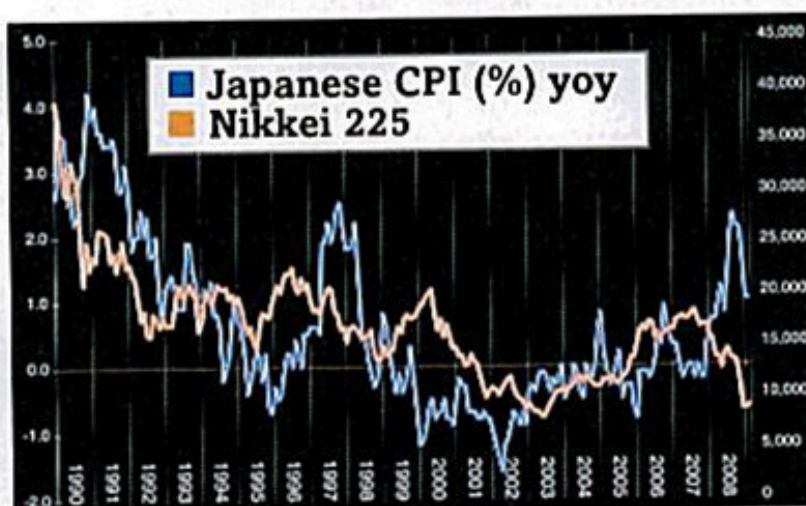
Inflation, stagflation or deflation?

The Obama administration's promised \$825 billion economic stimulus package in the US, coupled with fiscal packages in markets as far flung as the UK, Germany, Taiwan and Japan, had prompted hopes the authorities could stoke inflation and use this to ease the debt burden which afflicts governments, corporates and consumers alike.

Yet recent falls in European, UK, US and Chinese inflation have raised fears governments are pushing on a string and a deflationary spiral similar to that seen in Japan in the 1990s is now upon us.

Howard asserts deflation rather than stagflation or inflation is the issue now, although

investors will need to be on their guard. 'Recently, the Bank of England was given authorisation to carry out "quantitative easing" to inject new money into the financial system if cutting the base interest rate – which currently stands at 1.5% –



ing to profit on the rebound of bank shares. We have seen increased activity in **Royal Bank of Scotland (RBS)**, **Barclays (BARC)** and the newly-formed **Lloyds Banking Group (LLOY)**. Our customers have even turned their attention to **HSBC**

was no longer an option. If this is carried out to a sufficient extent deflation would then be unlikely, although it could be at the risk of excessive inflation,' argues Howard.

Marc Spaelti is not sure any of this really matters. 'I strongly doubt that any of them will be "the big theme" for the year as other issues are likely to make the headlines in 2009,' he says.

Howard agrees a return to the 1970s woes of no growth and rising prices is not on the cards. 'Stagflation – which is a combination of rising inflation coupled with recession – is actually viewed as unlikely by the majority of economists in the present climate. The behaviour of our own customers, who at present are choosing to prefer standard gilts rather than index-linked gilts, suggest they are not expecting to see a return to inflation anytime soon in the current climate'.

Spaelti also believes price declines are inevitable. 'As the recession kicks in further and companies can choose between lowering prices to make a sale or close their factories, consumer prices are bound to weaken even further. This seems of little concern to central banks for now as keeping financial markets liquid through quantitative easing and coming up with plans for useful stimulus packages to counter growing unemployment rates will be taking the spotlight this year'.

Recession or depression?

'Recession is likely to be the dominant economic feature of the 2009 landscape,' says Halifax Share Dealing's Sue Concannon. 'Having said that, there will always be those well-established companies which are better placed to weather the storm as well as those niche businesses which are able to take full advantage of the current market conditions. In both cases developing deep, lasting customer relationships will be the number one priority for those enterprises hoping to successfully emerge on the other side.'

'Seeking out those opportunities to back the likely winners isn't the sole domain of professional fund managers; we can all develop well-informed opinions based on our own research,' explains Concannon. 'After all, for investors willing to take a long-term view it is where they believe the share price will be in a number

of years' time that counts – and not necessarily where the shares close at 4.30 today.'

'The continuing media focus and market volatility will eventually reveal the winners and losers of the current downturn and investors will have to remain alive to the changing picture. In the meantime, the investor needs to be happy that their chosen investment strategy fits their

own priorities and personal profile – whether that be day trading or investing a little but often across a range of asset classes to spread risk.'

Paul Howard is in no doubt recession rather than hopes for a recovery will dominate market sentiment this year. '[Last week's] official data from the Office for National Statistics confirmed GDP fell by 1.5% in the fourth quarter of 2008,' says Howard. 'This follows a fall of 0.6% in the third quarter, and represents the biggest quarter-on-quarter decline for nearly 30 years. As a result, the UK has finally caught up with US, Japan and Germany and we can officially declare ourselves to be in a recession for the first time since the early 1990s.'

'How long it will last is another question and one with a less certain answer. Some forecasters expect this time around will last longer than the recession in the 1990s, lasting for at least five or six successive quarters. As such, their expectation is that this will be a "full blown" recession that will certainly last for the remainder of 2009.'

Dukascopy – SWFX Swiss FX Marketplace's Marc Spaelti agrees a nasty downturn is the likeliest outcome and he refuses to rule out a 1930s-style economic collapse. 'As bankruptcies continue, jobless rates are headed through the roof and worries that the present recession may deepen to a full-fledged depression will be well founded,' he argues.

'Hopes for economic recovery based on governments' will to increase debt for stimulus spending are likely to fall short. While we admire president Obama's will to create up to three million jobs within the next few months, we point to the fact that close to 3 million jobs have been lost over the last two quarters and further significant layoffs can be expected as global demand for goods, such as cars, continues to contract'.

Sectors and stocks

The December rally saw prior market darlings such as mining, industrial metals, oil services and engineering stocks enjoy a welcome rally, but the subsequent sell-off has seen dependable defensives and yield stocks, in sectors such as oil, tobacco and pharmaceuticals come back to the fore. Following RBS' revelations of shocking

BIOGS

Marc Spaelti has 20 years' experience in investment banking with a focus on foreign exchange trading. In his career he has worked in different international banks around the world and is now Risk Manager for Dukascopy - SWFX Swiss FX Marketplace in Geneva.



Sue Concannon, Halifax Share Dealing. Widely regarded as a retail stock broking industry expert, Sue is non-executive director of Euroclear SA/NV and Euroclear, a board member of APCIMS and a Managing Director of Halifax Share Dealing.



Paul Howard is Senior Manager responsible for Corporate Development at execution-only broker TD Waterhouse. His responsibilities include corporate planning and product management. Paul's career in financial services spans 20 years. He joined TD Waterhouse from YorkShare in 1999 and has an MBA in strategic planning.



losses and concern more high street names could fall into government ownership, banks have taken another drubbing, but TD Waterhouse's Howard is seeing some brave contrarians treat this as an opportunity.

'We have noticed an interest in banking stocks by our customers throughout 2008 and the early part of 2009 while interest in mining stocks has decreased substantially since their peak in 2007. It appears that mining company investors are more likely to believe they were investing in a bubbly sector than banking investors. The exception to this are oil company investors that are hanging on in the hope for an upswing, and gold mining investors, most of who could be sitting on a gain'.

Spaelti is clear on which stocks he thinks should be avoided: 'Any industry running at overcapacity will surely come under severe pressure. The front runner may well be the automotive industry which has failed to reduce capacity years ago. Shipping and commercial flights are also bound to underperform as fewer goods are being shipped and travel expenses are cut by businesses and private travelers alike'.

Given his downbeat outlook it is not surprising Spaelti highlights defensive sectors. 'Winners are likely to come from sectors less touched by recent economic events. The food industry is believed to be fairly recession resistant; the same can be said for pharmaceuticals. While selected companies may underperform as prices drop and profit margins slip, the world's population continues to increase and basic needs for food and medical care are likely to increase,' he says.

The forex man also throws in one wild card: 'The sector which could excel above all others may well be the construction sector, as many of the stimulus packages announced will go into the renovation and upgrade of the present infrastructure. This said, it is yet to be seen if such efforts can make up for the much lower output of housing. It will also mean that the only companies to benefit are the ones which are able to switch from building cheap houses to complicated structures such as bridges, tunnels or railroads'.

Broad horizons

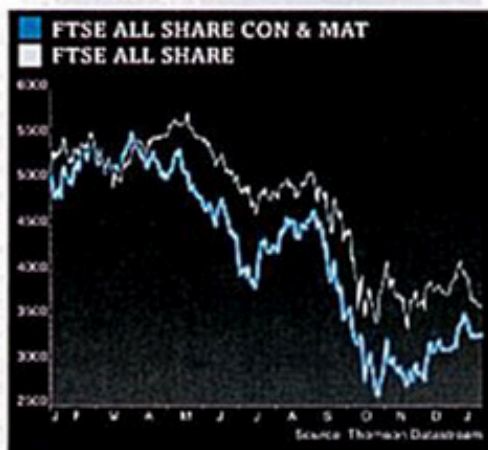
The UK's economic woes have also prompted many investors to look farther afield for profit opportunities, according to Howard. 'We witnessed a strong focus

on overseas investment in 2008, and this is a trend that looks set to continue. The results of the TD Waterhouse Investor Confidence Index – an independent survey to gauge current investor confidence – showed that 58% of respondents were most likely to invest in Asia while 31% would invest in the US.

'People have been tipping far eastern markets such as China because they have

there certainly are stocks worth buying now

high levels of personal savings compared to our deficits,' continues Howard. 'On the flip side, these economies also rely



on exports and could find they suffer from the knock on effect of a recession in the West. However, many predict that because the USA was the first to experience a downturn it could also be the first to recover'.

The big picture

In summary it looks as if macro-economic themes such as recession or recovery, inflation or deflation and particularly movements in interest rates look set to be every bit as influential in 2009 as they were in 2008. Returns available on cash are certainly a key factor so far as TD Waterhouse's clients are concerned.

'One of the most notable changes we have seen recently is a flight from cash, indicating the Bank of England's interest rate cuts have prompted savers to move back into the markets. Isas remain the investment product of choice but with Cash Isa rates declining on the back of the recent cuts in base rate, stocks and shares Isas are becoming more attractive for

those investors wanting to make the most of their Isa allowance for this year,' says Paul Howard.

Spaelti believes stock markets are in for another rough ride. 'Stocks should stay under pressure in 2009. Stick to sectors that are believed to be less affected by a recession. Compared to a conventional investment portfolio, exposure to stocks should be weighted much lower than usual.

'A good alternative investment is currency trading. With the advantage of being as liquid as cash it has good potential for gains. Currency trading is a volatile business and risks of overleveraging are high for an untrained investor, so adopt the most conservative strategy you can find.'

Uncertainty over the economy and corporate profits could easily mean investors prove reluctant to bet the farm on equities. Paul Howard says: 'We have also noticed a rise in trading of government and corporate bonds, both within Unit Trusts and on a self-select basis. Government and corporate bond investors will be dreading cuts in the credit rating of their bond's issuer during the next year – the most likely negative influence on bond prices in this period of low interest rates'.

Spaelti is not so sure this is the way forward. 'Stay clear of bonds and in particular US Treasuries, with yields at all-time lows,' he urges. 'Government debt increases worldwide, and additional bond issues are planned. For how long will investors continue to lend money for so little return? There is high probability of an interest rate hike sometime in late 2009 which would send bond markets lower'.

'Ultimately, diversification is the key to any good investment portfolio, says Howard, 'and as we have previously mentioned our customers are still willing to invest in equities – especially in overseas markets. Investors are taking a more cautious and considered approach to their portfolios by combining risk to ride out the present economic climate.'

Halifax Share Dealing's Concannon concludes on similar lines, adding: '[Portfolio strategy] would depend on an individual's circumstances. However, investing wisely through research and analysis and being clear on your investment strategy is likely to result in a mixed portfolio where exposure to risk is managed.' ■