

Economic Views for Investors

by Roger Nightingale

The B-of-E is worried about the economy

Reviewing the prospects for the British economy last week, the Bank of England said it would increase the extent of "quantitative easing." Previously, it'd planned to buy up £125bns of privately held assets; now it thought £175bns more appropriate. Why the change? Because its assessment of the outlook had worsened.

Its therapies aren't working. Dosages will therefore be increased

The setback in the last twelve months had been steeper than originally judged; the revival in the next twelve would be shallower. Thus far, lower interest rates had had a negligible impact on activity; higher public spending, none at all. The green shoots perceived by professional illusionists (in government and banking) would turn out to be false dawns. They were largely a reflection of the inventory cycle: the savage liquidation in the nine months to early June; the dead-cat bounce since then. It was final sales that would determine the shape of any recovery. And the outlook there was not good.

Arguably, it's the commercial banks that are the problem

There was no shortage of liquidity in the banking system, but there was an intense shortage in small and medium sized companies. That was why inventories had collapsed. It was the only way the companies could raise funds. The commercial banks had failed the innovative part of the corporate sector then, and it was continuing to do so now.

They're making too much round tripping . . .

Why? Because they could make much more money, much more safely, by lending to H. M. Treasury and the Local Authorities. Banks were able to secure funds from one part of the public sector at negligible rates and pass them on to other parts of it at higher rates! It was round tripping on an heroic scale. It was extraordinarily costly to the taxpayer; and produced no benefit to the economy. At no stage did the funds come into contact with those who *created* wealth; only with those who *consumed* it.

. . . to fulfil their primary function

Not true, claimed the authorities. Funds had passed to the corporate sector. The bond market had revived. True; for FTSE 100 companies, it had. Many of them had been able to raise significant sums. And what had they done with them? Paid off their overdrafts. And the banks, in many cases, had used the monies thus returned to them to buy the bonds! More round tripping. More bounce for the bankers. But no benefit to economic activity.

The Bank hopes that higher asset prices will ease the strains

The Bank of England sees the problem, but doesn't know how to resolve it. The liquidity, it concedes, is bound to be used initially to re-jig balance sheets. Subsequently, it'll boost asset values. The hope is that, later still, it'll fire up spending. Maybe. But it's going to be a long and embarrassing wait.

In housing, similarly

The story is much the same in the residential property market. Lower interest rates have stabilised house prices, but not housing starts. The Bank's policy has helped middle-aged home owners, but not the building sector. Nor has it done anything for the young would-be house buyer. His application for funds (like that of the medium-sized company) is rejected by the lender. Too risky.

Such problems go unnoticed in Europe

If the Bank of England's problems are tricky, those of the ECB are trickier still. The German economy, savaged in the phase of inventory liquidation, is bouncing back correspondingly briskly now. But final sales look as bleak as ever. GDP might grow for a couple of quarters, but will falter again thereafter. If consumption and investment don't revive, the spectre of a thirties-style depression will loom again.

Trichet, a modern-day Bourbon, recommends eating cake

And Germany is the strongest of the EZ countries. Its matchless technical virtuosity allows it to survive the euro's severe over-valuation. Not so the others. They will find conditions exceedingly difficult in the next twelve months. They need a sizeable devaluation, but the ECB seems determined not to give them one. Eastern Europe, the Baltics in particular, may consequently disappear in a puff of smoke. Will Trichet notice? Will he relent? Will Parisians man the barricades? 1968 revisited? Interesting times.

Assets are not valued appropriately. They'll rise

The good news is that asset valuations will continue to rise. Equities most particularly. Profits will be strong because wages will be weak. And the multiple applied to those profits will expand because there's nowhere else to deploy the excess liquidity. The indices are headed for a 15% rally in the remainder of 2009, a further 25% in 2010.

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