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should ask...

...investments  
and money

A networking lunch and lecture

9th November 2007  
Venue: York Racecourse

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## Issues for investors

- The 'credit crunch'
- House prices
- Commodity prices
- Inflation
- Prospects for assets

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## The 'credit crunch'

For a number of years, the global economy has enjoyed a strange balance between

- economies such as the US and the UK, where consumers wanted to spend, and
- economies such as China and India, which wanted to grow through production.

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## The 'credit crunch'

The working arrangement whereby emerging economies supplied cheap goods and services, happily purchased by developed economies, suited both sides.

This was not only in terms of the very immediate relationship of supply and demand, but also because the very substantial cash flows generated by emerging economies found their way back into developed economies through the purchase of bonds.

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## The 'credit crunch'

The effects of this have been

- to drive bond yields down to levels that may be regarded as being at odds with underlying economic fundamentals, and
- to make borrowing both cheaper and easier, in effect putting off the day of reckoning that might otherwise have been expected to end periods of significant imbalance.

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## The 'credit crunch'

There have been two clear  
consequences –

1. Ample liquidity has supported huge levels of borrowing which in turn has supported housing markets and the private equity industry, which has largely relied on cheap borrowing to make sense of highly geared asset purchases.
2. Both lenders and borrowers have been prepared to take risks with borrowing arrangements that they might normally have declined.

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## The 'credit crunch'

During the summer, markets became aware of the adverse consequences of lax lending policies

- as declines in the over-extended US housing market exposed the frailty of sub-prime mortgage loans in circumstances where some borrowers had 'no income, no job, no assets'.

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## The 'credit crunch'

- The problems with such loans were substantially exacerbated by the way in which financial institutions had parceled up the mortgages and sold them on, often with derivatives-based structures.
- Major banks and other financial market participants stopped lending.

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## The 'credit crunch'

- Central banks, such as the US Federal Reserve, acted quickly by providing funds to the market and cutting interest rates, despite rising inflationary pressures.
- This certainly averted a crisis, although the near-failure of Northern Rock revealed how difficult conditions can turn.

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## The 'credit crunch'

In terms of the market consequences, the immediate impact of the 'sub prime' crisis was

- a sharp increase in investment market turbulence, and
- a 'flight to safety' with Government bonds moving higher.

However when it became apparent that markets were to be bailed out by Central banks, confidence was largely restored and 'risky' assets began to recover.

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## The 'credit crunch'

The underlying problems of economic imbalance remain.

The real damage will be done if and when Central banks feel unable to provide support.

We should expect this when rising inflation pressures become too material to ignore, and interest rates begin to rise once more.

Meanwhile, we should expect increased turbulence and some high profile casualties.

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## House prices

Rising house prices are a reasonable consequence of cheap, readily available credit.

Prices may be extended against conventional metrics – but bubbles are only deflated when a trigger event occurs.

We would need a material economic downturn or uptick in inflation for the UK party to end in tears.

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## Commodity prices

Strong industrial commodity prices have resulted from strong demand and limited supply flexibility.

Demand from emerging economies looks set to continue to be robust.

And the supply response is likely to be limited.

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## Commodity prices

Agricultural markets are straining to keep up with demand. Prices have been spiralling upwards.

Global food production needs to grow at 2.5% per year just to keep pace with the dietary needs of its population.

Biofuels expansion adds another 80 bps to the demand growth for agricultural products over the next five to eight years.

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## Commodity prices

Agricultural production would need to grow at 3.3% per annum in order to meet total global demand.

Acreage expansion potential appears limited, given rising environmental concerns, urbanisation and land degradation.

The onus is on productivity growth, but in the case of cereals, productivity has grown at only 1.3% in the past 20 years.

- This implies that agricultural prices will continue to rise.

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## Inflation

The availability of cheap manufacturing, and now services, from developing economies, in conjunction with new technologies, free trade and the absence of capital and currency controls, have provided a strong dis-inflationary impetus for developed economies.

This has affected the prices of goods and services, corporate margins, and asset prices too.

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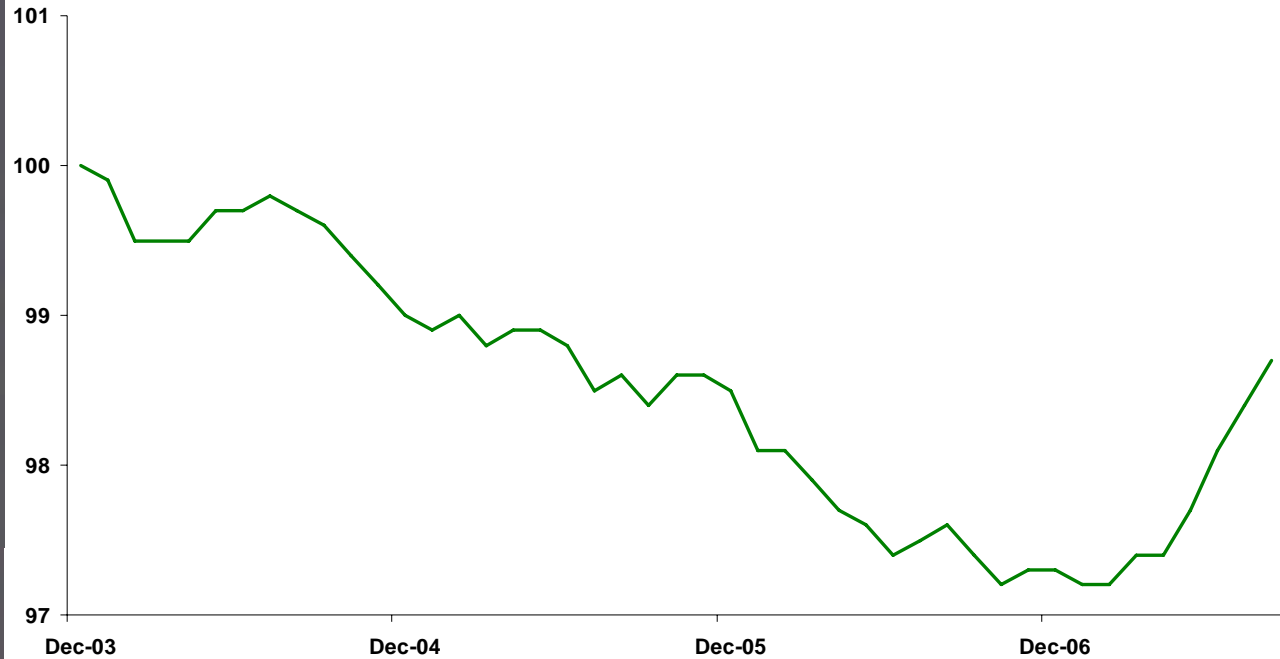
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# Inflation

## Prices of Goods From China Clearly Accelerating



Source Datastream

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## Prospects for assets

With real estate, we expect that

- prices may fall back in the face of low transaction volumes, and a more difficult environment for borrowers.
- Over time the prospect of attractive rental growth will support prices.
- Superior performance will likely be associated with higher yields and yield growth.

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## Prospects for assets

For now bonds are buoyed by the prospect of easier money rates than would otherwise have been the case.

We also have buyers recycling liquidity.

But there are risks that inflationary pressures rise, undermining at least real returns.

And 'sovereign wealth funds' may switch focus.

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## Prospects for assets

Looking forward, we see equity markets as well supported by high levels of free cash flow yield.

But we expect an increasing worldwide focus on company quality and dividend paying capability, as the global economy slows.

There are other risks, such as a reversal of the benefits that shareholders have enjoyed at the expense of workers – so vigilance is appropriate.

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