

FINANCIAL CRISIS MK II?

Global equity markets have fallen sharply amid concerns about a second global financial crisis. Below, we give an update of recent developments together with our views.

In recent days, global markets have been at the eye of a perfect storm comprising (i) renewed and widening sovereign debt crises in the eurozone, (ii) a last-gasp but inadequate agreement to raise the US government debt ceiling and (iii) a widespread deterioration in global economic data, suggesting that growth is slowing once more. The storm was topped off on Friday by the downgrading of the US government's debt by the rating agency, Standard & Poor's. For the first time in S&P's history, US sovereign IOUs no longer carry a AAA-rating.

The three factors are, in our view, interrelated. Very weak economic growth or renewed recession makes the sustainability of heavy government debt burdens, both in the US and Europe, more open to question. The sharp deterioration in sentiment has been exacerbated by concerns that, in both the US and Europe, recent policy action has been forthcoming but has failed to resolve the issues plaguing financial markets.

In Continental Europe, national governments have only recently delivered a second series of measures to support Greece and stave off contagion to Italy and Spain. In the US, the spending cuts promised in order to secure an agreement to raise the debt ceiling were widely viewed as too small, as well as being too reliant on unspecified future measures, to be fully credible. The ferocity of the US debt debate also showed that the American political system was perhaps incapable of addressing the major challenges facing the economy. This was one of the reasons given by S&P in removing the US AAA-rating. The extreme weakness in financial markets suggests that investors are becoming increasingly concerned that there is little more that can be done in the short term, either in Europe or the US, to address the unfolding crisis.

Consideration of the events discussed above suggests that we may be heading back into a financial crisis of comparable proportions to that of 2008. However, there are more policy levers available and, in our view, these will be operated to prevent the crisis from spiralling out of control. In Europe, these include renewed and increased purchases of government bonds by the European Central Bank and the expansion and acceleration of the powers of the European Financial Stability Facility. In the US, the gravity of its economic predicament led the Federal Reserve yesterday to freeze interest rates for the next two years and hint at more economic stimulus to come. Furthermore, America's reflection on the self-inflicted nature of a rating downgrade, will, in our view, lead to an improved agreement on the debt ceiling in due course.

With regard to the economic data, this has been by no means all poor, as we saw with the US employment data last week. Moreover, with the oil price falling by almost 20% from its late April peak, bond yields now much lower and the expectation of further policy steps from governments and central banks in due course, we remain optimistic that the second half of the year will see a gradual improvement in the economic picture.

Considering investment markets, with equity prices depressed following the recent falls, we do not believe that this is an appropriate time to reduce holdings. Valuations are attractive and companies remain profitable and focused on the longer term. By contrast, safe haven assets, such as UK or German government bonds are, in our view, considerably overvalued.

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