
CHAPTER 3

Shifting deck chairs on the Titanic

'You better start swimming or you'll sink like a stone, for the times they are a'changin.'

Bob Dylan

We have examined in the first two chapters the business models of companies and sectors that result in strong competitive advantage. The next step is to assess how they fare during the course of the economic cycle, as this determines when they should be bought and sold.

The first part of this chapter examines how the economic cycle can seriously enhance or damage your wealth. It is vital to select the appropriate asset class and sector. Investing in the wrong sector at the wrong part of the economic cycle can lead to a catastrophic loss of capital. The second part is to analyse how asset classes behave in a typical economic cycle and identify opportunities.

1. The economic cycle

'Most other fund managers refuse to believe that the cycle exists any more: they believe that consumers can go on spending indefinitely.'

Peter Webb, Eaglet investment trust.

Share selection can be compared to shifting deck chairs on the Titanic. You may have chosen a good spot to sit on the ship but that is not very helpful if it is about to hit an iceberg. Similarly, it is imperative to choose shares that will not sink when the economic cycle changes. Some understanding of this will, in all likelihood, be the most important determinant of success or failure. Sadly, all too many investors and businessmen extrapolate from the past to the future and assume that existing trends will continue. They fail to understand that the trend has a bend in it and even less understanding of when that bend may happen.

It is vital to recognise the current point of the economic cycle. Once this is understood, the appropriate asset class can then be selected. Essentially, investors should have a good tailwind behind them and this is best and most easily achieved by being in asset classes that are rising in price and avoiding those that are falling. Battling against a strong headwind is futile. Another way of riding the cycle is to be long on assets that are rising and short those that are falling. We will return to this later but first we need to examine what causes the cycle and where we are on it now.

What causes the economic cycle?

‘Change is the law of life. And those who look only to the past or the present are certain to miss the future.’

John F. Kennedy

The economic cycle is a normal part of life. In a typical cycle, the economy starts with equilibrium between supply and demand in the four factors of production, namely land, labour, capital and enterprise. Presently, companies begin to feel confident and anticipate that profits can be improved, so they increase output. The demand for the four factors of production rises accordingly and their prices rise. Additionally, people foresee continued and increased demand for their labour so they feel confident about spending on consumer goods. Borrowing increases and this fuels the housing market. The economy starts to operate above its long-term growth trend, which is about 3% a year. Inflation, a trade deficit and a falling currency ensue and this threat is met by the central bank with higher interest rates. This increases the cost of capital, one of the four factors of production, and, with more resources earmarked for that purpose, there is less left over for the other factors. The demand for these falls, as companies and people tighten their belts, and recession ensues along with a severe bear market in shares and houses. Inflation is eventually wrung out of the economy and it can once again return to equilibrium. Then the whole process can start all over again.

Alan Greenspan’s view

‘Don’t confuse genius with a bull market.’

Wall Street slogan.

Alan Greenspan, chairman of the Federal Reserve, assessed the economic cycle admirably in 1997: ‘There is no evidence, however, that the business cycle has been repealed. Another recession will doubtless occur some day. History demonstrates that participants in financial markets are susceptible to waves of optimism, which can in turn foster a general process of asset-price inflation that can feed through into markets for goods and services. Excessive optimism sows the seeds of its own reversal in the form of imbalances that tend to grow over time. When unwarranted expectations ultimately are not realised, the unwinding of these financial excesses can act to amplify a downturn in economic activity, much as they can amplify the upswing.’

‘Clearly, when people are exposed to long periods of relative economic tranquillity, they seem inevitably prone to complacency about the future. This is understandable. We have had fifteen years of economic expansion interrupted by only one recession and that was six years ago. As the memory of such past events fades, it naturally seems ever less sensible to keep up one’s guard against an adverse event in the future. Thus, it should come as no surprise that, after such a long period of balanced expansion, risk premiums for advancing funds to businesses in virtually all financial markets have declined to near-record lows.’

These words are so apt that they are well worth carefully re-reading, as it could save investors a fortune. There are mini cycles of about three to four years but the whole cycle lasts for about a decade, as evidenced by the recessions in the early 1970s, 1980s and 1990s. On this wave theory reckoning, another recession should be anticipated in the not too distant future. The reason recessions seem to occur every decade may be because it takes that long for those at the sharp end to forget the pain but, once forgotten, the assumption becomes that it will not return. Also, a new generation has not yet felt that pain and naively acts without fear until it is their turn to experience a recession. If people forget the lessons of history, they are doomed to repeat them.

A history lesson

‘Truth is the daughter of time.’

Josephine Tey, author.

We should examine what has happened over the last three decades to understand where we are in the economic cycle today. The stock market boom lasted 18 years from 1982 to 2000. The 1987 stock market crash proved to be but a correction in that overall bull market. It is very unusual for a bull market to last so long and it was a response to changed macroeconomic conditions. In the 1970’s there was stagflation, which is a combination of inflation and no growth. This had a number of causes, such as the quadrupling of oil prices, very strong and aggressive unions, high taxation and protected economies that restricted currency movements and propped-up lame duck industries. A new determination to tackle these problems lead to conservative parties coming to power that re-invigorated the economy both in the UK and US. They opened the borders to free trade, in the UK’s case made necessary anyway after joining the EU. Currency controls were swept away and direct taxation was reduced to encourage private enterprise. The behemoths of state industries were privatised en mass. The demise of heavy industry and growth in smaller companies eroded union

membership and the causes of strife evaporated, most notable amongst them being ruinous inflation. The result was that strikes became rare.

On the face of it, the economy today seems to be in fine fettle with continued growth in GNP, unstoppable increases in property prices and ultra low interest rates and unemployment. Yet, scratch below the surface and a different picture emerges. We are past the top of the economic cycle but some of the traditional measures that mark this event have yet to become evident. One that has done so is a lead indicator of trouble ahead, namely the three-year rout in the stock market up to 2003. In 1987, for example, the stock market crashed and the authorities' rapid response was to ease monetary policy by lowering interest rates. This fed inflation and then interest rates had to be increased sharply, causing the recession in 1991-92. It is not feasible for the stock market, the main yardstick of economic growth, to experience such a bear market and also have ongoing health in the real economy and property prices. Eventually, the latter will have to face up to the reality of the ominous signals that the stock market has forecast.

Greatest bubble in stock market history

'The hangover may prove to be proportional to the binge.'

Warren Buffett

Low inflation broke out in the mid-1990s. This was a puzzle at the time to many, including Alan Greenspan, chairman of the Federal Reserve, because, with the economy booming, inflation would have been expected to increase but it did not. There were a number of reasons, including a quiescent oil price, intense competition and a strong dollar making imports cheap. Also, inflation was low because most people merely extrapolate from the past. For example, if shares or houses are increasing in value then investors climb on board, as they expect this trend to continue. It seems that a key ingredient in the high inflation from the 1970s to the mid-1990s was the expectation of more inflation. People saw there had been high inflation and pushed for high wage increases to compensate, which itself then caused inflation. When that cycle was eventually broken and low inflation became the expectation, based on current low inflation, then wage claims ratcheted down.

This low inflation allowed central bankers to reduce interest rates steadily since the mid-1990s. In general terms, there is a direct and inverse relationship between interest rates and asset prices. Low interest rates result in increased asset prices and vice versa. If interest rates are low, borrowing is cheap to buy assets,

such as property and shares. Also, the value of a share is the discounted net present value of all dividends that will be paid in the future. If the discount rate is lower, reflecting low interest rates, then the value of a share increases accordingly. The result was a massive increase in borrowing by companies and individuals that culminated in the stock market bubble that ended in the TMT mania in 2000. Low inflation and interest rates proved a curse, not a blessing. The booming stock market was not due to a significant increase in profits, as these had been falling since 1998, but because the PER quadrupled and reached a staggering 43 in the Standard and Poor's index. It was the greatest bubble in stock market history. The three-year bear market up to 2003 brought the PER down but was still at the same level as when the market crashed in 1929, at around 30. Then the Great Depression ensued and it took 25 years for the market to regain its 1929 heights. The ultimate arbiter of world stock market levels is the US long bond. Its yield is around 5% and should this rise significantly, to say around 8%, the markets would be in dire straits.

The curse of low inflation

History provides a powerful reminder of the curse of low inflation, as the three biggest stock market bubbles and subsequent busts, which were 1929 in the US, 1989 in Japan and worldwide in 2000, were caused by low inflation. Japan has been in a bear market since 1989 and its stock market level is but a quarter of that peak. It can take a very long time to unwind asset bubbles and it is wisest to prevent them occurring in the first place so that the economy remains in equilibrium. Unfortunately, such common sense is not that common.

Furthermore, there are serious doubts as to whether the PER is based on real numbers after scandals such as WorldCom, the failings of the defunct auditors Arthur Andersen and accounting treatment of items like share options and goodwill. If anything, in a world that has long since lost financial conservatism, a PER of 30 may well, in reality, be even higher if earnings have been overstated, thus making the stock market more overvalued. However, recessions uncover what the auditors do not and reality eventually returns. The corporate backdrop has been bleak in the real economy too. Profits in the US suffered their sharpest fall since 1929 and profits in the UK hit the lowest for 10 years after the TMT crash. The response was to cut costs wherever possible and profits have recovered, at least for now.

Followed by the housing bubble

‘When you combine ignorance with leverage, you get some pretty interesting results.’

Warren Buffett

The reaction by central banks to the 2000 stock market meltdown was to carry on reducing interest rates to the lowest levels for half a century in a misguided, foolhardy and futile attempt to avoid a recession. Setting interest rates at the lowest level for half a century is, by definition, an extreme and very rare act leading to a hangover that is likely to be equally extreme and unlike anything experienced for half a century. The central banks have rewarded those that borrow at the expense of those that save and this has produced a false and untenable economy. Spending one’s way to prosperity is a peculiar notion and would not sit easily with Charles Dickens’ Mr. Micawber: ‘Annual income twenty pounds, annual expenditure nineteen, nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds nought and six, result misery’. Millions of consumers would laugh at such a notion, at least for now, hooked as they are on debt.

The response to this cheap money was that a mountain of it flowed into property and this led to a second bubble, which is still expanding. This was the last thing the economy needed, when the concentration should have been to unwind the stock market bubble fully. UK house prices more than doubled since 1995, with important implications for the health of the economy. The increased property prices eventually trickle down into the real economy, as wages and prices need to increase to offset the higher cost of one of the four factors of production (labour, capital and enterprise are the other three). The reaction will be to use less of any factor of production that suddenly increases in price and use more of that which is cheaper so there will be substitution, for example by producing in low-cost countries.

Reverting to the norm

‘Whenever you get a wild excess on the upside, the following correction doesn’t just go back to normal; it almost always falls way below normal.’

Sir John Templeton, author, philanthropist, Founder of the Templeton Growth Fund and John Templeton Foundation.

All markets tend to revert to the norm, which is the long-term trend line, and the

UK stock market was 40% above its norm in 2000. That anomaly was removed in the three-year bear market when it again hit the norm. In the previous house price boom of the late 1980s, prices were also 40% above the norm. The subsequent bust meant that prices hit the norm again by 1996 after years of falls. House prices are now even more exposed than in 1989, as they are a perilous 50% above their norm and, at some point, another bust can be expected so that prices once again hit their long-term trend line. The housing bubble could burst for a variety of reasons. Eventually, all the people and speculators who want to join in will have bought and the lack of such buyers on the margin will lead to falling prices, as confidence evaporates to be replaced by fear. Other factors could be a rise in unemployment and interest rates. The fall in prices will deter further buyers but there will be great selling pressure from speculators rushing for the exit, resulting in a collapse. Looking at how far the price of any asset is above its trend line is a good way of assessing the presence of a bubble, although Alan Greenspan has claimed asset bubbles are hard to identify until they burst, which would be a convenient defence if it were true.

Mega recession in the wings

'For those properly prepared in advance, a bear market in stocks is not a calamity but an opportunity.'

Sir John Templeton

The increase in the unrealised gain in house prices enabled consumers to strip-mine this manna from heaven and fuelled a massive increase in spending. This has kept the wheels on the economic bus, at least for now. This spending has been crucial because the consumer accounts for two-thirds of the economy. The snag is that consumers are relying on the unrealised gain being permanent but it will disappear in a housing bust, turning into negative equity. The mortgages will not vanish so miraculously and the pain of repayment if interest rates increase will be extreme, especially if there is a significant rise in unemployment. Add to that the psychological ingredient of a 'feel-bad' factor and all the usual suspects are lined up for a recession. It could be the worst in living memory, as, historically, the severest are those resulting from the deadly combination of a stock market bubble and massive over-investment and borrowing, as two bubbles have to be unwound, not just one.

The borrowing can take up to a decade to be repaid or written off and, if low inflation persists, its real value will stubbornly remain intact. By contrast, the

recessions in the last half-century were not caused by low interest rates but by high interest rates which were imposed to reduce rampant inflation. Thus, we are now sailing into uncharted economic waters and a depression could result, rather than a recession. If low interest rates do persist then the unwinding of the housing bubble may be similar to the Japanese experience since 1989, which has been a long and painful economic squeeze rather than a short, sharp recession. The stock market will be in a crisis either way and this should provide a rare and fantastic buying opportunity. Recall that in 1974 the stock market dividend yield was 12% overall and that the deeply depressed shares could be bought at a further 40% discount by buying investment trusts like Foreign and Colonial.

Conflicts of interest

‘Mr. Greenspan, I always enjoy your presentation because, frankly, I wonder what world you live in.’

Bernie Sanders, Republican Congressman.

The false economy has been egged on by central banks and governments, who have aided and abetted the two bubbles. Why should this be so? Central banks and governments are keen to maintain their reputations and be re-installed into power. This provides a conflict of interest, as the temptation is to try to stimulate unsustainable, short-term growth rather than manage the economy for the long-term good. Alan Greenspan admits that the power rests with the markets but that still does not prevent central banks believing they are powerful and clever enough to control the economy. Indeed, Gordon Brown, the UK Chancellor of the Exchequer, made the unbelievable claim that he had abolished the economic cycle by taking the ‘tough decision’ to give the Bank of England independence in setting interest rates. These words will haunt him when the recession proves him wrong. One problem is that central banks have a narrow brief to control interest rates and have but scant responsibility for borrowing levels. This lack of responsibility is truly astonishing and a solution would be to make central banks responsible for preventing asset bubbles as well as inflation. That way they could stop the bubbles in the first place rather than sorting out the mess afterwards, which is their preferred method. A more sensible attitude would be to recognise the economic realities of life, suffer a mild recession and avoid one later that will be much more severe.

Deflation

The Federal Reserve, other central banks and the media have expressed fears about deflation. It is a reality in Japan and is a possibility in Germany more than the US. It seems an unlikely scenario in the UK because inflation is a high 5% in services, which accounts for two-thirds of the economy, and their limited substitutability by consumers means that this type of inflation will probably continue. This high rate of inflation in services is offset by deflation of 2% in physical goods, which is due to intense international competition as substitutability of goods is generally easy. There are no prizes for concluding that a company has a rosier future in services than making physical goods. Should deflation in fact transpire, it would increase debt in real terms and exacerbate the unwinding of the debt bubble. The central banks are running out of room to manoeuvre to 'prevent' recession, as interest rates are low and they cannot fall below zero.

Perilous US economy

'There cannot be a crisis next week. My schedule is already full.'

Henry Kissinger, US statesman.

The US economy looks perilous as it has massive debt with very low consumer savings. The current account and trade deficits have rocketed to about 5% of GDP and this profligacy is financed by 80% of the world's savings. This largesse by the rest of the world could be withdrawn at any time and such lack of control is as dangerous as it is uncomfortable. Repatriation of foreigners' money would be unsurprising, as US interest rates are low. Further, the US stock market has recovered strongly since the three-year bear market to March 2003 but the rally has the hallmarks of being an unsustainable 'dead cat bounce' rather than the start of a major bull run. This view is based not only on macro economics but also on technical analysis, such as Elliott Wave theory, and stock market history. The dollar has tumbled and hit an all time low against the euro, with more falls likely. A weak currency means that imports cost more, so inflation should rise and lead to higher interest rates. This would burst their housing bubble and a worldwide recession would then beckon. However, it would mark the beginning of a sustainable and healthy economy, once the excesses have been eliminated.

Where are we in the cycle?

On an historical basis, we are past the top of the cycle, given the severe bear

market and the economy is set for recession, which may yet be postponed by low interest rates but not cancelled. As explained above, this cycle has not been typical because of the absence of inflation. This has allowed interest rates to be kept low and so bond and property prices are high. Just how long the central banks can forestall the day of reckoning is unknown. It is unlikely that the next recession will follow the same timetable as the last three recessions because the ingredients are dissimilar and so extreme: two bubbles and ultra low interest rates.

How to find out where we are in the cycle

'Never trust an economic boom fuelled by consumer debt.'

Neal Weintraub, author of *Tricks Of The Floor Trader*.

An investor does not need to be an economist to find out where we are in the cycle. There are many signals given by business and the public. Those signals from business indicating a raging bull market and the time to sell may include:

- PER ratios and forecast increases in profit are very high
- institutional cash holdings are very low, stock market indices are beginning to falter and are far above the norm
- a mania for a sector, investment style, asset or geographical area
- bad news is dismissed and good news is a catalyst for action
- new issues are oversubscribed and trade at a premium
- the stockbroker's phone is always engaged
- inflation and interest rates are beginning to increase but are dismissed as blips
- dividend yields are at record lows

Signals from the public indicating a raging bull market and the time to sell may include:

- media and pundits are overwhelmingly optimistic
- doomsters are few, ignored or fired
- consumer and government borrowing and spending are high
- speculation in shares and housing is rampant
- advertisements abound for foreign holiday homes
- dinner party talk is boastful of success in the markets
- few can see any reason for a change
- political stability seems unending
- empty restaurant and trains seats are rare

- sudden appearance of new cars in the neighbourhood
- investors think they are geniuses, complete novices show interest in risky investments and their 'success' is highlighted in the press
- investment conferences are packed and the circulation of publications like Investors Chronicle is at a peak
- conspicuous consumption of luxury goods, such as fireworks, champagne and cigars at Christmas and New Year parties

The indicators of a bad bear market are the reverse and are excellent buy signals.

2. The cycle of opportunity

'We view our level of liquidity or gearing as probably the most fundamental decision we have to make on behalf of the shareholders of Personal Assets – much more so than which individual stocks we should buy or sell.'

Ian Rushbrook, fund manager.

We have now analysed the economic cycle and where we are in it. We turn our attention to how different asset classes behave in the cycle so that investors can profit by riding trends.

How asset classes behave in a typical economic cycle

Shares, property, cash and bonds are attractive during different stages of the economic cycle, in that chronological order, and provide opportunities. Let us assume that we are near the top of the cycle in year one, as outlined in the table at the start of chapter 4. The economy has boomed and inflation is on the prowl. Interest rates increase to combat this and now is the time to be out of shares and into cash. This is because share prices drop before the real economy falters, as the stock market is a lead indicator by anticipating the future some six to nine months ahead. Cash is king, benefiting from high interest rates and ready to take advantage of juicy prices in the ensuing recession. Property still remains robust for a couple of years but then it succumbs as well, although in this current cycle it has lasted longer as it has been propped up by ultra-low interest rates. Assuming that interest rates do rise, bonds should then be bought, locking into these high rates just as they begin to fall, which is when the recession has run half its course. Sell bonds when their prices rebound, which is approximately one year before the bottom of the recession.

Share prices have been now falling for some years in this scenario. Buy shares six months before the bottom of the recession, as they begin to rally following the lowering of interest rates to kick-start the economy. Property should be bought as the ‘green shoots of recovery’ become apparent. Inflation has now been wrung out of the system in this painful manner. Share prices and property rise until the economy begins to overheat. Inflation is starting to increase and higher interest rates can be foreseen. Now is the time to switch out of shares and into cash since we are approaching the top of the cycle and the process can then start all over again.

The conclusion is to be in cash at the peak of the cycle and in the subsequent recession. Then invest in bonds to benefit from falling interest rates, then shares and, lastly, property, near the trough of the cycle. Note that the best time to buy the asset is at the start of their runs and then hold them until switching to another asset class that becomes more attractive. If an investor is in the wrong asset class and, in particular, if it is bought at the end of its run rather than the beginning, then it is likely to be very costly.

Investment strategies

‘If you warn 100 men of possible forthcoming bad news, eighty will dislike you right away. If you are right, the other twenty will as well.’

Anthony Gaubis, investment counsellor.

a. Hold cash and recession resistant shares

A sensible investment strategy with the economic cycle past its peak might be to hold up to, say, half a portfolio in cash with the rest in shares that will withstand a recession. Bonds and property should be sold. Shares can offer opportunities whatever the cycle, it is just that performance is much more difficult in a bear market. To be out of shares completely is another strategy. However, an investor might well then miss the re-entry point and trying to pick the bottom of markets is practically impossible. Stock markets have a nasty habit of shooting up unexpectedly. However, the shares selected must be able to withstand a recession. It is imperative, therefore, that they have sound business models in attractive sectors, as pointed out below and in chapters 1 and 2.

A long-term ‘buy and hold’ strategy for shares will be unsatisfactory, as it is guaranteed to be hit by bear markets caused by recessions. Unit and investment trusts that track, or quasi-track, the index will similarly disappoint. Managers rarely want to stray too far from the performance of their peers, no matter how

unsatisfactory it may be. There are some funds, such as Personal Assets and RIT Capital Partners, that actively move in and out of asset classes to ride the cycle with success but they are a rarity.

b. Hedge and other funds

'Protection against adverse market conditions was provided by our liquidity, the diversity within the portfolio and the increased investment in asset classes which are less directly correlated to markets. Your company has been an investor in selected hedge funds in the pursuit of absolute and relatively consistent returns.'

The Lord Rothschild, chairman of RIT Capital Partners.

One route to consider is hedge funds, which have grown enormously in popularity and now number 6,000 worldwide with assets of \$9 trillion. They have a variety of strategies to protect against bear markets. Their tools include shorting (selling shares they do not own), derivatives, futures, options and leverage. Many aim to be market neutral by being equally long and short and to make money from stock picking. They are predominantly based offshore and target high net worth individuals. FTSE 100 company Man Group is one of the leading providers with \$40 billion under management. George Soros' hedge fund is Quantum and Warren Buffett ran one in his early years and said there was nothing mystical about it. Another offshore fund is Green Cay Asset Management run by Dr. Jane Siebels and is majority-backed by billionaire Sir John Templeton, the legendary global investor.

One solution for a private shareholder may be to buy an investment trust, like RIT Capital Partners, that invests in hedge funds as part of its wider remit to manage a portfolio of shares and securities. Alternatively, a private shareholder may try hedging himself by going long and short or, instead, just going short in anticipation of a bear market but this strategy is for professionals only.