

Whilst it's tempting to assume that markets and the real economy are inextricably linked, and of course ultimately they are, right now the economy looks to be relatively unaffected by the ongoing "financial crisis".

Of course, investment markets and economies can affect each other, but this is by no means a foregone conclusion, and the evidence shows that the commonly held belief that financial crises cause economic crises is largely wrong. For example, the emerging market debt crisis in which American banks over-lent, the Savings and Loans debt problems, most of the financial crises arising from countries defaulting, etc. did not cause the economy to slow. Indeed, the announcement of Mexico's default in 1982 delivered enormous bank loan losses but ushered in the biggest bull market and strongest economic environment seen to date.

While bad economic conditions can understandably cause financial crises (because debtors' cash flows worsen), financial crises typically do not cause economic crises.

On balance we think that it is very unlikely that the irresponsible lending that took place will sink the economy.

We say this because we believe that

- 1) the existing bad debts are not large enough (one or two percent of GDP) to jeopardize the system and
- 2) if they started to pass beyond what we think is most likely in terms of breakdowns in faith (e.g. the enormous pile of commercial paper that needs to be rolled forward runs into a shortage of demand), the Fed could deal with it in lots of ways (e.g. including giving the banks the liquidity on the condition that the banks buy the commercial paper).

That said, we anticipate that what is happening here is bigger than what commentators now commonly refer to as a "credit crisis".

Normally credit problems occur when borrowers pile on debt and cash flows suffer, either because interest rates rise or the economy falls. But here we have a situation where credit keeps flowing and debts keep increasing, and it is an extension of having too much credit/liquidity and not too little.

Taking a few paces back, we can observe that the capital that has been pushed/sucked into the U.S. was placed in the hands of the most elastic borrowers first (low grade borrowers for mortgages) which worsened their financial conditions until they ran into trouble. If money remains easy (which is very likely), it will next be pushed/sucked in by the next most elastic borrowers who in turn will become overleveraged and run into problems.

The American household sector as a whole is now in pretty bad shape, with stretched balance sheets and a deteriorating poor cash flow outlook, so that pushing more money into its hands will lead to worse and worse financial problems pretty quickly. This means that we should expect that there will be a spreading of credit problems even though interest rates will decline and credit will be readily available.

This chain of events will likely continue until foreign investors increasingly realize that the U.S. is not a good place to invest. In other words, as long as foreign investors believe that the U.S. is a good place to lend or invest, the financial conditions (i.e. balance sheets) of the American household sector will continue to worsen causing a spreading of the problems

A couple of interesting questions related to this are

- 1) when will foreign investors understand this dynamic and lessen their lending/investing to Americans?,
and
- 2) how will things play out if they don't.

It may be that investors need to experience poor returns before the mood changes, and reasonably investors will lighten their weightings in the face of adverse experience, which would be expected to reflect underlying conditions and risks, with the range of acceptable investment opportunities diminishing over time.

At the moment, international investors are disproportionately attracted to providing capital to Americans because
i) the dollar's weighting in their portfolios is large because of its position as the world's major reserve currency, and
ii) the American, dollar-denominated capital markets are much more developed than other capital markets.

As it becomes increasingly apparent to these investors that the most important determinants of the desirability to lend or invest are not these qualities - they are the investee's financial conditions and prospects - and as it becomes increasingly apparent that the American household sector (and the other sectors that are dependent on the American household sector, like the American business sector) are at risk, less foreign capital will go to Americans.

Should it never become apparent to them, they will see their investments increasingly perform poorly while they continue to lend to an increasingly narrow array of borrowers.

A conclusion that follows from this assessment and perspective is that we do not anticipate that the Fed lowering interest rates in order to stimulate more borrowing is a cure for the "financial crisis" at hand. Indeed it looks as if the biggest bubble is in U.S. dollar denominated debt, and in due course we should expect a significant steepening of the yield curve in the face of reduced foreign investment in U.S. dollar denominated assets.

Of more tactical interest to market participants, the August US employment report came in well below expectations with a 4K contraction in jobs for August and modest downward revisions to prior months. June and July had less than 70K jobs created each, so while the August numbers probably represent to some extent some caution on the part of employers given the current environment, the picture had been getting softer to begin with.

Markets moved to reflect the expectations of weaker growth, with a big move in bond yields (and an even bigger one at the short-end of the curve), a modest decline in stock prices, and dollar weakness. The current pricing now reflects expectations for between 25bp and 50bp of easing this month by the Fed.

On a yearly basis employment growth is now around 1% with the household survey a bit weaker and the payroll survey a bit stronger. While the unemployment rate was flat on the month (because the labour force contracted - both the payroll and the labour force numbers can be flukish on a short-term basis), employment growth has now slowed to a pace consistent with a moderate rise in unemployment.

Amidst all the talk of central bank easing, it is important to take note of what is actually happening to borrowers, and taking a broader view of the global economy, there are risks that the losses sustained by entities experiencing a re-pricing of their credit risk affect the growth outlook even if they are not likely to be system threatening.

Thus recent market action has made it more costly to borrow for many market players, from financial institutions to households.

This repricing of risk has been particularly acute on the short end of the curve, as concerned money market investors have shied away from most securities other than government bills.

LIBOR spreads, which traditionally have been only about 20bps above the equivalent government security, have now risen sharply, as concern has risen about the impact of the credit crunch on banks' ability to repay on their debts (in part because of the rise in the LIBOR rate and compression of government yields).

While the increased spreads give a sense of the perceived risk of the banks, the absolute level of the rates determine the cost of borrowing for market players and, therefore, the impact on the economy.

The result of the repricing of LIBOR has been an implicit tightening of credit conditions across the developed world by 20-75 bps. Thus we set out below the rise in the 3m LIBOR rate since the beginning of the crisis for the major currencies:

| USD | GBP | EUR | JPY |
|-------|-------|-------|-------|
| 0.34% | 0.75% | 0.48% | 0.19% |

(note: change in 3m Libor Rate from 1st August to 6th September).

These hikes in LIBOR may slow GDP growth, and as to the scale of slowdown, we would normally expect the 75bp move in the UK to translate through to a slowing of growth of up to 1%.

A chunk of the impact of higher LIBOR rates can be traced to the time frame over which higher rates remain in place, and at the moment, the spread of LIBOR rates to the equivalent government yield is relatively stable for loans due up to a year

in the future, suggesting that the banks expect the elevated risks to repayment of the loans to be persistent. Only the spread on USD lending shows a fall over the next year (although this is from a higher level initially).

Overall, the broader credit crunch has increased the perceived risk of banks and, as a result, has lifted inter-bank rates above their traditional fairly low and constant spread to government rates.

The impact of this has been an implicit tightening of conditions for the real economy for the developed world, and will likely lead to further slowing without central banks providing the liquidity necessary to relieve the concerns about risk in the banking system.

As to why the markets went sour and why LIBOR sits at premia to what we might describe as 'fair', it seems as if on a number of levels, there has been a breakdown in trust.

The initial failure was found in broken assumptions over the quality of collateral and the modeling of correlations, or the expected relationships between asset yields and risks. More recently, confidence in other banks and in the ability of any individual bank to obtain funding have led to a seizing up of the unsecured interbank market.

At the end of the day, central banks want to see the money markets functioning normally again. They have tried different approaches. These have ranged from essentially ignoring the problem in the term markets and concentrating only in the overnight, to taking on some of the credit risk of the private sector by expanding the types of collateral eligible for repurchase agreements.

But these efforts have had only limited success, with as outlined above, three-month LIBOR remaining well above policy rates.

This suggests that either more time is needed for some of these policies to work or a different approach altogether is necessary.

The US employment data were sufficiently poor that the Fed may no longer feel concerned that easing delivers unacceptable moral hazard, and the cash and related markets already discount aggressive US easing, to a low of 4% next year.

Markets may move to discount even more, given the significant downside risks to growth associated with a weakening labour market, and whilst data can be equivocal, all the key employment indicators (payrolls, ISM non-manufacturing employment numbers, household and payroll surveys, and jobless claims, along with temporary worker employment and construction employment figures) are now consistent with a slowing of the US labour market.

We can reasonably expect the employment market to be directly connected to consumer spending and US retail sales growth has already slowed, and this in turn suggests weaker global industrial production growth ahead. Lower case estimates from economists and investment houses are that the trend growth rate of real retail sales may now be as low as 2.5-3% rather than the 4.7% trend that prevailed from 1995-2006. Real retail sales grew by 3.3% p.a. in the 15 years before 1995.

Slower trend consumer spending is not the same as a sharp cyclical contraction, which would likely require a much weaker labour market, but the risks of such a contraction appear to be increasing, as sentiment is damaged by further housing related stress, as well as the jobs climate.

We do attach a 20% probability to a less attractive scenario, with the current liquidity crisis evolving into a credit crunch., which in turn could depress significantly real economic activity and corporate returns.

With macro economic variables, we tend to think that consensus views are a sensible start point for considering forward looking conditions, but it is perhaps illuminating to map out how scenarios can move conditions away from consensus expectations. Thus, to put numbers as to how we think these scenarios play from a UK point of view, we set out our assessment of conditions for the UK economy on the basis that with scenario I, conditions follow an LTCM type progression, and with scenario II, conditions follow the tech bubble experience, and provide current (July survey) consensus data:

| | Growth | | Inflation | | Interest rates | | 10 year yields | |
|--------------------------|--------|-------|-----------|--------|----------------|-----------|----------------|-------|
| | 2007 | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 | 2008 |
| Scenario I: | | c2.25 | | 1.75-2 | 5.5-6.0 | 4.75-5.25 | 4.75-5 | 5.5-6 |
| Scenario II | | c1 | | c1.5 | 5.5-6.0 | 4-4.25 | 4.75-5 | c4 |
| Current consensus | 2.8 | 2.2 | 2.4 | 2.0 | 6.1 | 5.8 | 5.3 | 5.3 |

What we see with scenario I is that whilst global growth is unaffected and money policy soon returns to focus on inflation risks, the UK position is affected by a slowing of the housing market.

With Scenario II, the liquidity effects intensify, credit conditions deteriorate, and central banks aggressively ease money rates.

In terms of how these scenarios contrast with current consensus expectations, scenario II delivers much worse growth, lower inflation and lower cash and bond yields. With scenario I, cash rates are easier, at least in terms of official policy, supporting growth, whilst inflation pressures remain muted. However in recognition of increased risks to inflation in due course, bond yields react nervously delivering higher yields.

In thinking about the outlook for equities, if we were to focus on possible equity responses to any decision by the Federal Reserve to cut money rates and the historic pattern, we can see that since 1984, on the first cut equities have rallied 100% of the time over the following month, but only 80% of the time over the following twelve months. One issue is that the size of the rate cut currently being discounted - c75bp off by year end - has only happened during a recession or the crisis period surrounding the collapse of LTCM. Hence as in 1998, some analysts expect that it will take 50bp rather than 25bp to push equities higher and offset worsening US economic news flow. But conditions now are better than at the time of the LTCM crisis - the macro economy is in better shape, bond/equity valuations are more relaxed, and companies carry less leverage.

But history can be a poor guide to the future, and it may be more illuminating to consider what equity markets presently discount and therefore what is already in prices, relative to what may reasonably lie ahead.

Based on current data and consensus projections for the S&P500 of \$102.6 12 month forward earnings per share and 12 month forward earnings growth of 11%, and then 12.3% for three to five years and terminal growth of 5%, we calculate that the forward looking equity risk premium for US equities is around 5.5%.

If we substitute in more conservative assumptions of around 6.5% growth for the next five years and long term growth of 5%, together with the assumption that returns on equity fall back to long term averages over the next five years, then the equity risk premium is around 3.75%.

The long term average equity risk premium is just under 3.5%, and so also is the 'fair value' premium if we model current credit spreads, equity market implied volatility, and OECD and ISM lead indicators.

This picture of relative value and the forward looking implied payment for risk is repeated across a range of markets including the UK, and equity free cash flows are generally ahead of corporate bond yields, where break even default rates are now, if anything too high in the corporate bond market. Thus spreads on euro fixed interest have widened over the last three months from around 50bp to around 90bp, and we expect this spread to narrow as confidence returns. With the scenario which we believe has greatest probability - that economies reflate, liquidity is rebuilt with central bank assistance, and investor risk appetites rise - equities are favoured over government bonds, and this is consistent with the view that the post-bear market rally has not yet run its course.

With the more negative, but lower probability scenario, cash and government bonds outperform whilst credit and equities suffer.

We will continue to monitor markets and both macro- and micro-economic conditions, adjusting our conclusions in the face of the merging data and information flows. This is a fluid environment and we will welcome any enquiries or requests for updates as may be required.



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