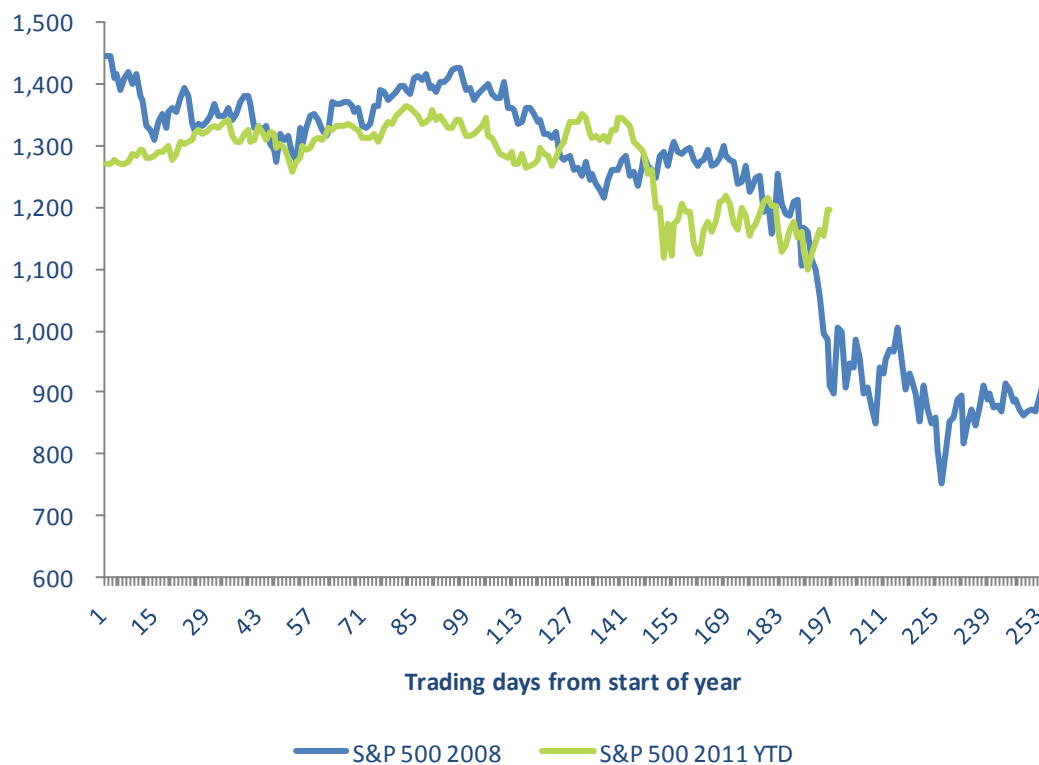


## IPS View: Is this 2008 or 2009?

Is the worst now over or is this 2008 redux? Speaking to investors and fund managers, as we do, we can't remember a time when there has been such a split of opinion between those who think this is the beginning of something much worse and those who think the worst is nearly over. This IPS View looks at these competing camps. We will be honest: at IPS we think it is too early to come firmly on one side or the other. We do, however, finish by listing what we would like to see to become bullish again.

### Where do we go from here? 2011 YTD and 2008 compared for the S&P 500



For the bears this is 2008 part II. Whatever mistakes they made in 2008 they are for sure not going to repeat them again. The lesson: cut risk and wait for the storm to blow through rather than hold on looking for markets to recover. September's falls in emerging market currencies and equities are the latest example of investors cutting risk first and asking questions later. This is in spite of the fact that emerging markets are much stronger on a fundamental basis in many of the areas (government and consumer debt levels for example) that are front and centre in investors' minds.

However, for the bullish this is more like early 2009. As was the case then, some assets look very cheap. The mistake in 2009 was to be so paralysed by fear that asset prices might go down again that you missed much of the sharp rally when it eventually came. Fear of missing out means you need to force yourself to invest even as sentiment (and consensus) remains bearish and assets keep getting cheaper. Also, remember it was the liquidity pumped into the system to address the world that drove the rally. Recovery in the broader economy came later, in part led by the recovery in asset markets. We note that the liquidity taps were switched on again by both the ECB (via its bank lending program) and the Bank of England (QE2).

So some are scared of a crash, others are scared of missing out on the rally fuelled by liquidity pumped in to prevent the crash. Some are cutting risk when they can, others adding slowly on sell-offs. Which approach is right? First, start with the bearish view. Deleveraging is continuing to mean slow growth in developed markets. Strong growth will not come from the consumer as they are focussed on repaying debts and rebuilding savings. Governments are similarly trying to reduce spending either for political reasons (small government is good) or for fear the bond markets will punish them for any recklessness. This leaves business and business investment as the last possible engine for growth. But why should business invest when consumers and the government are cutting back? What exactly are they investing for?

The bearish argument then runs that, unlike in 2008, the authorities have run out ways to fix the problem. Interest rates are at zero. Further quantitative easing is possible but there are reasons to be sceptical about how much positive effect it actually has. Large scale fiscal stimulus is off the menu. This means developed markets are stuck with slow structural growth and no obvious way out of the problem. All it takes is a shock to the system – Eurozone crisis, I'm talking about you – to tip developed markets into a recession from which it will be hard to escape. For the bears this is more or less where we are now: recession is coming and there is not much we can do about it.

However, the lesson of 2009 was that resilient emerging markets plus a liquidity fuelled rally in asset markets could prevent the worst from happening and get growth going again. If this is the case again then the right thing to be doing now is to be steadily scaling into cheap investments where the risk/reward is best. But how likely is this recovery scenario? We list below some of the things we would like to see to start thinking it is time to be positioned for a bounce. We wrote this list a few weeks ago and note that some of these things are starting to happen. This means we have been tilting slightly more positively of late. It is still however – particularly for Europe – too early to declare that the worst is over:

1. US avoids recession and resumes positive but not spectacular growth. Recent data from the US (Friday's non-farm payrolls and survey data) have been more positive and consistent with 2% area growth. If this is the case then US high yield credit – currently yielding 9%-10% – looks attractive to us. You don't need a boom in the US for this to make money, simply to avoid the worst. We have and will likely continue to add this to client portfolios.
2. Our recipe for the Eurozone is: (i) recapitalise the banks to withstand default from the weakest of the Eurozone countries (Greece, Portugal, Ireland); (ii) provided unlimited liquidity for the government bonds of the rest of the Eurozone members and (iii) let Greece default. It looks to

our eyes that the Eurozone leaders are slowly, grudgingly shuffling in this direction. Although, relying on the politicians to do the right thing has been the single worst investment strategy of 2011, we think they may slowly be “getting it”. With expectations so low there is, at least, a possibility that they will deliver on some of the above and deliver a positive surprise for markets.

3. Increased liquidity from developed market central banks. Last week the ECB announced unlimited liquidity provision for Eurozone banks through to the start of 2013 and the Bank of England launched QE2. While these are not as important as a move to QE3 by the Fed, they are at least positive moves at the margin.
4. This leaves emerging markets. These were in many ways the positive surprise that helped the world avoid the worst after 2008. Right now China in particular seems determined to stamp out nascent core inflation and property speculation. As long as this is the case we are not putting much hope on Asia, for example, being a source of good news this quarter. However, it is worth remembering that many sources of inflation (commodities, food) have fallen in value recently. Also, if growth in Asia is being slowed down by the government, then all it needs is a switch of policy stance to re-ignite the region. This could happen quickly. Emerging markets have got a lot cheaper in a short space of time without, in our view, the fundamental picture changing. We are getting ready, when the time is right, to increase our exposure to them.

In summary, we are ready to act quickly to profit from an upswing should it look like these catalysts are falling into place. One thing we pride ourselves at IPS is being able to act quickly when situations change. For now, though, we are happy to keep our powder dry, run our portfolios at lower than normal risk levels and wait for the opportunity to develop.

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