

News & Views



Rutland Investment Managers LLP

How will the crunch end?

After the various bailouts, guarantees and widespread government interventions, experts remain divided as to the ultimate fallout from the crisis. The Armageddon scenario suggests the assorted packages, interest rate cuts and other measures fail to shore up confidence in the banking system and liquidity dries up completely.

This is indeed a possibility. However, inflation is coming down, so they say – giving central banks the scope to cut interest rates. This may not solve the problem, but it should at least help ease the lending crisis to some extent. A more moderate scenario suggests a gradual deleveraging in the economy. Here, the measures succeed in restoring confidence and credit becomes widely available again. In this scenario, there is a slowdown in the wider economy, but it is relatively modest. The economy contracts for a period, but job losses are not severe.

The most optimistic scenario – still championed by some economists – suggests that, once liquidity is restored in the banking system and lending normalises, many of the wider problems, such as the downturn in the housing market, the squeeze on personal balance sheets and corporate weakness, will be resolved. What is sure is that investors and economists will keep monitoring the overnight bank lending rate. If this continues downwards, we may move towards a more positive scenario. Otherwise, we may need to baton down the hatches and prepare for a bumpy ride.

Welcome to the latest edition of News & Views, our update on developments in the world's stockmarkets.

If you would like to discuss any of the issues raised in this newsletter, please do not hesitate to give us a call.

Contact us:

Common mistakes

We are all human and we all make mistakes. But for investors those mistakes cost money. Knowing the most common pitfalls can help you learn from the mistakes of others and avoid losing out. For example, following the herd can be a recipe for disaster – remember when people piled into dotcoms in the late 1990s? Also, don't panic on a downturn. Selling out without serious reason will crystallise a loss and you may miss out on a rebound. Finally, never chase a quick profit, thinking you can time the market – this is no different to gambling on horses. Investment is a long-term game and requires planning. Any other approach makes it a highly risky business.

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What is Deflation?

You might think that falling prices would be a good thing. However, a sustained and persistent period of deflation would have very negative consequences for the UK economy.

In a deflationary environment, consumers will delay making purchases, believing that prices will continue to fall. This makes it harder for companies to sell their goods, forcing firms to slash prices and leading to lower profits, declining wages and job losses. In turn, this leads to a reduction in disposable income and falling demand for goods and services, creating a sustained and damaging deflationary spiral.

Factors affecting markets

For much of this year, markets have been driven by short-term sentiment. Whether it has been Hank Paulson's bailout package, interest rate and inflation numbers or political factors, day-to-day news flow has tended to govern the direction of markets. In this climate good stocks have been marked down with bad and scant attention has been paid to long-term corporate prospects.

However, there will come a point when markets have to return to fundamental factors. When they do, they will start to take a closer look at potential economic growth. Weakening economic growth has brought down commodity prices and inflation and freed up central bankers to lower interest rates aggressively with the aim of restoring liquidity in financial markets and boosting flailing economies.

In the UK, interest rates are now at their lowest level since 1951. Although the inter-bank rate is likely to remain out of sync with base rates until the credit problems have worked their way out of the system, lower base rates will go some way towards helping corporate and individual borrowers.

While markets tend to react positively to interest rate cuts, the magnitude of the cut initially spooked investors, though the indices rebounded soon afterwards. Of course, interest rates are not the only issue – governments, particularly that of the UK, will face huge debts long after this crisis is resolved and this will be a significant headwind for economic growth.

With some easing of credit conditions, the outlook for earnings will come under scrutiny again. In this case, markets are likely to become more discriminating. In the recent rout, good has been marked down with bad, which has created anomalies. The retail sector is a good example, with the likes of Tesco having maintained earnings, while other companies, such as M&S and Next, see revenues under pressure. Stronger financial companies have been marked down regardless of their prospects, simply because the sector is so out of favour.

The market is likely to begin to re-recognise value. A lot of companies are on historically high dividend yields and this may become more important in a post-credit crunch climate. If earnings appear more secure, so will the dividend and investors will start trusting it as a marker of value again. Also, if interest rates fall, income-seekers will need to look elsewhere for yield. At the moment, markets are extremely short-term in their outlook. Once the impact of the various liquidity measures is clear, longer-term factors are likely to make a difference again.



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