

# BARRATT & COOKE

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## January 2009

	<u>1/1/00</u>	<u>1/1/02</u>	<u>1/1/03</u>	<u>1/1/04</u>	<u>1/1/05</u>	<u>1/1/06</u>	<u>1/1/07</u>	<u>1/1/08</u>	<u>5/4/08</u>	<u>1/7/08</u>	<u>5/10/08</u>	<u>1/1/09</u>
FTSE 100	6930	5217	3940	4477	4814	5618	6220	6457	5947	5625	4980	4434
FTSE All Share	3242	2524	1894	2207	2411	2847	3221	3287	3039	2856	2522	2209
Dow Jones (US)	11452	10022	8342	10454	10783	10717	12463	13265	12609	11345	10325	8776
S&P 500 (US)	1469	1148	880	1112	1212	1248	1418	1468	1370	1277	1099	903
Nikkei Dow (Japan)	18934	10543	8579	10677	11489	16111	17225	15308	13293	13514	10938	8860

### Leading Growth Equities

AstraZeneca  
BHP Billiton  
BG Group  
Cobham  
G4S  
W M Morrison  
Tesco  
Whitbread

### Higher Yielding Equities

BP  
Centrica  
GlaxoSmithKline  
National Grid  
Pennon Group  
Rexam  
Rio Tinto  
Scottish & Southern Energy  
Vodafone

### Smaller Companies

De La Rue  
Halma  
Hunting  
Spirax Sarco  
VT Group

### Overseas Companies

Roche  
Syngenta  
Woodside

### Investment Trusts / Unit Trusts & Overseas Funds

Caledonia Investments  
Henderson TR Pacific IT  
M&G Corporate Bond Fund  
Monks IT  
Murray Income Trust  
Scottish Mortgage IT

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### “The Party is Over, But K.B.O.”

Many people have been blamed for the disasters of 2008, from “irresponsible bankers” to “greedy speculators”, from “inefficient governments” to “inept regulators”. Though these have all had their part to play, I feel we have all been ignoring the fundamental cause being:-

“The end of the world’s 20 year spree of decadence”

starting from the success of Thatcherism and Reaganism which was built on “finance” and “power”, through to the “bully boy tactics of George Bush Junior”, and the Champagne Socialism of “New Labour” (which showed very little prudence).

Students were given “Student Loans”; Bank Notes became “Plastic”; Houses became investments and not homes; Mortgages became confetti; “Small time investors” were encouraged into the risk of Equities with Privatisations and Demutualisations.

Financial Products became more and more speculative seeking “absolute returns”; and the world became a “den of gamblers” with; Derivatives, Hedge Funds and Internet Betting, on everything from horses to shares, from oil to wheat.

Bankers using mirrors believed they were able to increase the “piles of cash” that had to be lent. And, as this invisible cash circulated the world, property prices rose, commodity prices rose, and the whole world partied, with just one hang-over stop (the day the dot.com boom exploded).

There were signs that the party was coming to the end with

The collapse of Northern Rock in September 2007

The collapse of Bear Stearns in March 2008

but the music really stopped with the bankruptcy of Lehman Brothers on 15<sup>th</sup> September 2008.

All these events have been detailed in the 5<sup>th</sup> October Newsletter and 10<sup>th</sup> October 2008 Update, and therefore do not need to be repeated.

The lights were finally turned off by “Mr Madoff” as he “made off” with his US\$50bn fraud.

I now know why Hedge Funds are so good; some just make up the figures, and gullible investors believe them. (Am I the only person in the world who smelled a rat?).

Barratt and Cooke have been part of this party, but I believe we have always kept our eyes on responsibility, and historical formula.

We have always

- 1) Insisted that Clients should only invest in Stockmarkets, after they have;
  - a) Homes
  - b) Sufficient depositsand they should
  - c) Only invest surplus cash
  - d) And never borrow to gamble.
- 2) While Markets have been high, we have encouraged clients to have;
  - a) Increasing cash deposits (for eventual investment)
  - b) A proportion of Gilts (for liquidity and safety)
  - c) A large proportion in Top Quality Equity to ride out any storm
  - d) Only a small proportion in smaller, more speculative stocks (for potentially greater returns or indeed losses).
- 3) We have got some sectors wrong including Banks and Property which have been disappointing but, we have always kept a well balanced spread of Equities.
- 4) We have avoided Derivatives and Hedge Funds.

## **Uncharted Waters**

We now live in unprecedented times, with unprecedented solutions. Though 2008 has been compared to 1929 and there are some similarities of;

- 1) Gambling crash
- 2) Followed by a total lack of liquidity as banks went bust

the world is now a very different place, with “instant visibility”, “regulations” and “global electronic trading”, making economic movements global, and so much quicker.

We are now experiencing:

1) Banks all over the world going into administration such as

Lehman Brothers (US)  
Washington Mutual (US)  
Northern Rock (UK)  
Bradford & Bingley (UK)  
Icesave (Iceland)

or rescued from disaster either by other banks or Government intervention

Merrill Lynch (US)  
Goldman Sachs (US)  
Morgan Stanley (US)  
Fannie Mae (US)  
Freddie Mac (US)  
Fortis (Netherlands)

and without the intervention of the UK Government it is likely that

Royal Bank of Scotland  
HBOS (Halifax Bank of Scotland)

would have gone bust.

At the start of 2008, if one had ever thought this could happen, one would have quite literally been “certified as insane”. Even deposits in AIG, once the world’s largest insurance company, and recommended by many leading institutions, have been “part frozen”.

This leaves us with the position of nobody trusting Bank Deposits where only the first £50,000 is guaranteed per customer per banking licence. UK Depositors have never seen this before.

2) In the 1974 Banking Crisis, when Dennis Healey had to approach the IMF “The International Monetary Fund”, he raised interest rates to 15%, to “encourage saving and stop expenditure”.

This time, the Government has reduced Base Rates to 2%, to “encourage expenditure at the cost of saving”.

2% is the lowest recorded Base Rate since the Bank of England first set Base Rates in 1694, with 2% twice recorded in the 20<sup>th</sup> Century including 1939-1945.

It is likely that Base Rates will fall further which will then be the lowest rate for over 300 years!

Though inflation (RPI) averaged 4.3% in 2007 and has averaged 3.2% in 2008, some financial commentators are now predicting deflation in 2009. This could be the first time investors have experienced deflation since 1960.

3) Conventional Gilt Yields are at a 60 year low with:

		<u>Price</u>	<u>Gross Redemption Yield</u>
Short dated Gilt	4¾% Treasury Stock 2010	105.3	1.02%
Medium dated Gilt	5% Treasury Stock 2018	115.7	3.03%
Long dated Gilt	4¼% Treasury Stock 2055	114.1	3.66% <i>(Source FT)</i>

4) House prices have fallen in 2008 by 16.2% *(source Halifax House Price Index)*

5) Commercial Property prices have fallen in 2008 by approximately 25% although this is difficult to quantify as properties are not changing hands.

6) Commodity prices have varied widely:

	<u>Low - 2008</u>	<u>High - 2008</u>	<u>01/01/2009</u>
Wheat	£80	£185	£105
Copper	\$2800	\$9000	\$2843 <i>(Source LME Website)</i>
Oil	\$35.13	\$147.27	\$46.33 <i>(Source NYMEX Website)</i>

with Gold, being purchased as a hedge to currency:

	<u>Low - 2008</u>	<u>High - 2008</u>	<u>01/01/2009</u>
Gold	\$712	\$1003	\$886

7) Other forms of investment have collapsed including

Antiques, Art, Wine, Bloodstock

with the exception of

Agricultural Land (which is Euro related).

8) And most significantly

Sterling

which has fallen against the US Dollar and crashed against the Euro.

	<u>01/01/2008</u>	<u>01/01/2009</u>
£1 against the Euro	1.36	1.04
£1 against the US Dollar	1.99	1.46 <i>(Source Proquote)</i>

while at the same time whole economies have come under threat of default such as

Iceland  
Greece  
Ireland  
Pakistan

and even some “lunatics” now fearing the default of the UK.

## **The Economic Tug of War**

The “Tug of War” sides are:-

**In the negative corner** “The Credit Crunch Team” (8 members)

**In the positive corner** “Sense will prevail Team” (8 members)

**Referee:** VAT; (just 2½% off VAT makes it a wimp).

Following the US Sub Prime Mortgage Crisis and now the World Credit Crunch, there are 2 powerful economic forces in the UK pulling in opposite directions.

As the “Tug of War” intensifies, and the strain is taken, Stockmarkets will remain very volatile, as one side strengthens and the other weakens and vice versa.

**In the negative corner** “The Credit Crunch Team” (8 members)

### 1) The Banks

Having lost billions on irresponsible lending to Property and irresponsible gambling in “Financial Instruments” which they did not understand, all Banks fear each other’s undisclosed losses. They are therefore hoarding cash to strengthen balance sheets rather than lending to each other. Lending has therefore “dried up” causing the “Credit Crunch”.

### 2) Corporate Britain

Is heavily borrowed and Credit will have to be replenished. Without liquidity from the Banks, this will lead to forced “Rights Issues”, “Distressed Sales”, and in the present case of the Retail Industry, “Administrations” e.g. Woolworths, Whittards of Chelsea, Zavvi, The Officer’s Club, Adams & USC.

### 3) The Public

With fears that unemployment will rise to 3,000,000, the UK public has had a bad attack of Man Flu, called “The Feel Bad Factor”, and has stopped spending (for the first time ever, Mrs Barratt is pulling in her horns!).

### 4) The UK Government

Having bailed out the Banks, and now increasing public spending on infrastructure, there is now an excessive Public Debt. Is this brilliance or madness?

### 5) Inflation

Has certainly fallen sharply, but fears of deflation will weaken the economy further.

### 6) 2008/2009 Corporate Results

Dividends from Banks have been slashed as will other corporate dividends in weaker companies which go to the wall.

### 7) Investment Income/Pension Income

With lower deposit rates, investors, depositors and pensions will receive lower incomes, causing less spending.

8) Anchor Man

Gordon Brown - in which the UK has lost total confidence.

**In the positive corner** “Sense will prevail Team” (8 members)

1) Bank Base Rate - the lowest for 300 years

2) Lower Energy Costs - Oil down from US\$147 to US\$46

3) Lower Factory Input Costs - Commodity prices have fallen sharply

Each of these three points have a direct effect on Corporate profitability immediately.

4) Sterling - Down 24% against the Euro during 2008.

This will make exporting easier, and discourage imports.

5) The Government

Is lending unprecedented sums of money to the Banks to lend to Corporate Britain, and The Public.

6) Historic Formula

On all known formulae, Leading Equities (which will survive) are extremely cheap at the moment.

Conventional Gilts are extremely high.

Cash Deposit Rates extremely low.

Which all attract investors to Equity yields.

7) Anticipation/Investment Sentiment

The world knows the Economy will recover one day, and Stockmarkets always anticipate events many months in advance.

8) Anchor Man

Barack Obama - is making all the right noises at this stage (just as Tony Blair did!).

The UK Economy is therefore in a “Tug of War” situation, and as the forces of economics hit the headlines, so will Stockmarkets move accordingly, and as violently.

**Nobody** knows who will win, or when, but after many “Tug of War” heats, Barratt & Cooke has absolute confidence that “Sense will prevail”, and that this “Credit Crunch” will eventually be vanquished, as it always has done throughout UK Economic History.

We feel that this “Tug of War” will go on longer than many commentators suggest, Stockmarkets will be very volatile in between, and it will be right to:

- a) Keep liquidity for future investment
- b) but use volatile movements to pick up cheap quality equities.

We shall continue to pray that the rope is strong enough, and does not break if plan A is unable to take the strain.

## Barratt & Cooke's Investment Advice

It is our job to weigh up all the pros and cons and give our advice accordingly taking a step back from Macro Economics to simple common sense.

The World must continue to:

Eat	(Supermarkets/Foods)
Drink	(Beverages)
Live	(Household Products, Utilities)
Move	(Oil/Metals)

And one day:

Cars	Will have to be replaced
Houses	Will have to be built
Banks	Will start to lend again (we have nothing to barter)
Stores	Which survive, will benefit from the failure of others.

Indeed, the whole economic cycle will start again.

And, though we enter 2009, as depressed as we did in 1974 when the only "New Year Newspaper Tip" was

European Ferries 5½% Preference (for the discounted travel tickets)

between April and July 1974 the FTSE 30 rose from 150 to 350!

In due course, long term fundamental formulae values will return:

1) The value of houses should be between 3½ to 5 times salary, financed by 20% Deposit and an 80% Mortgage (on a conservative valuation).

2) FTSE 100 Stocks should be valued on

	<u>Long term formula</u>	<u>01/01/2008</u>	<u>01/01/2009</u>
P.E.	15x	11.3x	8.9x
Yield	3%	3.2%	4.4%
Dividend cover	2x	2.5x	2.5x

It is likely that profits will be down overall, but sectors such as Supermarkets, Drugs, Utilities etc, should still show growth. With well covered dividends we expect incomes to rise overall in the FTSE 100 (with the exception of the Banks). Indeed, yields on Equities now look attractive compared to Gilts.

3) The Government's target for inflation is around 2½%. They now realise that Deflation is an even greater threat than Inflation

Gilt Yields should be 2% above inflation

Corporate Bonds approximately 3% above that.

4) 50 years ago, Equities yielded more than Gilts (the yield gap).  
In recent history Equities yielded less than Gilts (the reverse yield gap).

Now Equities yield considerably more than Gilts (Equity Yield 4.4%, Medium term Gilt Yield 3.0%)

On all the above facts, even allowing for a temporary fall in Corporate Profits, Conventional Gilts must be too high (except Short Dated for the Government Guarantee). Equities must be too low.

## Investment Strategy for 2009

I have faith, and I have faith in long term Stock Exchange investments, keeping a balance of:

Cash	(Deposit, pending investment)
Gilt	(For safety and liquidity)
Quality Equities	(For potential long term growth and rising dividends)

A small proportion of smaller companies (for greater potential of growth but with greater risk).

As Clients know we follow a “Model Portfolio” which is then “Tailor made” for each client.

At this stage

### Cash

We have built up Cash Deposits pending reinvestment in due course (for sums over £50,000 we have purchased gilts for the Government Guarantee). There is little yield, but it does give the liquidity to purchase Equities as and when action is required in these volatile markets.

### Gilts & Corporate Bonds

We prefer Index Linked to conventional Gilts. Corporate Bonds can be held where income requirements are essential, but they do not have the Government Guarantee.

### Equities

At this stage we are still avoiding investing new money into

Financials	(except Prudential)
Property	
Leisure	(except Whitbread)
Retail	(except Supermarkets)

However we like:

Supermarkets	Morrison
Pharmaceuticals	GlaxoSmithKline/AstraZeneca
Industrials	Smiths Group
Utilities	Centrica
Food	Cadburys
Oil	BP/Shell/Tullow
Miners	BHP Billiton/Rio Tinto (which now look too low after the bid has been aborted)
Beverages	Diageo
Support Services	Bunzl

(All the above should benefit from the fall in Sterling except Centrica/Morrison).

However, with very volatile Stockmarkets we are putting “limits” on to purchase selectively at lower prices. We shall purchase further sectors in due course, at the appropriate time to retain a balanced portfolio.

## **Fixed Interest**

Medium dated Conventional Gilts now yield below 3% to redemption which is exceptionally low.

There is, however, a case for purchasing

	<b><u>Price</u></b>	<b><u>Gross Redemption Yield</u></b>	<b><u>Redemption Date</u></b>
4¾% Treasury Stock 2010	105.3	1.02%	07/06/2010

for the Government Guarantee, but otherwise all Conventional Gilts are too high.

## **Index Linked Gilts**

Have been much more volatile than normal, on fears of “Deflation”. Even if Deflation averages 1½% through to 2011, (which is unlikely), we prefer Index Linked to Conventional Gilts. Though retail prices are falling now, in due course, the fall in Sterling, and the rise in Government borrowing and expenditure will have inflationary influences.

## **Corporate Bonds**

Corporate Bonds in quality companies yield above 6% gross, and for income are more attractive than Conventional Gilts. However, during the Credit Crunch there is always the risk that a top quality company could go bust (though unlikely).

## **Overseas Markets** *(by John Everall)*

2007 saw some strong rises for the emerging growth economies of Brazil, Russia, India & China (BRIC). However, these gains were more than eroded in 2008, as investors realised that emerging economies were not immune to the problems in the Western economies (the so-called “de-coupling effect” proved a fantasy).

Surprisingly, the FTSE 100, although down, fell by relatively less than other markets:

UK FTSE100	- 31.3%
New York Dow Jones	- 33.8%
New York S&P 500	- 38.5%
Frankfurt Dax	- 40.4%
Sydney ASX	- 41.3%
Tokyo Nikkei 225	- 42.1%
Paris CAC40	- 42.7%
Hong Kong	- 48.3%
Mumbai	- 52.4%
Shanghai	- 65.4%
Moscow	- 72.4%

Overall: World Market Index MSCI Index - 43.9%

Emerging Markets Index MSCI Index - 54.9%

Looking at 2008:

## **US**

US interest rates have been slashed to a range of 0% to 0.25%. This means that monetary policy has gone as far as it can go and the Federal Reserve will now start pumping money into the economy by purchasing mortgage backed securities and Treasury Stock. The US, having been the first major economy into recession, is likely to be the first one out with Obama promising a massive Government spending programme.

## **Europe**

European debt levels are lower than US/UK levels and so Europe has been less affected by the problems in Banking/Finance (although Switzerland, Ireland and Iceland have had dreadful 2008s). Therefore European Interest Rates have remained higher than UK/US rates and there is scope for further reductions.

## **Japan**

The Japanese economy is still beset with sluggish growth and we remain cautious.

## **China/India**

China has been affected by the sharp slowdown in Western economies. GDP has grown above 10% for the last 5 years, but now looks set to fall below that in 2009. India has also been affected by the global slowdown, and the terrorist atrocities in Mumbai have added further problems. Both countries are promising large Government spending on infrastructure etc, which should help mitigate the slowdown in growth. We still remain positive on the longer term potential of China and India.

## **Australia**

Australia has had a volatile year with the huge swings in oil and commodity prices.

## **Exchange Traded Funds (ETFs)** *(by John Everall)*

ETFs are Exchange Traded Funds which trade on the Stock Exchange in a similar manner to stocks and shares.

ETFs are “open-ended” funds which aim to track a market index after taking out a management charge (typically 0.3% to 0.5% per annum).

Barclays are one of the largest providers of ETFs and the Barclays iShare FTSE 100 aims to track the FTSE 100.

At Barratt & Cooke we do not normally purchase ETFs since, by definition, they will always underperform an index, once charges are taken out.

However, ETFs are very useful as a “trading tool”, especially the Barclays FTSE100 iShare since:

1. The fund is marketable with good liquidity
2. Dealing spreads are tight
3. By purchasing the iShare 100 index, you are not taking the risk of buying individual shares in these uncertain markets
4. There is no stamp duty
5. Quarterly dividends are paid in line with the FTSE 100 index yield (after charges are deducted)

If Stockmarkets fall back from their present level, and remain volatile, then we shall seriously consider iShares at that time and will contact appropriate clients accordingly.

*Please note ETFs can only be held in Nominees.*

## **Corporate Actions**

These have slowed down very considerably and over the last 3 months we have advised clients

- 1) Not to take up the placing issues in

HBOS/Lloyds TSB  
Royal Bank of Scotland

2) We have advised on the Rights Issues in

Centrica  
Standard Chartered

3) We expect to write on many more Rights Issues as companies re-finance balance sheets by Equity issues rather than Bank borrowing (as was the case before Cash became so cheap in the 1990's).

4) We shall be writing to clients regarding the Lloyds TSB/HBOS merger in due course.

### ISAs

We shall be looking at all ISA positions before 5<sup>th</sup> April 2009. We have written to clients with Cash ISAs.

### Final Comment

Looking into the Crystal Ball of 2009, the UK economy looks bleak, indeed as I write the temperature outside is - 5 °C.

We believe the economic cycle will revolve, and the UK will pull out of recession, but not yet. But do not forget the Stockmarket recovers long before the economy.

Over generations Equities have performed better than Cash Deposits and Gilts and we have total faith that this will continue.

We have explained our investment strategy, and why. As Churchill used to say in the dark days of the War "K.B.O". Barratt & Cooke certainly will!

CWLB

01/01/2009

PS: The real meaning of K.B.O. is unprintable in these refined pages, but sums up the present situation perfectly .

There will be two prized Barratt & Cooke pens awarded to :

- 1) A correct answer drawn out of a hat
- 2) The best original definition,

and I am sorry "my castled lord"

K.B.O. Keep Buying Oil

was a good try, but not quite good enough.