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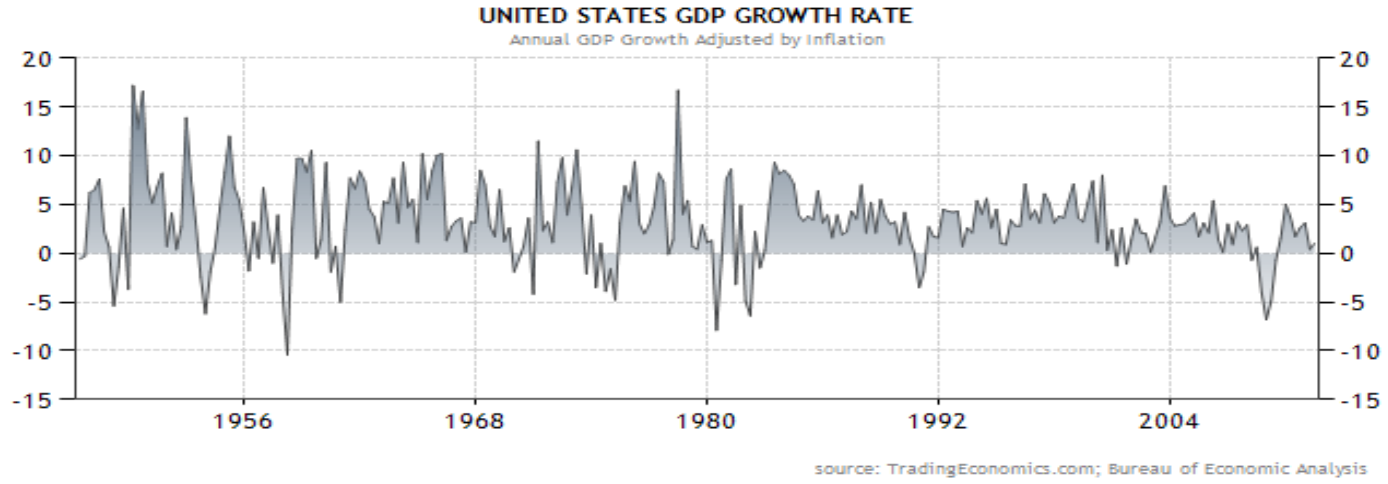
Market View

The image of September has to be that of a rabbit sitting in the road mesmerised by the approaching car headlamps, except it is not a rabbit but the European political system and the car is Greece. Despite pressure from the IMF, The World Bank and the USA each of whom have used stronger and stronger rhetoric to try and scare the Europeans into action the French and the Germans appear happy to keep having meetings about meetings and put the decisions off until they really have to be made. There is much reporting of another Credit Crunch but currently that is not correct, there are no signs of tension in the inter-bank market where rates remain stable and the ECB active. There are concerns that one may happen that is true and if European leaders continue to prevaricate and Greece does it's inevitable default in a disorderly manner it is a possibility, but we cannot invest on what may or may not occur, if we did portfolios would constantly swing in and out of cash and achieve nothing.

We have to look through all of this noise and make a judgement based on the available evidence. That evidence is pointing towards a continued slowdown in the rate of growth for Europe, USA and UK and without further stimulus in all probability will get worse. Whether this slowdown will tip into recession, the dreaded double dip is not yet clear, but the longer US and European politicians dither the more likely it becomes. It remains our view that China is the key, the US economic recovery slowed when Chinese interest rates went up; it is in the East where we our attention should be focussed for the real market direction not Brussels.

Should the double-dip be dreaded?



This chart shows the US economic growth rate since WW2 and the recessions are when the growth rate dips below zero. Firstly it shows that recessions are rare events that don't last long. Double dips are even rarer with the last of any significance in the early 1980s. The post war years saw the most regular boom and bust cycle, compared to the 1980s which saw a sustained period of above average growth, just after the last double-dip. The pattern that appears most often is a slowdown to minimal growth followed by a pick-up; therefore statistically our mind-set should be that is what is happening now. What is intriguing is that the last double dip in 1981 was in part due to a debt crisis (Latin America). But what came after was a prolonged period of above average growth.

What we are experiencing now are two separate political crises that are preventing significant economic issues to be resolved. Obama is powerless to carry new stimuli through Congress without Republican Party support. The Europeans can't make a decision and if and when they do may be restricted by national politics. As investors it makes it very difficult for us to plan a short term strategy. Bonds are a safe haven but are overvalued and if the above issues are resolved and growth resumes to near normal levels we would lose money on bonds and equities would be the place to be. However if not, despite being much undervalued equities will struggle and may fall further whilst these political impasses continue and as a result recession talk intensifies. But for how long could they continue in the doldrums?

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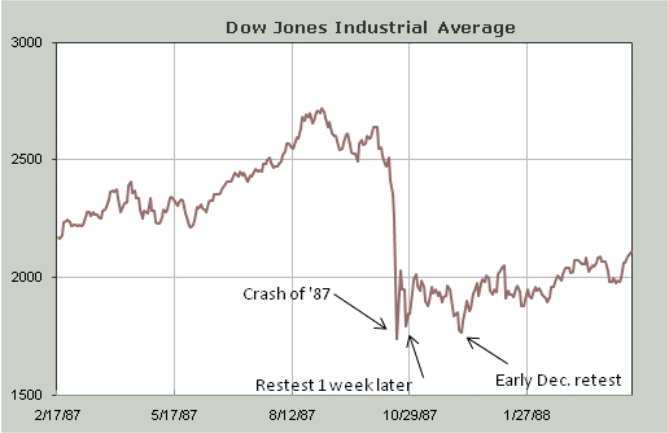
US Equities Well for US it's easy to calculate, taking the very worst case if Congress and the Tea Party block Obama's dash for growth jobs plan and the US does double-dip then Obama looks like a dead-duck for the Presidential election which begins early next year. The most likely outcome would be the Republicans come back to power on an economic growth ticket and up go markets. Remember markets move ahead of the event. So from here our maximum time frame for pain is no more than 12 months. Not nice but in the long term scheme of things very manageable.

Europe Finally seems to be getting some sort of plan together and more importantly it appears sensible. The risk with betting against Europe is that when they do act it always involves an element of overkill. The spectacular late grand gesture is nearly always the European way. For Anglo-Saxon investors this is a nightmare making markets even more unpredictable than normal. Selling now may look very clever for a week or two but equally in month or two could look very stupid. The plan as reported by the BBC's Robert Preston who is the usual Treasury conduit for public information is for a 50% cut in the value of Greek Bonds, an e2trillion stability fund to buy up Italian and Spanish Bonds (stop speculators from trying the same thing with those countries) and a TARP style fund to buy Greek bonds from those European Banks that have included them in their capital base. On the face of it this plan ticks all the boxes. But can it be enacted? Particularly can Angel Merkel carry it through the German political process, the EFSF vote is a start? Unlike the USA this is potentially an open issue though we suspect that the deeper the crisis gets the closer we are to a grand resolution as the politicians will have no choice but to make a decision.

China The Chinese must look at the West and rub their hands with glee, China sees itself as the historic pre-eminent economic power with the last 200 odd years as a short term aberration. They may not "do" democracy in the western sense but the Premiership does change every 10 years with 2013 the next changeover date. All Chinese Premiers like to consider their legacy and for Wen Jiabao he is unlikely to want to leave on a downbeat note. China is due to reflate soon, just a question of when it starts and by how much, this to us is the real key to the future of the markets not Europe.

The 1987 Crash Roadmap



Last month we compared current markets to those of October 1987, when the initial sell-off was followed by 2 to 3 months of churning around before markets eventually took off again. So far the pattern is holding up, markets have touched the lows but each time found support. Much will depend upon the political news if the pattern will hold but also we mustn't forget about the economic news. Any sign that the now priced in recession isn't happening or is not so severe will see equities return to favour. Equities are very cheap; at the beginning of a "normal recession" they are at their most expensive, not the case now. There is immense value in equities provided the current political mess can be overcome.

Markets. These continue to be tricky markets as we are dependent on upon politicians on both sides of the Atlantic doing the right thing. Predicting politicians is fraught with danger particularly in Europe. But as we have said before current market conditions are not exceptional, this is normal with equity investing and is why we have balanced portfolios. A final thought; currently the top 8 US Banks have $1trillion in capital and $54bilion exposure to the PIIGS, they can all default if they want to US Banks could cope. Compare this to 1981 (the last double-dip) when most of Latin America defaulted, US banks then exposure was 263% of their then assets. The World didn't stop, "it's different this" time remain the most expensive words in the investment world.

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