

HALKIN SERVICES LIMITED
INTERNATIONAL
RISK ANALYSIS AND ASSET ALLOCATION
SERVICE

DIRECTORS:

Dr P.J. Warburton
A.N. Brewer
R.J.W. Catto
R.J. Griffiths

Tel: +44 (0)20 8879 6116
Fax: +44 (0)20 8944 6920

email: halkin@halkinservices.co.uk

Company secretary:

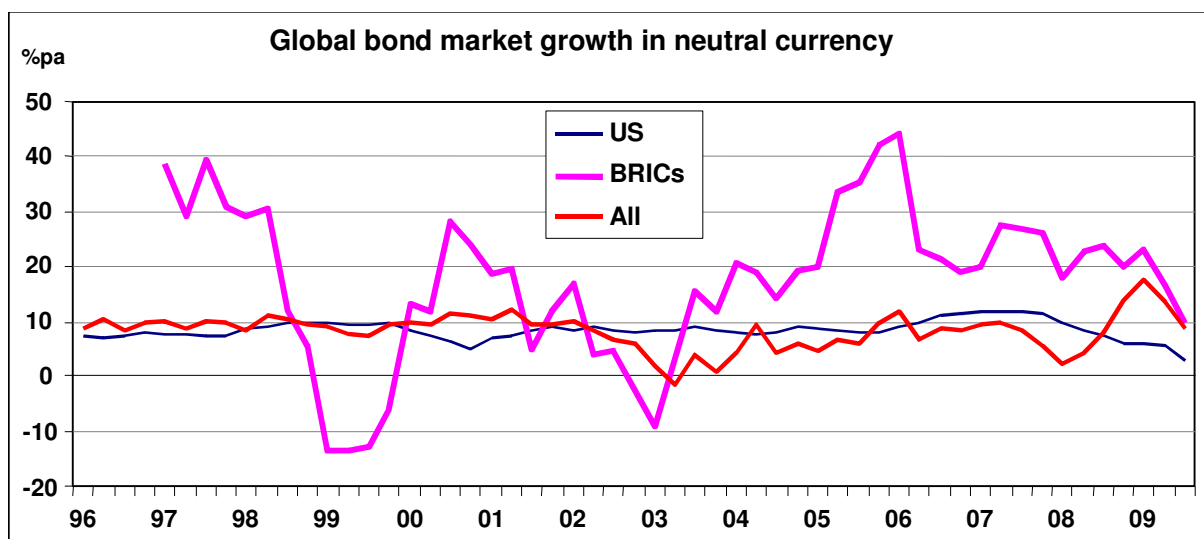
Mrs P.A. Ranken
21 Vineyard Hill Road
London
SW19 7JL

Weekly Letter no: 358

28th January 2010

OVER-EASY CREDIT PREVAILS

Our central bank generals seem intent on steering the global economy along a course of indefinitely easy credit – witness the latest minutes of the FOMC. At last, one brave soul – Thomas Hoenig – has emerged “who believed that economic and financial conditions had changed sufficiently that the expectation of exceptionally low levels of the federal funds rate for an extended period was no longer warranted.” Chairman Bernanke speaks and acts as if he believes that the Fed has a free pass when it comes to the inflationary threat, yet the disgust surrounding his re-nomination tells another story. The 30-35 senators who oppose his nomination embody a deep-seated unease regarding the reliability of Bernanke’s judgement. This principled dissatisfaction is not an attack on his character or his credentials: it asserts that he has exceeded his authority and has embarked on a dangerous and foolhardy enterprise. When the president finds it necessary to bring back Paul Volcker to stand beside him at a press conference, the subliminal message is that the administration acknowledges a lack of substance and gravitas in economic matters. However, in all likelihood, the chairman will obtain the necessary votes to continue beyond 31st January and his flawed judgements will hold sway over the Fed for years to come. In another nuance, the minutes leave the door open to an extension of the securities purchase programme “in the light of the evolving economic outlook and conditions in financial markets.” This could be read as meaning that securities purchase has become an established part of the Fed’s armoury and could be redeployed at will. How long will it take the equity markets to figure out that the rhetoric of central bank tightening – in the US or China – has no real substance as yet? One factor that is holding back the progress of equity prices in recent months is the reappearance of significant capital issuance, which is itself a symptom of easy credit conditions. The Bank for International Settlements has recently released an update of its comprehensive data on the domestic and international global bond markets and the annual growth rates remain in positive territory.

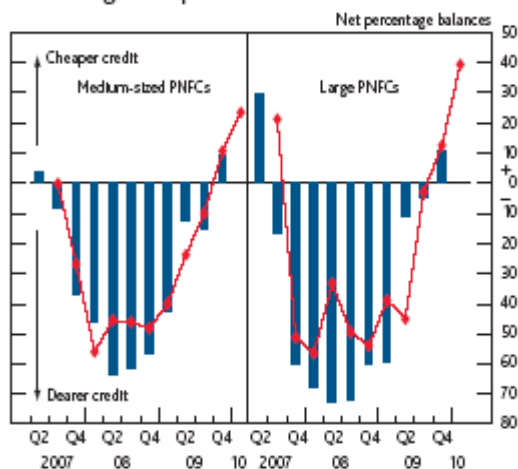


International bonds outstanding (US\$27trn) increased by almost 12% in the year to end-September in US\$ terms and by almost 9% in currency-neutral terms. Notable contributions to this growth have arrived from Greece (up 33%), Ireland and Denmark (28%), Portugal (27%), Sweden and Belgium (26%) and the UK (18%). The credit markets are not closed, either to big government or big corporations, and central banks are determined to do everything in their power to keep it that way.

UK CREDIT CONDITIONS IMPROVE

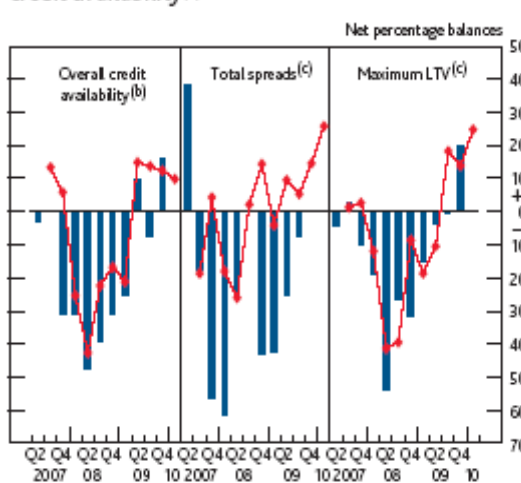
Unless my eyes deceive me, there is a common feature of the charts below, drawn from the latest quarterly *Trends in Lending* publication from the Bank of England. “A net balance of lenders reported that spreads over reference rates on new lending to medium and large businesses had narrowed over the past 3 months. A slight reduction in fees and commissions was also reported.” Among mortgage lenders, “a net balance of lenders reported that there had been some increase in the availability of new secured credit to households in 2009 Q4.” “A net balance of lenders anticipated a further increase in credit availability in 2010 Q1.” Yes, credit conditions are improving for borrowers: the terms are getting better and credit is more widely available. Despite many such indications of a credit easing, the mood of industrialists, retailers and especially commentators is black as soot. Hence, when the UK released preliminary figures showing just 0.1% growth in Q4 GDP growth on Tuesday the gloomsters were in hog heaven. No matter how concerned one is about the medium-term prospects for the UK economy, it should not prevent a phase of rapid GDP growth which extends into the first half of 2010. The two compelling stories about Q4 and Q1 are the ending of the slump in business expenditures on inventory and capital goods and the subsidisation of the consumer through low interest rates and government transfers. The problem for the statisticians is that these are spending narratives and the preliminary estimates are based solely on output data. It is rather like obtaining an eyewitness account from someone standing at the back of a crowded room. However, instead of taking this news with huge pinch of salt, the media seized upon it as proof of a) the abysmal state of the economy; b) the incompetence of the government; c) the irrelevance of government measures. These preliminary data prove nothing: they are liable to significant upward revision as more complete information becomes available and as the whole profile of GDP in 2009 is likely to have a facelift when the annual Blue Book adjustments are made in the summer. If, as seems likely, the US will record quarterly growth of around 1.4% when reported on Friday, it will be ludicrous to maintain that the UK has not enjoyed a comparable benefit from business inventories and a revival of consumer spending. It is quite credible that the UK gain might be only half as large as the US, but not one-tenth the size. Those businesses that have survived the slump are gradually reinstating capital expenditure and inventory. They are not shouting about it, for the last thing they would wish is for a withdrawal of stimulus.

Chart 1.5 Credit Conditions Survey: spreads over Libor on lending to corporates^{(a)(b)}



(a) Net percentages are calculated by weighting together the responses of those lenders who answered the questions. The blue bars show the responses over the previous three months. The red diamonds show the expectations over the next three months. Expectations balances have been moved forward a quarter so that they can be compared with the actual outcomes in the following quarter.
 (b) A positive balance indicates that spreads over reference rates have become narrower, such that all else being equal, it is cheaper for corporates to borrow.

Chart 2.5 Credit Conditions Survey: measures of secured credit availability^(a)



(a) See footnote (a) of Chart 1.5.
 (b) A positive balance indicates that more secured credit is available.
 (c) A positive balance indicates that spreads have become narrower, such that all else being equal it is cheaper for households to borrow, or that maximum LTV ratios have increased.

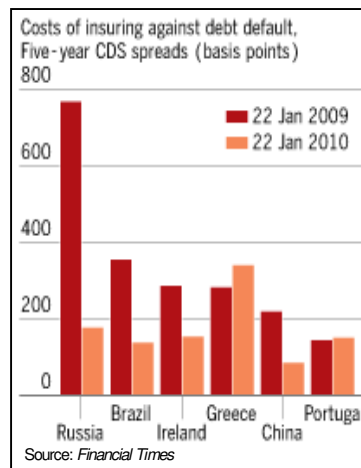
DIARY DATE

Our next event is a lunch at El Vino on Thursday 11th February, when Vince Whitefoord, of pension managers and advisors Whitefoord Ltd, will address us on the subject: “Pensions: 20th century dream; 21st century nightmare!” We have a number of other events in process and will keep you informed of developments.

Peter Warburton

AGAINST THE WALL: PIGS LOSE OUT TO THE BRICS

In the past week, the *Financial Times* has published several articles that, while not necessarily focusing directly on Europe, have thrown light on the peculiar predicament of European countries. In the first example here, Tuesday’s Lex [article](#) examined the performance of the debt markets in the ‘Bric’ countries. It’s conclusion: the bull run has been justified and, barring a sovereign credit crisis in the US, the “bubble could blow bigger yet”. *En route* to this conclusion it highlighted the way credit default swap rates had fallen so rapidly in the ‘Bric’ countries and risen so rapidly in the ‘Pigs’ (Portugal, Ireland, Greece, Spain) that, in many instances, Bric rates are now below those of the Pigs. This raises one of the great questions that 2010 seems set to resolve. While Bric rates may be justifiable, the rise in ‘Mediterranean’ rates can only be justified by a catastrophic view of the future of the Eurozone. You know where I stand.



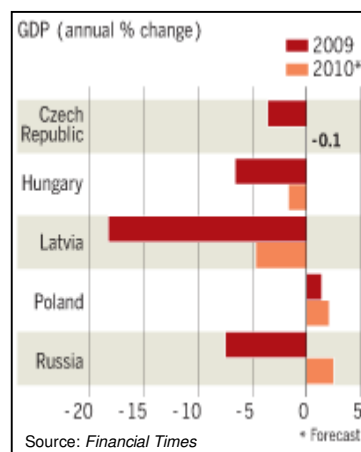
IRELAND ISN'T GREECE (OR ITALY)

In a week when Greece ‘successfully’ sold €5bn of 5-year bonds (at a price), but had its advances to China spurned (for now) and saw its credit default swap rate hit a new record, there has been another inundation of comment and analysis of Greece’s plight. The second *FT* [article](#) picked up on the theme, but set it in a slightly different context – the investor selectivity that has emerged between the Eurozone’s ‘Pigs’. Its particular focus was the way that Irish spreads have narrowed relative to those of Greece, emphasising the painful and credible efforts that Ireland has made to control its public deficit. This has been one of my favourite themes, but it is not the Greek-Irish spread that seems most interesting, but the Irish spread over the supposedly successful Italy. That, too, has been narrowing, and should narrow further as Italy supplants Ireland in that acronym.



EASTERN EUROPE: BACK FROM THE BRINK

The final *FT* [article](#) in this selection comes from Monday’s Lex column. Its topic expanded a theme touched on here last week: the economic renaissance of Central and Eastern Europe (CEE) in general, and Latvia in particular. The chart shows two aspects: the scale of the turnaround from economic Armageddon to something close to renewed growth this year, and, more significantly, the huge variation in performance between CEE countries. In particular, “Poland – the only EU country to escape recession – the Czech Republic and Slovakia should lead central Europe out of the downturn.” (Incidentally, another CEE theme from last week’s Letter – Ukraine’s presidential election and the significance for its relationship with Russia – was fully developed in a Stratfor [article](#) that we distributed a taster for on Tuesday.)



Robin Aspinall

JAPAN: OF CYCLES AND CERTAINTIES

Monday's edition of *The Times* carried an article in response to China overtaking Japan to become the world's second-largest economy. Another example of the old Japan hands coming out to defend the country's reputation? '[Don't write Japan off. The giant is stirring](#)' was written by Bill Emmott, who wrote for *The Economist* from Tokyo during the 1980's. The article is notable for three features.

First, the article is rather less enthusiastic than the title would suggest. The subtitle "... after years of stagnation Japan seems ready to shake itself up" implies future possibilities rather than current realities, but even this is more forceful than Emmott manages to be. Rather, he refers to Japan needing "quite a revolution", in the way that it experienced a political revolution in 2009.

Second, the focus is on whether the new government can deliver such a revolution. The optimism is based on this summary: "A country that invigorated its service sector, rescued its working poor and also had the booming China market nearby could do well". Third are the comments on the article. The level of hostility is surprising – and perhaps this provides the most significant insight. When the old hands find it hard to be positive, and the certainty of received wisdom finds it easy to be negative, maybe it is time to adopt a contrary position (I wonder how many of the comment writers have actually been to Japan and seen how well-organised and advanced a country it is?)

It is also worth questioning whether Emmott is right to put so much emphasis on either the new DPJ administration specifically, or the importance of government generally. Last year's election victory marked the end of an era as the LDP lost power comprehensively for the first time in more than half a century. By definition therefore, it also marked the beginning of a new era. However, it was and is much less clear what that means.

Specifically, it felt last year as if the election was only a temporary and potentially unstable stopping point on the way to a new political settlement. It feels even more that way now, given allegations about financing irregularities swirling around both Mr Ozawa, the driving force behind the DPJ, and Mr Hatoyama, the Prime Minister (allegations which are being given headline coverage across the Japanese media). Note that it is not so much the details that matter here as the fact that, to Japanese eyes, the alleged activities look and feel like the money politics stories that constantly dogged the LDP in recent years.

Generally, political and economic cycles tend to move together. A focus on the trees of specific policy steps might therefore miss the wood of a long stock market pricing cycle...

CHINA: WE ARE ALL JAPANESE NOW

By coincidence, *The Times* also carried an article that shines another light on last week's discussion of population trends in China. '[Beijing plans to relax 'one couple, one child' rules](#)' notes that the mooted relaxation comes as the "authorities appear to be anxious that urban couples are less willing to have a baby". China's super-fast growth is apparently "resulting in a new class of urban yuppies who want to enjoy the good times without being tied down by family".

The logic of this argument is not obvious. Economic growth reduces the desire to have children, so the response is to remove a legal barrier to having children? It sounds more like confirmation of a less palatable truth: China is experiencing the same demographic trends as Japan, just at a distance of a few years.

Robert Brooke

The information in this report has been taken from sources believed to be reliable but Halkin Services does not warrant its accuracy or completeness. Any opinions expressed herein reflect our judgement at this date and are subject to change. This document is for private circulation and for general information only. It is not intended as an offer or solicitation with respect to the purchase or sale of any security or as personalised investment advice. Halkin Services does not assume any liability for any loss which may result from the reliance by any person or persons upon any such information or opinions. These views are given without responsibility on the part of Halkin Services or its officials. No part of this report may be reproduced in any manner without the prior written permission of the issuing company.

Registered Office: 91 Gower Street, London WC1E 6AB. Registered in England: 04559723

www.halkinservices.co.uk

©2010 Halkin Services Limited. All rights reserved.