

Written 2005  
Published 2006

## CHAPTER 7

# A Word of Warning on Near-Term Possibilities

## Glossary

- **ETF:** Exchange Traded Fund quoted as tradable instrument in stock market.

Sometimes I wonder how doctors and solicitors can get out of bed in the morning, knowing, as they do, all the ways you can get seriously sick or get sued in a normal working day. In the investment world lots of folk are afraid ever to make a decision, petrified of losing their money unless it remains in cash at the bank, where they can visit it and hug it like a comfort blanket. Time and again these ossified billions are left stewing, with lousy real rates of return, while investment opportunities are lost. It's better to be in markets, taking the volatility and sticking with it through thick and thin, than hiding in a bank afraid to do anything. Even if there is a substantial correction in the world economy, it's impractical to think about switching out – after all, most of us are up to our necks in illiquid property.

Doom and gloom prophets have been with us since the dawn of time, and they'll always be there, forecasting catastrophe, but the truth is that for every bull market, there's a bear, and for every optimist, a pessimist. This doesn't mean, however, that expert analysis on the potential for a major structural shift in the world economy can be ignored. Lessons taught by history and set against the backdrop of current economic events are worth a pause for thought, particularly for those with more vulnerable balance sheets than others.

There is probably nothing as upsetting as the thought that the guy next door is growing his wealth faster than yours. This paranoia can propel normally cautious and careful investors into taking high risk decisions that could quickly unwrap in the event of a sharp correction. Some Irish investors have unacceptably high gearing in balance sheets as mini property empires have gradually become the norm. But the availability of interest-only finance for those on modest incomes, in many cases secured against the family home, isn't a one-way ticket. Circumstances can change. If your overall level of borrowing exceeds 50% of your assets, you are taking a big bet on two things:

1. There is no property bubble and valuations are reasonably set against economic circumstances.
2. You are in an employment, or in a sector that is featherbedded against any structural shift in the increasingly globalised and interconnected world economy.

Before you embark on any further gearing, you should carefully assess the risks involved. That's what this chapter is about – it's a little gloomy, but we're going to look at the global economic situation and the various quarters that pose threats to your swag bag.

## A snapshot of the world today

The world population is growing quickly and, according to the UN, is expected to reach 9.4bn by 2050. This has serious repercussions as population increases fuel the appetite for raw materials, causing scarcity and rising prices. This applies particularly in relation to energy, a situation exacerbated by the fact that 65% of oil reserves are located in the troubled Middle East region.

The reason for the prolific population increase is our increased life expectancy. Back in AD 1000 life expectancy was just eighteen years, now there is a population of 50,000 Americans who are



over the age of 100. The 'grey population', as our oldsters are affectionately known, is expected to reach 2bn by 2050 according to some forecasts, which represents a threefold increase from the present level. The developed world is greying at a faster rate, with a substantial fall between the number of workers and those retired from work. As a result, old age pensions are placing a strain on developed economies. In Germany, for example, pensions currently account for 15% of GDP.

More people also means more inequality. There is an ever-widening gap between those who live comfortably and those who just subsist; 80% of the world's population lives in developing countries. Even within developed countries, such as the United States, wealth is skewed: 1% of the population controls one-third of the national wealth, and the top 1% of US shareholders hold 50% of the values of all stocks, while one-eighth of Americans live below the poverty line, with annual incomes of less than \$20,000. Although the developed nations of the world represent just one-fifth of the global population, they account for 86% of private consumption.

The removal of international trade barriers has created an increasingly globalised economy, throwing into sharp relief the difference in labour costs between rich and poor countries. We are already witnessing widespread movement of labour-intensive industries from rich to poor countries.

### *Global economic risks*

The single greatest risk is a sharp correction in the worldwide economy triggered by the twin effect of the softness of the US economy and the potential structural shift that could occur as wealth moves East. The dollar has been the traditional reserve currency, but the US has accumulated an enormous budget and trade deficit. The trade deficit – created by an excess of imports over exports – is shifting dollars out of the US, principally to China and South East Asia, where vast dollar reserves are being

accumulated. Meanwhile, the US Government continues to swell money supply and ramp up US Government debt, much of which is purchased by foreigners, thus creating further dollar outflows.

These twin deficits along with the substantial debt accumulated by US consumers, businesses and financial institutions must eventually be repaid. If the US were a limited company or a person, then, technically, it would be declared bankrupt. As it is, it is supported largely by confidence in the dollar as the favoured world reserve currency. But confidence in the dollar may not continue forever, and in the event that the US resorts to protecting its traditional industrial base from the threat of foreign imports by raising trade barriers, the strategic response from developing nations with vast dollar reserves may be to switch to the Euro as the new world reserve currency. Meanwhile, in order to lessen the real value of the debts outstanding, the US Government may be forced to let the dollar devalue sharply. The resulting shock to the worldwide economy could trigger a sharp and prolonged recession, followed by significant falls in property and shares values.

This is one prediction. Other analysts differ in their outlook, anticipating that the US will gradually ease its way out of its debt without triggering these responses and reckoning that a falling dollar would trigger large-scale buying of US assets from big funds underweight in US positions. But in the event that the doomsayers get it right, it's important to understand how to protect your balance sheet so that it can weather any significant downturn and, in particular, why over-extending your position by being too highly geared might lead to your balance sheet being destroyed by events entirely beyond your control.

### *So what are the stress points?*

The developed world, particularly the US, has become heavily debt-reliant as Governments continue to spend beyond their means by financing deficits. The OECD reckons that by 2008 the total amount of Government debts accumulated by OECD members



will account for 86% of their total GDP. Already the debt mountain has accumulated to about \$16 trillion, half of which is held by the US Government and issued in the form of Government bonds held by pension funds, life offices, unit trusts and foreign Governments. Interest rates are once again on the rise, increasing the debt repayment burden for Governments. The continuation of debt-based spending is largely dependent on confidence amongst investors, consumers and companies who invest in further economic growth. The threat of deflation – which is already happening in core areas in the US, such as manufactured goods – has been offset by inflation, particularly in services like insurance, banking, etc., and in commodity prices like oil. But the elasticity of spending on the back of increased debt can't continue forever and a readjustment is therefore likely.

China's emergence as a major economic power with a vast pool of cheap labour poses a threat to the US economy that may be met by protectionist barriers, like its recent imposition of tariffs on steel and Chinese-made television sets. If, as some believe, there is excess global capacity through an over-supply of most products, then deflation could replace inflation as the major threat to the worldwide economy in the early part of the twenty-first century, a century that is likely to be dominated by China's emergence as a major world economic power.

China's GDP has been growing at around 10% per year, leading to a huge boom in exports and consequently creating a massive trade deficit with the rest of the world, a quarter of it with the US. China already produces half of the world's cameras, one-third of its air conditioners and television sets and one-fifth of its fridges. Falling prices have already affected these sectors, mainly because of Chinese imports. The reason is easy to see: in 2002 factory wages in the US were \$17.00 per hour; in China they were \$0.40 per hour. Having grabbed a vast share of worldwide household goods, China is poised to move up the value chain into the high-tech sectors. Its vast labour pool of 800 million workers is producing IT engineers for foreign firms, who then relocate to China with wages of \$15,000 a year – some fifteen times the

average national wage in China, but a tiny fraction of equivalent costs in developed countries. Furthermore, the Chinese Government does not have to worry about paying old age pensions – there is none. It's a situation that contrasts sharply to that pertaining in the developed world, with its greying populations. It's not all one-way traffic, however, and China is hugely dependent on the USA. A sharp decline in the US economy, leading to a fall in Chinese exports, could have very serious implications for internal Chinese stability, arresting the huge move in population from poor rural areas to wealthier urban areas and potentially triggering unrest on a vast scale.

### *Other geopolitical risks to be aware of*

Well, if the level of debt held by the developed world, the potential for trade wars, manufacturing and technological transfers, and the emergence of low-cost labour juggernauts like China weren't enough to give you some sleepless nights, the geopolitical map is not exactly a sea of calm either. US foreign policy has become increasingly unilateralist in recent times. It's now become clear that the US-led invasion of Iraq had nothing to do with weapons of mass destruction and everything to do with securing US oil supplies. The resulting increase in global terrorism and insurgency was an inevitable backlash and acts of terrorism will continue to pose a serious threat so long as the US persists with its current foreign policy. While acts of terrorism will not, on their own, trigger a worldwide economic correction (except, that is, in circumstances where terrorist cells use so-called dirty bombs, or in a nightmare situation, a nuclear device), they will accelerate the pace of any recession. These threats are also posed from other quarters of US foreign policy, with growing tensions between the US and China and a fragility of relations between the US and Iran, North Korea, Sudan and Syria, all identified by the current US administration in its 'axis of evil'.



### And finally . . . the threat of bubbles

The history of bubbles in economic events has been well documented. Irrational exuberance is nothing new – we've seen entire populations abandoning reason to hop on board the latest get-rich-quick scheme. Examples of such events range from the tulip mania that gripped Holland in the 1630s, the 1720s South Sea bubble in Britain, the property and share bubble in the US in the 1920s that triggered the Great Depression and the dot.com collapse in 2000 after the bubble in Internet stocks throughout the 1990s. Bubbles are typically characterised by strong growth in property or share prices, followed by dramatic growth leading to sky-high valuations. The US depression of the 1930s was triggered by this pattern following the introduction of electricity, gas and water supplies, to which crazy valuations were applied. Before the dot.com collapse valuations on technology stocks in the so-called 'new economy' reached insane levels, as did property in Japan before being hit by deflation and a whopping 60% fall in property prices. Closer to home, Irish residential property at the outset of 2006, and projected to grow another 10%, looks increasingly like it's in a classic bubble.

In Ireland, private sector credit has continued to explode upwards at rates close to 30% year-on-year growth. At levels unprecedented in Irish economic history the total level exceeded €260 billion in 2006 – nearly twice Ireland's GNP. Eventually this debt must be repaid, and with interest rates rising the cost of servicing debt may sharply reign in consumer spending and impact on the construction sector, which accounts for one-fifth of Government Revenue and 13% of the workforce. As an investor, you can't prevent a bubble burst, but you can respond sensibly when all around you are losing their money!

### After all that, how can you protect your investments?

A fundamental correction in the worldwide economy is not a new prediction, nor is it a certainty. Throughout the course of history there have always been significant threats to economic well-being, but it would be an unwise investor who would blissfully ignore past trends. In the event that there is a correction, however, it will not happen overnight. The warning signs should be well signalled in advance. So, how can you protect yourself?

#### 1. Reduce your debt

Lifestyle debt, such as credit cards, term loans and other forms of short-term financing, should be eliminated through the sale of liquid assets, such as cash deposits, saving policies and shares. Ideally, your overall level of investment mortgage debt should not account for more than 50% of your investment property values.

#### 2. Switch your debt to dollars

In the event of a correction and the beginning of a freefall in the dollar, one way of reducing your relative debt burden would be to talk to your bank about switching from Euro mortgages to dollar mortgages and, if the bank isn't forthcoming on the subject, move to other lenders, if necessary.

#### 3. Sell properties

In the event that your balance sheet is over-gearred, it would be wise to read any coming correction as leading to a fall, followed by a prolonged period of flat property prices. Depending on the degree of risk associated with your property, its tenants, lease lengths and location, you would be wise to consider taking your profit and reducing your property exposure to very strong properties and leases only. Don't leave this move too late as in the event



of the start of a fall in property prices, the lead time to liquidating property will lengthen as prices fall.

#### 4. *Shift your financial investments*

Investments in pension schemes, collective investments, such as unit-linked funds, and private stock portfolios, particularly those exposed to higher risk equities, should be shifted temporarily to Government bond funds and gold funds. Any investments held in US dollar assets should be switched to Euro-based\* assets as anticipation increases that Euro will become the world reserve currency.

#### 5. *Diversify into precious metals*

Commodities such as gold, silver and diamonds are the typical reserve during times of very significant economic uncertainty. Until the early 1970s gold was the reserve asset supporting the dollar, and gold typically increases exponentially in line with a fall in confidence in currencies. This means that in a deflationary cycle, gold is likely to increase significantly in value. If you want to invest in gold bullion, you can do so through Exchange Traded Funds quoted in London.

#### 6. *Other practical steps*

On the basis that your income is likely to be uncertain for some time, revert to the traditional family budget to avoid overspending. Keep your spending to necessary expenditure only and avoid optional spending on lavish items. Remember, you are trying to avoid building up debt.

#### 7. *Be careful with cash deposits*

It's been many years since bank defaults were major news, but a very severe correction could threaten the stability of banks with low investment grade and over-exposed to property lending. Shift those deposits you have with weaker financial institutions, including some local credit unions, which may face instability due to localised job losses, and spread your deposits across banks that have received the highest credit rating from rating agencies such as Standard & Poor's, Moody's and Fitch. These ratings can be monitored on websites such as [www.standardandpoors.com](http://www.standardandpoors.com). In the Irish market the bank with the highest credit rating is Rabobank, which has an AAA rating.

#### 8. *Avoid stock select risk*

If a large part of your balance sheet is dependent on the performance of one stock – whether by choice or because you work for a public limited company that rewards staff by issuing shares – you may be particularly exposed. It makes sense to undertake a phased sale of share options on a methodical basis so that you don't have too many of your eggs in one basket and are not over-reliant on the performance of any one. Don't let CGT on profits deter you from following the strategy of diversifying your balance sheet.

That's enough of that. We'll leave our gloomy discourse there and head to pastures new. But don't fret about it too much: if there is a long economic winter in store, at least you'll have plenty of company, you know, sitting around the fire while the former multi-millionaire next door gets his turn to go off for more turf on Ned the donkey. Every cloud has a silver lining!