HARGREAVEHALE

INVESTMENT BULLETIN

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Taking on the Banks

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The electoral setback for the democrats in Massachusetts has convinced Obama that a policy change is necessary. Now he has lost his senate super majority, he must confront the lobbyists protecting private healthcare interests and those protecting Wall Street, often the same set of people. The banks are a much easier target, unpopular with the electorate and unpopular amongst a number of influential republicans as well and the calculation must be that it will be easier to force through a compromise package on his medicare bill by rattling the cage of the banks. Flanked by the mighty and well respected Paul Volker, who is well known to be independent of special interests, Obama said that banks should be banned from running their own trading desks and owning, investing in or sponsoring hedge funds and private equity groups.

More or less everybody thinks that it is not sensible that banks should leverage up customer deposits and punt like mad, knowing they will be bailed out by Governments if the game goes wrong. Quote from John Maynard Keynes in 1936:"When the capital development of a country becomes a by product of the activities of a casino, the job is likely to be ill done". But most politicians have to date seemed reluctant to take the big banks on in the absence of an integrated global response because of the potential loss of national tax take as the big banks set up shop elsewhere. But with Obama leading the way, the Europeans will likely follow.

Whether this is the right time to do the right thing is another matter. The Banking sector is still sick. Many existing banks continue to face balance sheet pressures from bad loans and regulatory pressure to increase capital. The weakness of their customer base in terms of credit quality will continue in the foreseeable future to lead to high levels of debt write-offs because of inadequate provisioning to date. The preference of the banking sector to refinance itself, and repair balance sheets Japanese style, via quantitative easing has resulted in reduced credit facilities particularly for medium sized and small businesses. For example in the UK, net lending flows have been falling since the first quarter of 2008. Widening spreads and increasing fees to compensate for lower volumes is no answer. All this at a time when a number of the big integrated banks are using the exploding monetary base to punt more or less interest free money and collect headlines and bonuses as a result. Folly, greed and a political imperative for a US president fighting for his reputation. The chances must be that the Special interests ranged against Obama will in the end overwhelm him but the fight will possibly be bloody.

But what would happen if the unexpected happened and the big banks were forced to stop punting? Clearly not good news for the obvious beneficiaries of proprietary trading such as Icap, Tullett Prebon and indeed the London Stock Exchange. But are there any wider implications for commodities, and currency alternatives such as gold. What about the price of oil?

It is a bit like asking the question: What is the extent of China's stockpiling of industrial metals? Very few people know and of those that do, they aren't about to put you in the picture. But there is likely to be quite a bit of leveraged playing around in commodities. When oil prices suddenly spiked in 2008 to $147 a barrel, there did not appear to be a commensurate fall in stocks or rise in demand. A well publicised causality was an industrial company which was rumoured and we certainly have no idea of the truth, was rumoured to have short positions equivalent to 20% of the US's crude oil inventories. Just by way of example, pushing up oil prices by $50 per barrel for one hundred days could at a guess have cost the world $500 billion. Of course speculation can be either of the short or of the long variety and who knows what the net position in any one commodity might be at any given time but a combination of unprecedented monetary expansion coupled with nominal interest rates is a potent brew for speculative excess and volatility.

In this context, the crude oil market went into contango in June 2008 (a situation when spot prices fall below prices on oil futures) and reached a high point in December 2009, although it has partly unwound since. In such a situation it makes sense for both investors and producers to stockpile oil and book on-land tank farms and ships for oil storage, particularly when charter rates for ship are so low. Shipbrokers have estimated that there are a total of 145 ships holding 140m barrels of oil floating around the world, an example of the potentially distorting effect of investors rather than industrial users on a particular market. If the spread between current and future Brent crude oil contracts continues to narrow, tankers are likely to start offloading oil. This could have interesting implications for tanker rates in general and ship brokers in particular. But that aside much of this investment in stockpiling oil is said to be financed by adventurous bankers. Take the money away from the table and what happens? History tells you it has happened many times before. Cue "Bet a million" Gates, director of the American Steel and Wire Company in the run-up to the great Wall Street crash. When he announced the closure of his mills, the assumption made by investors was that the business was failing. Gates agreed saying " We're short the stock" resulting in a collapse of the share price. Gates then successfully covered his shorts before going long again and then announcing the reopening of his mills.

The problem for commodity markets is not just that there is now serious political capital to be made by re-engineering the integrated banks which could take a bit of puff out of speculative markets. For example speculative positions in zinc are said to account for 30% of the market. With demand likely to wane, if Obama gets what he wants, there is also the matter of supply. In aluminium, there is evidence that that nearly half the production cutbacks estimated at 7million tonnes a year at the beginning of 2009 have already been unwound. In Nickel, there is a big overhang of excess inventory and unused capacity. In copper, it is said that a large surplus has been disguised by Chinese stockpiling and some of this might well resurface during 2010. Of course, there are bright spots such as iron ore and coking coal but it appears that a lot more Western Banks are now getting back into the business of large scale project financing, not least because the Chinese, in order to secure off take agreements are being increasingly aggressive in providing finance. This suggests that more production could start to come on stream next year.

None of this would matter much if there was any serious evidence of top-line growth in retail sales, or evidence of falling unemployment, any feeling that the consumer is going to start spending rather than saving.

Talking to taxi drivers in Las Vegas recently, it is however clear that consumers are in saving rather than spending mode. The local papers in California and Arizona were full of stories of enforced cutbacks in Local Government spending as a result of reduced contributions from National Government. Fewer bus services, libraries, school cutbacks. These particular States have outsize local budget deficits and have been more than average sufferers from collapsing property prices, but there are only three states in the union which enjoy actual budget surpluses. Meanwhile as the favorable impact of fiscal stimulus programmes for last year works its way through the system, the US needs clear evidence of reducing unemployment.

News flows relating to economic issues are managed carefully, for example the US Authorities slipped out the news on Christmas Eve that they would continue to support Freddie Mac and Fannie May beyond the original December 2009 deadline, suggesting that they still believe that the property market is not fully recovered. Similarly the Bank of England confirmed that the quantitative easing would be continued by £25 billion into 2010 suggesting some doubt as to the strength of the recovery. The recent unemployment measures in the UK, which had a very positive spin put on them, actually showed a loss of 113,000 full time jobs and a big rise in the number of involuntary part time workers. Not the time to bully the banking system for political advantage.

This is particularly the case because of signs of monetary tightening in China. Because of accelerating GDP growth, there is now a rumour that the Chinese New Year will see a rise in nominal interest rates. Given their preference for tightening reserve requirements rather than increasing rates in order to keep their currency as competitive as possible this would be an important sign of the Authorities desire to slow down the current bubble economy. Soft landing rather than crash is what observers are hoping for, particularly commodity bulls looking at the incremental addition China contributes to global growth.

To conclude: It would be foolish to assume that the basic building blocks for a global recovery are not still in place. But the transfer to the individual taxpayer of the recent debts incurred by Western Governments to offset deflation and recession is only just starting. The process seems to be happening now at individual State level in the US and should start to happen in Europe during 2010. In the UK political parties are starting to compete with each other in terms of proposed spending cuts.

It is clearly vital that this process happens in an orderly way and under the control of individual Governments and in the correct time span, and not as a result of a foreign currency crisis as in Greece. A crisis increase in interest rates would not be helpful. Clearly there are fine judgements to be made. Should the Bank of England be influenced to end or reduce quantitative easing because inflation appears to be increasing or should it continue to look through the next three months inflation figures to a fall in the numbers this Autumn? Will foreign exchange markets allow indebted Governments the luxury of controlling the timing of fiscal cutbacks? Will the Chinese Authorities act quickly enough to prevent a bubble bursting? Will Governments and Central Banks be able to act in concert to realign the interest of bank employees, bank shareholders, bank depositors and the taxpayer without creating a crisis of confidence within the financial system? The calls not to re-elect Bernanke as Fed Chairman do not add to that confidence. But until we see hard evidence of Western consumer confidence returning, rising employment numbers and continued industrial demand beyond initial restocking, the investment outlook must remain clouded.

This is partly because, certainly in the West, fiscal stimulus programmes initiated early last year by Governments are now likely to be replaced by cuts in fiscal deficits particularly as inflation starts to tick up and maybe start to influence Central bank thinking when it comes to quantitative easing. At the same time taking on the banks and reducing the volume of casino trading could have unintended consequences, in particular in relation to bank profitability and their ability to lend not just to Governments seeking to fund their deficits but also to commercial and corporate debt markets. And on a trickle down basis for that matter it could reduce lending activity in the mortgage market. Discouraging geared money could turn out in an unexpected and deflationary way. Politics aside, now is probably not the time to take on the banks. They are largely still in hospital. What they need to be is in robust health.

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