

**Bill Dinning**, Head of Strategy at AEGON Asset Management, explains the stages leading towards a market recovery.



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# riding out cyclical risks

We view the current financial crisis as a three-stage process. The first was the crisis culminating in systemic risk so great that government injections of capital into banks and assorted other interventions have been necessary.

This stage really erupted following the bankruptcy of Lehman Brothers. That action had many unexpected consequences as it revealed the complexity and interdependence of seemingly uncorrelated financial markets. For example, the \$3.5 trillion in US money market funds had enormous difficulties because of their dependence on Lehman-backed financial instruments to meet their yield promises. After the combination of interest rate cuts, direct

purchases of assets and equity injections into banks, it seems reasonable to think that Western governments have done enough to offset systemic risk in the major markets. Banks are beginning to trust one another enough to lend again, although the price at which they will lend is high.

## cyclical risks

The second stage focuses on cyclical risks, which remain significant. The global recession is likely to be the worst since at least the early 1980s. Earnings estimates are falling but so are company share prices, indicating that not all of the bad news is yet reflected in the price. With banks restricting credit, market

interest rates remain at elevated levels compared to official rates.

The normal transmission mechanism from official interest rates to market ones is effectively broken. So, in the near term official interest rates must fall to show the market that the authorities are doing their utmost to get the economy moving again. At the time of writing, I expect to see further interest rate cuts in the UK and Europe before the end of the year.

As the focus shifts towards the 'cyclical' and away from the 'systemic', financial markets will be able to price themselves rationally. For example, we will likely see corporate bond spreads move away from discounting 40% default rates, a level that has no historic precedent.



## indicators of improvement

### upturn

At some point, markets will be willing to look through the bad news in search of an upturn. That is stage three, in which individual company share prices will no longer decline on bad news and consumer discretionary stocks, the traditional early-cyclicals, should lead the stock market. Amongst these leading stocks are those in the construction industry, and it is worth remembering that with housing at the root of the crisis, any effective rally will require the participation of the homebuilders.

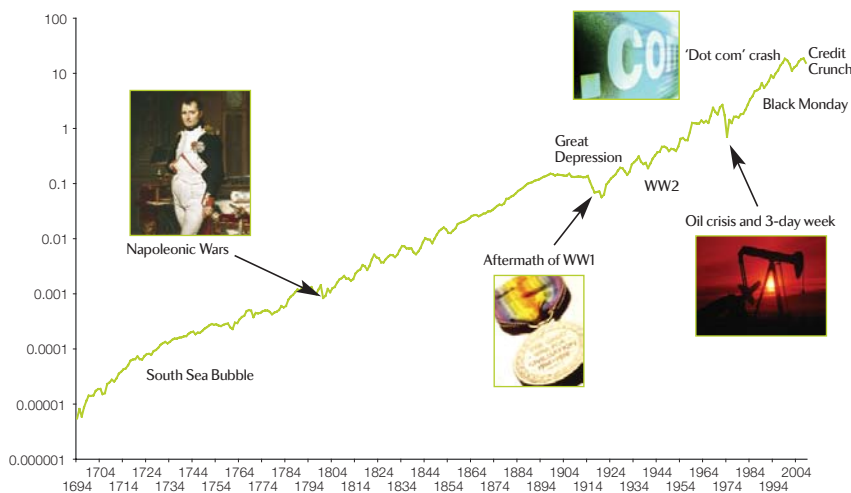
For now we see a transition underway, from systemic fear to cyclical fear. It is too early for investors to see the opportunities in cyclical markets, however muted that opportunity may be. We remain in an environment of ongoing de-leveraging and rising savings rates, which will curb growth rates in the future. ●●

AEGON Asset Management's **Audrey Ryan** has recently been appointed to run a mandate within Skandia's UK Best Ideas Fund. Turn to page 26 for a full update on the Skandia Best Ideas funds.

One key indicator of improvement is mortgage rates. The 30-year fixed-rate mortgage in the US has averaged 1.3 times the level of the 10-year government bond yield over the last decade. With government bond yields at 3.75% as we write, this suggests that the mortgage rate 'should' be around 5%. It's actually 6%. A lower mortgage rate is a prerequisite for an improvement in housing, and it's also the easiest way to translate lower official interest rates into lower monthly payments for homeowners who can re-finance. The mortgage rate continuing to drop would be a good sign that we are moving from systemic to cyclical risks.

At that point expect to see more charts like this one, showing the total return of the FTSE All Share, adjusted for inflation, since 1694. The 'credit crunch' certainly deserves its place in the pantheon of crises over the last 314 years, but overall that line is upwardly sloping. Bear markets create opportunities and there will come a time to seek them out more aggressively.

FT All Share Index, Inflation Adjusted Total Return, 1694-2008\* (Log Scale)



Source: Global Financial Data, FTSE World Indices, Bloomberg, AEGON Asset Management UK  
\* To 31 July, 2008

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