Article

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How a US Recession will impact on European Investors

For almost 100 years the Greenback has been the global currency of choice. If you want to book a hotel room in Lagos or Lima, Bali of Kathmandu the rate is likely to be quoted in US dollars. If you wish to speculate in oil or frozen orange juice (on the commodity market) then the Dollar will be used to quote the traded value. If you wish to invest in an emerging market fund or an international equity fund then the chances are that the base currency will be priced in USD, too. Why is this the case and why does the US economy have such a big influence over our lives?

The reason for the popularity of the Dollar in many parts of the world (in favour of local currency), dates back to times when governments started to issue promissory notes in favour of gold and silver coins. One of the main problems with gold and silver coins was that, whilst the physical value of the coin could not be argued (irrespective of which government issued the coin), the value of precious metals were particularly volatile and the value of a coin had more to do with its weight than its stated value. Another more practical challenge with coins was that they were really quite heavy to carry around.

Governments that issued promissory notes, promised to “pay the bearer upon demand” and were guaranteed by silver and gold bullion reserves (generally at a ratio of about 15:1), a system commonly referred to as bimetallism. It was a huge step forward for the financial world as it enabled people to carry huge sums of money in their pockets rather than in wooden boxes, which had a considerable number of obvious advantages over a coinage system.

By the late 1900s the USA was a world power because of its vast wealth of mineral resources and relative stability. In many parts of the developing world it became common practice to negotiate larger transactions with USD in favour of the local currency because the Dollar could be much more easily traded elsewhere.

This phenomenon has perpetuated into modern financial markets where it has been necessary to identify a base currency for unit of value or for any asset class to be traded. The USD has generally been accepted as the base currency of choice and we therefore see many of the world's commodities such as oil and gas, copper and gold being traded in USD.

The Global trade of the Dollar has been highly advantageous for the growth of the US economy as many have been willing to accept it as a currency medium for investment and have therefore been equally willing to invest in USD-denominated assets, bringing enormous wealth to the country.

For this reason we see a potentially volatile Dollar when any global event occurs as it will generally impact positively or negatively on the value of an asset class. Trade in the asset is a potentially huge market driver for buying or selling USD. The exchange of currency is moderated to a degree if investors keep their Dollars to buy another USD-denominated asset but during times when the Dollar is on a weakening trend it is highly likely that investors will switch to an asset that is valued in a currency that is expected to strengthen in value rather than weaken.

In 1969 the US Government had its first real challenge with the value of commodities because the Gold price started to fall. From 1969 to 1974 the gold price went down from $900.00 per troy ounce to just $200.00, a drop of nearly 80% in five years. This spelt trouble for the Federal Government because although the Federal Note was a fantastic medium for transactions, the system still had a fundamental floor because Federal Notes were linked to bullion reserves, which had been decimated as a result of the fall in the gold price. As a result of this, Bimetallism as a currency method was dispensed with and has in fact been unilaterally replaced with notes that are issued on the strength of a government's future revenue expectations (from taxes and other treasury income), a mechanism referred to as the Fiat System, which amazingly enough, is un-backed by any physical asset at all and a holder of a note has no right to demand an asset such as gold or silver from the government in exchange for a note.

The USD is backed by future claims to wealth of American taxpayers (and other income sources to the United States Treasury), and many believe that the Dollar has little intrinsic value except for the value of the paper, and is only valuable as a medium of exchange. To support this position, in 1963 the words "Shall pay the bearer upon demand" were removed from all newly issued Federal Reserve notes.

Today we face a global financial market where many assets are traded in USD, a currency that has a particularly fragile future. It is a currency that is totally dependant upon the strength of the United States economy and the value of its legal tender is reliant upon the ability of the Federal Reserve to indemnify the value of the money in circulation against its future revenue expectations, the outlook for which is particularly bleak as we could be on the precipice of the largest recession the world has seen in recent years.

We have seen global equity markets react extremely negatively to the fact that Federal Interest Rates have been too high for too long, putting immense pressure on the domestic housing market and forcing mortgage foreclosures on many sub-prime borrowers. The irony of this is that the interest rates have been kept so high to control rising inflation. In simple terms the Fed has increased the cost of borrowing to a) leave people with less money to spend once they have paid their mortgage and other debts; and to b) stop people borrowing more money because of the cost of doing so. This is quite a simplistic analogy but it is a bit like an oil tanker coming in to port – you need to slow the engines down a good twenty miles before you get there because of the size and weight of the vessel. If the tanker only took this precaution ten miles before reaching port the captain knows he will not stop in time and a collision, although some way off, is assured.

The impact on the US property market is the same. By the time the results of high interest rates become apparent, it could be heavily argued that the interest rates have been too high for too long and the impact is wide spread.

The knock on effect of sub-prime borrowers defaulting on mortgages is that property prices (that are already depressed in some states because of the high cost of borrowing), will fall further, causing a domestic housing recession and huge losses for the lenders involved. In the case of the US Sub-Prime Mortgage Market a lot of this debt has been packaged up in bond issues and sold off to other financial institutions. To finalise the analogy; we are now ten miles away from port, we know that these losses are going to manifest as foreclosures will start to occur for those people that were unable to pay their mortgages six months ago and for those people that have just reached a point where they cannot pay their mortgages, the rate cuts will have come too late and they too may lose their homes too. The sale of each property will generate a loss to the bond issues involved and subsequent losses for any number of financial institutions around the world.

This all impacts on equity markets firstly because losses to financial institutions reduce their profits and make their shares less attractive and secondly because companies suffer the same cash flow limitations as individuals and also have difficulties in servicing extraordinarily high interest payments.

The answer, of course if for the Federal Reserve to cut interest rates but this will now be a predictable trend and the market is likely to react to it before it has occurred, with an expectation that the Dollar will assume a weakening trend, which will spell losses for foreign investors. To curtail losses, foreign investors would sell Dollars by disposing of bonds and equities in favour of alternative assets such as cash or near cash assets

The European market will follow this trend with a similar correction on equity markets, not only because of the vast amount of investment that institutions have in dollar assets but also because of the general expectation of a market fall. Bonds will be under similar pressure because of the increasing interest rate trends in Europe and the United Kingdom and we will therefore see a rare phenomenon where both bonds and equities become a bad deal at the same time.

The message is quite clear; that the past three years of an equity bull run, rising property prices and increasing bond yields has been a fantastic time for many investors to amass wealth but the gravy train is coming to an end and it would be prudent for central banks to ease off on interest rates and encourage a short-term rise in inflation to avert a global crisis. For investors, the safe option will be to lighten their weighting into equities, bonds and property in favour of alternative methods of investing that do not correlate positively towards core asset classes before the recessionary pressures of the USA start to bite in Europe.

One solution for investors looking for steady and incremental returns above the UK base rate can be found in traded life policies, which are US whole-of-life policies sold before the maturity date to allow the original owner to enjoy some of the benefits during their lifetime. They offer the benefits of steady, predictable returns during all stages of the economic cycle and are currently yielding in the order of 8-10%. But a fuller explanation of this burgeoning new asset class would have to be the subject of another article.