

## US Rate Cuts and Equity Market Falls, 21 and 22 January 2008

*Robert Talbut, RLAM's Chief Investment Officer, gives his reaction to recent dramatic developments in investment markets.*

### Overview

The final months of 2007 saw a sharp downward reappraisal of the growth outlook for the US. The consensus view was that the rest of the world would be largely unaffected, with the emerging economies in particular continuing to grow, buoyed by their domestic economies. This reappraisal was accompanied by the start of a series of corporate earnings downgrades and a shift to factor in more aggressive interest rate cut expectations in both the UK and US. Overall then, consensus opinion was taking a relatively sanguine view in that, while there would be some economic fall-out from the weakness in the housing markets and the tightening of credit availability, this would be balanced by positive interest rate support.

### Dramatic action by US Federal Reserve

Today, Tuesday, 22 January, has seen the Federal Reserve react to an increasing lack of confidence in markets by cutting rates by 0.75% outside of the regular timetabled meetings. It is possible that the rate will be cut again in the near future. We also expect the Bank of England to cut UK rates.

For some time now we had been taking a more cautious stance on equities with the belief that the economic damage would be more severe than expected and that analysts were far too complacent about the potential company earnings cuts that would be necessary. Hence we have held more cash than was in our benchmarks and our equity portfolios were rather defensively positioned.

As we enter 2008 we have seen a relatively sharp unwinding of the complacency that existed within markets. This we see as both healthy and inevitable. The US is likely to experience a recession in 2008 and the rest of the world will see a sharp slowdown. Indeed some commentators are stating that they believe that the US is already in recession. This will mean further downgrades to corporate earnings expectations which will affect both equities and corporate bonds.

Perhaps the final straw which has accelerated the growing negativity was the news last week of the distress of the US monoline insurers. Fitch has now downgraded Ambac from AAA to AA, the first ever downgrading of a monoline insurer. Monday and again today, Tuesday, has seen equity markets globally now starting to price in these revisions, leading to the falls that markets are now experiencing.

We believe that a solution will be found to the issues of the monolines as a failure to do so could lead to further wave of write-downs to the value of the bonds and other securities held by investors and banks. This in turn could set off another episode of lending aversion by the banks, increasing the risks to the growth outlook.

The high prices of risk free assets within fixed interest has concentrated our minds on value. Government bonds have gone to extreme valuations and we have rigorously searched for value within credit; investments within financials looking particularly attractive.

We remain confident that our values based approach that assesses structure, quality of covenant, default position and the price for risk in all our investments will reward our investors in the medium to long term. This has particular relevance in the current conditions within credit markets, where we have become even more confident of our current positions.

## Outlook

Turbulence in markets creates opportunity and we foresee that this growing pessimism will create a very attractive buying opportunity for equities and possibly other assets which we will look to seize out of cash. We expect this to occur at some stage during the first half of 2008 and will probably be marked by some forms of capitulation events, such as a panic selling by retail investors or an absence of bulls in the marketplace. This later stage is not unusual as analysts become overly pessimistic on the economic outlook. In contrast we retain the view that sharp interest rate cuts and possibly other measures to restore confidence will be implemented by the authorities around the world, providing the required support.

As investors, we are not selling equities, rather we are thinking of adding. We believe that it is times such as these when we are presented with real opportunities to add value through asset allocation. Looking to those areas that have performed the worse generally makes sense.

Source: **rlam** as at 22 January 2008 unless otherwise stated.

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