New Minerva Report

Iraq and the FSA

When you look at the market moves for January on this page, there are two things that jump out at you. Firstly, they are once again negative, and secondly the FTSE index's fall of 9.41% was by far the biggest fall of all the major markets.

The main reason why most markets are down is because of the uncertainty concerning the possible war with Iraq. Many commentators had assumed that the market had priced in war already. However, two factors have since affected the mode. The first factor is whether a war with Iraq will be quite as simple as most had been assuming. The original theory was that any war would be similar to the 1991 war when Iraq was expelled from Kuwait, and therefore would be over very swiftly. Now there are concerns that fighting from street to street in Bagdad will be a much longer and messier affair. Some are worried that Saddam will use some of the weapons of mass destruction that he is alleged to possess. (Incidently this had also been a worry before the 1991 war). There have even been voices that have suggested that Iraq could be the US's new Vietnam. The other thing that has upset markets, is that there is a growing realisation that military action could be postponed in order to ensure a coalition is formed, thus prolonging the period of uncertainty. It also means that decisions concerning company investment will also remain on hold that much longer, ensuring continued low economic growth. If the US is not prepared to wait for its allies to fall in behind it, this would also be taken badly by markets, as it will show divisions that are likely to widen between the major global powers. It could also induce an Arab backlash. Both postponement or US impatience could mean that the price of oil will stay higher for much longer than markets are currently expecting. A higher oil price is probably the greatest long term negative on the global economy, because it acts like a tax on growth.

So how are markets likely to react to news. The most optimistic position would be if the Arab nations were able to persuade Saddam Hussein to relinquish power, and take the option of political asylum in another country. The markets would react very positively to this. If the UN produce another resolution which enables a US coalition to be formed and war is declared on Iraq, the markets will probably rise once action starts, and then hesitate whilst they assess the probability of the likely success of the action. We will have to carry on waiting and seeing!

The fact that our market was down by more than most, was because of the life assurance companies. After the Equitable Life debacle, the Financial Service Authority (FSA) introduced more regulation to tighten up the rules regarding the viability of the life companies. Prior to these new rules, the life companies only had to ensure that on 31st December each year their asset mix to their liabilities, (solvency ratio), was acceptable to the authorities. Now they must check this on a continuous basis. In the year 2000, the whole thing started to go wrong. Because the solvency

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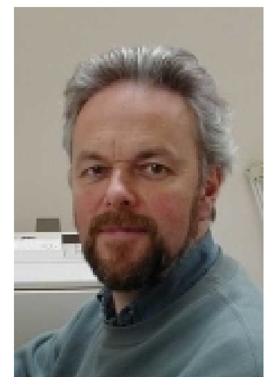

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ratio takes a different view of equities (shares) and bonds (fixed interest), they were forced to sell shares and buy bonds in order to maintain the ratio requirements. The further the stockmarket fell, the more shares they had to sell. At the year end, the FSA said that £25bn's worth of shares had been sold by life companies. Some have calculated that a further £7bn's worth have been sold in January. That is the reason why the UK market fall so much more than the other major markets. In fact, a mini-panic was setting in. Thankfully, the FSA reacted for the fourth time and has invited life companies to apply for a waiver of some of the solvency rules. To its credit, the FSA has recognised the problem of its solvency rules, and has been looking at rule changes which look at a 'realistic' financial position. Breaking the statutory solvency limits does not mean that a life company is insolvent in economic terms. There are a number of options open to a company before that position is reached. They can reduce payouts and put surrender penalties in place, which many companies are now doing. They can also close for new business. New business costs, as it is normally paid for in advance by up-front commissions.

Unfortunately, most FSA changes take a long time to put into place, which is why the rule waiver option was taken as an intermediate stop. The FSA had to act, as it is responsible for the well being of the market. The last thing it wanted to be accused of was actually creating a financial panic. Remember too that significant parts of the financial sector is impacted by the absolute levels of a stock market. Investment management fees is but one example.

UK Market Prospects

The selling from life companies will not cease, neither will the selling from pension funds. However, the selling already carried out, and the fall in share prices compared to bond prices, have meant that much of the redistribution of assets has now taken place. In particular, forced selling is now much less likely. Unfortunately, as with all fads, things always go on further than they ought, as decision makers extrapolate the immediate past into the future. This means that a rise in the market will be capped, as life and pension companies take advantage of higher prices to continue to reduce equities. The good news is that the floor has either been reached, or is not too far below. The main reason for this is the yield of shares. Anyone with a memory as long as ours will recall that in the past the yield was the reason for investment in the first place. Capital gain was an add-on if you were lucky. The bull market that started in 1982 changed that perspective, so that governments and actuaries alike forgot the basic rules. In fact it was this thinking that enabled Gordon Brown to rob pension funds by taxing their income. Who cared about income, when so much was made from capital gains! We now have shares yielding similar levels to gilts. Investors have the sure knowledge that they will get the income from gilts, but they also know that the prospect of income growing from gilts is nil. Of course dividends can be cut, which means a quoted yield today may be gone tomorrow. But it is interesting to note that 100 of the top 150 UK companies, measured by market capitalisation, have a prospective yield greater than ten-year gilts. It would be a high risk strategy for any actuary to suggest selling equities, with those kinds of yields, to buy gilts. Especially when the risks on the capital value of gilts has risen, due to the government's financial problems, (i.e. high spending coupled with low tax-take as the economy runs at half steam.)

So, with the heavy selling gone, the next thing we need is buyers. Once the Iraq situation is resolved, one catalyst for the market could be the takeover. Money is currently cheap. The private equity investors can now find many large companies producing free cash flow yields in excess of their usual target. It is no accident that Safeway has attracted so many bids.