

Investment, Socio-Economics and the coming contractions

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The UK has not had a recession since the early 1990s, and many of today's consumers may not remember the realities and hardships. It seems certain that, for instance, a number of retail chains will go bust over the next year or so, while the number of home repossessions will move commensurately in the opposite direction. Investors will need to ascertain who the likely winners and losers will be. By way of a basic example, one can try and define what goods might be considered a 'staple', and which discretionary luxuries can be cut back upon.

So, for instance, is your daily Starbucks a staple or a luxury? Or your copy of "OK" magazine? Or gym membership? Certain retail and leisure areas, however, *can* do well in a downturn, as, with the "feel-good factor" falling, people tend to revert to forms of escapism and cheap treats. Cinema chains, for example, can do well at such times, while Domino's Pizza is currently trading nicely.

An interesting and unexpected development was Sainsbury's reporting decent numbers recently. Theory had it that they would lose customers to Asda and Tesco, in a more price conscious world, but actually they were picking them up at a greater rate from M&S and Waitrose, while the likes of Aldi mop up at the bottom end.

Essentially these are questions we debate with our fund managers, as they attempt to understand changing consumer preferences. The more experienced managers are likely to be best placed to benefit, although there is also the theory that their younger counterparts will perhaps sense some of the changing trends earlier.

Inequality of wealth and income

The OECD recently ranked the UK as 7th worst (out of 30 countries) for income inequality; although this has at least been reasonably stable over recent years. Of perhaps greater concern for the UK is a lack of social mobility which is much worse than the US, and that unemployment is increasingly disproportionately suffered by the poorly educated, albeit benefits are decent in international terms.

Historically, boom times have been enjoyed by the population at large and were something of a leveller and an opportunity. However, in the boom since the early 1990s and as per others which ended in 'bubbles' the *distribution* of wealth and income has contracted. Juliet Schor the Professor of Sociology at Boston College

has highlighted the incredibly disproportionate gains of the top 20% of the population, by wealth and income, in the US but also most other Western countries. This wealth distribution, and bubble-like environment, encourages a shift in consumer practices and attitudes. Historically people's so-called 'reference group' was horizontal or proximate. That is to say that one might pop round to see the neighbour's new fridge or TV, the neighbour being roughly economically equal, and possibly wish to emulate them.

This has been replaced by a desire for more *vertical* emulation. The effect has been a boom in luxury spending. This culture of consumer excess is well illustrated by the proliferation of luxury cars and ordinary folk driving Humvees, designer clothes for small children, or indeed the latest side-by-side fridge/freezer and the newest plasma screen television. We are bombarded by media, and, for example, lifestyle shows, which can encourage an upward bias on our sense of what is normal for the average consumer.

The "aspirational gap" and "intrinsic values"

If most of the population desire an overly and unrealistically affluent lifestyle but median income is only half of that which is required, then aspirations will be frustrated. With that top 20% taking more, then the middle and lower middle classes have ever greater difficulty keeping up with said aspirational target. Crucially, consumers have responded, as we know, by reducing their savings and taking on record levels of consumer debt. Therefore the number of personal bankruptcies has risen substantially, as has the fraction of households without any assets or retirement provision.

An extensive body of psychological literature shows an upsurge in materialist values is negatively correlated with well being. Materialistic people are said to be less satisfied with life, lack vitality, and suffer more from anxiety, depression, narcissism and addiction problems. They are shown to be more anti-social and less empathetic, more competitive and less co-operative.

The Journal of Business Ethics took the view that time was the key and stated that people with more time on their hands show greater subjective well-being, happiness tending to increase through what money can't buy. However, before we all go off and join a naturist commune, it should be pointed out that work is not bad per se, as it can and should be fulfilling and creative.

Change on the way?

The boom years and globalisation, while positive in some ways, have also had their share of losers.

Average real earnings in the US is a measure that tells a sorry tale, before one even considers the current tax payer funded bail out. Productivity grew 20% from 2000 to 2007, yet the *real* income of the middle class working age household, fell 3%. It will be interesting to see how President-elect Obama addresses this problem, having campaigned on "change". It seems inevitable that there will be a thrust to focus on "rebuilding America", via infrastructure spending, tax cuts for middle classes and below, and doing whatever it takes to keep people in their homes. Whether Detroit receives a bail-out will be an interesting one, but Obama has made it clear that some "redistribution", for better or for worse, is on the cards.

The UK too will need to loosen the purse strings, although like the US the starting point is one of existing fiscal irresponsibility.

An Investment Angle

The economic contraction is going to come as a blind-side hit to a 20 year evolution of lifestyles and consumer attitudes. The recent falls in the stock markets give us an indication as to how severe this hit may be. It is rare for net wealth to suffer the kind of reduction that we are now witnessing, where property, jobs, savings and pensions are all under such pressure, across industries. The Financial system may not melt down after all, but this could still, sadly, be a *consumer* recession to remember. If so, house prices have the capability, simply from a supply and demand angle, to hit a further air-pocket, although the subsequent wealth-transfer to young first time buyers could yet be a net positive.

All of this is not to say that people will cease to be aspirational or that celebrity culture is necessarily going to go away. Rather that there will inevitably be a re-evaluation of priorities, and the economic and social environment of the next 20 years is highly unlikely to replicate the last 20, and certainly while recession-like conditions are predominate. Family life, walking on a bright winter day (or whatever), and achievable feel-good highs may make something of a comeback on wish lists, as opposed to second homes and thousand dollar hand-bags.

Financial assets can perform well during recessions though, and the successful investor will have learned the lessons of the boom period, without fighting yesterday's war, while continuing to evolve 'all-terrain' philosophies and processes. In Towry Law's case this involves working hard to contain the effects of what we don't and can't know, rather than leveraging what little we do know into the teeth of unexpected events. Some fund managers' processes will work better than others, and it is up to our Investment Team to identify which these may be, and continue to blend appropriately.

Conclusion

The investment, cultural, political, and socio-economic landscape is changing, although time tested investment principles should retain their value. Perhaps the biggest shock and change to consumers and investors recently has been the reality that their cash accounts may be riskier than they thought. Cash will always have its place in financial planning, but we know over the long term it is unlikely to fare well versus inflation or stocks and other real assets.

It is easy to fear the effect of this economic contraction and build a dire case around Western consumers, who, it seems, have never been worse prepared for such an event; tying a millstone of debt around their necks as economies slip into the murky pool of recession. That said, the inter-connected globalised world that was so horrifically quick to transmit its problems, equally has the potential to respond just as efficiently to genuine good news and defibrillator-style stimulation. People's perception often become the prevailing reality, and much as some commentators have warned against talking ourselves into a deeper than necessary recession, it is not unusual for people to take a while to appreciate that things have got better. After the recession of the early 1990s, consumers still felt they were in recession, and lacked that feel-good factor, long after the economy was already recovering. This is well illustrated by house prices which didn't really start to move again until 1996. So, there will likely be opportunities ahead of the herd.

In summary, it would seem that a sharp consumer and asset price recession is upon us. "Deleveraging" has become a well-known term in the press, in respect of banks and hedge funds, and consumers could be the next to apply this term to their own perilous financial position. The winds of change are blowing through many spheres, but we must remember that change brings possibility too. At times of change the holistic financial planning adviser/client relationship is crucial, and the positive management of risk never more appropriate.



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