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Market Turmoil

Standfirst: Investors spooked by the global financial crisis need to hold their nerve for now but prepare for worse to come, says Stephen Watson of Chartered Financial Planning firm Watson French.

At the time of writing world equity markets are in turmoil. The FTSE 100 has recorded a record series of falls on successive days, dropping 14% since August 1, with similar tales across other indices in Europe, Asia and the US.

These are dramatic reductions in unprecedented times.

Should we be surprised by this financial chaos? No, not in my opinion. When a financial crisis is bailed out by the state, the debt does not disappear; it merely passes from one position to another. Consequently we should not be taken aback by the sovereign debt crisis in the United States and in Europe. The negative impact of this mess on global equity markets was inevitable, and worse is to come. I highlighted this a few months ago in May at which point I offered the view that equity markets were highly risky.

So where do investors go from here and how will this affect our investment strategy now and the decisions we must make?

In the short term (the coming weeks) I believe that equity markets will bounce back strongly. This is likely to be driven by political intervention, which is already apparent in Europe with the European Central Bank buying Italian and Spanish Treasury Bonds.

It's possible that we will see something similar in the United States before the end of August, perhaps a third round of quantitative easing (QE3) where the Federal Reserve injects cash into the economy by buying assets like government and corporate bonds in an effort to stimulate economic activity. Barrack Obama has an election to win in 2012, so strong political leadership is critical - on both sides of the Atlantic.

Of course such political intervention is only a short term sticking plaster over the problem. However, it will have a positive impact on equity markets and investments are therefore likely to increase in value from present levels in the coming weeks. The bounce up could be as spectacular as the recent sell-off. This will ultimately offer opportunities to move investments from equities to the comfort of cash positions before the real storm takes place. The horizon looks very bleak indeed.

Sovereign debt has to be repaid for these problems to be finally resolved. The alternative to debt repayment is for governments to default on their debt and I have no doubt we will also experience more than one instance of debt default before the end of 2012. We can also expect that governments will use inflation as a part of their plan to resolve matters because inflation devalues debt.

Paying off the debt is down to us. We will pay more or the same amount of tax for less in the form of public services and state benefits. The implications of deficit reduction policies in the UK, Europe and the United States and their effect on equity markets are serious.

Newsworthy pay freezes in the public sector are I believe being silently matched in the private sector by the majority of employers. Even if private sector employers have the confidence and the scope to offer their staff pay increases, why would they in these uncertain times? It's unlikely. As redundancies in the public sector increase and new employment opportunities reduce will these be replaced by new jobs in the private sector? Also unlikely. We therefore face the very potent combination in the coming year of rising unemployment, stagnant levels of income and the rising cost of living owing to higher levels of inflation. The effect is less spendable income. Another recession is to be expected, right across the world's developed economies. Expect also some substantial falls in equity market values in the coming year.

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Under these circumstances our top investment priority and our strategy for clients is not to lose any money in the short term. Consequently we are advising our clients to move investments to short term cash positions and batten down the hatches. We also believe that it is a sound strategy to target inflation as an investment return and using specific investments funds to achieve this. The risk to capital invested in this way is if inflation were to fall in value. This is possible in the very short term, but in my view not possible in the medium term and beyond.

I recommended this to our clients in January and the combination of funds we recommended are showing increases of 7% and are a very low investment risk.

There will be huge opportunities to make good investment returns when these storms pass, but only if investors are able to buy into the markets at the lower levels. Moving to cash positions in the short term is therefore recommended, but timing is everything.

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