Schaefer Financial Management Limited
Chartered Financial Planners

1. Medium Term Outlook – 14 October 2011

The primary objectives of the Wealth Management Service are:

1. to protect the capital you have built up, and
2. to provide long-term growth ahead of the rate of inflation.

When there is a conflict we sacrifice growth in favour of protection.

2. Short Summary

2.1. Key Points

- After the savage falls from August, we may now have floor under share prices. However, they have risen too strongly recently and a pullback is on the cards. We may then see the yearend rally starting in earnest.
- If that is the case, it will be time to increase equities and cut back a bit on fixed interest.
- The current rally isn't anything of substance though and is largely down to market rigging by Central Banks. There has been little volume in the rises and this shows that few are buying. In contrast, falls in shares has seen large volume so I am doubtful about how far the rally can go.
- We still have nightmare problems with European debt and European banks. I don't much fancy skating on thin ice. I'd much sooner invest once real concrete action to clear the problems has been taken, rather than investing based on promises of future action. Words come cheap, especially when uttered by politicians.

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- It is still a waiting game until it is safer to invest. The upside potential for shares is pretty limited but the downside risk is horrid.

2.2. Action Points

- No action is required at this time.

- We may beef the equities up and reduce fixed interest towards the end of the month. It is too soon to do so at the moment.

3. Detailed Investment Update

The US, UK and Europe are just printing/borrowing more money all the time simply to keep the edifice from toppling over. As a result, we cure nothing and simple rack up yet more debt to be repaid out of future money.

3.1. Financial Markets – Short Term

It does look more and more like we have a temporary bottom at 4950 (FTSE 100) following the current plunge in share prices, and a reasonable short-term rally has built from here (now at 5490). How high markets go beyond this is anyone's guess and it will probably depend upon how much more newly printed money is dropped into shares prices.

Historically, September has often been the bogey month with large falls in equity values, while October has seen the bottom of the falls and the start of the recovery. An awful lot of money has been spent by Central Banks rigging the markets to prevent a meltdown in share prices. There were 5 occasions when the Central banks dumped money into shares to create a 'whipsaw' more like whiplash effect, reversing share collapses; last Friday for example the market moved 4.6% in around 35 minutes. We therefore got off relatively lightly during September when we consider the falls that could have happened.

November, December and January have traditionally been some of the best months for shares. So the odds are starting to swing in favour of rises rather than falls and we need to take this into account. The big question is how high can share prices go and what will happen next year?

We will soon be running up into massive resistance around 5500/5600 on the FTSE 100; if we break through this then we could rally all the way back up to 6100. However, following the big rally in shares over the last few days the markets are getting very overbought. Now is a good time for a pull back in prices, and in such a volatile market we may still have one last plunge to the bottom of the current trading range (4950) before we move higher.

The main problem that I have with the current rises is very low volume in the financial markets, pretty much all of the trading volume is from computer trading systems run by banks. No ‘real’ investors are actually buying at the moment.

In the following sections I take a look at the big issues currently affecting markets. We then draw some conclusions by looking at different time frames.

3.2. Financial Markets – Medium Term

Having looked for equities to collapse down to around 4500 on the FTSE 100, I now don’t expect this to happen in the short-term. It is clear that Governments will keep dumping money into share markets to prevent falls, so we should have a solid floor under prices at 4950.

The current situation is rather like the period from January 2011 to August 2011 where repeated intervention resulted in the FTSE 100 bouncing off the 5850 level 6 or 7 times before finally collapsing through in dramatic fashion during mid August 2011. Unfortunately, that’s what I expect to happen again this time – we plunge to new lows sometime in the Spring next year.

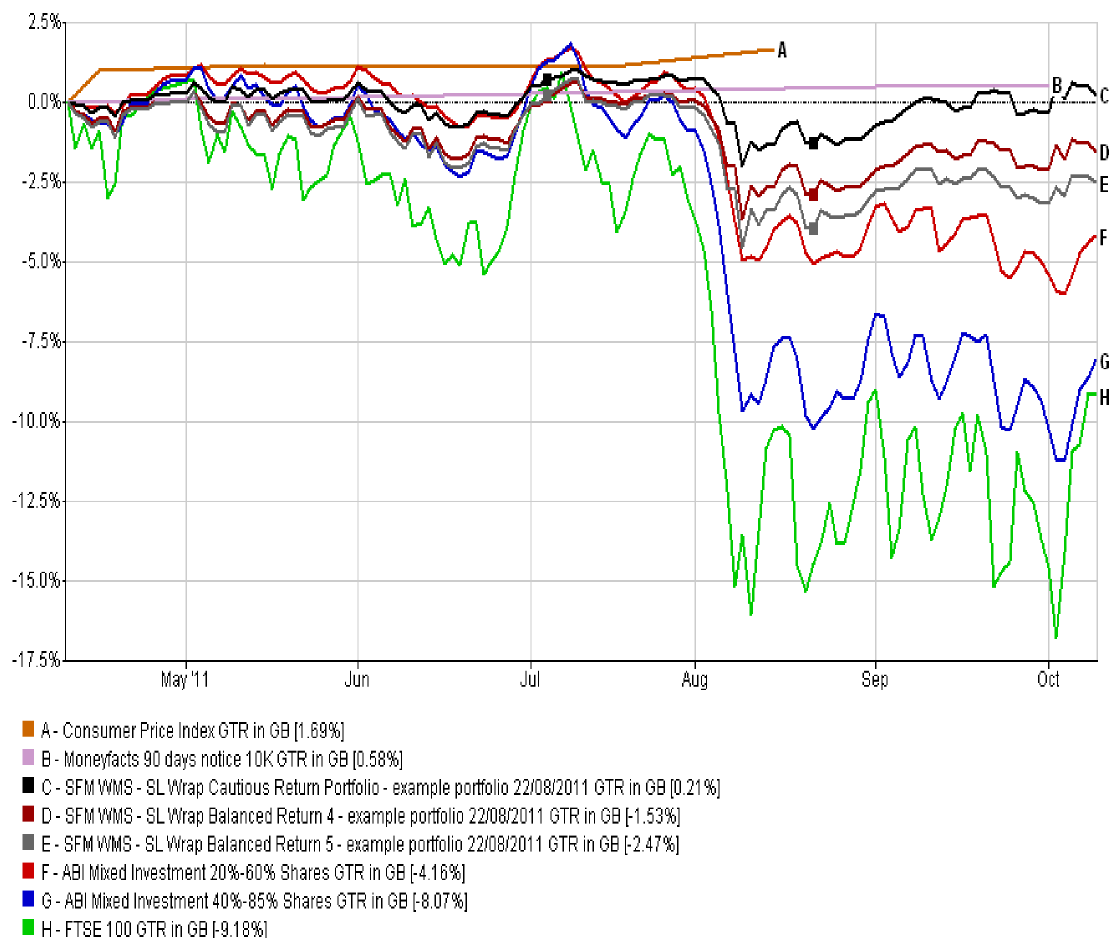
None of the actions being looked at anywhere in the World involve ‘clean sheet’ start again write offs of debt. So the World remains burdened by debt financing costs. We can look at the chart of the Japanese zombie nation which also failed to deal with its debts:

So the medium to long-term position looks very difficult and we still expect equities to make new post March 2009 lows during next year. We are still in an equity bear market that started in 2000 and the FTSE 100 index is currently a staggering 21% below its peak in 2000.

Until we find a way of taking the debt burden off people's shoulders then it is difficult to see how we can avoid drifting sideways for years pinned down by the cost of personal, business and Government debt.

3.3. Schaefer Short-Term Performance

It is useful just to provide some information on the current performance of the Schaefer example portfolios.



11/04/2011 - 11/10/2011 Data from FE 2011

Our general targets are the ABI Mixed 20-60% Shares and the ABI Mixed 40-85% Shares benchmarks. During the recent crisis we have opened up a healthy margin over the benchmarks, but this is now being cut back as a result of the rally in share values over the last few days.

3.4. We Need Statesmen not Politicians

Politicians' number one goal is to secure their own re-election so they can carry on draining the trough.

Statesmen take decisions, often at their own political expense, because they see the right thing to do for the people's future.

Sadly, it has been a very long time since we have seen a true Statesman anywhere in the World.

Until someone starts to take decisions to benefit us then we are likely to continue to suffer from falling incomes and rising prices.

3.5. Markets are being 'Rigged'

Money is being dumped into the market at key points by Central Banks in order to prevent shares from collapsing, and to make a handful of banks an awful lot of profit. In this way insolvent banks are being recapitalised with profits that come from losses suffered by investors who are shorting the markets.

Investment markets are supposed to represent life – when the economy is doing well then the majority of people have spare income that they are happy to spend. As a result, businesses make a good profit, which in turn feeds into higher share prices.

Politicians are currently trying to mask the true severity of the economic blight hitting the World economy. Why? If people's wealth is hit then they will blame the politicians, they won't get re-elected and the Eurocrats dream of a federal Europe is also at risk. The logical thing to do is boot Portugal, Italy, Greece and Spain out of the Euro but that means the end of the United States of Europe experiment.

Stable or rising share prices give the impression that things aren't that bad and will soon recover.

Rigged markets are dangerous because share prices don't reflect the true position in the economy.

That said, while the politicians struggle to come up with solutions to the problems they have created, 'kicking the tin down the road' can seem more attractive than letting markets resolve the debt crisis themselves by collapsing in a disorderly manner.

3.6. Quantitative Easing (QE)

UK QE

The Bank of England has just released QE2 of £75 billion and already we are seeing share prices and oil and commodity prices rise strongly, even though the economic fundamentals are actually getting worse. The money men are already talking of QE3 and QE4 early next year.

Europe QE

Europe is flooded with debt that Nations, yet alone banks, cannot pay for. So, instead of coming up with a solution to write off debt, European politicians in the form of Merkel and Sarkozy have 'solved' the problem and will almost certainly borrow/print more money in order to 'clear' debts within their own countries' banks. Perhaps they are thinking of a double negative in maths making a positive – borrowing more money actually reduces the total amount of borrowed money.

Europe has a solid and well respected track record of being able to agree on nothing. So it will be interesting to see what happens when the new 'debt solution' accord is rolled out by the 17 Nations at the heart of the Euro project.

There is also a further problem – France. Yes we all say in unison, never have liked the French – especially after last Saturday. France is the elephant in the room that no one seems to notice. French Government finances and the banking system are in a mess. Bailing out Greece, Spain and Italy is likely to cost France its AAA credit rating status and that poses dire problems for Europe.

Finally, Greece is going to get its next cheque from Europe even though it has failed on every count to meet the qualifying requirements set out by Europe. We simply can't afford to allow Greece to default. They are sensibly milking this situation for all its worth, getting the maximum amount of bailout before defaulting on their debts next year. Who can honestly blame them? I'm actually off to Greece next week to do some research and find out what the locals think as I think Greece is the key to how this whole situation resolves itself.

US QE

After the recent debacle over raising the debt ceiling, the US is in no position to print any more money. Obama wants to push share prices up because he hopes the feel good factor will get him re-elected. The Republicans want to get Obama out, which is why they have blocked measures to raise yet more debt to stimulate the economy. However, Obama has a little trick he can pull to push shares prices higher – POMO – Permanent Open Market Operations. Recently, several billion US $ has been released to a handful of US banks by the US Fed and the money has had an instant impact driving up shares and commodity prices.

The Republicans can't block this dripping out of POMO money because this is left to the discretion of the US Fed and doesn't need Congress approval. So Obama can improve his re-election chances but at the expense of the future because the POMO money has to be paid by someone.

The problem with QE/POMO is that it boosts share and commodity prices, this is super for the investment managers and bankers who are now looking forward to record bonuses again this Christmas. For the ordinary folk we face rapidly rising fuel and food prices and no prospect of a rise in incomes. One City fund manager kindly pointed out that his spending will increase dramatically as a result of his bonus, so the economy and 'ordinary people' around him will benefit greatly. That solves everything then.

It would have been far better if the money had been spent on a £75 billion jobs creation scheme – carrying out increased Public infrastructure works. This would pass the money outside the elite in the City of London and get the wider economy working and ultimately benefit a larger proportion of the population. The same thing applies to Europe and the US where an elite few benefit and the rest are left to suffer.

All this debt creation is part of a massive transfer of money from the poor to the rich, who pay little if any tax in any case. We have to pay for this with future inflation, higher taxes and reduced services and welfare State.

3.7. The Real World

The problem as I see it is that we are robbing Peter to pay Paul.

Huge special short-term tax reliefs in the US are causing businesses to bring forward capital equipment purchases into this year so they can get 100% tax relief on them. Business levels were already down this year but should now end the year level – so 'what crisis?' mutter the politicians.

The problem is next year, not only do we have reduced economic activity but we now have a pile of next year's business dragged back into this year. So next year has a double hole in it.

Bankers, politicians, economists and fund managers are all saying that it is time for consumers to do their part and start borrowing and consuming again, and then we can get back to 'normal'. There was a good article in *The Times* on Saturday about this.

The problem is that I think buying patterns have changed and I don't think we will be going back to the old ways any time soon. So we face a new paradigm,

one that's based on far less consumption, or certainly much fairer consumption.

This would mean a big change in economic models and future investment return expectations and this is not being factored into markets yet.

3.8. Fixed Interest Investments

Lots of data are pointing to a recession, possibly severe, for next year. Fixed interest funds have performed well and have limited losses on the Schaefer portfolios. With equities surging in the short-term, fixed interest funds are taking a breather.

A recent survey said that the UK was likely to enter a depression next year, that's much worse than a recession, fixed interest investment love depressions.

With so many unresolved problems like Europe, and the prospect of falling economic activity, I want to hold onto the fixed interest holdings a little longer just to see how things unfold over the next few weeks.

If equities fall back a bit before starting on the Christmas (sorry to mention that word) rally, then we may have a better point at which to lighten up a bit of fixed interest investments.

I still see fixed interest investments being a major part of the portfolios next year, especially if we slide into a further recession or even depression.

3.9. Overall Conclusions

I think we will see equities pull back probably towards the 5250 (FTSE 100) area in the next week or so before heading up towards 5850 for the year end.

Next year doesn't look good because I cannot see how we can magic away the debt overload. In 21 years the Japanese still have sorted out their debt mountain, in fact the situation is worse that it was.

Future investment returns are going to be dependent upon getting major moves in asset values right.