Weekly Digest
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Investec
Wealth & Investment

The weekly insight into world stock markets

Hurricane Watch

Most British people who were around at the time can remember what they were up to thirty years ago today when they woke up to the destruction caused by the Great Storm that swept across the south of the country. For many who worked in the City, the hurricane is inextricably linked to the stock market “Crash of ‘87” which started three days later on Monday morning. Coming just a year after the “Big Bang” deregulation of 1986, which ended the enforced separation of brokers and market makers, this was the first big test for the new “dual capacity” regime. It’s possible that the storm exacerbated some of the market moves, but in no way can one say that it was a cause of the crash. Trouble was already brewing on the other side of the Atlantic.

I was working for the stockbroking arm of Smith New Court in New York at the time. (The other side of the business was the old Smith Brothers jobbing firm). One of our sector analysts was over on a marketing trip and in the middle of the afternoon we were in the office of one of my clients. As the others were busy discussing the nitty gritty of Telecoms stocks, my eye was distracted by the Reuters monitor on the side of the client’s desk. The stock market was going down and down, and when the Dow Jones Industrial Average had fallen by more than 100 points (@4.5%) for the first time ever, I interrupted the conversation and said: “I think you’d better look at this. Your stock calls might be about to become irrelevant”.

Equity markets had already been skittish for a few days. They had been steaming ahead for the first half of the year, driven by liquidity, financial sector deregulation and a healthy dollop of speculation. Remember the film Wall Street, and its strapline “Greed is Good”? Although not released until December 1987, it was conceived and filmed during a rampant bull market – the S&P 500 rose 228% from its 1982 low to its August 1987 peak. However, the market had been doing its best to ignore the more negative factors.

Primary amongst these was a growing policy disagreement between the US and Germany. The US was accusing Germany of not doing enough to stimulate its economy, which might have helped to close the burgeoning US trade deficit; Germany was accusing the US of being too profligate. 1985’s Plaza Accord to reduce the value of the dollar was in danger of becoming too successful, and itself had been superseded by the Louvre Accord of February 1987, which attempted to stabilise the dollar. There was a threat of inflation in the air, a threat that was all too real after the experiences of the 1970s, and bond yields and interest rates were on the way up. Ally all those factors to a stock market that looked expensive – maybe not so much by today’s standards – and the stage was set for a setback.

There are obvious similarities with today, not least in full valuations and the threat of tighter monetary policy, even if it will still be exceptionally loose by historic standards. But, more encouragingly, central banks are now much more coordinated in their views, and appear paranoid about the threat of a market setback, let alone a crash. Indeed, this attitude first manifested itself in 1987 under the leadership of new Federal Reserve Chairman, Alan Greenspan. Interest rates were cut aggressively in the wake of the Crash so as not to allow the travails of financial markets to spill over into the real economy. The “Greenspan Put” was born, and exercised again after the Savings & Loans crisis, the Long Term Capital Management collapse, Asian Crisis and the internet bust. A case can be made that this behaviour led directly to the Financial Crisis, as market participants expected the Federal Reserve to provide support against any upsets.

Another parallel that can be drawn with today is the development of new financial instruments. In the 80s it was index futures and computer-driven portfolio insurance products that were held to account for helping to exacerbate what perhaps should have been a more measured fall. Today, the fear still centres on computer-driven trading, which now accounts for the majority of daily turnover, and also the growth of, for example, Exchange Traded Products. Here, there are worries that liquidity mismatches might arise between the funds and the underlying stocks – not to mention the fear that unsophisticated buyers might have been lured into instruments that carry more risk than they realise.

1987 was also the first truly coordinated global crash. International diversification was of no use. In fact, some markets, notably Hong Kong, failed to open for several days. The world is an even smaller place today.

So should we fear another Michael Fish moment? One thing is clear, and that is that the levels of optimism and euphoria seen in 1987 are today notable by their absence. It’s hard to recall now that in the UK the FTSE 100 Index rose a stunning 45.5% from the start of 1987 to its July peak. It was still up 36% by October. What the market achieved in six and half months in 1987, it has taken six years to achieve today! And even if the Bank of England puts up the base rate by 0.25% in November, that might well be it for a while.

Crashes are rare beasts, and it takes an unusual set of circumstances to create them. Of course, we never say never, but, at the risk of writing my professional epitaph, there is no particular reason to see one developing imminently.

Finally, on the original London Underground map, none of the stations have apostrophes in their names. This week, by what name is turdus merula better known?

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FTSE 100 Weekly Winners

Burberry Group	5.3%
Reckitt Benckiser Group	5.1%
Whitbread	4.3%
TUI	4.2%
St. James's Place	4.0%
Barratt Developments	3.8%
EasyJet	3.7%

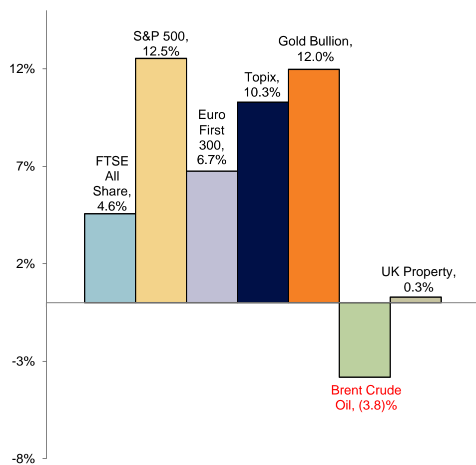
Source: FactSet

FTSE 100 Weekly Losers

GKN	-10.7%
Mondi	-9.6%
Smurfit Kappa Group	-6.7%
Next	-4.9%
Standard Chartered	-3.5%
BT Group	-2.9%
ITV	-2.9%

Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months

Source: FactSet

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