**<u>MONEY BOX</u>**

**Presenter: PAUL LEWIS**

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LEWIS: Hello and welcome to this special edition of Money Box to discuss our pensions, our savings and our mortgages after 4 weeks of turmoil on the financial markets. It's not just that the price of shares in London has fallen; it's the volatility, the up and down movement which saw prices plummet by 4% on Thursday only to rise back nearly as much on Friday. But they still finished 10% down on the levels seen in June and July. The source of this uncertainty is the United States, so let's go live first to New York to talk to Bob Brusca. He watches the markets closely as Chief Economist of Fact and Opinion Economics. Bob, share prices ended up in New York last night. Was there a sense there the problem is over or not?

BRUSCA: Oh I don't think you can solve this problem with one nice rally on Friday, but it was a good move by the market, it was a strong move, it was widespread. Markets still have undergone a big adjustment and there are still a lot of questions about the economy, about whether the problems in the real sector of the economy will spread, and there may be more work for the Fed to do.

LEWIS: Now the Fed, the Federal Reserve, the Central Bank in your country - it cut one of its interest rates, the one that it uses to lend to banks, by ½%. Did that have the effect it hoped for? Did it steady things as much as it wanted?

BRUSCA: I think the Fed would have to be very happy with the result. This is a very technical sort of insider rate, as you describe it. It's the rate that the Fed uses to lend its banks. It's not a rate that bank lending to the public depends upon. So there really isn't much in the way of interest rate consequences, but it should help some of the financial institutions that have had a difficult time get funding that otherwise wasn't there. So the Central Bank is really helping to fund the banks that in turn they hope will help to fund the public.

LEWIS: But it was a hint, wasn't it, that when it next comes to set that main rate that affects lending to the public, that will also be cut?

BRUSCA: Well the Fed had a statement, along with making this policy move, that said that basically the downside risks to growth had increased appreciably and it talked about how some of the financial conditions had deteriorated. And these are the kinds of things that it would say before it touched rates, but still it hadn't made the decision to cut the rates to the public and so we can only conclude that the Fed is still watching and waiting and hasn't seen enough. It would have to see something more or different before it would follow through and have a rate cut that would affect the public rates - the rates that we lock, the so-called base rates - in our case the rate for federal funds.

LEWIS: And if it was a reasonably good day on Friday, what's your expectation for Monday - I mean first Japan, which opens of course first, and then New York as the last one to open on Monday?

BRUSCA: Well Japan has different problems. In Japan, basically their stock market sell off has not really been part of the global sell off. It has had to do with the fact that the yen continues to rise and that this is putting pressure on their exporters. So the rising yen is really the problem. With the Fed you know perched to perhaps reduce rates again, the yen could be poised to rise some more, so that I don't think Japan is out of the woods.

LEWIS: And New York on Monday briefly?

BRUSCA: New York on Monday, I think you'll probably see some follow through. I think you'll see New York continue to go up.

LEWIS: Okay, Bob Brusca of Fact and Opinion Economics in New York, thanks. Well that is New York, but how does this uncertainty cross the Atlantic so swiftly and affect share prices here in the UK? Evan Davis is the BBC's Economics Editor.

DAVIS: Well it starts with some very clever people who lent money to some not so very clever people who didn't pay it back in the United States mortgage market.

LEWIS: These are the so-called sub prime mortgages to people who've got a bad credit rating?

DAVIS: Indeed. They lent money to people who were highly risky. What they've then done of course is parcel up the debts that they've made, put them into very complicated forms, collateralized debt obligations and the like, sold them on and these dodgy debts have found their way into the balance sheets of financial institutions and hedge funds all around the world. Now that then turns into a problem in the market for second-hand debt and that then begins to make banks worry about quite a lot of the credit they're getting. It makes it difficult for them to make loans and to sell those loans on into the market. So you have the so-called credit crunch in which lending is very difficult, so in a way one crisis spirals into other crises and begins to lead to quite a lot of ructions in the market.

LEWIS: But why is it that these very complicated debt arrangements affect share prices here?

DAVIS: It's a very interesting question that. The amount by which our share prices are swinging are vastly greater than the amount of defaulting debt on sub prime mortgages in the US, so something must be going on. Part of it is that there are a lot of these hedge funds who are losing money on defaulting debts, who find themselves short of cash. They borrowed money with terms and conditions. You have to make sure that the borrowing is not a huge proportion of your total fund. So they've lost money on sub prime, they're in breach of their loan terms, so then they have to sell shares to get the cash to pay back the loan.

LEWIS: So because they're selling shares in vast quantities, that's pushing the price down because there are more sellers than buyers?

DAVIS: Indeed so. You could get into some quite perverse things in which they're selling shares in order to find cash and then their fund is going down and so they're having to sell more shares to meet new payments on their loans. But there's another reason too. There's if you like a fear generally that the economy will take a dive as a result of this, so we can become scared that American consumers won't spend as much, so that means we'd better mark down the shares because companies won't make as big profits. And then there's the issue of lending more generally. Many of the stock market values out there have been propped up by companies borrowing money, private equity companies to buy shares to take over companies, so if the lending that they've been using to pay for the companies they wanted to buy and take over diminishes, then the share prices begin to fall. So it's quite interesting that there are a number of ways in which a mortgage issue extends to the debt market, which then finds its way into the stock market.

LEWIS: Is this over or is it going to get worse?

DAVIS: I really don't think I know the answer to that. Ultimately we have enjoyed quite a long period of strong growth on the back of easy credit. What the world is going through is the adjustment from that period to the new period when inflation has been a little bit more of a problem and central banks have had to say the party's over, guys. We've seen households having to deal with it in their mortgage payments, we're seeing financial institutions having to learn to deal with it. And all of this is people just feeling their way to a new equilibrium and I don't quite know where that equilibrium's going to be.

LEWIS: Evan Davis. Well to help us feel our way towards it, I'm joined by four experts on UK markets and the economy. Bob Parker, you're responsible for hundreds of billions of pounds of investors' money. You're Vice Chairman Credit Suisse with responsibility for its asset management. We've seen the value of shares in London fall about 10% in 2 months, but markets go up and down. Is this really as big a deal as we're making of it?

PARKER: Well let's not forget that we've had very strong equity market conditions since March 2003. This is the third correction that we've had in equity markets over the past year and a half. This correction in fact is much smaller - so far - compared with a number of other equity market corrections. And if we look at a number of markets around the world - notably in emerging markets but I would also add the US market and the German market - we're still up year to date. Where this is serious, as Evan was saying, is that we've got severe dislocation in the credit markets and there is a real problem in the US housing market.

LEWIS: You call it a correction. Does that imply that you think shares are roughly where they should be now? In other words, we've had the fall; we're now in a period of calm?

PARKER: If you look at the valuations of equity markets around the world and you look at a number of indicators on how to value those shares, they are cheap today relative to history and in addition they're cheap based on an analysis of corporate earnings growth. So I think probably over the next few weeks we're going to be forming a base.

LEWIS: Okay, well let's move onto Justin Urquhart Stewart who's also with us. Stay with us, Bob. Justin, you're a Director of Seven Investment Management. You and I have talked about markets for many years. So how does this feel to you compared with 1987, the crash, or 2003 when markets really did plummet?

URQUHART STEWART: Yes they did and those ones were actually really quite dramatic and you see 2000-2003, that was a 65% drop in the market. And what was particularly worrying about that …

LEWIS: It was over 3 years though.

URQUHART STEWART: Oh it was over a 3 year period, I mean one of the slowest crashes one's ever seen, but what it did was decimate a lot of people's pensions because of the focus that was there in equity markets in pensions. Now we're in a position where actually a lot more people have been given proper asset allocation, so they've got a broader range of asset classes, so only a proportion is actually being hit by this. And so I think what will be interesting to see is actually how these other asset classes have behaved, so people actually in their portfolios have probably had less volatility.

LEWIS: Yes, though other asset classes - I mean commodities, property - they're also down, aren't they? There's been quite a fall in a number of things. But you can now get more than 6% in an instant access cash account - Sainsbury's Bank, ICICI, IceSave - and on 1 year bonds, if you tie it up for a year, you can get more than that. Now if you can get those kind of no risk guaranteed returns, why would you invest in shares?

URQUHART STEWART: Cash is a very good asset class. There's nothing wrong with it at all. And so for people who are nervous at the moment and don't want to go into the market, a very wise decision to stay in cash. However, as part of a long-term growth portfolio, you want a range of asset classes, including cash, and so your manager will probably have been increasing cash over the past few months.

LEWIS: And just briefly a couple of e-mails from listeners a bit nervous about the safety of banks. They've heard things, they've read things. Is cash in the bank safe?

URQUHART STEWART: I'm trying to think of the last time a British bank or building society actually went bust and people lost money on it. It wouldn't be allowed to happen, frankly, and I can't see any of them in that position.

LEWIS: And Rosemary Radcliffe is here. She's an independent economist, often been on Money Box. Rosemary, a pretty big fall in the market. Is it really being driven by these concerns about US mortgages or are there some economic problems here that are driving it down?

RADCLIFFE: I think the US mortgage problem is the primary driver of this. I think one could argue that some adjustment was probably due anyway in stock markets. But against a background of a reasonably strong global economy and indeed a pretty strong European economy now with Germany doing quite well, our economy here is slowing a bit, the only worry really in the underlying situation I think is the US.

LEWIS: Yes, but you say a strong economy, but it is built on debt a lot, isn't it? The success of the British economy has been we've all borrowed, used our credit cards and gone shopping and kept the economy buoyant. Is there a danger that's going to slow down and come to an end, the time of easy credit?

RADCLIFFE: Well I think it is slowing as we sit here. We've had interest rate increases from the MPC, rates now up to 5¾%, and that means that the UK economy *is* slowing. Yes, there's a lot of debt, but at the moment at any event the economy is strong enough I think to support that because people's earnings are sufficient to be able to continue to service it.

LEWIS: And very briefly, you mentioned interest rates. In April you told us that we wouldn't see 6%. Most other people thought we would. Does this mean you're feeling pretty chirpy now that we're not going to get another rate rise?

RADCLIFFE: Well Paul, as you know, I tend to be a dove on interest rate policies and I just very much hope that rates will never go up further than is absolutely necessary. I think 5¾ was enough and I thought it before we went into the events of recent weeks, so I'm sticking by it and I hope the MPC does too.

LEWIS: Listening to us is David Kauders. He's a partner with Kauders Portfolio Management in Reading. David, we've heard some fairly hopeful views about the future. Are people here and investors right to think that things are smoothing off now?

KAUDERS: Well I have some concerns about what's going on because I think we've been measuring growth based on all this easy credit that we were hearing about earlier in the programme, and the problem is that the easy credit is going to slow down, there's going to be less of it around, credit is going to become scarce. It may also become cheaper as interest rates are forced down to try to contain the problem, but fundamentally we can't go on buying economic growth through lashings of easy credit and therefore we're dealing with a fairly fundamental change in conditions.

LEWIS: And are investors right then to be moving out of shares into cash, something that's a bit more certain?

KAUDERS: Basically yes because stock markets, as I see it, are far too high. There will be a rally over the next few weeks - I agree with Bob about that. The rally will be caused by the injection of credit that's happened in the last few days and that rally that's coming over the next few weeks is really a very good selling opportunity - sell into strength before the next surprise, which will be as surprising as the whole sub prime business has been over the last few weeks.

LEWIS: Well not a surprise to you obviously. Do you think shares are going to go down again?

KAUDERS: I think we shall see a rally in shares perhaps through September and then we shall see another decline based on a completely new story, new paradigm, new set of issues that we haven't thought of and we can't really anticipate. But fundamentally I don't go with the argument the economy is strong. The strength is artificial. It's looking backwards at past reported corporate earnings based on easy credit. Markets look forwards, markets discount the future and the markets are signalling to us loud and clear that there are a few problems out there.

LEWIS: Bob Parker, do you see those signals?

PARKER: One point I would like to make is this issue of where do you have a borrowing bubble and clearly you've had a borrowing bubble in the US mortgage market.

LEWIS: And this is because they were lending to people who absolutely couldn't or wouldn't pay the money back? They were silly loans.

PARKER: Yes, the default rates in the sub prime market at the moment are around 13% and we think they're probably going to go to 15% to 18% over the next 18 months, so clearly there's a structural problem there.

LEWIS: Two fifths of them weren't going to pay the mortgage back roughly speaking?

PARKER: Over the next 18 months I think that's a reasonable forecast. But I think one point that needs emphasising is that if you look at global companies their degree of borrowings are very low, their cash flows are very strong, their profits are very strong. So, yes, there is a problem with over borrowing by individuals and people who've got mortgages, notably in the States, but the corporate sector is in very good shape indeed.

LEWIS: Rosemary, you're backward looking; David Kauders is forward looking or markets are. Is that how you see it?

RADCLIFFE: No, I don't think so. I agree very much with what Bob's just said. I think our underlying position in the corporate sector, certainly in the UK and in the US as well, is relatively strong. I would agree that I think that there's been too much lending by too many institutions to too many people who shouldn't be borrowing and what we're seeing now is the markets recognising that and hopefully will do something about it.

LEWIS: Yes and we are seeing that already, Justin, aren't we? We're seeing mortgage rates going up for people who are bad risk. A lot of these sub prime mortgages in the UK are being pulled completely and then put back on the market at 1% higher, so we're seeing a tightening up of mortgage lending.

URQUHART STEWART: Indeed so. And this will be a concern, particularly for those 2 million people who will be coming off fixed rate mortgages in the next year. What they're going to be finding of course is they will have a significantly higher cost coming out of their monthly salary after paying tax and that will impact on the UK economy especially. 60% of our economy is based upon consumer spending, so we're at the level now of servicing debts that we were back in the early 1990s where we saw a retail recession. Now it doesn't mean necessarily we have to have a retail recession, but we're probably due for a slowdown anyway.

LEWIS: Yes, so you're not predicting a recession at this point?

URQUHART STEWART: No, I'm not predicting a recession.

LEWIS: You're saying it's a sort of …

URQUHART STEWART: But the markets will look to try and take that into account, so the growth will be I think pretty slow.

LEWIS: David Kauders, are you a bit of a lone voice in the wilderness predicting a further, quite significant fall in markets, in share prices later this year?

KAUDERS: Well to a certain extent, yes. There are other voices that have been saying be careful, it's not that easy. But there's always a problem that there's the weight of money out there that is invested and people feel they need to justify why they're there and why they're doing it. I see conditions changing very fundamentally in the same way as they did really in about 1990 when we moved from high inflation to disinflation and interest rates came down and the rate of inflation came down and we had a new paradigm for the next ten or twelve years. Now we have another new paradigm which is credit becoming scarce but cheap, and that has huge economic effects that really we aren't beginning to grasp other than saying yes it's going to change a little bit. I think there's far more than just consumer borrowing at risk. There's all the borrowing by hedge funds, there's all the borrowing by private equity. It may not be corporate straight, but there's hidden borrowing all over the global economy, everywhere.

LEWIS: We'll come back to that in a moment, but we mentioned pensions a while ago. One effect of course of the falls in share prices has been to plunge the UK's final salary pension funds back into deficit having too little money to meet their obligations. I asked Marcus Hurd, who's Senior Consultant and Actuary at Aon Consulting, how the volatility had affected pension fund deficits.

HURD: Just over a week ago, last Wednesday in fact, pension schemes were pretty much in balance, but at close of business on Thursday they were over 26 billion in deficit and close of business yesterday it was just under 20 billion.

LEWIS: What significance does this have for pension funds? Because they've been used to being in deficit - there was a short magic period when they weren't, but they have been in deficit for a long time?

HURD: Yes they have and I think we have to see the bigger picture here because although the deficit's around 20 billion, that's half of what it was at the beginning of the year when it was over 40 billion and a quarter of what it was in January 06 when it was over 80 billion.

LEWIS: So a lot better than it was. But of course we don't know it's over yet, do we?

HURD: No, we don't. The market would have to fall a considerable amount before it reached the levels it was at the start of the year. We also have to remember that pension schemes are a long-term investment and in fact one week over the course of a 30 year investment is a remarkably small period.

LEWIS: Marcus Hurd. Well with me is Joanne Segars. She's Chief Executive of the National Association of Pension Funds. Joanne, 20 billion deficit. It sounds a very big number. Does it do much for confidence in the pension system?

SEGARS: Well I think, as Marcus said, the real thing to remember is that pension schemes are long-term investments and they're looking to pay liabilities that are stretching over 30 or 40 years. And that's how pension funds will set their investment strategies. They won't really set their investment strategies according to you know one or two day shifts in the market. So I think there's no reason for scheme members to think that their pensions are at risk just because of the changes that we've seen in the markets over the last few days. And, as Justin said earlier of course, you know pension funds don't put all their eggs in one basket. Not all pension funds are 100% invested in equities.

LEWIS: There was a move though, wasn't there, some time ago - and Boots did it in particular with their pension scheme - to move *all* their money out of shares and put it into other things that were guaranteed because pension funds or final salary pension funds have clear objective - they've got to pay out a certain amount to a certain number of people over their lifetime, so they need money that's guaranteed, not at risk on the stock market.

SEGARS: Yes and what we've seen… I mean Boots at that time were sort of the lone voice in the wilderness, but what we have seen over the last few years is pension schemes, investments in equities falling and the investments in bonds and other investments increasing. And that's partly because those of us who are in those pension schemes are getting older and that's part of the liability schemes have to match.

LEWIS: We've also seen a lot of big companies who seem committed to their pension fund putting an awful lot of money in. I mean deficits didn't disappear because of rising share prices. They also disappeared because a lot of money had been pumped in. Are we going to carry on seeing that or is this market turbulence going to make more companies think oh blow this for a lark, I'm going to get out of this, it's just too much worry?

SEGARS: Well what we've seen since … I mean the good news is that what we've seen since sort of 2000-2003 is the wave of scheme closures really slowing and we have seen, as you said, schemes - Sainsbury's, Marks and Spencer's - putting big, big amounts of money into pension schemes. This year we've had a record amount of contributions - 13 billion - just for the largest pension schemes, the FTSE 100 schemes, going into pension schemes. So I am not sure that we will see a new wave of pension scheme closures.

LEWIS: And, briefly, people who are in a job where there is a pension scheme, should they join it; and if they're in it, should they stay in it?

SEGARS: Well inevitably I'm Chief Executive of the NAPF, of course I'm going to say yes.

LEWIS: Okay. Joanne Segars, thanks very much. Well comforting thoughts for people in salary related pension schemes, but of course Justin not such good news for those with personal pensions or indeed funds invested in shares or people paying into a child trust fund? People must be beginning to wonder should I be putting this money into shares given this turbulence on the market?

URQUHART STEWART: Well the thing about investing in shares, it's a medium term investment, by which I mean this is at least 5 years. So if you're worried about short-term issues now, then frankly you don't have to invest now, wait till it's a bit calmer. This market isn't going to get calm until we get the poison out and then identify the damage. We don't know what's wrong.

LEWIS: The poison being?

URQUHART STEWAET: The poison being how large these debts are and what the collateral damage is around it.

LEWIS: One of the problems, Rosemary Radcliffe, I suppose is we don't know where these debts are, do we? You're an economist, you study figures, but there are no figures on this.

RADCLIFFE: Well I think this is absolutely right and I totally agree with what Justin says. I think a large part of the problem of volatility in recent times has been because people simply do not know where these bad debts have gone. They don't know how big they are and they don't know where they are. And as a result, you get a reaction which is, as Evan Davies said in his introductions, grossly out of proportion to the scale of the problem. Now what I think we need to think about is how to make this system more transparent. If we knew how these bits of doubtful debt are getting packaged up with other bits of really rather more respectable debt, then there wouldn't be the same degree of problem. There has always been throughout economic history periods where too much money's been lent to unsuitable people. What we're now doing unfortunately is, with all these fancy instruments as Evan said, covering it up and that really just leads to disaster. We need to have a great deal more transparency in the system in my view.

LEWIS: Bob Parker, what are you doing to protect your investors? What are your predictions for the next year or so?

PARKER: Well there are clear areas which are attractive and I would highlight the companies and sectors which are paying very high dividends at the moment. There are areas clearly where investors have to avoid and I think the … simply putting it, it's where you have areas of high default rates and where you have over borrowing. And I think what's going to happen is that markets are going to be driven more by real money investors and we are going to live in a world where leverage is going to be penalised.

LEWIS: Leverage being borrowing money?

PARKER: Over borrowing.

LEWIS: So basically you're saying back to basics, are you? Invest in a manufacturer that buys something and then makes it and then sells it at a profit and forget all these complex financial institutions that might be in difficulty?

PARKER: Well I'd like to pick up on Rosemary's point. I think one key theme for investors is do not invest in anything where there is no transparency, and transparency I think is a very important issue.

LEWIS: Justin, briefly where do you think things will be in 6 months?

URQUHART STEWART: I think we're going to be in a position where the economy, global economy will be showing signs of slowdown. I think the markets themselves will have actually sorted out where the poison has been. There will have been some notable hedge fund failures and some banks will have had some significant losses. But after that, then you'll actually have a market which will probably be looking a bit more stable - not going up at the rates we've seen before, and I think it will be looking a lot more defensive than it's been over the past 2 years. So people have to look through now to actually seeing longer term that you're getting those returns.

LEWIS: Thank you very much for that and thanks to all my guests. That was Justin Urquhart Stewart and also Rosemary Radcliffe, David Kauders, Bob Parker and Joanne Segars. That is all we have time for today. You can listen to the programme again at bbc.co.uk/m,moneybox. You can hear the Inside Money on long-term fixed rate mortgages that was going to be broadcast today on Monday afternoon at 3. Money Box is back in 2 weeks time. Today the producers were Jennifer Clarke and Lesley McAlpine and I'm Paul Lewis.