Business Strategies: don't assume the worse is not to come

It's easy to be blinded by the fact that the crazy stock markets of a year ago have risen dramatically and to presume that that means all is well; that's a single measure and the other indicators do not support that conclusion.

It might seem strange that we, a consultancy that advises financial institutions, commercial concerns and governments on matters relating to money laundering, fraud, corruption and related topics would pay attention to economics. However, economic conditions create the environment in which economic and financial crime flourishes. And so what happens in the real world is in fact central to how we assess risk, monitor it and help our clients to manage it.

And we have several measures that we have developed that provide us pointers that are, generally, more accurate than those of the economists that governments rely upon.

In this article, I outline some of the indicators and what the tell us.

These results are fed into a matrix, along with the results of other indicators, to provide a "zone of risk" that we can regard as a general dynamic in economies and which can be extrapolated into the potential for not just financial crime, but also business risk.

The first indicator is to look at retail sales. Retail sales arise, at their heart, from two things: available cash and available credit. What drives those sales are need, perceived need and desire.

Measures of consumer confidence relate to desire: they are concerned, mostly, with discretionary spending. But rather than nebulous consumer surveys, there is real, live, hard data available: define discretionary spending and see how those retailers are faring.

The answer is that they did very, very badly in the big-spending season of November, December, January (where religious festivals and other gift-giving events are clustered) 2009. In fact, when the stock markets were at their most volatile, investors sat on their hands just as much as families

did. Many retailers in the discretionary sector did not survive, or survived only by gnawing off their limbs. Downstream, manufacturers did the same: having turned the automotive industry into a fashion industry, the manufacturers were taken by surprise when people turned having a new car from desire to need. And the reality that bit hard was that most people do not need a new car. The so-called "luxury goods" sector found the same thing: if you can write with a two dollar gel pen; why buy a Mont Blanc? For us, an indicator was the number of people in meetings who used pens bearing hotel logos: these are people who were thinking twice not just about the capital cost of the pen, but even about its running costs - refills for an expensive rollerball cost a lot more than taking a promotional pen from the bedside table. Their expensive, expired, pens stayed at home.

Taking incentives to trade in older cars for new ones at the taxpayers' expense out of the equation because it distorts the figures, the sales figures for new cars do not look good. Without an ageing trade-in, buyers are still not buying new cars en-masse.

But if one looks at retail in general for the November/December/January 2010 period, they show a much more positive profile - on the face of it. But underneath, the figures are not good.

A sideways leap for a moment: tax holidays for struggling businesses are approaching their expiry dates. This is a part of the "stimulus package" that governments have kept quiet about. They are focussing media and public attention on, primarily, the money they are spending. But underneath it all, they are paddling like crazy ducks, trying to increase tax revenues and to prevent tax leakage. In particular what they are not doing is talking about renewing any tax holidays or deferments that were put in place during the past 18 months or so.

Jump back: retailers have posted dramatically higher figures for the second period we are looking at as against the first. How have they generated those figures? The answer is, largely, from unsold stocks from previous periods. This must be so for the simple reason that their own purchases in 2009 were so small compared to previous years. And they have made sales by heavy discounting. What does that mean?

It's simple: they have sold redundant stock at discount prices - much as they would have expected to do in the sales periods a whole year earlier. They have, in terms of purchases and sales, been holding station. But their fixed costs, and their financing costs, needed to be met and, except for interest charges, those fixed costs have not, generally, been going down.

There are exceptions: in the UK, the Blacks Leisure chain of sports and outdoor clothing retailers fell into administration. Again. With a large number of shops, many in arcades and malls already seeing retailers literally shutting up shop, some landlords agreed to give the administrators rental

holidays. But, in general, such holidays have been rare. And across the world, one can see both chains and individual shops that are now boarded up. This is not simple industry shake-up.

The problem with a food chain is that if one end is bunged up, it gradually chokes. That's what happened with the entire discretionary spending area. When consumers redefined need, manufacturers failed and so did the whole system in between.

In an inverse of the butterfly-wing anecdote, the results were felt in China where millions were thrown out of work, often without pay, because consumers in Europe and the USA wanted to keep moths in their wallets.

And the anchorages of Singapore were filled with ships standing, empty, with nowhere to go.

Manufacturing has not recovered. Almost daily, figures are produced showing that there is an increase in production, that more goods are being shipped. The reality is that these comparisons are not against the heyday but against the dismal lows as the recession was biting worldwide. The truth is that retailers are restocking to adjusted levels of sales and those adjustments do not mean full warehouses. Retailers do not want to be caught with vast stocks of 12 month old product being ditched at dramatically cut prices. Example: a pair of trousers, usual price GBP70 in a large UK department store in late November: sale price, plus special "one day only" discount - GBP19. That means one thing: the store is making obscene profits in its usual price or it is dumping stock. The latter is the most likely. Was the shop full? No, in fact it had barely a customer. Another branch of the same store was selling almost all its winter clothing with at least 30% off - at the start of the winter clothing season.

What happened was simple: shops competing for scarce spending competed on who could sell cheapest and who could start their sales soonest. And that was not only in the UK, we saw the same trends in the USA, Germany, Australia, Hong Kong, Switzerland, Singapore and Malaysia. In fact, only France, in particular Paris, seemed to have avoided being consumed by sale fever - at least until mid December.

Consumers became involved in a kind of Dutch Auction: if retailers were competing to drop prices, then delay would mean yet more reductions. For those that had time to visit shops on a regular basis, monitoring stocks meant buying before they ran out, or before special offers ended or gambling that the product would return at a price that was lower still.

By the end of 2009, there was pent-up demand for all manner of goods. Things that had worn out, or looked like wearing out soon, were moved into the need or the perceived need categories. Also, after a year of austerity, people wanted a bit of fun. And they wanted to give gifts. Whilst Christmas stockings did not revert to the contents of a pair of socks and an orange, they were certainly less crammed than before. Parents felt guilty that they had not provided more lavishly for children the previous year and made up for it.

But salaries had not gone up. The items that had moved from discretionary to perceived need were paid for in credit. Credit card spending in those three months has ballooned.

House repossessions have declined, in particular in the UK. But this is not due to the bank's sudden largesse nor to a sudden reduction in problem loans: it's due to government policy to compel banks to allow arrears to accumulate further before taking action and then for the courts to allow further accumulation if the borrower can make even partial monthly repayments.

That is sensible on many levels - but it also exceedingly dangerous. The government is gambling that less repossessed homes will mean a less dramatic slide in house prices - and in the UK house prices in some regions have actually increased in the past year. And the government needs house prices to, at worst, remain stable. The reason for this is simple: the UK government has a stake in more than 30% of all household mortgages through its ownership of various banks or chunks of them. And if the balance sheets of those banks comes under pressure, the government is going to have to either close the banks or shell out more money.

As an aside, what this means is that the UK Courts have become, in effect, an instrument of Treasury financial policy.

In the US, so far this year, 19 banks have failed. Last Friday alone there were four (see our sister publication www.bankinginsurancesecurities.com) . There is a different pattern to recent failures, compared to the 130 plus that failed last year: this year they are much smaller banks, some counting their deposits and "assets" in the low tens of millions. These are the banking equivalents of corner shops or "mom and pop shops." These are the banks that have mainly family and small business customers. If they are failing, it means that the grass-roots economy is failing.

But household mortgages are not where the shocks are going to be felt with retailers begin to fail in larger numbers. And that means that larger banks are going to fall under pressure again.

Banks, generally, like landlords: banks can see what their lending is secured on and they can (generally) see a revenue stream. Banks look at empty commercial property and see an opportunity to re-let; they do not see a threat to their own balance sheet. But that's exactly what is going to happen.

But there is oversupply in office, retail and manufacturing space. The manager of a luxury goods shop in a new mall in Kuala Lumpur recently told me that the shop does not cover its operating costs - and that's despite being in a rent-free term. Landlords give selected upmarket shops rent-free terms to create an image for their premises - and to encourage others to rent. But at the end of that rent-free period, the shopkeeper has to decide whether to stay on and pay rent on a shop that is already making a loss, or to leave. A survey of similar shops in another nearby mall shows that, at the end of the rent-free period, or rent-free plus tie-in period, those shops are moving to secondary locations within the mall or moving to new malls where rent-free terms are available.

The bottom line for banks is this: a full shopping mall is not necessarily a profitable shopping mall. Don't look at the numbers on rental deals, don't look at the "footfall numbers." Go to
the mall busy days and count carrier bags; look at the clothes people are wearing: can they actually afford to shop in that mall, or are they just there for the free air-conditioning?

Is that cynical? No - absolutely not. The Singapore government says that 50% of all Singapore's electricity consumption goes to run air-con; and 80% of domestic consumption. Keeping cool is a need. But air-con is a perceived need. If there is a convenient place where keeping cool is free, household air-con can be moved to discretionary spending. In poorer countries, such as Indonesia, Malaysia shopping malls are literally filled with people who buy nothing except, perhaps, a meal at a food court - the same expenditure as if they ate at a cafe nearer home - which culturally is the norm for millions of Malaysians.

Is this only in poorer countries? No: in winter in the UK, people crowd shopping malls because they are warm (relatively speaking) and dry. Again, count the carrier bags. If one looks at the UK retailers who posted the best results for Q4 2009, it's the one-stop-shops - food plus good-enough other stuff so customers don't need to go outside. The US saw the same. Woolworths, a century old UK chain, died because it had no focus - and because its shops were in high-streets not malls and it sold almost nothing that could not be tossed into a trolley along with the grocery shopping.

Across the USA, a similar trend has been identified with free wifi in coffee shops: for the price of a cup of coffee, jobseekers were hogging a table for hours whilst looking for work; many coffee shops are reducing the availability of the service or stopping it altogether. Hotels report an increase in their lobbies being used for ad hoc meetings by people: these turn out to be people who no longer have offices and work from home or a mobile phone, a laptop and their car.

So, with manufacturing figures still extremely poor, shipping figures barely afloat and retailers having sold off their cheap stock to people who have now spent their credit lines and therefore have nothing left to spend, where does that leave the recovery?

It's simple: it leaves it in a very precarious state. We will see defaults in loans on commercial premises: something that has been relatively rare in the past three years. Everywhere from hotels to factories, from retail to offices will see cost-cutting from firms that can move to vacancy caused by business failure.

The commercial lending arms of banks have not been severely tested in the financial crisis - and the comfort factor of buoyant stock markets has led to oversight of the looming problems in the commercial sector.

But there are signs: in the USA, commercial lenders that fall outside the FDIC regulatory regime have already failed, but with little public recognition. Investment funds (so-called hedge funds) all over the world are complaining that they are finding it difficult to raise capital - blamed not on the scandals in their industry but on risk-averse investors who prefer to put their money into state-guaranteed deposit accounts with retail banks.

This is where the financing that falls between bank and venture capital comes from - and if that is drying up, then commercial construction is facing problems that may, ultimately lead to abandoned projects as developers become insolvent.

The cycle is set to shorten: banks are at last coming to recognise that credit card debt might present every bit as big a threat to their stability as the mortgage crisis. They are therefore cutting credit limits, often to the amount outstanding, thereby effectively killing the credit facility whilst at the same time requiring a portion of a family's cash-flow be allocated to repayment.

This will lead to an increase in pay-day loans: a recent PBS report said that there are more pay-day-loans offices in the USA than there are Starbucks. There are more than 500 in Colorado alone.

Payday loans attract extraordinary amounts of interest: a ten-day loan can cost as much as 450% APR. That has a direct ability on the ability of the borrower to fund his next month's expenses. A proposal in Colorado, published recently, would limit interest rates to less than 40% APR. But the rates are high for a reason: the fixed costs of the service are the same no matter how large or

small the loan. A flat-rate service fee when converted to part of APR increases the percentage dramatically even though, in cash terms, it is a small amount. But, to people who are so short of money that they need to borrow as little as USD200 against next month's salary, a USD25 flat charge plus interest is still a significant blow. These are people who have used up all available credit. They are at the bottom of the financial pile.

But they are the engine of the economy: they still need to buy food, clothing, housing, transport - and their costs of doing so are a higher proportion of their income than for wealthier customers.

These are the people who have had their last splurge and are now struggling to pay for it.

We expect to see

1) a surge in credit card default in many countries in the next three to six months

2) an increase in personal bankruptcy as a result of inability to meet credit card, bank and other loans

3) a decrease in retail spending, especially on discretionary goods: budget products will sell better than premium product: the "you can live on it, even though you might not want to" scenario.

4) an increase in the closure of retail stores with a resulting stagnation in manufacturing

5) commercial lending falling into arrear and repossessions in the commercial sector

6) insolvency in the commercial property sector, starting with retail and moving onto factories and offices.

These are indicators affecting only a section of the economy, and on their own do not give a comprehensive picture. But they do provide a broad direction which we consider will increase the risk of a variety of financial crime as well as broad economic risk.

Of course, we could be hopelessly wrong.

But we weren't when we warned of a global crisis arising out of a bubble in US housing prices and poor quality lending leading to a housing price collapse that would cause contagion across the world. We warned of that in 2006, having been monitoring the situation since 2005. We tried to hold a conference in 2007 to explain how contagion works and what would happen: not a single ticket was sold.

Of course, we could be hopelessly wrong.

But why would you take that risk?

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