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Well, at least it's clear now. A significant part of the shadow banking system was a sham that was given legitimacy by the actions of the credit rating agencies. Following numerous mishaps over too many years, it is evident that these agencies are incapable of assessing risk correctly. To restore trust, they may well have to be nationalised and run by technocrats.

The banking system also needs to be overhauled. In time, pro-cyclical bank provisioning has to be phased out. Just as we as individuals are (or more accurately, were) encouraged to put aside a decent contingency during prosperous times, so should the banks.

The illusory prosperity of the last five years or so was based on a massive easing of credit standards. Credit provision will necessarily be more heavily regulated going forward.

Globally, government spending is set to rise sharply, whilst unpalatable given the state of many countries' finances it is necessary. In time, tax rises are inevitable.

The upshot of all the above, is that when economic recovery occurs it will be anaemic. I fear that governments' in the West have already crossed the Rubicon and decided that the only politically feasible way out of this mire is to inflate debts away by competitive devaluations and quantitative easing. They are probably right.

Thus, it is my belief that although we will skirt deflation this year, what we have to brace ourselves for is a prolonged period of genuine stagflation. This is where inflation rises at substantial rates whilst real economic growth stagnates.

In between times, expect markets to be volatile. The western economies have hit a brick wall. This economic decline is made up of two main components. Firstly, a structural decline in demand and secondly, a rapid rush to destock. As ever, investors find it difficult to disaggregate the two. This provides opportunities. Shortly, destocking pressures will abate significantly and this will be taken as a sign that economic growth can restart its onward trek. It will see some early cycle stocks

bid up until evidence appears later in the year that the 'recovery' cannot be sustained.

The good news is that many stocks are discounting poor outcomes already and offer compelling value. In addition, deeply discounted rights issues by companies with good franchises but stretched balance sheets are being supported by investors. This is an important part of the healing process. Furthermore, there are numerous large companies with overseas earnings, low debt levels, good cash flows, discretionary capex budgets, compelling valuations and good dividend yields which certainly appeal in this era of extraordinarily low interest rates.

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