Investment Bulletin

SAUNDERSON HOUSE

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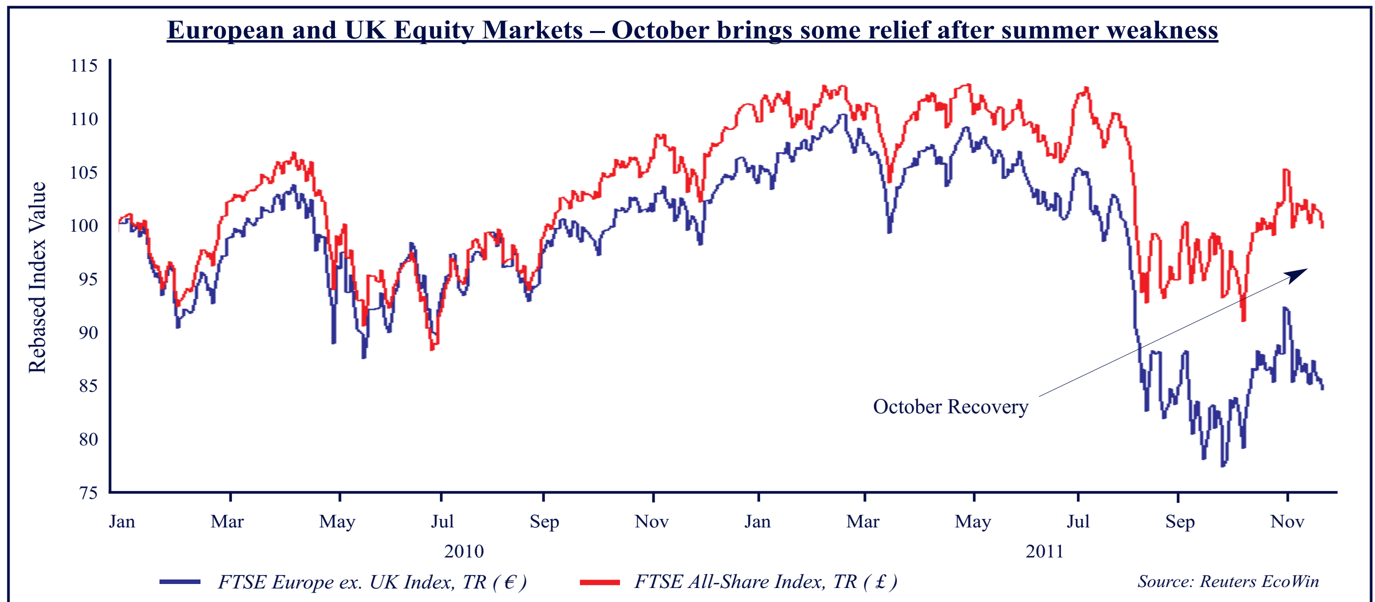
CONFLICT-FREE FINANCIAL ADVICE

FOR EVERY COMPLEX PROBLEM...

The European debt crisis continues to dominate the global economic and political landscape. The much discussed and much feared contagion from Greece to larger eurozone members seems to be occurring. Italian 10-year government bond yields are trading around the 7% level at which many commentators believe the country's public finances are unsustainable. Of key importance here is that Italy is widely considered to be too large to save. Italy is the world's eighth largest economy and, at €1.9tn, the value of its public debt pile is larger than that of any other country apart from the United States and Japan. So are we now back in full-blown financial crisis? In our view, the answer is 'no'. Below we explain why.

Since our last update, sent to clients at the end of September, political and economic turmoil in Europe has continued, causing both bond and equity markets to gyrate wildly. Perhaps the most notable event since September was last month's announcement by eurozone governments and institutions of new measures to address the crisis. These involved a 50% write-down in the value of Greek sovereign debt, a recapitalisation of selected European banks to ensure the write-downs did not trigger bank failures, and a planned leveraging of the eurozone's bailout fund, the European Financial Stability Facility (EFSF), to increase its firepower in order to provide a bulwark against contagion. This agreement was welcomed by financial markets with a 6% recovery in European equity prices on the day and falls in 'safe haven' sovereign bond prices, as risk aversion receded. The recovery topped off a strong month for equities which saw the FTSE Europe ex-UK recover by 8.2% with the UK's FTSE All-Share Index enjoying a similar recovery (see chart).



While the new measures to address the crisis were welcomed by markets, the relief was short-lived. Within a week of the new package being announced the FT's front page read, 'Race to save eurozone deal', as concerns about the sustainability of European debt burdens spread to core, and founding, members of the EU, Italy and France.

This, almost immediate, relapse begs questions such as, 'Why can the Europeans, together with the International Monetary Fund, not find a solution to the crisis?' and, 'Does a solution to the problem actually exist, or are we destined, sooner or later, to plummet back into financial crisis?'

The answer to these and related questions lie in the interplay of democracy, politics and economic reality. Solutions exists, but they are not straightforward and not without cost. Hence, what we are witnessing is a process whereby economic reality is slowly dragging indebted nations and their would-be rescuers towards a solution. Politicians have to make unpopular choices and convince self-interested electorates that the chosen path really is the best one available. A quotation from American essayist H. L Mencken comes to mind, 'For every complex problem there is an answer that is clear, simple and wrong'.

The 'answer' to the eurozone debt crisis is not simple. It will be arrived at when creditor nations, and the institutions involved (the EU, ECB and IMF), have extracted sufficient concessions from the debtor nations to enable them to justify the release of additional financing to their electorates, shareholders and stakeholders. Struggling peripheral nations will be forced to concede these concessions to the point at which they are just achievable and receive the (grudging) support of their electorates. Electorates on both sides will be put in no doubt of the dire financial consequences of not accepting the required concessions and that the deal ground out by the political process is the best, or least worst, available.

Evidence to support this view includes the following:

- At the prospect of a referendum, which if lost would have resulted in a Greek exit from the eurozone, the Conservative opposition in Greece supported incumbent socialist prime minister Papandreou and passed the required austerity package. Greece has now installed a technocratic government under Lucas Papedemos to oversee implementation of the austerity package.

- Faced with spiralling bond yields, the Italian parliament quickly passed emergency austerity measures by 156 votes to 12 to try to convince bond investors and European institutions that they can bring their public finances under control. Italian bond yields subsequently retreated. Prime Minister Berlusconi has since resigned to be replaced by Mario Monti, the ex-EU competition commissioner, who will head a government with cross party support in order to enact legislation to address Italy's public sector finances.

- France, at risk of being sucked into the vortex of rising sovereign bond yields and with its banks more exposed to the periphery than other eurozone members, announced additional budget cuts of €7bn for 2012, on top of the €12bn announced in August, in an attempt to bolster confidence in its public finances.

- With regard to the would-be rescuers, German chancellor Angela Merkel gave a clear message about German commitment to the European project in a speech to her party conference on Monday. Standing in front of a banner that read, 'For Europe, For Germany' she said, "The task of our generation is to complete economic and monetary union and build political union in Europe… This does not mean less Europe, it means more Europe".

With 60% of its exports going to other European nations, the impact on the German economy of a euro break-up and resulting currency revaluation is crystal clear to German politicians. It would lead not only to bank failures and financial turmoil, but the failure of many German exporters with the resultant impact on employment and prosperity. The task of German politicians is to ensure that their voters understand this too.

We conclude that it is in the interest of all parties for a solution to be found. Despite German reticence, such a solution is likely to include jointly guaranteed eurozone government bonds and an ECB with wider powers, including the ability to fully underwrite member government bond markets, if necessary. The solution may also include the Chinese, who look likely to offer financial assistance if a satisfactory structure to a further enlarged bailout fund can be found.

Thus the seemingly endless round of summits, rescue packages, adverse market reactions and subsequent recoveries are not evidence that a solution is impossible – simply that it is complex and must be achieved through a painful and repetitive political process. We are heartened that, despite the continued volatility, equity markets, supported by attractive valuations, are showing resilience through this process. We recommend that current allocations are maintained.

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