# Investment Bulletin

SAUNDERSON HOUSE

21 May 2010

CONFLICT-FREE FINANCIAL ADVICE

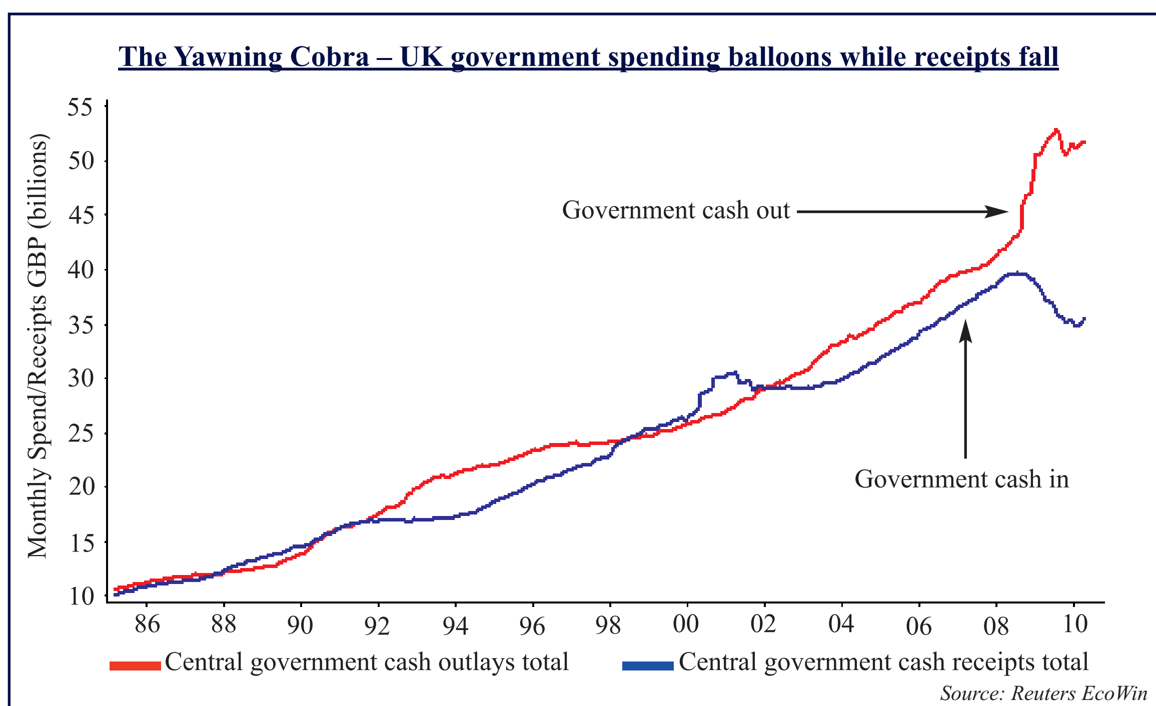

## COALITION OR DEMOLITION?

**IN THIS BULLETIN: UK budget deficit, inflation and index-linked bonds, Greece and the eurozone and current market volatility.**

**LATEST NEWS: Stephen Green, Group Chairman of HSBC Holdings plc, has agreed to speak on 'The Global Economy's Shift to the East' at a Saunderson House client lunch on 6 July - see below for RSVP details.**

## CAMERON, CLEGG AND THE COBRA

Prior to the recent sell-off in equity markets (see later comment), there was a brief wave of optimism in the UK as the uncertainty of a hung parliament gave way to hope that the country's first coalition government in 80 years can set party politics aside and address the economic challenges ahead. The Conservative-Liberal Democrat coalition has put the UK's yawning 'cobra-mouthed' budget deficit (see chart below) at the top of its policy agenda. With the UK's fiscal year 2009-10 budget deficit at c12% of UK economic output (GDP), urgent action is required. Across the channel, the crisis in the eurozone, with Greece losing the confidence of international bond investors, is providing an uncomfortable case study of what might lie ahead if the UK's finances are not addressed. The emergency budget of 22 June will provide the launch pad for fiscal retrenchment and an opportunity for the new team to establish credibility with bond markets.



In our view, provided early and appropriate action is taken, the UK can avoid following the peripheral eurozone nations into public sector debt crisis. As set out below, the UK economy has several advantages over its European neighbours, which give it greater flexibility:

(i) Without the shackles of eurozone membership, sterling has been free to depreciate, addressing the UK's lack of competitiveness. Between the start of 2007 and October 2009, sterling's effective exchange rate fell by 28%, encouraging domestic production and exports, thereby supporting economic growth and tax revenues.

(ii) While the UK's £163bn budget deficit, as a proportion of GDP, is every bit as bad as those in the eurozone, our total debt, at 68% of GDP is not much more than half that of Italy or Greece.

(iii) Finally, the UK has greater fiscal credibility. Greece's reputation, in particular, has been damaged by restatements of national statistics and a relatively poor record in collecting taxes from its citizens.

Evidence that the UK's fiscal credibility in the eyes of bond investors is fairly high can be seen in the 10-year bond yield chart below. While government bond yields of indebted eurozone countries have risen over the past few months, in the UK they have actually fallen slightly, despite the election producing a hung parliament.

## INFLATION, INDEX-LINKED BONDS AND 'WEALTH INSURANCE'

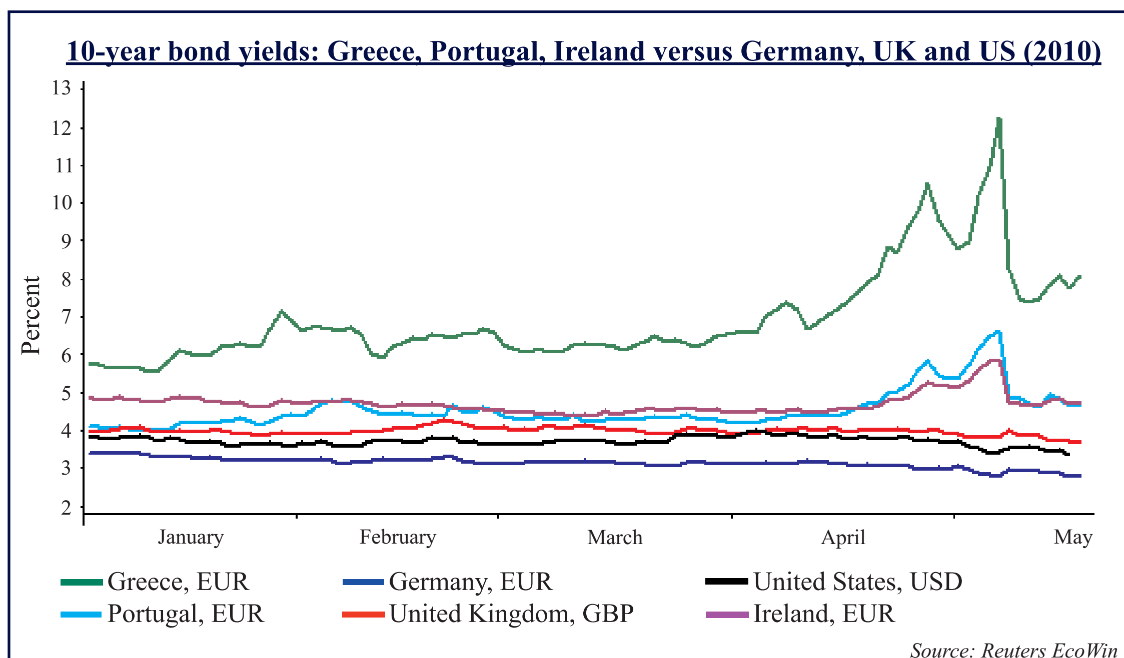
While a vote of confidence from international investors is clearly welcome, sterling's devaluation, the UK's record low interest rates and the Bank of England's use of quantitative easing (essentially the creation of £200bn of new sterling), all raise questions about inflation. For example, by increasing import prices, sterling's devaluation is potentially inflationary. Similarly, low interest rates encourage borrowing and support asset prices and are, therefore, potentially inflationary. Finally, printing new money is, quite intentionally, inflationary: if there is more money chasing fewer goods, the result must eventually be rising prices.

Despite recent data, we are not convinced that inflation will prove a concern for the UK economy. Our view is that there is simply too much spare capacity to allow price rises to become widespread. Currency depreciation, low interest rates and quantitative easing are all intended to ward off deflation. Provided the appropriate action is taken to raise interest rates in due course, we do not believe inflation will be a problem. We fully expect CPI to weaken in the coming months.

If, in our view, inflation is not going to be an issue in the medium term, why do we continue to recommend allocations to index-linked bonds? We believe that they remain an important part of portfolios, serving as a hedge against our inflation view being wrong - which could occur if the Bank of England is too slow in tightening policy as economic recovery gathers pace. Index-linked bonds, as low risk assets, should also provide some protection for portfolios against the eurozone crisis spreading further and undermining returns from equities and other risk assets. In short, index-linked bonds provide an element of 'wealth insurance' against the unhelpful outcomes of either inflation or further financial market turmoil.

## EUROZONE BAILOUT: LIKE A LOAN TO A TEENAGER?

It is perhaps ironic that Greece, once the super-power of the Ancient world, but now a relatively small economy within the European Union, should become the focus of the latest bout of tremors buffeting world markets. However, pressures within the European single-currency block, which Greece joined in 2001, have been mounting for many months. With a government debt to GDP ratio of about 120%, large ongoing budget deficits and a poor record of fiscal rectitude, the Greeks have suffered the ignominy of being all but excluded from international bond markets. As the chart below shows, Greece is not alone among the eurozone's peripheral nations in facing higher debt funding costs.




The current tremors in the eurozone are aftershocks of the earthquake that engulfed the global financial system in 2008-9. The credit crunch caused the recessions that have driven up government debt levels which has, in turn, triggered the bond market crises. The root causes of these aftershocks are, however, the design flaws in the single currency area itself. For example, the eurozone does not have mechanisms to control member budget deficits or ensure that the member economies are not on markedly divergent paths. As a consequence, Greek public sector debt has continued to mount and wage costs have risen relative to the core eurozone nations, such as Germany and France, leaving the Greek economy fundamentally uncompetitive.

Without the pressure release valve of currency devaluation, bond investors believe that Greek debt levels are unsustainable. Greece's government has introduced brutal austerity measures to reduce its deficit and drive the economy back to a competitive position but, as the recent riots testify, whether the Greeks are willing or able to live with such measure is open to question. A €750bn package of loans and loan guarantees from the IMF and EU member states and institutions has calmed immediate concerns about a default and helped reduce bond yields somewhat, but, like a loan to an unemployed teenager, such loans address the symptoms, not the problem itself.

## CURRENT MARKET VOLATILITY

Markets have suffered increased volatility in recent days. 'Safe' government bonds have risen in price amid an acute bout of risk aversion and the US equity market has now fallen c12% from its April high. While the eurozone crisis appears to remain at the core of investors concern, the immediate trigger has been a ban on some types of short selling by the German government, prompting some to question whether the German authorities know something the markets do not. Our view is that Angela Merkel and Wolfgang Schäuble, respectively Chancellor and Finance Minister of Germany, consider that the financial crisis was at least exacerbated, if not in part caused, by excessive short term trading and unrestrained speculation. They have taken steps to address this, albeit ones that could have been better co-ordinated with other eurozone authorities. The US Senate is also legislating to address the issues caused by speculative trading. Clearly, markets do not approve. As we are advisers to long term investors, as opposed to speculators, we do, which means this sell-off may represent a short term buying opportunity, where appropriate.

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## CLIENT INVESTMENT LUNCH – STEPHEN GREEN OF HSBC

**We are delighted to announce that Stephen Green, Group Chairman of HSBC Holdings plc, has agreed to speak on ‘The Global Economy’s Shift to the East’ at Saunderson House’s half-yearly investment lunch. Stephen is a career banker having joined The Hongkong and Shanghai Banking Corporation in 1982. He was Group Chief Executive from 2003 to 2006. It was announced recently that Stephen has been nominated as Deputy President of the CBI and is set to succeed Helen Alexander as President next year.**

The seminar will be held at 12 noon on 6 July at Plaisterers’ Hall, EC1A 4HR.
If you would like to attend do please reply to
Green@saunderson-house.co.uk

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