9th March 2012

Greek Tragedy Part 22

Since the Greek crisis first started in the summer of 2010, the European Union has held 22 meetings in its attempts to square the circle. This latest result has proved once again that the approach adopted has little chance of long term success, since it relies heavily on punishing the Greeks by imposing unparalleled austerity, in the face of seething popular discontent. As we all know, poverty is not a popular political platform. The enormous waste of resources now occurring in Greece, symptomised by the high unemployment, a precipitous fall in growth and the clear signs of enormous social stress, all point to the eventual failure for this draconian experiment.

Greece really needs a modern day Marshall Plan which would promote growth and lead to a large rise in tax revenues thus reducing the deficit. The extreme sensitivity of these vaunted forecasts by the European Commission and the IMF has been given very little prominence. So much so that any change in either direction of 0.5-1.0% a year will make a considerable difference to the forecast outcome. Unfortunately all efforts to translate this simple common sense approach into every day German have failed. Angela Merkel is running scared of her electorate and as a consequence has put her brain into cold storage.

This latest enormous piece of sticking plaster could last for three months, six months or even nine months. Essentially, the only way that Greece and the Greeks will recover is through economic growth. But they do need some encouragement to dig themselves out of this difficult situation. This can occur either as a result of leaving the Euro and devaluing the new successor currency or by receiving some acknowledgement from the EU that the present course of action being imposed is doomed to fail. For now the message remains the same; don't hold your breath.

The Greek fiasco has impacted the whole European continent due to the contagion caused by the continued drop in the value of their sovereign debt. Unfortunately, this problem will have to be addressed over a long time and it is for this reason that the European Central Bank has flooded the interbank markets with Long Term Refinancing Operations for three years at 1%. 800 banks participated in the latest tranche, of EUR 529 billion, at the end of February. Most banks are really happy to borrow money on these terms in current conditions, but not to lend it on. Consequently loans to households and non-financial institutions were flat in January.

So far this year most capital markets have performed quite well and there seems to be a general reluctance to acknowledge the difficulties which we still face. The Chinese economy is finally reacting to the monetary squeeze and the bubble in their residential property prices has truly burst. This will impose a strain on their banking system and already the central government has sent out clear instructions that the banks should not write down their property loans and that they should not be over zealous in collecting capital or interest. One can almost hear the system creaking. Nevertheless, China is a large country and it is quite likely that consumer price inflation will resume its downward path now that the lunar New Year holidays are behind us. This will allow the authorities to continue easing monetary policy, but growth will be below 8% this year as Wen Jiabao has just acknowledged.

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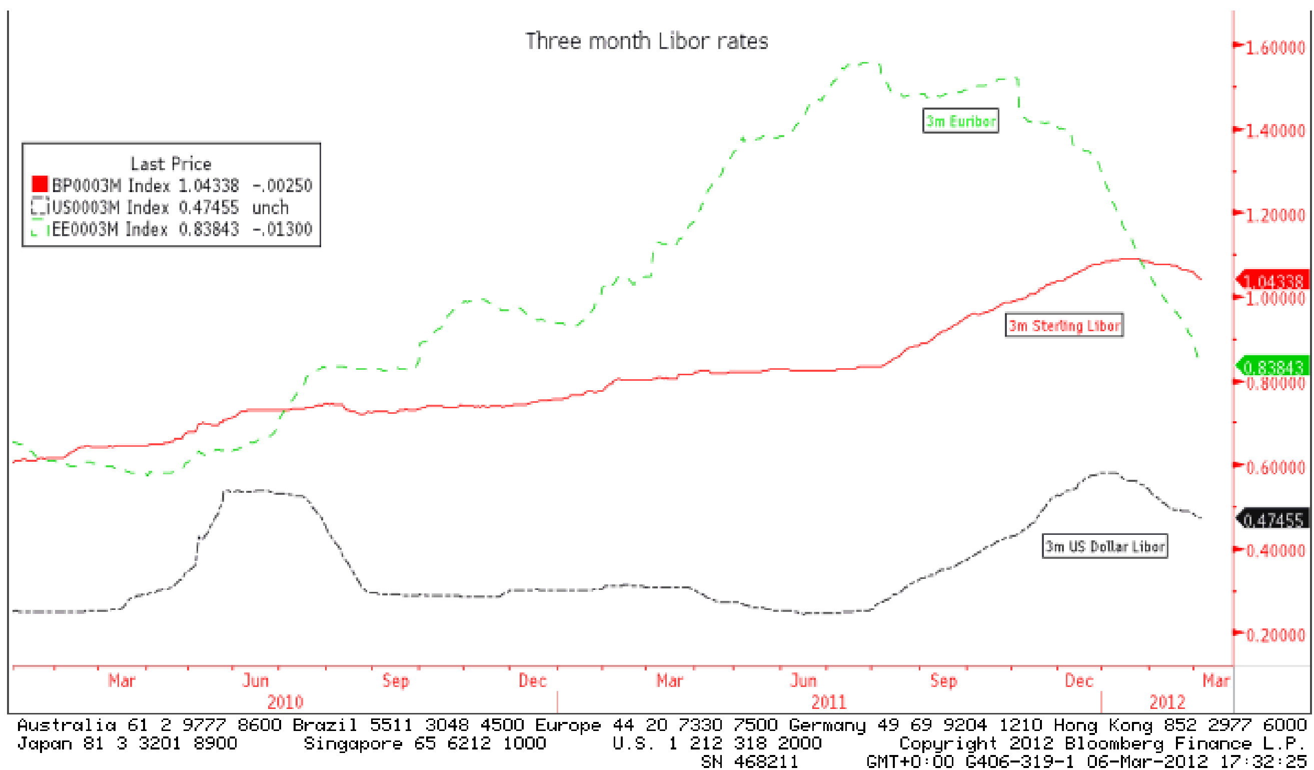
Here in the UK, it seems probable that the nadir of this secondary downturn within this long recession was reached during the fourth quarter of 2011 and that the overall economy will climb painfully out of the pit during 2012. More QE could actually prolong the pain as the UK money markets are still suffering from a severe liquidity squeeze exemplified by the continued elevation of UK Libor at double the indicated rate of 0.5% (see chart below). Unfortunately this big problem has been neglected by the Bank of England, which should be providing more medium-term liquidity directly to the banking system by renewing some of the facilities provided in 2009.



This could be achieved by buying residential mortgage backed securities and also buying up corporate debt with this current dose of QE rather than continuing to support the gilt market!

The greatest cause for optimism remains the USA where the employment numbers continue to improve, bank lending is on the increase and the residential property market seems to be finally stabilising; after almost six years of severe decline. We expect that the American recovery will gain traction as the higher employment numbers feed into increased consumer spending; which will in turn reinforce the recovery in the housing market. Provided US employment growth continues to strengthen, the American locomotive will play a vital role in leading the world economy.

Outlook

Central banks from the Federal Reserve to the European Central Bank, the Bank of England and the Bank of Japan have all stated their intention to keep interest rates low and to provide liquidity by being lenders of last resort. This reflects a growing determination by Governments and international institutions to tackle the European malaise and this should prove to have a positive impact on global capital markets.

This gigantic expansion in world money is currently fuelling the rally in capital markets. The biggest difficulty in the majority of countries relates to the fact that the monetary transmission system has broken down and the liquidity which has been supplied so copiously by the central banks is currently trapped in the capital markets and is being retained by the commercial banking system. Recently, it has finally begun to leak into the American economy as lending standards are relaxed and we expect that US banks will lend more during the year particularly in the second half.

The major caveat about this relatively sanguine view relates to the fact that the capital adequacy standards required of the banks continue to be tightened. The European deadline of June 30th, when banks will need to show slimmer balance sheets, is fast approaching. This has crimped lending even though many banks have substituted money market deposits with funds from the European Central Bank LTRO facility.

In the USA, many capital market participants are complaining about the severe restrictions being placed on normal trading activities by the proposed Volcker Rules. Meanwhile, here in the UK, the Governor of the Bank of England and the Treasury continue to exhort the banks to lend more freely to the small business sector. Nevertheless the fact remains that the Bank of England continues to penalise the banks for lending to these customers by requiring much heavier provisions in this sector than many other areas of their loan books. Whilst this dichotomy remains lending to small and medium sized businesses will continue to be restrained as lending to multi-nationals carries smaller risks and requires less intensive supervision.

Where does this leave the Investment Management Industry?

Not on the beach; but with its work cut out to protect customers' wealth in real terms and we summarise our conclusions below.

Current Investment Strategy

We believe that this evolving situation, which is being played out against a more optimistic backdrop, requires a multi-faceted approach:-

a) Maintain a good spread of assets across all asset classes including government bonds. We are not out of the woods yet; we are into the fourth year of a period of elevated market volatility and could well have another few years before it's over.

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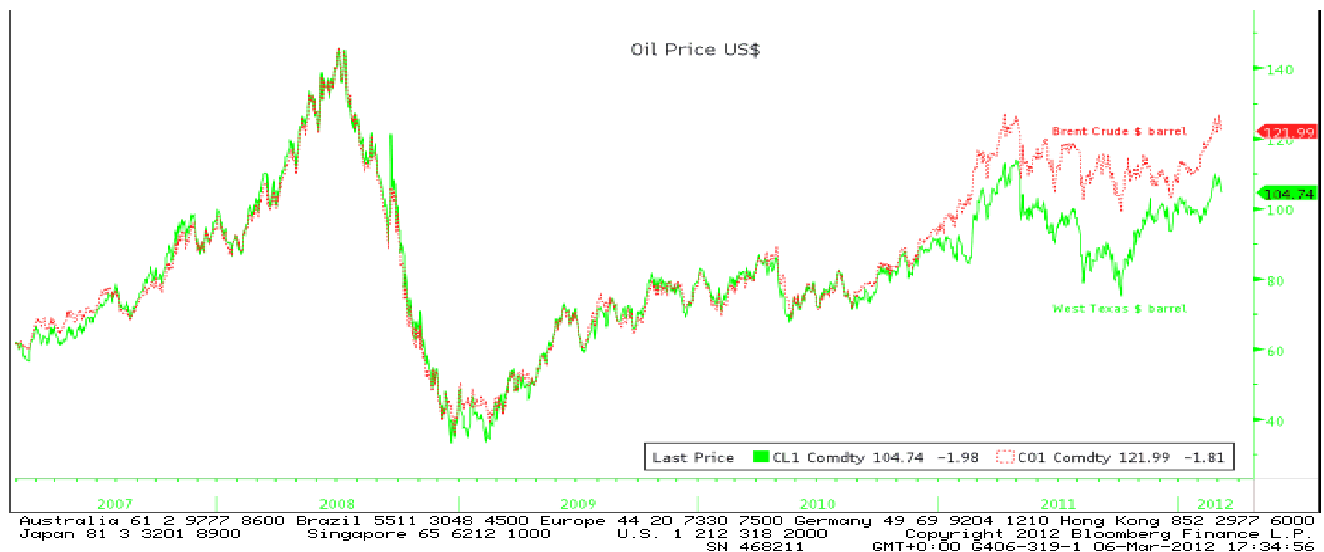
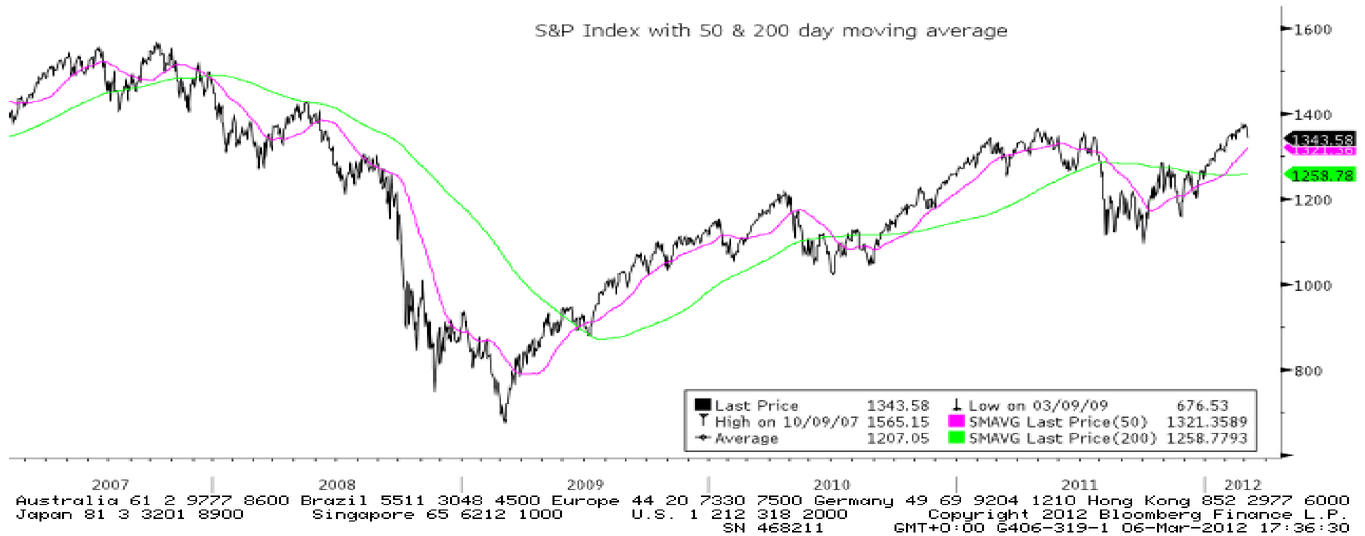
b) One can play this global market rebound, but we need to remember that the political situation continues to cloud many decisions. Firstly there is the Iranian crisis and its effect on oil prices (see chart below), next we have the continued fragility of the European banking system plus the ongoing popular unrest in the Arab world. We also have the political calendar with major elections in China, France, India and the United States coupled with discontent about the Russian presidential election result. All these events carry potential risks that could rear up at a moment's notice and try to derail the nascent recovery.



c) Stay long inflation hedges (real assets) given the huge amount of liquidity that has already been pumped around the world. There also seems to be considerably more on the way particularly from the Bank of Japan. After all the best way to get rid of a debt is to inflate it away!

d) Stay long quality assets, income yield and yield cover. A barbell approach with some mid cap/higher beta equities is fine, but be prepared to remove that beta at short notice or hold it for the longer term; this is much easier if you are holding high quality assets.

e) Keep some liquidity and don't panic if we see further troughs. Global central banks have proved that they are willing and able to pump in money if it is needed. This is very supportive for equity markets. On these occasions good quality assets may be bought at keen prices when such sharp dips occur.



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