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## Professionals' View February 2012

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### Tiptoeing Through A Minefield:

It really does feel like we're tiptoeing through a minefield right now. From an investor's point of view, we know that we're not going to get anywhere by standing still, but we can hear the bangs going off all around us. Cash is paying us next to nothing and we've been told that it's going to stay that way for many months at least. So we need to edge forward, not least because inflation, though falling slightly, remains above the return that cash is giving us. Markets have rallied strongly in January. Is it wise to join the group that now appears to be sprinting headlong towards the other side hoping to make it before the next bomb goes off? It doesn't take long for greed to replace fear as the dominant driver and that appears to be the case recently. Like driving on the motorway in a heavy fog, we know there's something in front of us, we've got our headlights on, but we're still not sure how far away it is. Stopping is too dangerous, so we proceed with caution hoping that we get through the other side safely. After all, the fog will clear eventually. It always does.

### Why Have Markets Rallied?:

Last month we said the following: "So what needs to change in order for things to improve? In short, in our opinion, the ECB's stance and unwillingness to declare itself as the lender of last resort to the bond markets." Well, lo and behold, we may just have witnessed this happening. The ECB's improvising of their 3-year long-term refinancing operation (LTRO) programme could be the game changer that we've been waiting for. It doesn't solve the sovereign debt crisis single-handedly, but crucially what it does do is keep the banks afloat. "A few weeks ago, those lending institutions overexposed to distressed debt faced serious threats of a run. Not any more" reads the BCA Research note of January 20<sup>th</sup>. They continue, "through the LTRO programme, the ECB has bought three years of time for banks to raise more capital, reduce leverage and restructure their businesses. Granted, if potential losses were realised today, many banks would carry negative equity value, but with unlimited amounts of cash

on hand, the risk of failure has been reduced." The world has probably just discovered in the ever-developing language of what Bill Mott of Psigma Asset Management calls "the greatest financial experiment in history," that LTRO is German for QE.

### Familiar Faces:

Lest we get carried away with irrational exuberance, Bill Bonner in *MoneyWeek* reminds us that there are some familiar faces under the surgeons' masks in the team tasked with resuscitating the Eurozone patient. Mario Draghi, recently installed as the head of the ECB, is a "veteran" of the World Bank, the Italian Treasury, and Goldman Sachs. "He was on the job in Rome while Italy was building up the debt that it now finds so hard to pay." The head of the IMF, Christine Lagarde, was the French Finance Minister between 2007-2010 "when France grew its public debt by about 50%". Dust any financial crime scene from the last 20 years and you will find prints from them and their confreres. They are the very same people that brought Europe and the world to the brink of financial disaster." Crikey, strong stuff.

Bonner continues to point out that the only real stress tests that mean anything are those exerted during real times of stress such as Bear Stearns and Lehmans. Until events bring things to a head, no one truly knows which banks or countries are insolvent. Gloomily, Bonner mulls, "most likely, they all are." But this is where the ECB's LTRO is so important. It has bought time. There are unlimited funds available for any bank that needs them. A backstop has been created for the banking system. This doesn't solve the problem of Greece, Portugal et al defaulting, though.

### March 20<sup>th</sup>:

This is the date that the next Greek bond matures. How much do they need to find? 14.5 billion Euros. There's a fair bit of emptying old piggy banks going on we'd imagine. It is being widely reported that Greece is close to a deal on its debt in the short term, but the pain for the population is only now beginning to be felt.

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Already Greeks are crying “enough”, while the Germans are proposing to take over the Greek purse strings themselves. Didn't Germany try to do a similar thing once before in Europe? Surely such a move wouldn't end well. That Greece will officially default or not is a question that has been kicked around for many months. The time is drawing nearer to when an answer will be given, but in the way of markets, attention is moving on to the next poser. Greek fatigue is evident. Portugal has re-emerged on to the Euro-fretters' radar. TwentyFour Asset Management has stated in a recent communication that “there is no doubt that Portugal is next in line behind Greece for market speculation and the contagion effect.”

BCA Research put it succinctly; “Trouble for Portugal means trouble for Spain.” Spanish banks have a 60 Billion Euro exposure to Portugal, which apparently equates to “roughly 70% of their common tangible equity”. Nevertheless, “removing Italy's 1800 Billion Euro sovereign debt market from the casualty ward and replacing it with Portugal's 160 Billion Euro market appears to be a relative success at the moment. On the face of it, an insolvent Portugal is affordable and absorbable, while an insolvent Italy is not.” Spain is on a par with Italy, but importantly from next month the ECB will take over the running of the EFSF and under certain distressed circumstances the fund will be able to buy secondary sovereign debt if a member country requests assistance and the ECB sees the situation as posing a risk to the Euro area. It's difficult to argue that Portugal bringing Spain down does not fit this category, so it may be that a line is being drawn in the sand and the world can come out of its hedgehog-like hibernation and sniff the clearer air of Spring.

### **Rays Of Sunshine:**

Remove the Eurozone crisis and there really are quite a few rays of sunshine out there. As explained earlier, an extreme outcome has become less likely, although not removed entirely by any means. With Armageddon shifted slightly out of the way, will investors start to focus on more optimistic issues such as US economic data generally surprising on the positive side recently;

China edging towards a soft landing and the authorities out there beginning to display fiscal easing; the Euro bouncing on signs that the economy is not in freefall; and an increase in M&A activity generally (Xstrata and Glencore being the most recent)? We've said in previous newsletters that if the European situation can reach some kind of resolution then markets would turn their attention towards the attractive equity valuations that exist relative to the strength of the corporate rather than the sovereign world.

If risk is being increased towards equities, what will this do for the Gilt and Treasuries markets? They must be vulnerable to a sell off if this is the case and investors in these assets should be very aware that for “low risk” investments, the potential for capital loss is out of kilter with the risk expectation. Beware. Otherwise, to us, high yield bonds and their current yields look particularly attractive, especially if wrapped in an ISA so that yields of 7% and more can be either taken or reinvested tax free.

The End may be nigh. Whether it will be a good ending or a bad ending will become clear in a timely fashion, but for the first time in a long, long time we are actually beginning to feel a little more optimistic. Let's just hope that, as we move from tiptoeing to lightly pacing through the minefield, we don't step on something nasty that will blow up in our faces.

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