
Professionals' View November 2011

KICKING THE CAN ROUND THE M25:

It's hard to believe that after what appears to have been one of the most tumultuous financial periods we've actually spent the last three years getting back to exactly where we started! On October 3rd this year, the S&P 500 was at precisely the same closing level as it was on October 3rd 2008. It appears that the proverbial can has not only been kicked down the road in that time; it has been kicked around the M25 about five or six times and is about to set out on another lap. Time to stop kicking the can- if we can.

At least this process was started by Eurozone leaders in the early hours of 27th October when they finally agreed the following.

* A new 130bn euro bailout for Greece with 100bn coming from the EFSF and 30bn from the IMF.

*A voluntary haircut of 50% on Greek government bonds for private banks

*Recapitalisation of banks to the tune of 106bn euro by June 2012

*An increase in the firepower of the main bailout (the EFSF) to 1tn euro.

However, and it's a big however, these agreements are in principle, and as the Financial Times put it later that day "the devil is in the detail and the data"

Hopefully more of the detail will emerge at the G20 summit in the first week of November in – and this does not bode well – Cannes, of all places. Surely someone could have come up with somewhere less kickable. Maybe the meeting will get kicked down the road to Monte Carlo. This trivial observation does the importance of the meeting an injustice. This could be the main opportunity for European politicians and world leaders to shore up the detail and deliver the sustainable "bazooka" for which the markets have been calling. Events in Libya have shown us that a bazooka of its own will find anyone who sits in a pipeline for too long.

Markets rallied strongly on the agreements outlined on October 27th, but now it is time to scrutinise what is actually on the table. Let's hope it's not a case of "buy the rumour, sell the fact."

HERR CUTT – HERO OR VILLAIN?:

We've said in previous newsletters that the huge problem facing Europe is that, unlike the 2008 crisis that was dealt with by the US and Britain because it could be, the Eurozone has so many different parties intertwined that whatever the solution that is put forward, someone somewhere gets hurt quite badly.

And unless you are into that kind of thing, voting to hurt yourself seems counter-intuitive.

If you thought that the Eurovision voting system was long and tortuous, the Eurozone makes it look like a casual show of hands. We have only just received the votes from our Finnish and Slovak judges on the original EFSF proposal first mooted on July 21st. The next round of voting is likely to become even more complicated. It is at this stage that it goes public rather than just to the panel. French and German domestic elections are looming not far away. If it was *Strictly Come Dancing* she'd dream of receiving a 9. In *Strictly Survival (Euro Version)* a Nein vote for Angela Merkel from the electorate or German lawmakers spells an early exit.

With non-Europeans such as the US and UK (non-Eurozone in our case) becoming more vocal in calling for a BIG solution to be finally delivered, the emergence of a key character, Herr Cutt, at the core of the argument is clear.

The Greek problem, as we've said before, will not go away. The quickest way to make it go away is to allow it to default on its original debt and restructure. It is the extent to which it defaults that is now the main issue, not whether it will do or not.

Reluctant banks had initially offered a 40% "haircut", but the headline figure of 50% was finally agreed after Angela Merkel and Nicolas Sarkozy joined direct negotiations on the issue on Thursday morning (source: BBC). The hope is that this level of "haircut" will see Greek government debt fall to 120% of GDP by 2020.

However doubts about the viability of the headline figure soon surfaced and the Financial Times subsequently commented "The details are critical. Depending on how the programme is set up, bondholders could end up with something significantly less onerous than leaders touted on Thursday morning".

Professionals' View November 2011

Legendary investor George Soros is more doubtful still saying "Unfortunately, the 50% haircut is effectively less than a 20% reduction in the overall debt for Greece, because it only involves the private sector and excludes all the debt that is held by the ECB, the other public authorities, and also the debt held by Greece because the banks, of course, will now be insolvent." (source: Sunday Telegraph)

In addition, European banks are now going to be recapitalised, similar to the US banks in 2008. James Ferguson in *MoneyWeek* says "there is a strong case to be made that Europe's banking crisis has yet to begin. If that is indeed the case, the Euro is about to face a credit crunch that could dwarf the one seen in America, not least because European banking assets are a much larger proportion of GDP than they are in the US."

Dexia Bank has already bitten the dust, having to be nationalised despite already having received 6 billion Euros in 2008 as a rescue package. How many more European banks are vulnerable to writing off levels of debt as high as those suggested? Sarkozy knows that French banks are among the most at risk. As we saw in 2008, just because you're a big name does not mean you are free from contagion. The problem gets worse when banks mistrust banks and refuse to lend to each other. This freezes the system and triggers recessionary risks. And if you have embraced austerity measures, the last thing you need is lack of the very economic growth that is central to the recovery plan for your nation. And so you get social unrest and so you get the perpetuation of the cycle.

Europe is in a real pickle. Ambrose Evans-Pritchard in the Telegraph is succinctly gloomy; "If you look at each component of the Grand Plan, every one creates a secondary chain of consequences that may ultimately prove self-defeating. It is why I fear there may be no plausible solution to Europe's crisis. The structural damage has already gone too far."

BUT THE WORLD DOESN'T STOP TURNING:

However Europe turns out, the world doesn't stop turning (we hope). There have been crises before and there will be many to come. Throughout it all, the world, and society, continues to function. Companies still make things. People still buy things. We can become submerged by bad news and fail to appreciate the positives. 1929 was not called the Great Depression for nothing.

2008 was bad, very bad, but there was a bottom to which markets fell. We may see the same again, who knows? But there will always be a time when markets realise that, actually, things are actually not **that** bad.

If the politicians can buy a bit of time, we can focus upon the other stuff, and that other stuff looks quite promising. China is slowing, but annual growth of over 8% is hardly near a tipping point. People have been asking for a Chinese slowdown to avoid the potential of a damaging boom-bust scenario out there. The US too does not look like it is slipping back into recession. "The overall environment, especially for US companies, is vastly better than it was in 2008" say Legg Mason.

We know that interest rates are to remain low until at least 2013 (Ben Bernanke has told us) so, if corporate US (indeed, corporate anywhere) is not faring too badly, and if companies continue to turn a profit and make cash, the sectors such as corporate and high yield bonds look worthy of interest, as they will pay a higher level of income to investors than cash or sovereign bonds as long as the underlying companies do not default on their interest payments.

Ultimately, equities too will benefit from the realisation that not all of them are going bust. The question though is at what stage do you think that they are cheap? In a secular bear market the temptation is to keep waiting too long for them to get cheaper still. Markets are strange beasts. It may not be a good idea to wait for the good news because it might never come. All that is needed sometimes is for the news to be less bad than expected. I'm not sure who said that "only monkeys pick bottoms". He may not have been a culture vulture, but he may have had a point.

The value of investments can fall as well as rise and past performance is not a guide to the future. The information contained within this document is for guidance only and is not a recommendation of any investment or a financial promotion.