

Professionals' View September 2011

It Feels Like There's Something Out There:

What have the Wall Street Crash of 1929, our own Black Monday in 1987, the ejection of Sterling from the Exchange Rate Mechanism in 1992, the sub-prime crisis in 2007 and the Lehman Bros collapse in 2008 got in common? They all happened during the months of September or October. As we tiptoe into September now, having experienced one of the most dramatic Augusts on record for market volatility, one cannot help but sense that there is something lurking out there which is going to add 2011 to the list of "Autumn event" years.

Unlike 2008, we can't really claim that we have not been given some prior warning this time around should we experience a crash. Some of the signals are stark. Bearing in mind that last month we repeated the phrase "IT WON'T GO AWAY" in this newsletter, let's examine some of the information that is available to us to see how the Eurozone debt crisis is unfolding.

August 25th :

"Lehman-style crash feared as credit markets signal alert" said the *Telegraph*. Credit Default Swaps (CDS) are insurance contracts issued against the debt of financial institutions, guarantees if you like against the bank defaulting on its debt liabilities. CDS rates have hit historic levels, higher even than those recorded during the banking collapse of three years ago. And why? "The problem is a shortage of liquidity...It feels exactly as it felt in 2008" said a senior London-based bank executive. Another, a senior credit banker with a European bank, says "I think we are heading for a market shock in September or October that will match anything we have ever seen before." We hear that European banks are not lending to each other – that the credit lines are freezing again in a re-run of 2008. We know what happened then, yet in recent days, equity markets have leaped by 5% or more. Is this a "hope" rally or are we worrying about nothing?

August 28th:

"EU banks must raise more cash". This is the view of the Head of the International Monetary Fund, Christine Lagarde, who goes as far as to say that the recapitalisation should be mandatory as we enter a "dangerous new phase" and a possibility of a "debilitating liquidity crisis". The French bank, Societe Generale, was forced to issue a statement that "all market rumours" were untrue as its share price fell 25% in a couple of days (but recovering since), but one has to wonder why the Head of the IMF would make public her concerns if they were not very real. It would appear to be a time to pull together.

But this is Europe. There's a fat chance of that.

August 30th:

"EU Rules out fresh capitalisation for Europe's banks". Doh!

Jean-Claude Trichet, President of the European Central Bank (ECB) said there was "no shortage of liquidity in the European banking system" while the EU economic commissioner Ollie Rehn insisted that the health of EU banks had improved over the past year. So who do we believe, the Head of the IMF or the European politician and banker? We couldn't possibly comment, but we secretly have our favourite.

But at least the Europeans put together a potential rescue fund under the leadership of German Chancellor Angela Merkel in July that offers some support for those delinquent members that have got themselves into a tangled mess with their crippling borrowing. As Italy and Spain threatened to trigger the collapse of monetary union, the ECB stepped in to buy Italian and Spanish bonds in such quantities that it drew a line under the share price collapse in August. As we stated last month, the only obstacle to this rescue act may be the German electorate themselves – "Will the German people have the stomach to now see their taxes

Professionals' View September 2011

supporting the profligate European states that don't display the same discipline and ethic as they do?" And the answer appears to be.....

"Euro Bail-Out In Doubt As Hysteria Sweeps Germany":

Doh again! This was the worrying headline that the *Telegraph* ran on August 29th which raises the massive question of what now, if the rescue fund (the EFSF) is not allowed to happen?

It appears that Merkel has lost the support within the coalition for the idea, as the Bundestag is to deliberate on whether the bail-out is actually illegal. It may breach Treaty law and undermine German fiscal sovereignty and has led to a furious backlash within the German state.

The German President Christian Wulff is huffing and puffing at the ECB's door claiming that its' mass purchase of Southern European bonds is a violation of its treaty mandate, warning that Germany is "reaching bail-out exhaustion and cannot allow its own democracy to be undermined by EU mayhem".

Which is all well and good, but no one appears to have a credible alternative as to how to deal with the question of Eurozone debt. There appears to be no rabbit to be plucked from a political hat, no magic wand to be waved. In short, IT WON'T GO AWAY. Max King of Investec sees the break up of the Eurozone as an inevitability, but not one that is necessarily unwanted. "We would see a partial euro break-up as potentially very positive, providing a signal to establish a more positive view on equities. In our view, we are almost at crunch point."

We have not even touched on the remarkable similarity that seems to be developing between the US now and the Japan of the late 80s early 90s. Japan back then suffered a property crash, a banking crisis, interest rates falling to close to zero (and then staying there), negative or very low growth, and the loss of their AAA credit rating.

Notice any similarities with the US today? They are mirror images. And what happened to the Japanese stock market? It fell by 70% and has not recovered some 20 years later, other than for one or two twitches in the meantime. Some people still claim that the UK is not in a bear market, despite the FTSE 100 being at 6700 in March 2000, yet standing at around 5300 at time of writing now, 11 years since the peak. If that's not a bear market I wouldn't like to see one. There is every chance that the bear market will continue, with each trough going lower than the one before while each recovery doesn't quite get back to where it's come from. How long this can continue is anyone's guess.

So it could indeed be a crunch point approaching. Is there any good news on the horizon? Well, in a couple of months, September and October will be over. That's something to look forward to.

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