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Strategy Outlook

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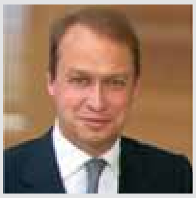
Editorial

As continents vie for the world's largest bailouts, the faltering and indecisive European offering looks unimpressive when compared to the US bank rescue plans post-Lehman, and the Chinese emergency fiscal package last year. But, in the long term, the effects should be the same: more money printed, greater public sector involvement in the economy, and lower interest rates for longer.

By contrast, the corporate world – with a record quarter for profits, the most 'cash on balance sheet' in fifty years, and dividend growth well excess of inflation – seems 'reassuringly' dull and solid. With yields considerably above government bonds and balance sheets often stronger than the national governments under which they operate, the opportunity for a strong recovery across our 'Nifty Fifty' style global equities is clear.

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Economic Outlook

Europe's next top bailout...

It is gradually dawning on global investors that – although the US fiscal and monetary rescue packages in the aftermath of the Lehman's crisis had many faults – the determined use of executive power to buy up problem assets, forcibly inject government capital into banks and bail out critical institutions was impressive, and – despite battles with Congress – timely. Similarly, the use of the command economy in China last year to direct huge fiscal resources to public infrastructure programmes (almost 5% of GDP in a single year) in order to support domestic and global growth was almost unprecedented, outside of wartime, in its scale and speed. Elsewhere, pity the Europeans, who were always bound to disappoint in the competition for the effective and timely use of financial firepower. The Greek rescue package has shown all the natural weaknesses of European decision making and the lack of executive authority in a multi-country system; narrow domestic voter issues have intervened, inconvenient electoral timetables (e.g. North-Rhine Westphalia) have skewed policy, and treaty restrictions on cross-border subsidies have forced the use of opaque special purpose vehicles. Finally, of course, sixteen governments (some with national votes required) have been needed to approve the funding, challenges may yet come from constitutional courts, and there are still treaty changes to be negotiated.

But will history – and, ultimately, markets – look more generously on the package in future months and years? In the short term, the unilateral German decision to introduce a short selling ban on European Sovereign debt securities, as well as on ten large German financial institutions, was not encouraging. Germany took this decision without consulting its partners, opening the way for 'beggar my neighbour' policies across the euro zone. On the other hand, since mid-May, several European governments have announced fiscal consolidation packages. First, the Spanish government approved the first public wage reductions since returning to democracy in 1978, and cut its forecast for economic growth for next year to 1.3 per cent, as it seeks to tame the euro region's third largest budget deficit. Italy – another large, debt-laden country – has just announced a €24bn austerity package over two years, focused mainly on spending cuts. Not only will the public sector wage be frozen, recruitment axed and funding to local authorities cut, but several state entities will also be closed. Finally, even France and Germany launched fiscal tightening, albeit of a very modest amplitude so far. Along with ferocious public sector cuts in Ireland, Portugal and Greece, the political will to make painful reductions is impressive. This is a hesitant, uncertain and mildly chaotic start to the fiscal consolidation needed globally, but that it is not 'perfect' is probably helpful; a terrible 'Shift to Thrift' could derail the nascent recovery we are now seeing. Financial markets will slowly but surely come to recognise this; interest rates will remain at

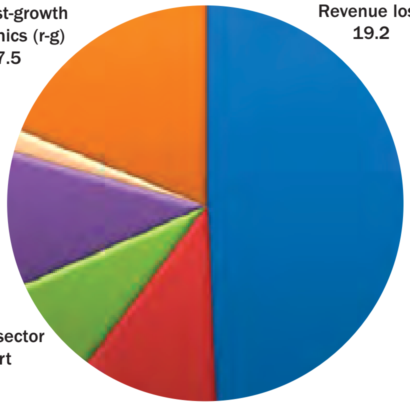
Chart 1: Governments are placing astonishing demands on investors which explains market paranoia over the Greece contagion

Advanced Economies' Gross Financing Needs, 2010 (In per cent of GDP, unless otherwise speficied)

	Maturing Debt	Deficit	Gross Financing Needs	Gross Debt (2009)	Average Maturity (years)
Australia	2.0	-5.0	7.0	15.5	4.8
Belgium	20.8	-5.1	25.9	97.3	5.4
Canada	15.9	-5.3	21.2	82.5	5.6
France	16.9	-8.2	25.1	77.4	6.5
Germany	10.2	-5.7	15.9	72.5	6.0
Greece	13.4	-8.1	21.5	115.1	7.4
Ireland	7.7	-12.2	19.9	64.5	6.7
Italy	21.1	-5.2	26.4	115.8	6.7
Japan	54.2	-9.8	64.0	217.7	5.2
Portugal	13.0	-8.8	21.8	77.1	6.2
Spain	10.3	-10.4	20.7	55.2	6.7
Sweden	6.8	-3.3	10.1	40.9	6.0
United Kingdom	8.6	-11.4	20.0	68.2	12.8
United States	21.1	-11.0	32.2	83.2	4.4

Source: April 2010 WEO for deficit and debt; Bloomberg and IMF staff estimates for maturing debt and average maturities

G-2 Advanced Economies: Increase in Public Debt, 2008-15 (Total increase: 39.1 percentage points of GDP; 2009 PPP weighted GDP)



Source: IMF staff estimates, April 2010

or close to zero, and bonds yields near to Japanese levels, while the euro finally regains its competitiveness – not a bad environment for the largest European exporters and our 'Nifty Fifty' style equities around the globe (especially when the Stoxx 50 index yields a full percentage point more than French and German government bonds).

The bazooka that failed to impress

The euro zone Financial Stabilisation Programme, while impressive in scope and size, did not succeed in calming market concerns for a euro break-up. Instead, the massive EUR/IMF 750bn package turned the spotlight on existing structural problems within the euro zone. The key failing of the IMF led programme is that it confuses liquidity with solvency; it provides plenty of liquidity but does nothing to address the longer-term structural issues that lie at the heart of the Greek crisis. Specifically, two key issues remain unaddressed: (i) how should a country that becomes insolvent go about the process of restructuring its debt? (ii) how should the euro zone promote sound fiscal policies at national level when it does not have a strong fiscal centre? Markets fears concerning the viability of the euro zone will only subside if credible frameworks to address both of these issues are developed. The first issue (of debt restructuring) is critical for immediate market confidence. The IMF-led package enables Greece to be able to borrow at non-market rates for roughly 3 years, a window during which it will have to restore the primary balance to surplus. But, the bigger issue of Greek solvency is left to be dealt with at a later date; quite how Greece will manage to service a debt to GDP level of 150% in 2013 remains unanswered. Even at an interest rate of 5%, Greece will need to spend 7.5% of its GDP on debt servicing every year; to bring the debt load to a more sustainable level, a budget surplus of 10% of GDP would be needed! Clearly, massive liquidity injections today do not alter the fundamental risk of sovereign insolvency. And this is what markets are unhappy with; liquidity today by no means ensures solvency tomorrow. The second issue is essential for the long-term credibility of the euro zone, as long as it seeks to function without a strong federal budget. The Stability and Growth Pact will need to develop sharp teeth and exact punitive costs for transgressions, and good times will need to be banked for a rainy day, not squandered as they have been in the recent past. The medicine is very tough, but it was certainly pleasing to see Irish bonds largely left out of the 'eye of the storm' this month, on the argument that public sector cost reductions and improved productivity might be generating some fiscal light at the end of a very long tunnel.

Finally, the political willingness to deliver the long-term fiscal commitment is another major uncertainty surrounding the Greek situation. The Hungarian case appears as very instructive: Hungary which turned to the EU and the IMF for a bailout in 2008, has committed itself to a multi-year fiscal tightening package. On June 4th, only a few days after the election, a spokesman of the newly appointed Prime Minister – which promised tax cuts during the campaign – said that a default was a possibility for Hungary in what may be seen as a attempt to renegotiate the terms of the agreement. This triggered a sharp fall in all Hungarian asset classes, a return of risk aversion globally and ultimately a U-turn from the Hungarian government with new tightening measures likely on the cards.

Do we now risk the 'Paradox of Thrift'?

So many column inches are now being given to the desire for budget balance and the need for aggressive fiscal retrenchment that

Chart 2: Governments and electorates are reacting with a rise in fiscal rules and risks of an untimely "lurch to thrift"

Fiscal Adjustments in Europe

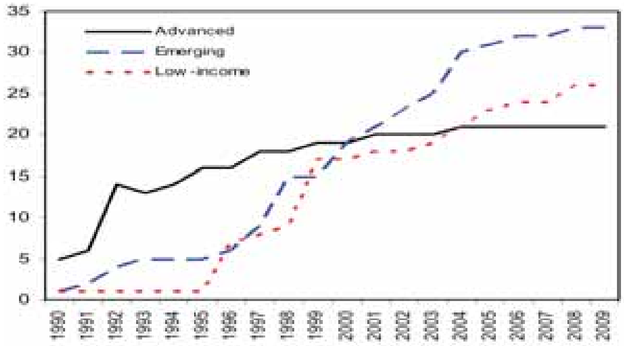
	Tax hike	Spending cuts	Savings per year up to 2013 in € bn	% GDP
Ireland	Carbon tax	12% civil servant wage cut Unemployment benefits cut by 4%	3.3	2.0
Portugal	VAT hike 1pp Income tax increase by up to 1.5pp Corporate profit tax up by 2.5pp	Recruitment Top-mangers wage cut by 5%	4.7	2.8
Spain	VAT up by 2pp	5% wage cut Cut in child benefit Freeze in pension benefits Cuts infunding to local authorities	20.7	2.0
Greece	VAT up by 4pp Excise tax increase	6% cut in wage 12% cut in benefits Hiring freeze	8.8	3.7
Italy		Public wage and recruitment Several states entitites closed Cuts in funding to local authorities	12.0	0.8
Germany		Cuts in benfits??	10.0	0.4
France		Public wage and recruitment	n.a.	
Total euro area			59.5	0.6

Source: National ministries of finance, May 2010

Chancellor George Osborne will today create an independent fiscal watchdog to rectify what he claims are "fixed" Treasury forecasts, says the Financial Times.

"He will name Sir Alan Budd as the interim head of the Office for Budget Responsibility, charged with looking into the Treasury books and preparing a 'proper set of national accounts'," the FT adds. Budd is a former chief economic adviser to the Treasury.

Number of countries with fiscal rules by type of country group



Source: IMF fiscal rules database; and staff calculations, November 2009

markets are beginning to fear that this itself will damage economic growth. Keynes' 'Paradox of Thrift' identifies the fallacy of composition; what is prudent for one may not be prudent for all. In other words, simultaneous belt tightening by different members of the euro zone can reduce total demand and savings, potentially triggering an economic contraction that could leave the economy in a more vulnerable state than where it began. The 'Shift to Thrift' is at risk of becoming a global phenomenon, as can be seen in the IMF summary of 'Fiscal Rules', which are steadily becoming enshrined in statute. By contrast, Larry Summers (the President's senior economic advisor) recently made a plea to Congress to 'grit its teeth' and pass a second stimulus to help dig the economy 'out of a deep valley.'

Or are we going to enjoy the benefits of an expansionary fiscal contraction?

While the 'Paradox of Thrift' correctly identifies the possibilities of a negative multiplier effect, it does gloss over the fact that there are many instances where fiscal contractions can improve private sector confidence and bring about a sustainable expansion. Even more paradoxically, this is popularly known as the 'expansionary fiscal contraction'. The most recent Economic Outlook from the OECD analysed the extent to which the private sector response can offset the public retrenchment. Typically, private sector 'dis-savings' offset 40% of the public sector 'savings', increasing with the size of government debt and credibility of the fiscal consolidation. In other words, the euro crisis could be a remarkable opportunity to improve the efficiency of the public sector, setting up a 'Right Sized' government that uses scarce tax revenues more effectively. This is not new; in the eighties, Denmark, Finland and Ireland all successfully used this template to bring about an economic recovery at the same time as fiscal consolidation.

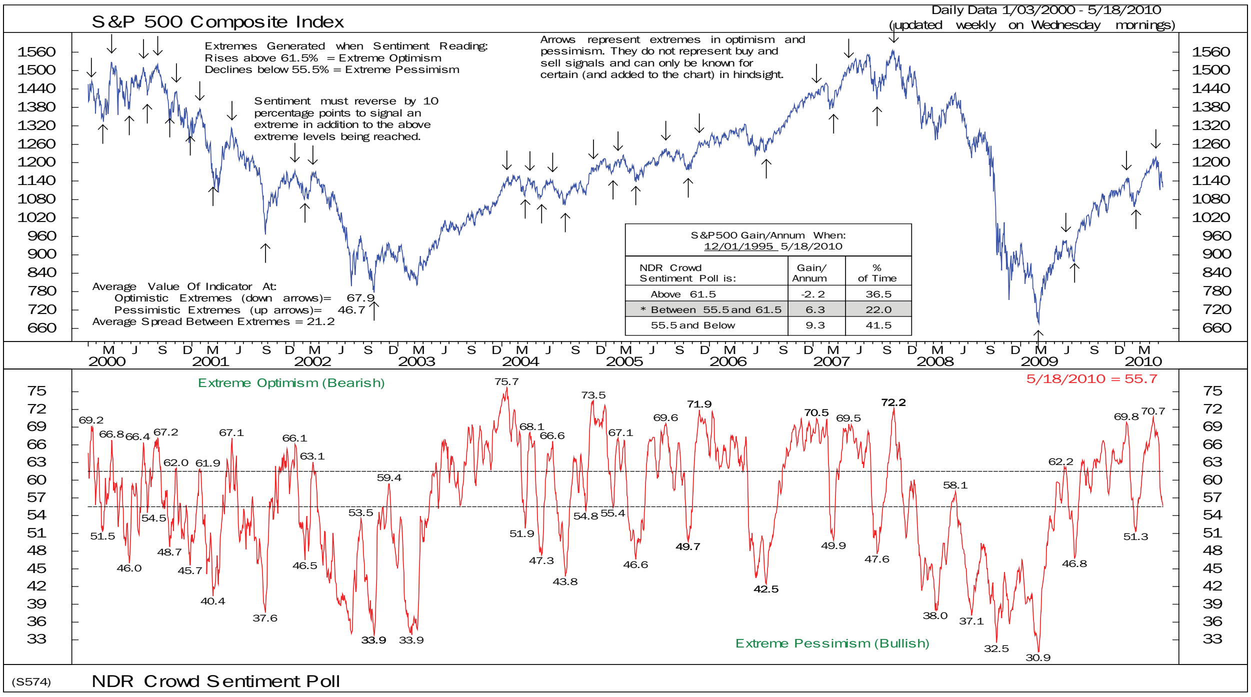
Another reason to downplay the 'Paradox of Thrift' is the fact that it is not the aggregate amount of debt (consumer, corporates and government) that is the real problem for the euro zone; this stands at only 220% of GDP for Europe, compared with 280% for the US, 300% for the UK, and 363% for Japan. The savings ratio in core Europe is six times that of the US; the problem is rather the distribution of the government debt. Hence, from an economic point of view, core Europe can (in theory) continue to finance transfer payments to the periphery for a long time. Perhaps the trend to thrift in the periphery, matched by extended private sector consumption in the core, is the ultimate goal.

Equities at the crossroad of growth, interest rates and currencies

The Greek turmoil has had three major implications for financial markets: (i) as Greek and other periphery bond yields increased, core long-term interest rates fell to their lowest levels on records; (ii) the euro depreciated by more than 15% against the US dollar over 6 months and 10% against a basket of currencies and (iii) European equity markets dropped by almost 15% in 1 month.

While amplified by the increase in risk aversion, the equity market sell-off in itself is not out of line with fundamentals. Indeed, the fiscal consolidation package in Greece, Ireland, Portugal, Spain, and now Germany, will weigh on the euro zone GDP growth. Moreover, the recent increase in Libor rates and in risk aversion may hinder the ongoing recovery in investment. As a result, the 19.5% corporate earning growth forecast by

Chart 3: Sentiment readings are finally starting to move into oversold territory…



Source: Ned Davis, May 2010

the market for 2011 is likely to be revised downward, but only modestly so, because the euro at €/$1.20 should directly and indirectly add nearly 14% to European EPS as well as 1% to GDP. To gauge how worried the markets are about earnings, we can look at dividend swaps markets, which are currently discounting a 13% decline in DPS between end 2009 and 2013 in Continental Europe compared to a 4% rise in the UK. Another measure is the punitive price action of BP (the stock is down 30% this quarter), despite more than adequate cash-flow and balance sheet strength to fund the ongoing spillage and cleanup costs. It's a sign of how harmful politics combined with an event risk can be, but also the sort of long-term value that is emerging in global equity markets today.

Strategy

To sum up, despite the ongoing fiscal consolidation, European equity markets now look peculiarly cheap, thanks to a weaker euro, stronger overseas growth and lower valuations (the EuroStoxx dividend yield is almost 1% higher than German ten-year bond yields!). One has to be cautious, however, as the risks of a self-fulfilling prophecy remain elevated: the collapse of equity markets on the back of fears of global slowdown could actually trigger a fall in business confidence and ultimately in global activity. Our belief, though, is that bailouts backed by central bank intervention are normally ultimately effective, but that in Europe's case, political issues, longer term solvency issues and extraordinary levels of academic and economic criticism mean that markets will take some convincing.

1. The Fed's preferred inflation gauge – the core personal consumption expenditures price index, which strips out food and energy – rose at an annual rate of 0.6 per cent in the first quarter, the slowest pace since records began in 1959 (according to an April 30th Commerce Department report). Core inflation in Europe was similarly weak, with a whiff of deflation and fears over the interbank market driving yields to below three per cent in core Europe and just above this in the US. In the near term, bonds continue to provide diversification benefits and a protection against another deflationary shock. Over the medium term, however, we do not see these yields as sustainable, seeing considerable risks of capital loss if the European crisis lessens, and long term inflation risks if it does not, and if quantitative easing is used aggressively. We increasingly prefer cash plus real assets (gold and blue chip equities), over finding ourselves locked in longer-term government issues.

2. Our hunch that energy and commodity prices would weaken markedly has been borne out this month, with declines of 20% in Brent Crude and 22% in nickel and lead, and we clearly retain our underweight position. Gold remains the marked exception (the price is up 3% in dollar terms and 13% in euros over the month) and continues to play a key role in offsetting longer-term currency and Sovereign risks; gold remains a core holding in balanced accounts. Our agricultural holdings are now modest, but remain our preferred long-term commodity class, and we see ourselves adding to positions later in the year.

3. The European crisis has taken attention away from the yuan/dollar and the perennial issue of 'currency

manipulation'. President Hu Jintao, at recent bilateral meetings with the US, said China will move 'gradually and independently' in altering exchange-rate policy, after keeping the yuan pegged to the US dollar for 22 months. If so, then a period of relative stability should allow a technical rebound in the heavily oversold euro, at least in the short term, and a rebound in sterling after its sharp relative falls against the dollar. Sterling is more sensitive to cyclical moves and could respond positively along with the improving tone of recent macro data.

4. Our general view that 'Nifty Fifty' style, Western blue chips would outperform higher beta emerging and 'mid/small cap' indices has proved broadly correct. The exception has been in Europe, where the collapse in the currency and relative equity weakness has produced an extraordinary 29%(!) decline for dollar investors, some 23% worse than the S&P. We think that this is not sustainable, and that dollar and Gulf investors should be steady buyers of high yielding European blue chips no matter how counter intuitive this may feel. Global equities remain our preferred asset class, but – with volatility now too high to make equity protection affordable – investors must patiently add to positions on down days through the remainder of this quarter with sentiment now moving into oversold territory (see Chart 3).

5. In Asia, geopolitical tensions appear to be rising on the Korean peninsula, following the sinking of a South Korean corvette close to the demilitarised zone, and North Korea's Kim Jong Il stating his 'preparedness for war' with the South. Following decades of often inflammatory comments from their Northern counterparts, South Korea's Kospi index appears to price in such political risk, trading at 9.5x 2010 earnings versus 13.5x for the Asia ex. Japan region. The issues raised though are just one example of an investment opportunity that we have been following in our thematic mandates for more than a year, in our opportunity set "The Inevitable Rise of Asian Defence Spending", which targets key Asian and Western defence contractors for accounts which permit such investments.

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