



## Financial markets walking a European tightrope

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**It has been a tumultuous couple of weeks in global markets - similar in nature, direction and volatility to 2008. Global emerging markets had fallen 12.88% and Asian ex Japan markets 12.05% as at 11th August. US treasury yields have fallen close to 2008 lows and there has been a sharp rise in prices of gold, the Swiss Franc and the Yen. What changed? Clearly this is open to interpretation, but first and foremost, our answer is that markets don't like uncertainty and there remain huge uncertainties as to the ability of Europe and the US to deal with their debt problems and maintain a reasonable level of growth at the same time. The main point from an emerging markets perspective is that the falls in the emerging markets are again being caused by a global macro-economic issue. This is a continuation of the so called "risk on, risk off" environment. Unfortunately these issues are likely to result in lower growth in the West which will have some real effect on emerging markets. However, Asian and emerging economies, and hopefully their stock markets, are better placed than most to handle the consequences of slower growth and, just as during the last global crisis, we would expect them to be the first to recover once conditions stabilise.**

Of the two issues hurting markets (US downgrade and European peripheral country crisis) we see Europe as being the more serious. In particular, despite a 2nd Greek bailout package agreed after much prevarication, the markets continue to fret about all of PIIGS (Portugal, Ireland, Italy, Greece and Spain) and last week Italy and France. These concerns have obviously not all materialised in the last 2 weeks however, the lack of resolution produces a slow water torture for markets.

What did materialise was the decision of the European Central Bank (ECB) to buy Italian and Spanish bonds as yields rose sharply – just two days after they said they wouldn't. This coincided with the S&P downgrade of the US from its AAA rating after the 2 main political parties could only agree to raise their debt ceiling/agree some kind of fiscal package at the 'midnight hour' to avoid defaulting on their debt. The S&P were actually accused of getting their numbers wrong by USD2tn, but they still downgraded due to the perceived lack of political will to reduce US Federal debt over time in a meaningful way.

Although everyone largely agrees in both Europe and the US that debt must be reduced, the political debate and hence the uncertainty in markets, is caused by the argument that if you impose fiscal prudence growth will stall and thus you should effectively keep spending, if at reduced rates. It appears that now the markets are starting to realise that rather than a continued economic recovery from the sub prime induced crisis of 2008, the cost of the US and Europe getting its books in order after a 10 year expansion is going to be much lower growth than currently forecast for some time – perhaps even economic stagnation if the more bearish forecasts prove correct. Economists (starting with Bernanke and Mervyn King last week) are going to be reducing their GDP forecasts and analysts are going to be reducing their sales and earnings forecasts. The question is whether these more subdued forecasts are already priced in. If the US issue could be seen in isolation then we would say "yes". The United States has shown many times over the years a unity, dynamism and problem solving ability that makes it difficult to bet against them. We are working on the assumption of low growth, but not a recession for the United States going forward.

Of more concern from our perspective is Europe. A resolution of deep seated structural issues requires political and economic consensus amongst many countries, large and small, rich and poor. Especially, it needs agreement domestically in Germany, which will have to choose either to bankroll the peripheral nations for a lot longer - or to accept the blame for the break up of the Euro. Markets may rise, possibly substantially, were they able to firstly agree a much larger bail out package and how it is funded, and secondly, agree realistic deficit reduction measures, but all of this needs to be done quickly to remove the uncertainty. Speed traditionally hasn't been the European way - markets may force it on them this time.

The current bailout package, the European Financial Stability Facility (EFSF), can currently issue bonds up to Euros 440bn. It is guaranteed by the 27 member states. This package is not big enough to bail out all of the PIIGS countries were they to be unable to pay their debts. Also Spain, Italy and France are guarantors to that fund themselves. In reality, Germany will have to fund most of the others - presumably with their own electorates' support - and in exchange for further austerity measures for any country that receives funds. So far Ireland, Portugal and Greece have received funds, but they are all small. Italy, Spain and obviously France are not. Were the Germans seen as not willing to fund this or that the others would prefer to exit the Euro, devalue their currencies and default, then European banks would suffer write offs larger than in 2008 .

These are intractable and deep seated problems that the European Union and its decision making organs are not well designed to handle. They take longer than the markets would like and issue contradictory and confusing messages whilst trying to make their decisions. We are by no means confident that policies that solve these problems can or will be enacted, but for the time being the combined resources of the ECB and the German Treasury are enough to delay the evil moment. All parties in Europe seem to be hoping that "delaying a problem" and "curing a problem" are one and the same.

### How does this affect our markets and what have we done?

Economically, lower growth in the West means that exports will slow and economic growth is likely to be lower in most economies. Heavily export oriented or trade related markets like Korea and Taiwan, and to a certain extent Singapore and Hong Kong, will be more affected than more domestically oriented markets China or India. Overall, the downgrade in growth in the West is likely to have a measurable impact on emerging growth – but the decline in confidence and increase in risk aversion is going to be a much more important consequence for markets.

Since the end of July we have reduced exposure to Korea and taken profits from resilient stocks, primarily in China and India. We have re-invested the sales in adding to underperformers, primarily in our favoured areas of resources and consumers. With regard to resource stocks, in our opinion the main two drivers of non-oil, non-gold commodities are the ever increasing demand from emerging economies and the delays in bringing new capacity on-stream. In our opinion, the slower growth rates from developed economies will not have enough impact on the supply/demand balance to change this picture.

More generally, given our optimism that emerging economies can weather the storm it is tempting to take advantage of recent declines to increase the risk profile of our strategies – if we are right about the durability of growth in emerging economies it is probably right to buy now. However, we have to acknowledge the growing risks of a much worse than expected outcome in developed economies. Emerging markets would not be insulated from such problems and history tells us that in the early stages of a crisis, risk assets such as emerging equities would perform badly. Overall therefore, we have decided to stick with our modest pro-growth tilt, but not to increase it.