HARGREAVEHALE

INVESTMENT BULLETIN

Doing something about Greece…

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Most crashes do come out of a clear blue sky. Few financial journalists forecast the 2008 implosion, certainly few regulators or Central Banks. The IMF, the world's number one financial watchdog said of subprime collateralised debt obligations in the run up to the 2008 crash: "there is growing recognition that the dispersion of credit risk by banks to a broader and more diversified group of investors has helped make the banking and overall financial system more resilient....Consequently the commercial banks may be less vulnerable today to credit or economic shocks."

Regulators now seem to be saying that conventional bonds are somehow less risky than equities. Indexed linked bonds, possibly, but conventional bonds unlikely unless a deflation looms. Conventional sovereign debt distinctly no. The FT picked this up today in an article on the Bank's reserve requirements in relation to stress testing. Says the FT, "the most mind bending element of Solvency 11 is its treatment of sovereign debt, which is assumed to be risk free....... it is difficult to know if this is a stroke of monumental stupidity or a flash of pure genius". It could be pure or rather evil genius because it encourages investors to buy sovereign debt, much of which is conventional rather than index linked at a time when yields are at an all time low and the creation of a supersonic inflation might be the least unattractive way out of the West's current economic predicament.

Well, not necessarily attractive. Look at the inflation in Germany between two world wars. The French insisted on extraordinary levels of reparations so the Germans paid these reparations with wheelbarrow loads of worthless cash. But the social cost was huge. The daily price increases were dizzying. Menus in cafes could not be revised quickly enough. A student at Freiburg University ordered a cup of coffee at a cafe. The price on the menu was 5000 marks. He had two cups. When the bill came it was for 14,000 marks "If you want to save money", he was told, "and if you wanted to have two cups of coffee, you should have ordered them both at the same time".

The "inflate your debts away" solution is apparently being more widely discussed. It involves the Central European Bank printing endless amounts of cash, buying up Eurobonds or the sovereign debt of peripheral countries with the inflation unleashed by this exercise eroding the debt sitting on Countries and Bank's balance sheets.

More likely is the issuance of jointly guaranteed Eurobonds, bonds backed by every member State. At present some 100 billion Eurobonds have been or have been earmarked to be issued. This is a relative drop in the Ocean, but makes a lot of sense in the short term because it avoids the mess surrounding an actual sovereign default and it can be presented to the sceptical German voter as a burden shared. In the longer term, one pessimist has calculated that at least two trillion Euros might have to be issued to stop the rot which in time could actually imperil the "triple A" status of Germany and its immediate satellite countries.

However, in a democracy, politicians will do what they can to play for time and avoid reality. This is why the Eurobond solution which would be probably supported by the Chinese, is a neat short term solution. It is not however a long term solution because it is actually a form of magic, a loan accompanied by a financial operation which miraculously produces a triple "A" rating on what are effectively junk bonds. It could be said to be uncannily reminiscent of the "slice and dice" magic of sub prime collateralised debt obligations or the US Government's guarantees on Fannie May. Eventually the local populations will get fed up of austerity and as any Eurobond guarantee will be coming from some countries which themselves could be in need of a bailout, the pool of guarantors will reduce, increasing the pressures of the last men standing.

There remains the possibility that this weeks emergency meeting of European leaders to discuss how bond holders can contribute to the Greek bailout is not a success. And it is this prospect that is worrying the markets with the yields on both Spanish and Italian Sovereign debt rising sharply. The key sticking point is the German premier, Angela Merkel's insistence that the Banks take a hit of around 30 billion Euros on the existing Greek restructuring. But under intense US pressure it appears that she is daily softening her stance and the outcome could be a compromise which reduces the writedowns of the private sector banks, such writedowns being defined as "reprofiling" or "debt extensions" thus avoiding being a technical default. This may seem to be splitting hairs but the ECB, the European Investment Bank, which is a critical provider of liquidity to the market, has said that it would not accept collateral for its lending where the issuer is in some form of default. If the bailout went ahead without a technical default, then there would be a relief rally in bonds, particularly in the Italian and Spanish markets and probably equities, such as Italian Banks would breathe a sigh of relief. But a full blooded rally would also require conviction on the part of the market that the proposals were more than temporary sticking plaster and also a successful deal on US sovereign debt issuance going forward. Both events seem unlikely.

It is perhaps useful to get the European Sovereign debt problem in some sort of prospective. Sovereign European debt represents 85% of European GDP, equivalent to a market capitalisation of around 6 trillion Euros. Of that, approximately 2 trillion Euros could be potentially characterised as "problem" debt in the sense that an overall average writedown of 15% to 20% might be required. Total Greek Sovereign debt is 320 billion Euros, quite extraordinary when you think that the GDP of Greece is just 2% of total European GDP. If Greek sovereign debt matched its GDP, it would be just 120 billion Euros.

By contrast, the US sovereign debt market is much bigger than Europes. It has a capitalisation of 14 trillion Dollars all of which is due a possible status change if no compromise deal is agreed by the 2nd August. This is really big potatoes. Obama has already walked out of the discussions with Congress once during the debt reduction negotiations and no doubt he will do so again. But the likelihood must be that a deal is hatched before the deadline, most likely involving tax increases a couple of years out, post the next election, as well as some spending cuts or cuts in subsidies to the farming sector, such as for ethanol blending, which is having the effect of increasing grain prices.

Thus the stage could be set for a relief equity rally with possibly an end to the recent relative strength in precious as opposed to industrial metals. But the weakness of equity markets in Europe is not just the result of market worries over the procrastination of European leaders, but also recognition of the sheer scale of the longer term issues that will one day have to be faced. This is combined with a certain amount of cynicism over the recent stress tests of European banks coupled with increasing macro evidence that there is evidence of some slowdown in industrial activity not just in the US, but also in the perceived engines of global growth, such as China and India.

In a perverse sort of way, the stress tests which sought to reassure did the reverse because the criteria against which the judgements were made did not include default. Even assuming no default, according to a paper by Credit Swisse no less than 27 European banks would need to raise an additional 82 billion Euros just to maintain basic Tier 1 ratios above 7%, if Irish, Greek, Portuguese, Spanish and Italian government bonds were written down in line with current market prices.

What equity markets really want is a sign that the Authorities are getting to grips with the reality of the situation. As the Latin American debt crisis of the 1980's showed, as long as the Authorities, specifically the IMF and the Central banks extended credit in whatever form to the local banks, and the pretence that there was no impairment was maintained via "reprofiling" and "debt extensions" then the actuality of the situation was that the debt ratios of the countries concerned over time continued to increase as interest costs on rolled over debt rose. Political pressure on those in power accelerated. And consumers suffered alongside social stability.

What Europe really needs now is the European equivalent of the Brady plan in South America. The Brady plan was a bold one, facing up to the need for at least partial default. New investors were able to buy existing Sovereign debt at discounted prices and then use the debt to buy public assets at discounted prices. New capital was attracted and equity markets took off. For investors in Brazil in the early 1990's it was something of a once in a lifetime buying opportunity.

But according to the Chief economist of one of the integrated banks, this weekend will see a sticking plaster resolution to the Greek crisis. He was also concerned that a half baked solution would mean that the recent rise in Italian and Spanish bond markets yields would not be reversed. This could discourage the growth of bank credit and economic activity as banks continue to prioritise the protection of their balance sheets. As it is there has been a concerted move back into safe haven assets in the Western economies with the yield on 10 year US Treasuries falling from 2.96% at the beginning of June to a current 2.89%, a movement roughly matched by German

Bunds. This in response not just to the approaching European debt crisis and the increasingly noisy brawling between the Republicans and Mr Obama but also to evidence that GDP growth, more or less everywhere in the world is slowing. All this against a background of already contracting bank lending, despite the massive boost to the monetary base as a result of the quantitative easing programmes.

Deflationists might be interested in the ACPI INDIA FIXED INCOME UCITS FUND who visited us recently. Formed in August 2010, this is a fund investing in Indian Government debt as well as Government backed corporate bonds known as PSU's, (public sector undertakings). Few investment vehicles offer foreigners access to Indian Sovereign debt due to the difficulty of obtaining the appropriate licenses, with less than 1.2% of Indian Government bonds owned by foreigners. The limit for foreign ownership is 5%. The current price as at the 22nd July 2011 was $10.8126. This includes rolled up interest on Government Bonds with an element of currency appreciation. The Rupee is expected to appreciate 3%/4% over the medium term against developed world currencies. At present, GDP growth and manufacturing industry activity is slowing as a result of a prolonged period of 10 interest rate hikes in the past 15 months. The HSBC/Market Purchasing managers index fell to a 9 month low of 55.3 in June. That said, inflation is still strong reflecting disappointing harvests but the next six months could be an interesting time to invest, particularly as the managers have performed well against a background of increasing interest rates over the past twelve months.

Chinese manufacturing growth has recently fallen to its lowest level in more than two years. In an attempt to reduce inflation, China has over the last nine months raised interest rates four times and bank's reserve requirements no less than eight times. China's official purchasing managers index, a key measure of the manufacturing sector dropped to 50.9 in June, down from 52 the previous month, and with the fall back in some commodity prices there must be a good prospect that the cycle of rising interest rates may be coming to an end. The Chinese Premier has recently indicated that the availability of grain going forward is good, particularly as China has made a series of large grain purchases recently in Western markets. Unfortunately for UK investors, there is no mechanism for UK investors to buy Chinese Government bonds, although an indirect way would be via China Life, which has a very large portfolio of Chinese Government bonds in its balance sheet.

The impact of interest rate hikes on the Chinese and Indian markets over the last twelve months has been, unsurprisingly, negative. The Shanghai Composite Index is 12.5% off its twelve month high and the BSE Sensex India is down 12.3% from its high over the same period. By contrast Western markets have performed much better, which is bizarre but reflects the simple fact that Western policy makers are uncomfortable with the idea of raising rates in response to rising inflation because of the over indebted nature both of their Governments and of their citizenry.

This relative weakness could provide an interesting buying opportunity because the World Bank is still forecasting 8.5% growth rates for developing countries in East Asia this year and 7.5% growth for developing countries in South Asia. However, a lot depends on the resilience of consumer spending in the West, and therefore a lot depends on the wisdom and judgements of politicians in Europe and in the US in coming weeks. The recent decision by the European Central Bank to raise interest rates by 20% to 1.5% is not a good omen. Nor is the intransigence of the Republicans in their negotiations with Obama.

The maintenance of consumer spending in the West is of more than passing interest to emerging economies. Dependence on export markets varies. For China, exports represent approximately 36% of GDP. For Korea, the figure is 54%. Brazil and India have a much lower dependence on world trade. For Brazil, exports represent just 14.5% of GDP, for India, the figure is 23.8%. Those investors who are uncomfortable with the outlook for developed world spending going forward should perhaps consider the Advance Emerging ABLE (Advance Brazil Leblon Equities) which is a Dublin quoted open ended investment company, specialising in mid and small quoted companies servicing mainly the domestic Brazilian markets, which has presented to us on a number of occasions.

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