HARGREAVEHALE

INVESTMENT BULLETIN

"Dealing with Gridlock"

23rd December 2011

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Gridlock continues in the reform of the banking system. Gridlock continues in the solution to the European Sovereign debt crisis. The sheer extent of the banking crisis was revealed for all to see in the recent announcement from the ECB. 523 banks signed up to the ECB's liquidity window. The two gridlocks interconnect because of the high cost to sovereign states of bailing out their banks and the regulatory requirement, post Lehman, for the banks to load up their balance sheets with sovereign debt on the grounds that such debt was of the highest quality.

But gridlock does not have to be permanent. It could be broken if the integrated banking structure is dismantled. If "casino" banking is entirely separated from legitimate commercial and individual bank lending activities, depositors would be unaffected in the event that a "casino" bank went bust. Of course there would be some counterparty risk but the recent bankruptcy, one of the largest in US history, of a commodity trading business MF Global, run by ex Goldman Sachs CEO John Corzine tested but did not destroy the system. There was no risk to the savings of the public. And if you did dismantle the integrated banking structure rather than retain it by so called "ring fencing" you could free up billions of pounds of capital for legitimate industrial lending. Nor would there be any requirement for buffer capital to protect depositors against the consequences of casino punting. Then the current gridlock in the banking system would be unlocked.

Of course bankers are fighting tooth and nail against the total separation of their activities. They want to play in their casino secure in the knowledge that if they make a mistake they will have to be bailed out by Governments because they are part of an integrated banking system that includes depositors. As Liam Halligan, the Chief Economist of Prosperity Capital Management writing in the Sunday Telegraph in December said; "Breaking the deadlock involves shaking down the banks, taking on their mendacious executives and whilst standing behind depositors forcing a wholesale restructuring..... The banks though are still too powerful..... Our political leaders in a show of cowardice that future historians will deride, remain incapable of standing up to the money men".

The Banking lobby has so far been extremely successful. It has managed to steer the discussion away from total separation towards the dubious concept of ring fencing. Dubious in the view of the much respected ex chairman of the Federal Reserve bank, Paul Volker, because in the final analysis even if the banks have more buffer capital and therefore are "ring fenced", if the bankruptcy event is big enough and they go under they still take their depositors with them together with the recently raised buffer capital. Equally important, the integrated banking structure remains intact, which means the bonus/casino structure is still intact.

The critical impact of keeping the integrated structure in place via ring fencing is that banking ratios and reserve requirements have to be made more stringent. In particular, the regulator's demand for additional buffer capital is putting more and more pressure on banks to accumulate cash and it is no surprise that banks are now trying to reduce the size of their loan books as fast as possible. This constrains credit growth, exerts downward pressure on economic activity and eventually of course impacts the tax base as unemployment rises and VAT receipts fall. As a result, fiscal deficits widen and sovereign debt gets downgraded. A vicious circle that needs to be broken. It needs political willpower.

If you look at forecasts for 2012, the rough figure for overall World GDP growth is around 3.5% made up by largely nominal Western GDP growth, offset by significant albeit slowing growth in emerging market economies. This is now being put at risk as a consequence of Western banks deleveraging.

European banks are the largest providers of credit to emerging markets with estimated loans outstanding of around $2.5 trillion. In an effort to raise the buffer capital required to retain the integrated banking system in the West, European Banks are now calling in these loans. It is estimated that $600 billion of buffer capital is going to be required in the short term which will create a significant credit crunch just exactly where it matters most, the still growing economies of the emerging markets.

An example is India. Western capital running home to be categorized as "buffer capital" has resulted in the Indian Rupee falling by nearly 25% against the US dollar in just eight weeks. Imagine what that does to an economy in terms of overall imported inflation. It means that the laborious interest rate hikes racked up over the past eighteen months which served to restrain rising inflation will have little impact in the face of such large scale currency depreciation. The same could broadly be said for other emerging economies such as Brazil. The Brazilian Real has fallen by 18% against Sterling since July.

Fortunately, China is no longer an emerging market and its currency is not freely convertible. It is not therefore impacted by Western capital flows. It is not reliant on overseas funding to finance GDP growth. China's current account is in surplus. It's external debt position is low, only 10% of GDP whilst reserves represent no less than seven times external debt. Not only is the fiscal deficit just 1.8% of GDP, but its banking system is operating with a very low loan to deposit ratio of 75%, reflecting in part a high level of household deposits. In short, unlike their Western counterparts best characterized as incompetent spendthrifts, China has benefited from being run by much wiser policy makers, increasing interest rates and reserve requirements when necessary. A hard landing in China may be on the wish list of some Western economists. The reasons are well versed: deflation in the housing bubble creating a pickup in non performing loans. But to counter this, the Chinese banks have already begun raising more capital, whilst the Government has given permission for local Governments to trial municipal bond issues. As it is China's big banks are far better capitalized than those in the West with the top five banks having capital adequacy ratios of around 12%.

However, European banks are not just responding to regulatory pressure to repatriate funds from emerging markets. European banks also hold substantial amounts of US dollar assets in the US. Turning such assets into cash for repatriation to Europe could have a negative effect on US Bank balance sheets. It is interesting that for the first time in some weeks, major US banks have started to show pronounced weakness. In one day this week, for example Bank of America shares fell by 4%,Citigroup’s shares fell by 4.7%, JP Morgan was down 3.7% and Morgan Stanley down by 5.5%. Some resolution of the liquidity crisis affecting global markets is clearly extremely important.

The policy response from Europe to-date has been extremely disappointing both in response to liquidity issues and in relation to Sovereign debt. Stock markets have largely given up hope as a result. The options open to politicians are clear. One option has to be to consider, plan for and organize default for those countries like Greece where fiscal stability programmes look unrealistic in the longer term. And as part of this option, to accelerate the process of fiscal integration for those countries remaining in the Euro currency block. On the face of it, not a feasible option because of the complex political decision making involved.

An alternative has always been what might be called the Central Bank option. This is a much more realistic one, because it can be put into effect without involving politicians subject to the democratic process. Via Central Bank dictate it is much simpler to spread the burden of Sovereign debt liabilities via massive programmes of quantitative easing and/or the issue of bonds issued under guarantees of the ECB. To date, there has been gridlock, because such bond issues/ QE required the democratic consent of the German Bundestag and a multiplicity of nation states. This democratic consent has not been forthcoming.

For the immediate future, the key remains the ability of the European Authorities to orchestrate the rolling over of both Sovereign debt and Bank debt as it comes due during 2012. The recent announcement by the ECB looks like a seriously positive move which could for the first time deal with gridlock because it does not require the sanction of politicians. The ECB has announced the issue of a three year credit facility of 490 billion euros to 523 banks, the longest term facility in history. Such facilities are provided at roughly one per cent and should address the liquidity problems dominating money markets in recent weeks, ease the process of rolling over both bank and Sovereign debt. In addition, there will be a further credit facility offered in February.

ECB President Mario Draghi said that he hoped the new liquidity measures will start to restore credit to households and firms. But he added that banks can also use the cash to buy back their own bonds or buy Government Bonds. His measures are certainly a gift to the banks. Borrowing from the European Central Bank for three years at a nominal interest rate and buying Spanish and Italian bonds on a yield of 7% is reminiscent of the refinancing of the Japanese banks post their own crash and should provide much needed stability to the system. It has the additional merit of circumventing the tortuous discussions of national politicians in Europe who need to play to their respective electorates with the result that no decisions are actually made.

As investors are aware, the ECB is not allowed to indulge in Anglo Saxon quantitative easing. It cannot buy primary Sovereign issues in Europe and monetize the cost. What it has been doing on the quiet is buying Sovereign issues in the secondary market from banks and other financial intermediaries who have bought them as primary issues. So it has supported the primary market as best it can. It was faced with the threat of Sovereign debt downgrades which would have made it difficult for commercial banks to be the purchasers of primary issues. This is a neat way round the problem and has been described by the FT as the equivalent of European Quantitative Easing. Great news for markets in the shorter term and great news for banks in terms of survival. There is a strong case for saying: bring on Quantitative Easing in any form, US, European, British. Bring it on because investors could well be faced with deflation, deadly to those whose assets are geared.

One of the interesting aspects of the policy gridlock since the summer is that it has led to impasse when it comes to decisions. Consumers have postponed decisions to spend, corporates have stayed capital spending programmes. Forward order books are falling. Legislating for more buffer capital for banks has meant limiting bank and mortgage credit to consumers thus further reducing confidence, a vicious circle, all a direct consequence of Western policy procrastination. The impact on global prices is material.

Soft landing/hard landing, China's economy is undoubtably slowing partly as a result of a property bust but mainly because of slowing exports to Western markets, in particular European markets. Unsurprisingly this is having a material impact on the prices of commodities. China is the world's biggest consumer of commodities, accounting for 62% of iron ore buying, 58% of soya beans, 12% of crude oil and 22% of copper to name but a few. As a result, a plethora of metals have seen sharp falls in prices this year. Nickel is down 24%, aluminium is down 19%, zinc is down 24%, platinum is down 18% and iron ore is down 23%.These price falls have yet to be reflected in the prices of manufactured products but consumers should start to see this reflected in retail prices this Spring. The oil price too is a bit of a puzzle. Prices have held up in part due to the cessation of Libyan exports but the combination of flat out production from Saudi Arabia, increased supplies from Iraq, and new non Opec production hitting the market could create a modest surplus, particularly in the face of a reduction in demand from squeezed consumers. Major supply interruptions, including a EU embargo on Iran remains a possibility, but in the absence of serious supply restraints some downwards pressure on oil prices look a possibility, particularly because Iranian exports have increasingly been directed towards South Asia and the Far East.

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It is also interesting to look at food prices in the UK in the past three months. Clearly input prices are highly vulnerable to natural disasters, harvests, etc, but there has been a big fall in the price of branded and own branded food prices sold in supermarkets since July. July to November 2011 saw Asda own brand prices falling by 5.1%, Sainsbury branded prices fell by 3.6%, in fact looking at the spectrum of the top six supermarket prices, branded and own brand and with just two exceptions, prices have been falling.

With such deflationary pressures at work, there seems to be little likelihood that new QE programmes will trigger inflation and higher interest rates. Quite the reverse, in the major western economies inflation has certainly stalled. In Europe the inflation rate is negligible. In the UK, the published inflation rate of nearly 5% is highly misleading.

The Bank of England, in its recent quarterly review, has adjusted the published consumer price index for the rise in VAT and the fall in Sterling and has indicated, admittedly within a wide range of outcomes, that UK CPI might have been in deflation for the last two years. This despite a massive Quantitative Easing programme roughly equal to one third of the UK's total gilts market.

In the US, there are some promising signs that the housing market is finally showing recovery and there are hopes that the worst may have been seen in unemployment. However, two critical components of GDP expansion in the past two years accounting for an estimated 80% of such growth have been exports and capex. Both are at risk from a weak European consumer and from the recent strength of the US dollar. With consumer demand likely to be muted and with gridlock in Congress, which could lead to tax rises for consumers, it is likely that inflation will remain low.

Given such a backdrop, it is vital that both the US and UK trigger more QE programmes in early 2012 at the first sign of weakness in GDP activity. Both the US and the UK have signalled their willingness to act. The good news is that Euroland can finally join them. The ECB has now devised a QE programme of its own which does not have to go through due political process. The new head of the ECB can institute more lending programmes which will release more cash which in the words of ECB President Mario Draghi can be used for the purchase of bonds for refinancing

sovereign and bank debt as well as importantly for "restoring credit to households and firms." This is a major commitment.

For equity investors who have recently been focused on the tortuous proceedings of European politicians playing to their electorates, the idea that Central Bankers might be taking more direct action is good news. However their remains a distinct danger that the deflationary price pressures currently underway are being underestimated. Bring on the printing presses NOW.

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