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## **Happy new year?**

2012 seems to have been coming for ever. The year is etched in our minds from the countless references to it, as, of course, this is our Olympic year. For many, it will be a once in a lifetime opportunity. True, it will have a cost initially and these costs may exceed the original estimates, but the short term pain will benefit many in the longer term in all sorts of ways, even though others may never actually see or feel the benefits directly themselves.

In this sense then, 2012 can be seen as the Eurozone's Olympic year too, as it will, we feel, be a defining year for the European bloc en masse, with costs to some areas offsetting the longer term effects to the wider whole.

## **So where are we at?**

We are at an almighty crossroads. Spaghetti Junction appears as a mere Pelican Crossing in comparison, but a direction must be taken and how quickly we negotiate the hazards will determine how safely we emerge on to the straight and narrow again.

2011 was not simply an *annus horribilis*; it was an *annus absolutely ghastlyius*. There are not many to whom we speak who will not be sorry to see the back of it. The immediate future, however, does not exactly appear to be lined with much hope or anticipation either, but that may not necessarily be such a bad thing, with the darkest hour being just before dawn and all that.

The pain trade last year was investing in the stock market as opposed to the bond markets or gold, thus being optimistic that all was fine and dandy in the jardins und gartens of Europe.

The best performing UK asset class in 2011 was index linked gilts, while among the worst performing sectors was emerging market equities.

Is this coming year going to be a continuation of this trend or is it a time to begin poking around in the ashes of last year's forecasts to see if any bargains remain unscathed?

One view is that it will get worse in Europe (and thus the effects on the rest of the world will similarly be aligned) before it gets better, but that once it begins to get better the recovery could potentially mirror the rebound that saw 2009 being such a profitable year for those who were prepared to put a bit of risk on the table.

## **What needs to change?**

So what needs to change in order for things to improve? In short, the ECB's stance and unwillingness to declare themselves as the "lender of last resort" to the bond markets. The debt tsunami is fast approaching. Italy has 150 billion Euro of debt maturing between February and April this year.

How are they going to pay this amount back to their debtors?

If they borrow it, the rates that the bond markets will demand from them will most likely be out of reach. And to whom do they owe this money? Of course, it is not just Italian debt that causes the discomfort to European bank executives, but on top of Greek, Portuguese, Irish and Spanish woes, the Italian problem may be the straw that gives the banking sector the ultimate hump.

In September alone, investors (most likely from the US and Asia) withdrew 100 billion from French banks. BCA Research point out that debt crises are not new, and it must be useful to look at previous ones to see how this one will most likely play out. There are many similarities between this current situation and the Great Depression of the 1930s and one of the most important lessons to learn is that monetary deflation is the only viable way to fend off the continuation of the debt crisis. "In essence, a debt crisis occurs when creditors have collectively lost their confidence in the liabilities they hold. As a result they liquidate their holdings for cash, creating a severe shortage of money. A central bank must increase the money supply in order to meet the escalating demand for money, or the banking system finds itself under siege. Without a lender of last resort guaranteeing the solvency of its lending institutions, a panic run and spreading failures among banks becomes inevitable."

That, in a nutshell, sums up a possible scenario in the coming months. An "event" will force the hand of the ECB to proclaim itself in some form the lender of last resort that it has steadfastly refused to do thus far.

We expect this "event" to trigger a further bout of volatility on the markets, with a subsequent period of instability, followed by a re-focusing on corporate fundamentals and a realisation that the world has not ended.

It was Brooks Atkinson that said, "In every age "the good old days" were a myth. No one ever thought they were good at the time, for every age has consisted of crises that seemed intolerable to the people that lived through them."

While on the subject, a couple more quotes that may bring a smile or a sense of perspective to us are thus: "Nostalgia is a file that removes the rough edges from the good old days" (Doug Larson) and "everyone seems to think yesterday was better than today. Don't wait 10 years before admitting today was great. If you're hung up on nostalgia, pretend today is yesterday and just go out and have a hell of a time" (Art Buchwald). One hopes that Mr Buchwald is not put in charge of the ECB any time soon but the overall tone of the message is one that we could all heed.

### **So what happens now?**

The options after a debt crisis appear to be threefold - growth, default or reflate.

Growth is virtually impossible in the short term, especially from countries such as Greece and others who are faced with massive austerity packages.

Default and deflation are the two most likely scenarios and we can look back at previous crises for proof.

- 1992-93 saw the Sterling crisis and a devaluation of the Pound of 28%
- 1993-94 the Chinese RMB fell 35%
- 1994-95 the Mexican Peso lost 60%
- the Asian Crisis of 1996-98 saw ASEAN currencies devalue by 55%
- The Russian Rouble shed 76% in 1998-99

- 1998-99 also saw the Brazilian Real fall 45%
- it was the Turkish Lira's turn in 2001 to drop 60%
- The Argentine Peso lost 74% when they devalued in 2002

Each time it was only after events had come to a head and dramatic currency shifts had occurred that crisis-stricken economies could move on, but move on they did. The Euro is different of course because it is a mish-mash of numerous different States at varying levels of indebtedness, but looking at these previous events, who would bet on the peripheral states still being part of the "main" Euro in the future?

The ECB have been likened to walking on a treadmill, only moving fast enough to keep pace with the evolving financial crisis. BCA Research again put things concisely "in sum, the Eurozone needs a large infusion of money to alleviate debtor burdens. It also needs nominal growth to reduce indebtedness. This can be done either through default, a huge transfer of wealth from outside the Eurozone or ECB money printing."

China appears to have scotched the idea of the huge transfer of wealth idea if one takes the comments literally of Jin Liquin, Chairman of China's Sovereign Wealth Fund. : "If you look at the troubles which have happened in European countries, this is purely because of the troubles of a worn-out welfare society. I think [the EU's] welfare laws are outdated. The labour laws induce sloth, indolence....some countries happily retire at 55 to languish on the beach."

So ECB money printing it is then. Exactly when this will happen remains unclear, but with US data signifying a lessening chance of double dip that side of the Atlantic, the Chinese economy slowing but with scope for further reduction in interest rates there and throughout Asia, and many companies sitting on cash that they don't know what to do with, the outlook once the European crisis reaches its nadir is actually quite promising.

Let's just hope it happens sooner rather than later!

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