



Merchant Cavendish Young

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(Please note that we have now moved office and our new address is 51-55 Gresham Street, London EC2V 7HQ. Our phone and emails remain unchanged).

On the edge

As this is being written, it feels as though we are on the edge of something unpleasant. A tipping point appears to have been reached. Fabio Capello enjoys more confidence from the incumbents of Soho Square (Football Association HQ) than the Euro enjoys from the rest of the world.

To be fair, it is not just the Euro. There are signs that the global recovery is already stalling and this time around there is far less in the global authorities' coffers to help it. "The risk barometers are flashing red," says David Oakley in the FT.

An index that measures future volatility in the S&P 500, the VIX Index, has surged of late but, as yet, is still some way off the levels that it reached in 2008. "It feels like the summer of 2007...when inter-bank lending was just starting to freeze," says Jack Ablin of Harris Private Bank.

We tend to agree with Jack, as we have said in previous editions that the Greek debt crisis is very similar to the collapse of Bear Stearns – a big enough event in its own right but a precursor to bigger ones to follow.

So what exactly are the main concerns now?

The main concerns revolve around Sovereign Debt, the future of the Euro, European banking solvency and a global "double-dip". One would be bad, but it is difficult to see how the existence of one would not lead to another and then the other.

Most commentators now seem to view the Euro as a dead man walking. These are in many cases the same commentators that saw it as the new reserve currency for the world little more than 18 months ago, and who were reading the last rites for the US Dollar.

Don't get us wrong, it is in trouble, but is it really imminently about to disappear?

We'd say not.

The best description of the Euro in our opinion has been given by Josef Joffe, publisher-editor of German weekly Die Zeit, and quoted in Fund Strategy. "It didn't take a PhD in economics to know that you can't have a monetary union without political union. I used the image of taking 10 train engines and coupling them together. The idea is that they didn't have a lead locomotive. Each of these engines had to move at the same speed at the same time otherwise the train would derail....and that has exactly come to pass."

What Joffe omitted to mention was that 6 extra engines had been attached once the others were underway. One of the key rules that member states, founding and new, were supposed to adhere to were limits on fiscal deficits of no more than 3% of GDP and public debt of 60%. Even Germany found these impossible to adhere to. But now they appear to be taking the role of lead locomotive.

Act Two

Ted Scott of F&C describes "Act One" of the credit crunch as being "the explosion of debt and its associated derivative products that culminated in the collapse of Lehman's and the subsequent global recession....The response by governments....has been regarded as a success but one of the consequences of governments' aggressive monetary stance is that debt has been transferred from the private to the public sector."

"Act Two" of the credit crunch is now a fear over the solvency of countries and their ability to service their debt, rather than the solvency of the banks.

Yet this isn't the whole picture because the solvency of the European banks is interwoven with the risk of sovereign default. According to the Bank of International Settlements, British-based banks have £158bn tied up in Ireland and £103bn in Spain. German, French and other European banks have far more exposed to Greece, Spain and Portugal. This causes suspicion between the banks themselves and a freezing of lending at the very time that it is needed in order to oil the recovery. A projection of this behavior leads inevitably to deflation, the effects of which we have all seen in Japan over the past 20 years.

The Eurozone banks were not subjected to the public stress-testing that their American and British counterparts were after the 2008 crisis. This is in the process of changing. And from this, we see light at the end of the tunnel.

Reasons for hope

Whether this light is daylight or the onrushing Euro locomotive we're yet to find out, but there is one or two reasons to be slightly more cheerful than the markets are telling us to be.

Firstly, the very fact that we can look back and see an outcome from the unprecedented events of 2008 is a positive. Policy was made up on the hoof back then. This time around the Eurozone policymakers have a track to run along, however unpalatable it may appear. None of the choices that any of us face are pleasant quite frankly, but some are less bad than others.

We like contrarians, as the herd more often than not gets it wrong. We repeat some comments from Barry Norris, Partner at Argonaut Capital and an expert on Europe, whose contrarian views make interesting reading. On funding for new bond issuance he says, "Any new sovereign bonds issued will have access to this funding backstop (European Stabilisation Fund) contingent on agreement with the EU/IMF on appropriate fiscal reforms. This makes assumptions of imminent sovereign default seem far-fetched. No one is going to run out of money soon."

On the imposition of austerity measures, “the peripheral countries have no credible option but to accept these terms. Leaving the Euro would overnight devalue all of a country’s assets and leave the value of their liabilities unchanged, hence wholesale bankruptcy of a nation. ...soon, only those for whom attending demonstrations is a hobby or a career choice will be left. This diminution of civil strife rarely gets reported.”

On credit risk, “in a worst economic scenario, the owners of government debt will not be the European banking sector, but other European governments, the IMF and the ECB. It is however difficult to imagine a more benign creditor, perhaps willing to postpone interest payments in the desire to secure the return of original capital.”

And against a backdrop of a continuing low interest rate environment and weak currency, “it is possible that financial markets are over-estimating the negative impact of the sovereign crisis on the real economy and under-estimating the positive impacts of lower interest rates and a weak Euro stimulus on the real economy.”

And another positive signal

It often pays to take a hint when you see one. Against the overwhelmingly gloomy outlook of the past few weeks as investors have dumped equities in favour of safe haven US Treasuries and Gilts the dividend yield on equities has risen and the yield on bonds has fallen. So much so that the equity dividend yield now exceeds bond yields for only the third time in 30 years according to Fund Strategy.

And the previous times this had happened?

In March 2003 and late 2008 shortly before equities staged a dramatic and exciting rally Money Week also flagged this statistic. Referring to the latest gilt/equity yield ratio (GEYR), they point out that “for the past 50 years the GEYR has averaged nearer to 2:1. On this basis equities are cheaper than they were at the lows in 2003 and have only been cheaper on this measure in March 2009 – just before the market began its last huge surge.”

Like a job applicant, the gap in “service” between late 2008 and March 2009 is significant. The fact that the index was flashing “buy” in late 2008 masks the fact that equities became an awful lot cheaper still just afterwards.

Amongst the gloom though, we see positive signs. The market has sold off aggressively already from its Spring high, factoring in much of the concern that is being aired at present.

September 2008 was unprecedented and brought the world to its knees. The fact that we are talking about the risks now shows that it is not such a surprise. It is not an “unknown unknown” and one has to ask the question, is the European banking system quite as systemic as the American one?

It is serious, don't get us wrong, but the worst- case scenario doesn't *feel* quite as scary as it did back in 2008. Maybe a bit of sunshine may not be quite as out of touch as some are suggesting.

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Ranked in the top 25 IFAs in the UK by Private Client Practitioner Magazine May 2010

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