

## INVESTMENT NOTE

February 2010

# Spain, Greece, Italy and Portugal - The Four Horsemen of the Apocalypse?

Sovereign debt issues throughout Europe are hindering markets

**Global equity markets started the year well, initially posting solid gains and moving higher. However, despite a better than expected fourth-quarter earnings season, risk-aversion has returned, pushing markets back into negative territory for the year. The prominent drivers of this situation are the sovereign debt issues that are now befalling the southern states of Europe.**

The “four horsemen” are centre stage in a bizarre Euro-centric view of the world at this time. Soothsayers and technical forecasters are arising from their slumber in a devilish attempt to undermine the underlying, slightly positive, economic/corporate changes visible in the major global economies.



Interestingly Greece, which is subject of the most concern at present, has a budget deficit only fractionally higher than that of the UK's 12.7% but does not have:

- (a) The flexibility to devalue and give their export industries a boost (due to its membership of the EU); or,
- (b) The will to implement, or accept, desperately needed budget reforms (yet!).

As a sign of the issues prevailing, Customs Officials walked out in protest at proposed budget cuts. More will follow and the Greek labour force will be the cause of its own demise. In short, the development of “Euro-land” by the Mandarins of North West Europe will prove to have been an accident waiting to happen. It has now been estimated that, even if Greek financial stabilisation measures are enacted, it may cost the European Central Authorities up to £26 billion to prevent it from defaulting on its debt. The EU's fear of such a default, and the possible contagion to other euro-zone nations, (particularly the other three horsemen), has forced it to overlook the Maastricht Treaty's “no bail-out” clause intended to protect the interests of “financially sound” Governments over the “more financially stretched” ones.

With Italy, Portugal and Spain following closely behind, are we set for a Euro crash, a stock market crash, and disbelief in the strength of any Government Debt at all. “Beware the Ides of March” could turn into “Beware the Ides of February”!

**We contest that the position is likely to unfold with:-**

- (a) The Euro becoming a weaker currency; and,**
- (b) Any serious setback in equities providing the last real buying opportunity before the major bull market unfolds.**

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**For Further Information Contact:**  
**TAM International Limited**  
 7<sup>th</sup> Floor, Wing B, Cyber Tower  
 Ebene, Mauritius  
 Tel: (+230) 454 6400  
 Fax: (+230) 454 5413

Our “Outlook for 2010” document predicted some periods of weakness unfolding and we are in such a period now. Our “Bull Markets Climb Walls of Worry” document also outlined how we see the next 24-36 months. We do not see the “horsemen” bringing down the global financial system and we take the threat of a financial meltdown, as a result of the Greek debacle, to be only a minor possibility.

As the UK had been subject to much speculation regarding a downgrading of its sovereign debt, the UK Government was required to take more direct action and embarked on the largest quantitative easing campaign (relative to the size of the economy). The deterioration of UK public finances and budget deficit (especially after an injection of £200 billion in the financial markets) certainly highlighted the fragility of the UK economy and did justify the weakness in Sterling recently witnessed. The baton has now been passed to the Euro and the weakness of the southern states of the Euro mainland. However, the UK Treasury and policy makers were free to respond to the prevailing economic environment and adopt policies intended to navigate the economic mêlée. One area that has certainly helped the UK is the changes in the labour markets that took place over the last thirty years which saw the demise of the countries manufacturing base and with it, the power of the unionised labour force. For example, there has been little back-lash to the 16,000 job losses at Lloyds Bank since the start of the recession. Such flexibility, how ever unpleasant, will allow the UK to absorb some short-term pain as part of a long term remedy. We do not see the potential ceasing of the stimuli recently announced in any way negative but more that the Government is now of a mind that the worst is behind us – this is a long term positive in our view.

Unfortunately, much of the flexibility the UK can rely on is not available to nations within the European Union where a “one size fits all” monetary strategy must and has been applied. The European Central Bank must set interest rates for and apply other monetary policies to twenty seven nations as diverse in economic prosperity as they are in culture and language. Such policies cannot always address the individual nuances of certain countries and have allowed, in the case of Greece for example, their budget deficits to spiral out of control. This now threatens a default in Greek debt, the credibility of the Euro-zone and even its potential break-up (how ever remote), of many of the ideals of the Euro economy as a whole. Indeed the current situation has squarely pushed the Euro to the back of the race to be the world’s reserve currency with the Euro now at a ten-month low against the Dollar.

**How do these developments affect our investment strategy?** As highlighted in our Outlook for 2010 document, our concern for European (ex-UK) stability, has led us to maintain zero equity exposure to Europe for the first half of the year. However, in-line with our policy of opportunistic investment, we may, if we see compelling over sold situations, add selective European exposure to our portfolios. Our expectation for positive performance for most other equity markets is also offering us an opportunity to build further directional equity exposure at levels not seen since the third quarter last year.

**In summary, we believe there will be further negative news to emerge from Europe but also do not expect it to be sufficient to derail the global economic recovery. Furthermore, much of the decline in non-European equity markets is a short-term over-reaction and, thus, offers us more opportunity in the future. We remain optimistic that 2010 will close out higher and, the soothsayers and doomsters that have reared their ugly heads as a result of this Greek Tragedy, are “stale bears” looking for any reason to sell off these markets.**

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