

Politicians staring into the abyss

"Man looks in the abyss, there's nothing staring back at him. At that moment, man finds his character. And that is what keeps him out of the abyss." Lou Mannheim (Bud Fox's boss) played by Hal Holbrook in the film Wall Street (1987)

In weekend elections, France has elected a new president, François Hollande, and Greece, well, hasn't elected much at all. On the face of it, the common factor is that both are the result of a rising wave of anti-incumbent backlash driven by voter's resistance to austerity measures right across Europe. Spain has recently unilaterally pushed back deficit targets and the Dutch coalition government has collapsed amid disagreement over the best way to tackle the Euro crisis. Elections in the UK and even Germany have been unpleasant for the ruling parties. However, with the exception of Greece, the reaction from markets has been muted. It appears to be politicians, rather than the Euro and stock markets, staring into the abyss. What are the issues here and where are we going?

Some sections of the media are spinning the story as voters making a straight choice between "austerity" and "growth". This is misleading choice, of course, and playing with words where "austerity" is now a bad word and "growth" is a naturally good word. Who wouldn't choose good over bad? And so the people have spoken and they want a greater emphasis on growth. But growth, in this context, comes at a hefty price. Perhaps Gordon Brown put it more accurately in 2008 weighing up "prudence" versus "inflation" for the monetary mechanism by which growth would be generated will be inflationary. Is this necessarily a bad thing? As we have seen with the Bank of England, if you have a central bank which is complicit in allowing inflation to run without raising rates, it's a nice way to inflate away one's debt. There's not much evidence that this has been used as a tool, this early, to eliminate debt but the prospect of inflation cannot be easily dismissed. Inflation could feature strongly as part of the Euro crisis endgame, in our opinion, which seems ironic when we're in the middle of a recession.

Austerity, on the other hand, is a very difficult thing to impose on a country. The problem is that debt to GDP in a typical European country is over 100% (about 105%) and still rising. To turn things around and run a 5% surplus, for example, would require a 10% swing. This would hurt a lot and it would have to keep on hurting for over a decade to get back to an acceptable level which, for any government, would be very difficult to do and stay in power for two electoral cycles. There are tremendous risks for any government undertaking an austerity approach but this is the route which, in the early stages, is the way it's started. As we have seen, some governments have been shown the red card at the first opportunity regardless of their left/right political stance.

But austerity is not, and never has been, the silver bullet to solve the debt crisis on its own. The whole (now unpopular) approach ultimately relies upon a Germany / France /ECB / IMF bailout for the weakest Eurozone states. This is highly controversial with voters in northern Europe unwilling to bail out their southern neighbours after years of slack governance but, in the main, is the current strategy. Putting aside all the rhetoric and endless opinion in the media, editorials, FT that we read, it's difficult to find anyone among our peers, friends, ex-colleagues, other fund managers etc who really see how the current raft of support measures and contingency plans add up. Also, there is the political aspect to consider. Angela Merkel has elections in 2013. Our current take on the complicated coalition politics is that she will display unwavering commitment to a solution founded on austerity right up until her next term is secured and only then throw in the towel and allow German money to bail out the south. She wouldn't find any opposition from her Green party coalition who are all for it. Even the German opposition parties are for it. Angela Merkel would be pushing on an open door.

So, in conclusion on the Euro at least, we think the most likely outcome is that the Eurozone debt crisis muddles through via a combination of austerity and a greater tolerance for the emergence of inflation and that the Euro, as a currency, will survive. In extremis, some countries might leave the Euro but the political will of the European Council will carry enough weight to keep the concept of a single currency alive in a slimmed down Eurozone.

We think the bigger call is still between investing in bonds or investing in equities rather than currencies in isolation. We think bonds are overpriced and that equities are cheap on several measures. Within that we are particularly keen on the USA followed by UK. If we saw excessive weakness in the Euro, however, then we have already made plans to take advantage of overly poor sentiment to buy good quality European stocks on cheap valuations.

We recognise that these, and several other factors, are already weighing heavily on investor's fears. However, we have already positioned client portfolios relatively cautiously with underweight positions in equities but have, nevertheless, come through the first quarter of 2012 with some good outperformance overall. We continue to look for excessive weakness in all equity markets as a buying opportunity but this would, at most, only be moving to being closer to benchmarks.

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