Illumination: Equity strategy and market outlook

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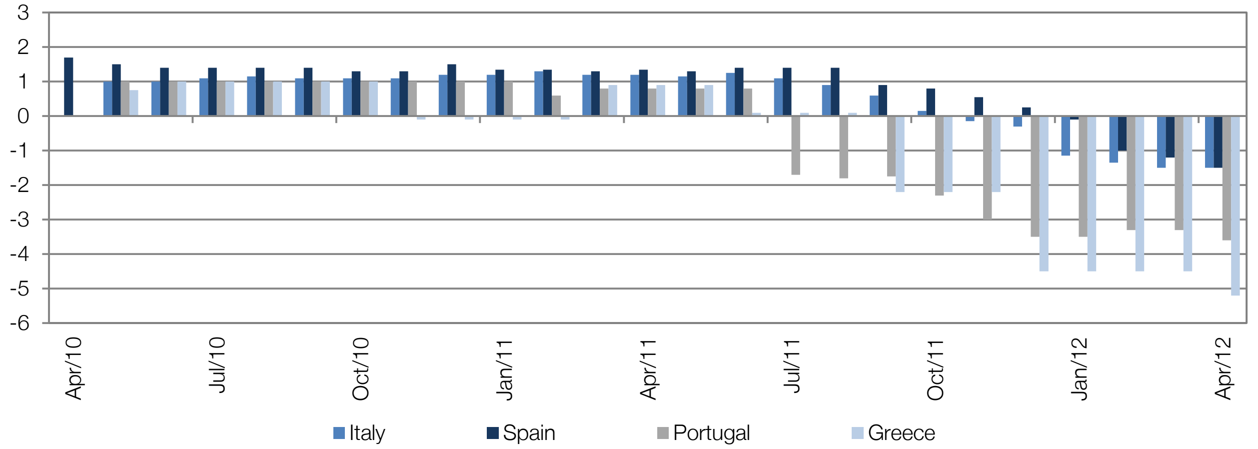
Global perspectives: Political economics

- **Austerity was driven by politics.** For the last year we have feared the implementation of austerity would crush growth in peripheral European economies. Though presented as an economic solution to excessive government debt, austerity was primarily designed to fit the requirements of Northern European domestic politics. Though politics and economics are always linked, in times of crisis they become tightly bound. The economic effects of austerity are now driving political change.
- **Greece remains an open question.** The collapse in support for the New Democracy and PASOK parties in favour of the extreme left was predictable in a nation with 22% unemployment. With the major parties unable to form a government, another Greek election due in June leaves both the status of the Greek bail-out and the composition of the eurozone in question.
- **Merkel now isolated.** With the fall of Sarkozy, Merkel is now isolated in both Europe and the world in her dogged determination to push through austerity no matter what the consequences for growth. At this week's meeting of European leaders, a number of pro-growth measures are being revived despite being vetoed by Germany last year. It remains to be seen how much progress can be made.
- **Capital flight continuing.** Depositors in peripheral European nations have two very good reasons to park funds in Germany – bank solvency and euro break-up risk. With no risk premium being paid, the capital flight is entirely rational. Commercial banks in the core are cutting lending to peripheral borrowers and adding to the effective capital flight. The evidence from the imbalance in the eurozone's TARGET2 settlement system is unequivocal.
- **What to do next?** In April we reversed course and suggested cutting portfolio risk. European stocks have fallen by 7% since. Investors have correctly re-introduced a risk premium into growth and periphery exposed sectors. Banks have also suffered. However, there has been little indiscriminate selling of the magnitude seen in Q411. We believe the correct strategy is to use the volatility to obtain positions in quality, non-financial franchises with a medium-term investment horizon. If inflation and growth expectations fall further, further rounds of QE cannot be excluded.

From the economics of austerity to political uncertainty

For the last year we have feared that austerity would crush growth in peripheral European economies. The over-emphasis on the needs of the creditor nations (core) versus the debtors (periphery) has left the whole of Europe worse off. Consensus GDP expectations are still falling in the periphery, Exhibit 1, and unemployment has risen to politically unacceptable levels. Yet Exhibit 2 shows fiscal tightening is forecast to continue to drag on peripheral economic growth in coming years.

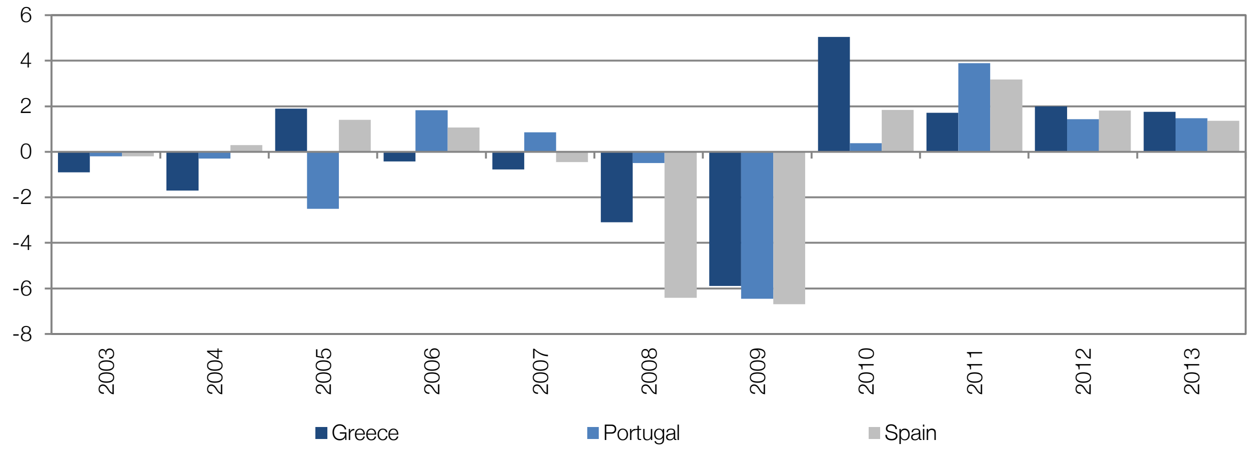
Exhibit 1: Peripheral Europe – consensus 2012 GDP expectations (% change)



Source: Bloomberg

In Greece, support for the parties responsible for the bailout package has collapsed, leaving the nation with a caretaker administration until new elections in June. With the extreme left Syriza opposed to the bail-out package, the commitment to the euro is being questioned. Once again, the real question is not Greece, which is too small to make a significant impact on eurozone finances, but the implications for the larger peripheral nations.

Exhibit 2: Peripheral Europe – forecast fiscal tightening (% GDP)

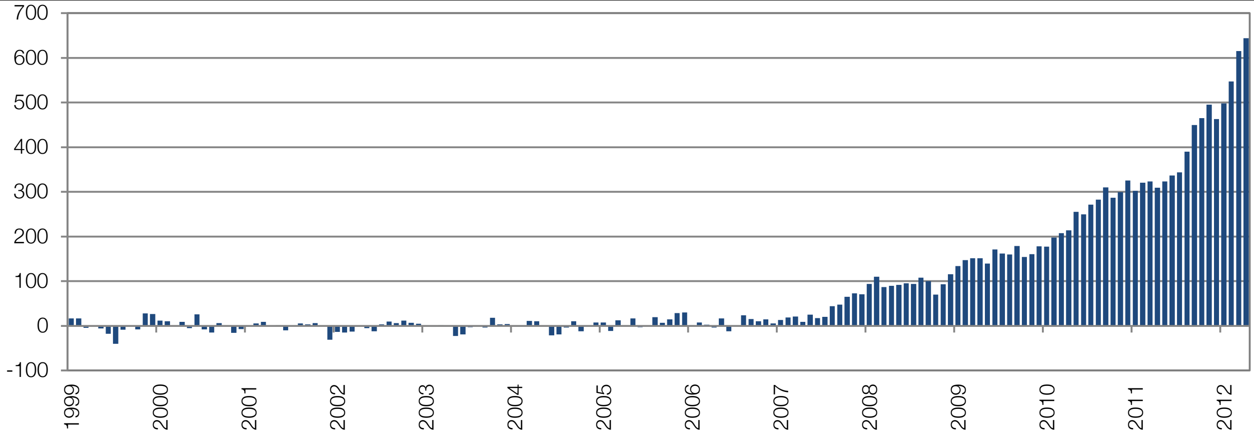


Source: OECD

A combined fear of bank insolvency and a break-up of the eurozone is driving liquid private sector assets out of the periphery and into the core. This can be seen in the imbalances being built up in the TARGET2 system for settling cross-border euro transactions between central banks, Exhibit 3. While the flight of deposits has contributed to the imbalances an equally important factor has been the withdrawal of lending in the periphery by core banks. This lending has been replaced by local banks, funded by the ECB's LTRO facilities.

In this way, the action of the ECB can be seen to be facilitating the orderly withdrawal of private sector credit from the periphery – or in other words financial dis-integration. Perhaps the Bundesbank's vocal opposition to the ECB's activities should be seen in context of a rapid build-up of claims (and risk) against peripheral central banks.

Exhibit 3: German claims on TARGET2 (€bn)



Source: Bundesbank

For equity investors we can see very little merit in having exposure to the periphery of Europe when faced with the near certainty of weak growth, an outside chance of a eurozone break-up and a possibility of capital controls. If equity valuations become distressed then the risk/reward balance may shift – but we are not there yet.

Merkel looking isolated

It is not only in Greece that the failure to engender growth has been politically costly. Sarkozy has been replaced by the socialist Hollande as President of France. Hollande is reviving a number of growth-oriented ideas, including project bonds. Many of these initiatives have previously been ruled out by Germany. With growth in the eurozone ebbing there is also growing international frustration with what is perceived to be an unnecessary crisis caused by policy failure.

In aggregate, Europe's fiscal and current account positions do not look insurmountable. But the insistence that each nation in Europe is economically self-sufficient – while Germany continues to enjoy strong export-led growth – is at odds with a European vision.

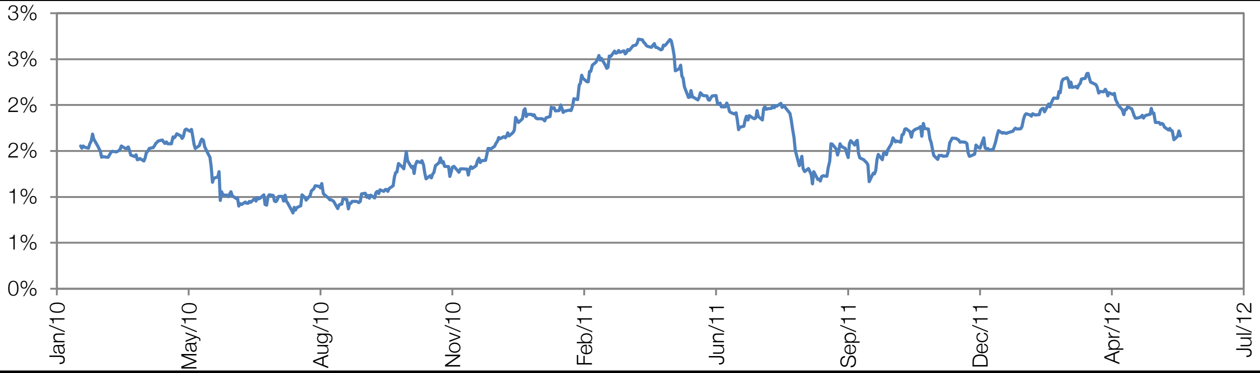
Since 2008 markets have cycled between despair as self-sustaining growth proves elusive and hope as monetary policy has responded to declining confidence. It would be tempting to believe that careful analysis of the European political processes could provide the insights required to forecast these changes in sentiment. We would compare this to attempting to predict the path of a chaotic system without any knowledge of the initial conditions. In our view European policy is self-evidently ad-hoc, politically driven and unpredictable.

Where next?

Having advised clients to cut risk in April the Stoxx-600 index has fallen by over 7%. Though a significant decline, there has been little indiscriminate selling. The sharpest falls have been borne by sectors exposed to growth and the periphery of Europe. This is an entirely rational response to declining survey data and capital flight. The quality non-financial equities which we favour have been much more resilient.

The recent market declines have not therefore opened up a clear opportunity to invest for the medium term in the same way as in Q411. We remain of the view that a portfolio of quality non-financial equities and corporate bonds, combined with cash on hand to take advantage of opportunities as they arise, remains the correct strategy at present.

Exhibit 4: US 2-year inflation expectations declining again



Source: Bloomberg

Conclusion

In the short term we believe the upside risk of policy initiatives will stabilise markets near current levels. As inflation and growth expectations fall in the US, Exhibit 4, another round of QE cannot be ruled out from the US Federal Reserve. The same growth and inflation logic applies to the UK and further QE would find favour with the IMF. In Europe we expect further initiatives aimed at attempting to slow the capital flight from the periphery.

Though still a highly unpredictable situation, we note that support for the Greek Syriza party has fallen over the last week. Current opinion polls suggest New Democracy will be the leading party in the June 17 elections. An election enabling the formation of a government that supports the EU/IMF bail-out package is likely to be accompanied by a substantial relief rally.

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