

PROFESSIONALS' VIEW – JUNE 2010

Europe Loves The Germans – It's Official!

It's official. Everyone in Europe loves the Germans. With a landslide victory of such proportions as to be a mere heady dream for politicians in this country (or any other country apart from dictatorships) Germany received a resounding boost from their European counterparts in what can only be seen as a unanimous backing for what it offers the rest of the Continent. Yes, it won the Eurovision Song Contest in a manner which brought back memories of Lulu's Boom-Bang-A-Bang and Sandie Shaw. How apt if the Greek entry had been a remix of Ms Shaw's Puppet On A String.

Is it coincidence that the rest of Europe turned to Germany for musical reassurance and uplifting this year of all years? At a time when Portugal, Spain, Italy and Greece face the equivalent of a *nil point* vote from the rest of the Global Community with regard to the purchase of their sovereign debt issues, Germany showed that they are prepared to do what they feel they need to do in order to steady their own ship. The redoubtable Angela Merkel shocked the markets with her unilateral banning of naked short selling. The French in particular, and other "Northern" members of the Eurozone, were more than a little miffed that they were not consulted – an indication of who wears the trousers in the Eurozone alliance.

Will The Euro Survive?

This has been the main question being asked by economists, asset allocators and holiday-makers alike. Ian Henderson of JP Morgan makes a good point when he suggests that "if it got to a vote again, people would probably vote to go back to

where they were." Others such as Richard Woolnough of M&G and Adrian Frost of Artemis also doubt that the single currency is workable in the long run, but rather unhelpfully are less than precise on their timing. "The Euro will fail," says Woolnough, "but whether that is in 1,000 years, 50 years or next week, who knows?" That's about as helpful as saying put your money on England to win the World Cup, because they *will win* it again, but whether it's this year or not, well we can't say that [Let's hope we win it again before they introduce goal line technology: Ed].

One thing is for sure though. It is very difficult to make a case for the Euro strengthening significantly against other currencies, particularly the US Dollar, as indeed it is difficult to see Sterling rallying too rapidly either, so it makes sense to look to Dollar denominated funds and avoid investments exposed to the Euro while this particular leg of the credit saga is played out.

The Double D Is Back:

In March we wrote, "we are seeing a clear trait among economists and fund managers at the moment. Those who were caught out by the banking crisis in 2008 are seeing their portfolios recover sharply and now believe that they were right all along." Now that markets are significantly off their highs of March, are we really out of the woods regarding the banking crisis?

It must be said that, although there are similarities between the run up to the financial crash of 2008 and now, it doesn't *feel* as if the threat is quite so bad. But is this dangerous complacency?

The collapse of Lehman Brothers, Merrill Lynch, RBS et al, was a seismic event that shook the world.

Europe got away with being relatively unscathed structurally. Now it's different. We have already seen smaller regional Spanish banks (the equivalent of a building society really) going under. We witnessed the domino effect in 2008 of inter bank lending and liabilities. The biggest exposure to the sovereign threat of default from Greece, Portugal and Spain lies within the European banking system. With every ripple created by a smaller institution collapsing, a bigger wave builds. The IMF points out that "the Eurozone is well behind the US in terms of writing off bad assets." A report in the FT estimates that the German Landesbanken (regional wholesale banks) "could yet have to write off 800 billion Euros" [*MoneyWeek* 28.05.2010].

This threat, along with data coming from the United States showing a stuttering in recovery of the housing market, has allowed the re-emergence of the Double D phrase – Double Dip and Deflation. It has been assumed in most quarters that the Quantitative easing (QE) programme activated by the UK and US governments would lead inevitably to inflation. Indeed, the latest figures from the UK show inflation some 1% above target, at 3.7%. But there is a growing opinion that this is just a blip in the short term and that deflation still poses a Japanese-style threat to our markets and economies.

Where Is Safe At the Moment?

Safety is the wrong word to use in investment terms. How many people are literally getting their fingers burned by holding a "safe" stock such as BP just now? Not only has the share price taken a dive, but there is uncertainty over whether its dividend (for which many individuals and institutions hold this stock) will be cut. This also puts a question mark over the wisdom of "index-hugging". BP is the biggest stock in the index, so its' troubles have a disproportionate effect on the index to which it is wedded.

It is hard to see how investors can get too badly burned by holding gold in its various forms. As a real asset, and importantly a finite asset, it remains a safe haven in times of turbulence. Yes, the price can, and will, fluctuate, but with every dip likely to be bought into by entities far bigger than you and I, there appears to be an underlying floor to the gold price that should act as a security blanket when we need it.

Returns on cash are almost certain to remain low in the short term at least, yet money will continue to seek a return. Corporate bonds still pay an attractive yield in comparison to cash, and it can be argued that the largest companies in the world are more stable than some of the governments that regulate them. Our comment about BP underlines the risk one takes in investing in single issues however, so diversification is key, but if we avoid a deep double dip, defaults should be avoided in the corporate world so that consistent income can still be earned from good bond funds.

And in times of volatility, it makes sense to invest in a multi-asset strategy, particularly one that allows for some extra defence in the form of shorting indices and sectors. Mrs Merkel would not agree, but let's hope that the Eurovision victory can lighten her mood.

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