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MANAGING WEALTH EXPRESS

Managing Wealth Express – Europe special

The problems in the European debt markets continue and the lack of cohesion becomes increasingly obvious.

Greece

Greece remains at the core of the tensions within the Eurozone. Its next €8bn tranche disbursed by the International Monetary Fund (IMF)/ European Union (EU) is due at the end of September but the IMF/EU/European Central Bank (ECB) taskforce is less than impressed with the progress Athens is making. For the January to August period of this year, budget revenues have fallen by 5.3% and expenditure has risen by 8.1% compared with the same period in 2010. This has led to a budget deficit of €18bn for the year to date, or 7.8% of GDP, which is just below the target for the whole year. The Greek government are trying to implement a raft of new unpopular measures aimed at further cutting the public sector workforce and increasing taxation. Due to the ineffective collection of taxes, the latest property tax due to be introduced will be added to electricity bills to try and enforce better collection rates. According to the Greek finance minister, Greece has enough cashflow to October so it is critical that the next tranche is received on time. We think there will be a rushed attempt (again) at appeasing the IMF/EU/ECB taskforce and the next tranche will be received.

The wider problem

Investors are losing patience with the Eurozone. This can be seen through bond yields and the fragility of the share prices of Europe's largest banks. In addition, over the last few weeks there have been some clear signals that there is a fundamental difference of opinion between EU decision makers. Jürgen Stark, an executive board member of the ECB, resigned earlier in the month after a disagreement over ECB strategy and losing out on the position of President to Italy's Mario Draghi. Germany's vice-chancellor, Philipp Rosler, has said "an orderly insolvency" should be considered, which clearly angered Angela Merkel, the German chancellor who responded saying "everyone should weigh their words carefully" and "we will do Greece the greatest favour if we speculate less". There has been a lot of concern regarding Angela Merkel's poor showing in recent local elections that could put pressure on her ability to lead, but her coalition party still has a relatively strong majority that looks solid until the next general election in September 2013.

Solution?

The reason why the Eurozone problems continue is that each solution is very messy, time consuming and calls for a fundamental change in the structure of the Eurozone. There are three main options;

- 1 Issue Eurozone bonds, which is a bond backed by all Eurozone members, in place of each country issuing their own government debt. This bond would likely have a 'AAA' rating, which would greatly reduce the funding costs of peripheral nations, but potentially increase the cost to Germany. It would result in budgets that would be centrally managed and a huge convergence in fiscal policy and loss in sovereign control i.e. the Eurozone becomes not only a currency and monetary union but also fiscal union. Whilst this would take years to implement, in our opinion

this is the only sustainable option for the long term viability of the Euro project. The President of the European Commission, Jose Manuel Barroso, has indicated that the Commission is putting forward a proposal for the creation of a Eurozone bond, indicating that the suggestion is being taken seriously.

- 2 Muddle on through. This remains the most likely short-term option. The ECB and EFSF (European Financial Stability Facility) would continue their support of the Italian and Spanish bond markets to try and keep yields at sustainable levels. The EFSF and its 2013 replacement, the ESM (European Stability Mechanism), would have to be increased in size, but the Germans are keen to ensure this mechanism does not become similar to a Eurobond structure through the backdoor. Another temporary fix, as suggested by the new head of the IMF, Christine Lagarde, is to recapitalise the European banking system to make it more robust to potential falls in asset values and debt restructuring. Whilst the UK banks have been trying to rebuild their balance sheets, the European banks (excluding the Swiss banks) have yet to substantially improve their capital security. Significant capital injections would be politically sensitive and socially unpopular but they could lead to a rise in market confidence.
- 3 Greece defaults / leaves Euro. The economics and law behind this potential is very complex. If Greece defaulted on its debts, it would most likely leave the Euro at the same time. It is likely that Greece can only leave the Euro if it defaulted. Both issues pose grave risks not only for Greece, but also the Eurozone and wider global economy. Willem Buiter, Citigroup's Chief Economist, earlier in the week presented a bleak picture for the Eurozone in the light of a withdrawal from the Euro. He pointed out that there would be a huge drain of capital, including deposits from any country that had the slightest inkling of leaving the Euro, and assets would move to 'core' Eurozone countries such as Germany, Luxembourg, Finland and the Netherlands. This would put a huge strain on the banking system in the region.

Conclusion

Why is this important? The UK exports 40% of all goods and services to continental Europe. It is key, not just to the UK economy, but also the global economy that stability is returned to the Eurozone, and European policymakers can concentrate on delivering growth to the region rather than trying to concentrate on Greece and the euro project.

The solutions are very socially and culturally sensitive. The populations of each Eurozone member do not want to lose any control over their sovereignty and fiscal control. Despite this, pressure is mounting for a unified Eurozone as it is unlikely to last in its current state and something needs to give. However, it is likely that conditions will get worse before a solution is agreed. Jim O'Neill, Chairman of Goldman Sachs Asset Management, points out in his latest note that "really powerful decisions need an appearance of a real crisis before the German electorate can be persuaded" and Morgan Stanley concur in their note saying "economic and market conditions will probably have to get a lot worse than they already are as Germany and other core countries need to stare into the abyss.... before they agree to write the proverbial cheque".

Investment opportunities

Structured products

The global equity plans with Morgan Stanley remain open for a short period and are an excellent opportunity to invest at these depressed equity levels. We have also developed two new plans, one that offers an attractive 7.5% income per annum, and the second offers 120% growth in the UK, European and US equity markets. These two plans will be launched over the next couple of weeks.

Syndicated property investment

We are close to exchanging on a property located in a prominent position on Argyle Street in central Glasgow. Let to Greggs plc until October 2023, with a tenant's option to break in 2018 and extend the lease by a further five years at expiry. The syndicate will provide a net income yield of 6.6% from year six.

Equity income

Income from dividends continue to look attractive with the average yield being 4.2% across our preferred income funds.

This week in review

UBS 'rogue' trader loses \$2bn

The Swiss bank, UBS, announced on Thursday that it had fallen foul of an estimated \$2bn fraud by a London-based trader, named as Kweku Adoboli. Despite the limited information divulged by UBS, the Financial Times reported that Mr Adoboli was linked to ETF trading. UBS can absorb the huge loss, but it is a massive blow to their reputation and recovery from the losses mounted in 2008. Swiss banks have had a long-standing reputation of security and prudence, but UBS has damaged its reputation and investors and clients will be wondering what is going on at the bank and how this could have happened. It is the second large fraud associated with ETF trading after Jerome Kerviel of Société Générale caused a \$6.8bn loss in 2008 from making trades outside of the bank's procedures. There have been several warnings over the last few months (Gillian Tett of the FT offers a very good insight) regarding the murky world of ETFs and this latest headline will force the hand of regulators to improve transparency and enforce stricter risk controls.

UK inflation and retailing

The Consumer Prices Index (CPI) rose to 4.5% in August from 4.4% with the Bank expecting it to rise above 5% by the end of the year. The Retail Prices Index (RPI) rose to 5.2%, from 5%. The rises were due to a rise in clothing, footwear and furniture prices. Next and John Lewis made announcements regarding their trading positions in the week. Next stepped up its forecast for 2011 after increasing prices by 7% to offset the rising inflationary pressures. Its pre-tax profits were up 8.5%. John Lewis posted pre-tax profit of £90.4m for the first half of 2011, an 18% fall on 2010 due to an increase in investment spending. Retail sales by value were 3.2% higher in August compared to 2010, but volume fell by 0.1%, which highlights the pressure from inflation and weak demand.

Meeting with Sir Mervyn King

We met with Sir Mervyn King, Governor of the Bank of England, this week. The main theme of the presentation was the need for economies to rebalance. The last decade has seen an inflexion point in the future of the global economy. The historically dominant West has seen its influence wane and become more dependent on the high savings built up in the East. This dynamic has now reached a point where the strains are clear and governments are losing control of their destiny. This is not just restricted to China and the US but can also be seen in the Eurozone and the UK. The need for the West to reduce its dependence on domestic demand and increase its exports, and for the East to increase its domestic demand and reduce its dependence on exports, will not be a short-term process. It was difficult not to be impressed with his understanding of the UK and global economy and what is needed to ensure a sustainable recovery.

By Ben Wattam, Investment Research Manager

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