

DECEMBER 2011



*Best wishes for Christmas and the New Year*

## PROGRESS IN EUROPE?

Regular readers of our commentary will be wondering if their November issue has gone missing. In fact, we decided not to write a commentary until after the latest meeting of European leaders had taken place on 8/9 December 2011. We believed that decisions they were going to make on moving towards solving the European sovereign debt crisis could lead to any prior analysis becoming redundant.

Twenty-six European Leaders agreed to revise treaties so that the euro zone's commitment to greater fiscal discipline is enshrined in law. The United Kingdom refused to sign up to these treaty changes, so the covenant between the other EU members will be on an inter-governmental basis.

The agreement will lead to a "fiscal compact" to ensure that members adhere to budgetary discipline. A balanced budget would have to be adopted by each government with the European Court of Justice enforcing compliance. Brussels would carry out closer surveillance on non-compliant countries and fines would be made if the 3% deficit limit is breached.

It was decided to rapidly deploy the €440bn European Financial Stability Facility (EFSF). In an attempt to strengthen the firewall to contain the debt crisis, it was decided to bring forward the new €500bn European Stability Mechanism to July 2012, one year earlier than intended, taking over from the EFSF in mid July 2013. Currently there is no agreement to run the funds in tandem, which would have given considerably more firepower. This is due to be reviewed in March 2012. Furthermore, within the next 10 days the EU is deciding whether to provide an extra €200bn to the International Monetary Fund (IMF). The requirement for private bondholders to bear some of the losses during future rescues has been dropped from the European Stability Mechanism Treaty. We are still concerned about the prospects for the EFSF, given that Standard & Poor's has warned that a number of euro zone countries which provide support for the facility may have their credit ratings downgraded.

There are also indications from Germany that directing its taxpayers' money or credit to indebted European countries via the IMF would be unacceptable. This suggests that circumventing internal EU or European Central Bank rules by using the IMF as a conduit will fail. Given the importance

attached to this element of the plan, it is unfortunate that it may have stalled so quickly.

The reaction to the proposed measures was initially favourable with European markets moving upwards, and Italian and Spanish bond yields fell significantly as a result. The firewall strengthening measures and further intervention by the European Central Bank (ECB) should mean that Italy and Spain will be able to cover their debt funding. The ECB has provided further support for European Banks by cutting interest rates by 0.25% to 1%. This is the second consecutive monthly reduction of 0.25%. The ECB also reduced its bank reserve requirements and now accepts a wider range of collateral and is offering longer term funding for banks which are finding it difficult to borrow.

## THE FIVE MONTH CRISIS

When we wrote our commentaries in the summer, we expected the EU to act more quickly and decisively than has been the case in addressing the problems facing weaker European economies. We are still unconvinced that the measures agreed upon to date are sufficiently robust, or even appropriate, to solve the longer-term problems of the euro zone. We are concerned they will take too long to implement and afterwards, whether they will be sufficiently strictly enforced. After all, the 'European Stability and Growth Pact' was agreed when the euro was introduced, but has not been adhered to by many countries on numerous occasions, including Germany and France. Germany was the first country to break the terms of the pact, but now blames others for doing so. Whilst the outcome remains uncertain, we expect that European markets will remain volatile, impacting on global markets.

Nothing that has so far been discussed will solve the underlying problem of several euro zone economies being completely uncompetitive as members of a German dominated currency union. The plans discussed to date treat the symptoms but by no means provide a cure. The markets are fully aware of this and even if these plans are implemented, it can be assumed that there will be future problems.

## SLOWING GROWTH AND CENTRAL BANK ACTION

Stronger economic growth would, even only at trend levels, provide considerable relief to heavily indebted euro zone economies. The same is true for other indebted economies such as those of the US and the UK. Far from promoting economic growth, the euro zone's plans threaten to stifle it during a period of strong deflationary pressures. This threatens to exacerbate rather than to relieve the debt pressures within the euro zone.

Indicators from around the world, the Purchasing Managers' Indices (PMI) or their equivalents, are reflecting contraction in European and Asian economies. Globally, the major exceptions are India and the US. The US is showing a five-month high although tax incentives for capital goods are supportive of these figures. Slowing global growth unsettles riskier assets, but the impact of these disappointing statistics was alleviated by the announcement of coordinated action by the world's central banks. A number of banks announced interest rate cuts and the Federal Reserve in the US cut the rate that it charges the ECB and the central banks of Japan, the UK, Switzerland and Canada to borrow US dollars. These actions sought to improve liquidity in the global banking system which helped markets and provided a strong signal that policymakers were willing to try to avert further problems in the euro zone.

### POSITIVE NEWS IN THE US

The unemployment rate fell in November to 8.6%, the lowest level in two and a half years. Consumer confidence in the US also rose in November as it appears that consumers feel that current and future conditions are set to improve. This improved confidence reflected in the stronger retail sales figures over the Thanksgiving weekend. The capacity of the US economy to assist a global recovery should not be under-estimated. The US remains by far most important single economy in the world – although the EU collectively is more important overall.

### OUR VIEW

With the continuing uncertainty in Europe, slowing growth there and in some Asian markets, tempered mildly by some positive news from the US economy, we remain relatively cautious. We feel that there is still value in parts of the larger company

end of the UK market and that following falls in Asia Pacific markets and Emerging Markets, these regions also present some opportunities.

European equities offer not dissimilar long-term value opportunities, following recent falls. US equities are more fully priced on a long-term view, although that may change if the US economy is able to grow at a higher rate than currently expected. In general though, the outlook for Western economies is depressed by heavy consumer and government debt and the need to reduce it. The problems in the Western banking system mean that less credit is available, and this factor will heavily influence the behaviour of consumers together with business investment over a sustained period. This said, corporate balance sheets are generally in rude health, and those Western companies that can profit from the growth of Asian/emerging market consumption stand to gain substantially – as well as the domestic companies of the countries concerned.

The AAA rated debt instruments, particularly gilts and US treasuries, are benefiting from a flight to quality, raising prices and suppressing yields. With gilts yielding little more than 2% p.a. and inflation at 5% p.a. there is suggestion of a bubble. With inflation set to fall rapidly, interest rates likely to remain low and general deflationary pressures, gilts are likely to remain a safe haven presently. Whilst exceptional profits have been made since 2008 (and indeed over the past 12 months), we are taking these, whilst leaving core holdings intact. Higher grade corporate bonds have also fared well – and there is probably some further scope – at least for 'real' yield – as inflation falls. The higher yields offered by lower graded debt and international bonds are also of interest.

We have been surprised by the resilience of markets in recent months. It seemed very unlikely they would tolerate the instability in the euro zone over so lengthy a period, and no solution is in sight yet. Conversely, markets have shown an inclination to rally strongly on the slightest sign of a solution to the euro zone's problems – even if only a temporary one. This suggests investors are increasingly conscious of the longer-term danger presented by inflation, the lack of security in the global banking system and the miserable return from cash – combined with elevated security risk. The emphasis on yield seems to be increasing and lower equity prices and (in some countries) bond prices, present sound long-term opportunity. Shorter term confidence is very fragile with markets reacting swiftly and probably exaggeratedly to both positive and negative news flows. This seems likely to continue for some months yet.

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