



## Newsflash

A new month and the 41<sup>st</sup> issue of Viewpoint from FP.

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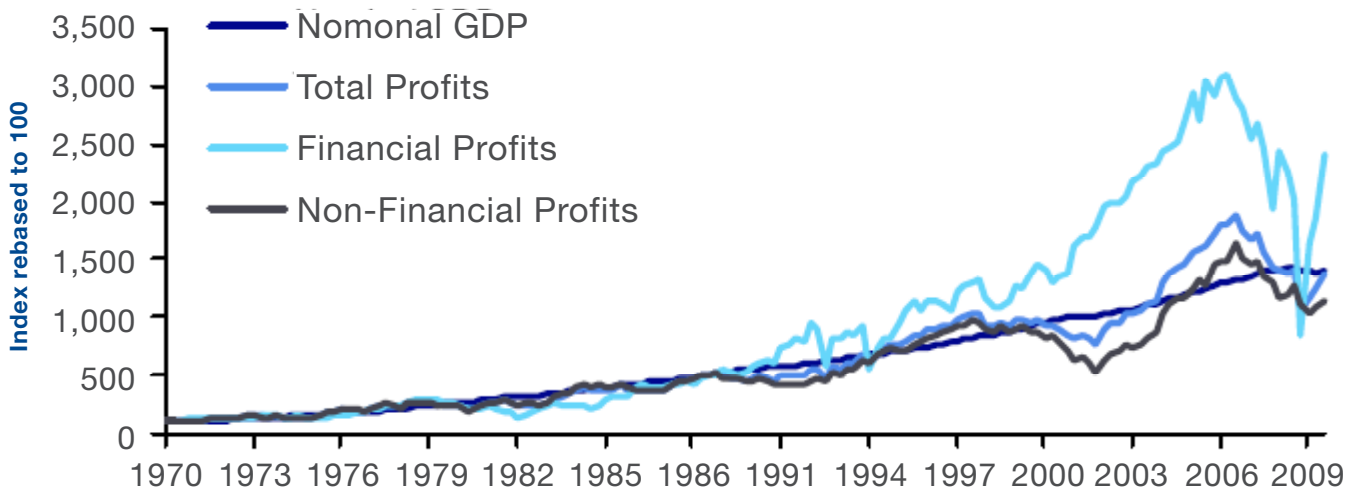
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Early in the month President Obama may have received a political bloody nose from the good people of Massachusetts and will no doubt have to put his healthcare reform bill on hold, but he has bounced back with a populist stance in taking on the bankers. A re-imposition of previously restrictive legislation will be very unpopular with Wall Street and therefore very well received by the rest of the population. It will, in all likelihood, spill over to Europe as well. Curbing bankers' bonuses (amongst other measures) will probably do very little to sort out the fundamental issues of over-indebtedness of the West. Politicians have however shown in the past that they are sometimes hard pressed to think beyond the next election, not to speak about the next popularity poll. Northern Rock, RBS and Lehmans did not go belly up because of their trading activities – they bit the dust over-leveraging their balance sheet by lending to poor creditors and whether this was done by plain vanilla lending or the retention of securitised products is irrelevant. Nevertheless, separation of trading activities from banking now seems likely as few Republican politicians may want to imperil their careers by standing up for the banks – and the banks only have themselves to blame. It also seems likely that capital ratios will have to take account of an increasing range of off-balance sheet assets and this (more sensible) measure will have implications well beyond the European banks at which it is primarily aimed. All financial institutions will be under pressure to retain capital (lower dividends and rights issues) and shrink balance sheets to 'risky' borrowers

(less lending and more sovereign bonds). Banking profitability is likely to be on a secular decline and this will have negative implications for global growth.

Deutsche Bank published the graph below which compares the profitability of the US financial sector with non financial sectors (rebased at 100 in 1970), and a clear anomaly exists:

lost only -0.7% in January, and ended in the black (+2.0%) when measured in US Dollar terms. Emerging equity markets fared slightly worse when compared to their developed counterparts as the MSCI Emerging Market Index produced a return of -5.6% in US Dollars. Most market commentators support the growth story for emerging markets, but this may just be somewhat of a contrarian indicator over the short term.



Source: Deutsche Bank, Bloomberg

They further stated that with hindsight it is clear that had financial profits not rebounded in the manner they have done over the last 12 months then the global economy would still be mired in a deep recession with the risk of Depression high. The footprints of the financial sector are all over the Global economy and to leave financial earnings back down at trend levels would be to leave a trail of destruction in the real economy. So whether it was luck or judgement, allowing financial institutions to return to super-normal profits again allows the economy to resemble 2007 in many ways.

Global equities pulled back during January with all the major indices in negative territory. In the US the S&P 500 retreated -3.6% in US Dollars, with their British neighbours across the Atlantic seeing a similar pull back of -3.6% (in Pound Sterling) in the FTSE All Share index. In Europe (-3.4% in euros) the theme was much the same, with US Dollar strength further detracting from returns for investors who favour the greenback as base currency for their global investments. Japan was the notable exception as the Topix

Global bond markets were stronger towards the end of month as investors' enthusiasm for risky assets waned and demand for government bonds pushed yields lower. US Treasuries gained (JP Morgan GBI +1.6%) and in Europe (+0.4%) and the UK (+0.6%) government paper performance was also positive in local currency terms in spite of all the sovereign risk concerns. Investment grade bond spreads over government bonds widened, but the reduction in the underlying reference yield cushioned the effect. In the US, Eurozone and the UK investment grade bonds had a good month, and further out in the risk spectrum high yield bonds did particularly well (+1.3% in the US and +3.4% in the Eurozone), especially when compared to the weak equity markets.

The US Dollar strengthened against the two major European currencies (+3.1% against the euro and +0.8% against the Pound Sterling) as well as a number of emerging market currencies, but lost ground against the Japanese Yen (-2.7%). Commodity markets were also particularly weak as broad

commodities, agriculture, oil and gold pulled back on fears of a less than robust global economic recovery.

Property securities continued to exhibit volatile performance and lost ground across all major geographical regions, save Europe.

Our preferred exposure to this asset class is investment into direct property with managers who do not have any legacy issues or impaired assets in their portfolios, as this should provide much more of a diversification benefit than securities which have been closely correlated with equity markets in the recent past.

## Asset Class Performances

Asset Class/Region	Index	Currency	Jan 2010	YTD 2010
<b>Equities</b>				
United States	S&P 500 NR	USD	-3.6	-3.6
United Kingdom	FTSE All Share TR	GBP	-3.6	-3.6
Continental Europe	MSCI Europe ex UK NR	EUR	-3.4	-3.4
Japan	Topix TR	JPY	-0.7	-0.7
Global	MSCI World NR	USD	-4.1	-4.1
Global Emerging Markets	MSCI World Emerging Markets TR	USD	-5.6	-5.6
<b>Bonds</b>				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	1.6	1.6
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	1.6	1.6
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	1.6	1.6
Us High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	1.3	1.3
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	0.6	0.6
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	GBP	2.3	2.3
Euro Government Bonds	Citigroup EMU GBI TR	EUR	0.4	0.4
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	1.6	1.6
Euro High Yield	Merrill Lynch Euro High Yield 3% constrained TR	EUR	3.4	3.4
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.0	0.0
Global Government Bonds	JP Morgan Global GBI	USD	0.5	0.5
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	0.2	0.2
Global Convertible Bonds	UBS Global Convertible Bond	USD	-1.2	-1.2
Global Emerging Market Bonds	JP Morgan Global EMBI+	USD	-0.1	-0.1

Asset Class/Region	Index	Currency	Jan 2010	YTD 2010
<b>Property</b>				
US Property securities	MSCI US REIT TR	USD	-5.4	-5.4
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	-7.0	-7.0
Europe ex UK Property securities	FTSE EPRA/NAREIT Europe ex UK TR	EUR	0.0	0.0
Asia Property securities	FTSE EPRA/NAREIT Asia TR	USD	-6.8	-6.8
Global Property securities	FTSE EPRA/NAREIT Global TR	USD	-5.9	-5.9
<b>Currencies</b>				
Euro		USD	-3.1	-3.1
Sterling		USD	-0.8	-0.8
Yen		USD	2.7	2.7
Australian Dollar		USD	-1.2	-1.2
Rand		USD	-2.4	-2.4
<b>Commodities</b>				
Commodities	RICI TR	USD	-7.9	-7.9
Agricultural Commodities	RICI Agriculture TR	USD	-7.6	-7.6
Oil	ICE Crude Oil CR	USD	-6.3	-6.3
Gold	Gold index	USD	-4.1	-4.1
<b>Interest rates</b>				
	<b>Last meeting</b>		<b>Current rate</b>	<b>Change at meeting</b>
United States	27 January 2010	USD	0.25%	0.00%
United Kingdom	4 February 2010	GBP	0.50%	0.00%
Eurozone	4 February 2010	EUR	1.00%	0.00%
Japan	18 February 2010	JPY	0.10%	0.00%
Australia	2 February 2010	AUD	3.75%	0.00%
South Africa	26 January 2010	ZAR	7.00%	0.00%

Source: Lipper Hindsight, February 2010

## FOCUS – Some PIGS are more equal than others

In George Orwell's cutting allegory *Animal Farm*, it is asserted by the pigs that "All animals are equal but some animals are more equal than others". This is an apt reflection of the present issues facing Greece, the least equal of the 'PIGS', as the rogues gallery Portugal, Ireland, (Italy) Greece and Spain have become known.

The credit crunch stemmed from a crisis of confidence relating to private sector debt that billowed into a significant systemic risk that had the financial system and even countries such as Iceland on the brink of collapse. Following on from coordinated multi-governmental initiatives the world gradually moved away from the risk of systemic failure that was a genuine concern following the collapse of Lehman Brothers in 2008. In the meantime, corporate and personal balance sheets have been

different sort. As government balance sheets bloat there is a degree of concern relating to their ability to finance their repayment obligations. The predominant risks associated with government debt relate to the ability and willingness of these countries to repay their debt holders in full, when required. Generally speaking neither of these risks is especially significant in developed markets as the majority of countries had scope to roll debt even if unable to pay it down and investor-friendly governments would balk at the thought of defaulting on their debt. The cost of insuring against default of a sovereign issuer can be implied from the cost of a credit default swap contract on that government's debt. As can be seen in Figure 1 below, the cost of insuring against default in many Eurozone countries was low in the years prior to the credit crunch and also there was a large degree of similarity in the CDS cost.

European 5 Yr USD CDS

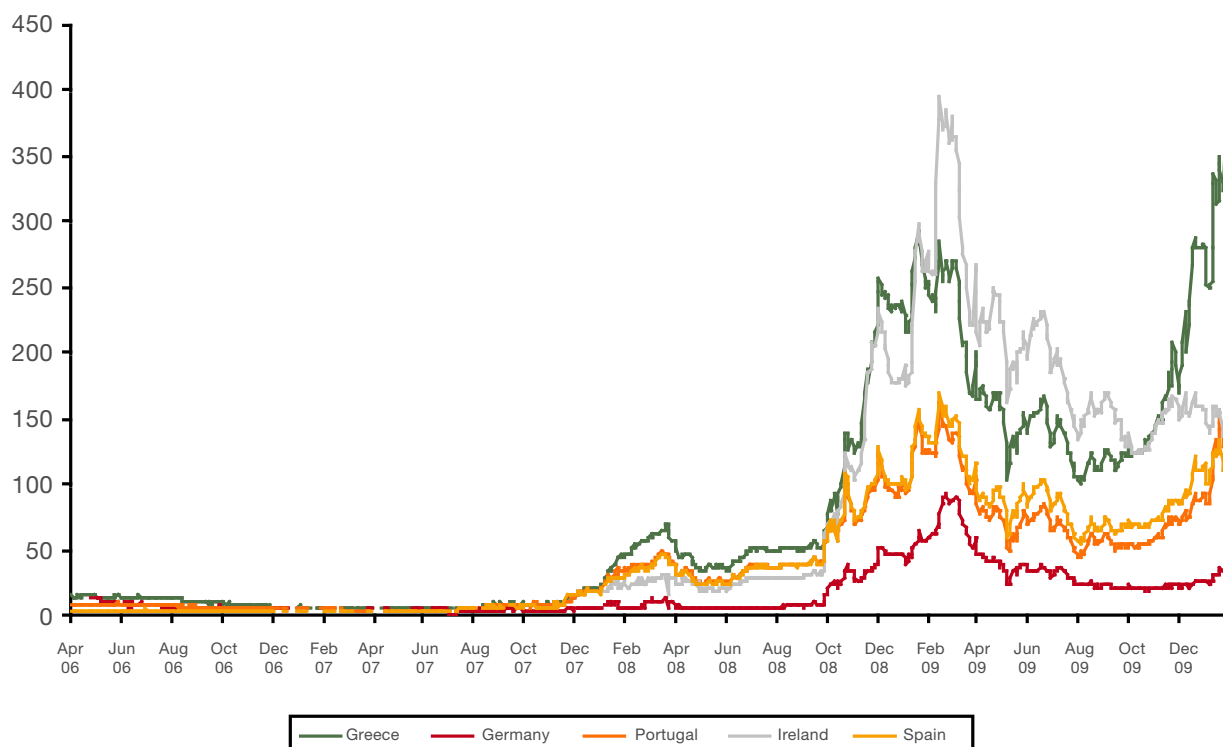


Fig 1, Source: Bloomberg

stabilised if not repaired and much of the leverage has been transferred to the public purse through initiatives such as Troubled Asset Relief and Quantitative Easing. The markets' attention has been gripped of late by solvency issues of a

Today these spreads are significantly higher and reflect a greater apprehension of the potential risk of default from these issuers. Greece's CDS is notably higher than other 'second tier' Eurozone countries that have come to constitute

the PIGS. This is because Greece is in a particular mess and the proximity of potential default on that debt is greater than the other jurisdictions listed. Each of the PIGS have in their own way introduced emergency measures designed to convince investors that they are serious about reducing their borrowing, but Greece appears most vulnerable at present.

Greece has submitted a three year stability plan which is aimed at cutting the budget deficit from 12.7% to 2.8% of GDP. Furthermore, the government is likely to introduce something of a tax amnesty to encourage investors with funds abroad to repatriate them without fear of charges of tax evasion. That is not to say that taxation is likely to become lax. There have been protests in Athens from public sector trade unionists objecting to government moves to target them with higher tax. This move on the part of the Greek public is perhaps understandable, but also worrying in the sense that the majority of the proposals have thus far only rhetorical significance. Greece, a country with recent history marred by violent civil disorder, should be braced for a significant public

The Greek nation has, like the much maligned developed world consumer, been living beyond its means and has amassed a significant debt burden as a result. A succession of budget deficits has brought their debt level to over 100% of GDP. Having a high level of debt to GDP, although worrisome, is not necessarily catastrophic in its own right. With the right maturity profile and a willing market, outstanding debt can be rolled and hopefully managed down through time. Japan, for instance has 280% of GDP outstanding in debt and although the long term prospects of an ageing and miserly economy are poor, there is no immediately apparent risk of default there. This is partly due to the fact that governments with a free floating currency are able as a last resort to print money to meet their repayment obligations. The inability to monetise debt is a risk more usually associated with foreign currency denominated issues as the government of a particular country cannot print a currency of a different country. From an investor perspective, therefore, this Greek debt is tantamount to a foreign currency issue and so relies on whether foreign currency reserves or the ability to attain foreign currency sufficient to repay it.

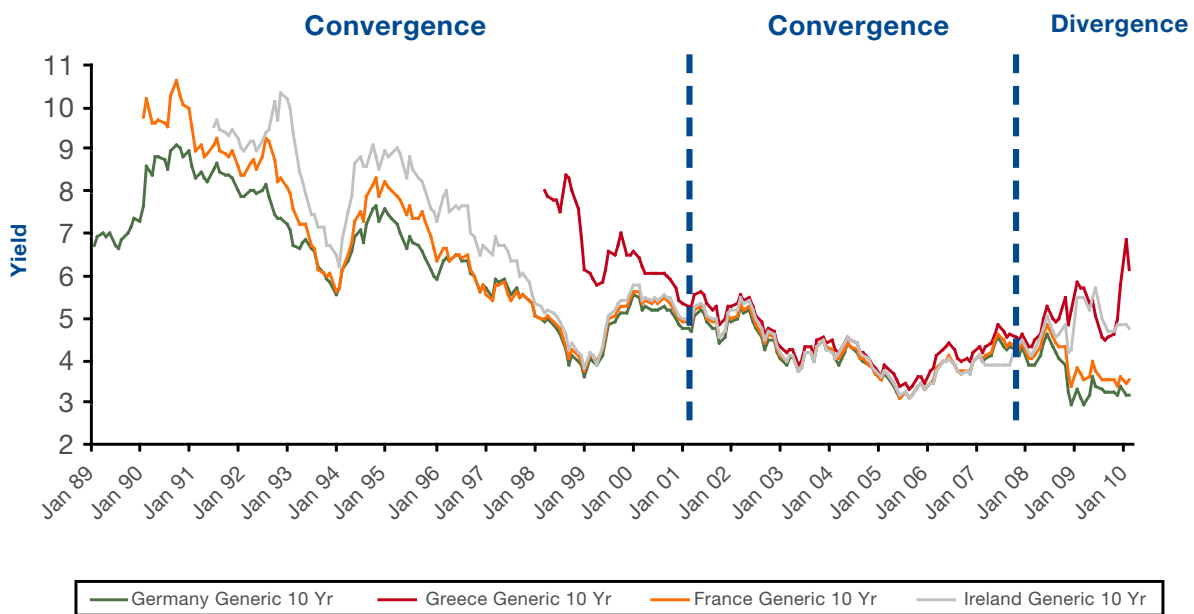


Fig 2, Generic Government Rates, Source: Bloomberg

backlash if and when these initiatives start to bite. Greece will ultimately have to restore its fiscal condition by creating a fiscal surplus which will provide funding necessary to bring down debt levels over time.

Fig. 2 shows the yield convergence that brought European interest rates broadly into line prior to the issuance of the single currency. The converged rates reflected a united, if not formalised fiscal and monetary proposition from the

member states that resulted in broadly similar levels of risk priced in on same-currency debt, hence the very similar spreads. The convergence trade now appears to be over and rather, the dominant theme is one of divergence. Given the lack of an explicit guarantee for ailing nation's debt within the Eurozone, a degree of divergence between their interest rates is arguably appropriate, despite the same underlying currency and interest rate policy. Perhaps convergence was asking too much of such disparate economies, despite their shared currency and interest rates. In contrast, the US is an example of a functioning monetary union. Each state is effectively an economy in its own right and the performance of the USA perhaps suggests that only where there is true confluence of aspirations and culture as well as Federal fiscal and monetary policy makes currency union workable. Even in the US, however, there remains significant disparity of wealth throughout the population.

As Viewpoint comes to print, it appears that Europe is opening up to the possibility of aiding Greece in some capacity. The question that the Eurozone inevitably faces, however, is whether to use this opportunity to enact a greater synchronisation of economic policy across the 27 member bloc. There is no question that Europe is comprised of disparate economies and by managing only one element of their financial and fiscal proposition centrally, there remains scope for a vast array of different policies in terms of taxation and debt for each of the member states. Europe imposes many rules to encourage fiscal discipline on the part of its members, but there is a growing clamour to increase the formability of these structures. The ultimate step would be a fully integrated fiscal union, but that would be a significant departure from the present set up and is unlikely to occur in a single move. What is likely is an increased invasiveness on the part of Europe's regulators which should pre-empt these destabilising events.

There is an argument that any bailout of Greece would perpetuate moral hazards similar to being 'too big to fail'

in the banking world, however, the aim for stability seems laudable in this instance. A rescue package would bring relief to the Eurozone in the short term, but it might also be a source of considerable discord. The European Union is not obliged to bail Greece out and in doing so they will likely lose credibility in countries such as Ireland where a set of austere measures have been greeted by acquiescence by the Irish public. A significant capital injection to Greece would surely therefore be greeted with distain in Dublin if one of the PIGS were more equal than others. A different option for the Greeks would be to leave the single currency. This would provide the opportunity for Greece to manage their own interest rates in future, which is arguably appropriate given recent events. This move might even be positive for the Eurozone as a whole, although it will likely be destabilising in the short term. The effects for Greece's debt would be severe, however and whatever currency the Greeks adopt would be likely to devalue significantly. Exit from the euro is politically very difficult and highly unlikely in this instance, however many second rate European nations may be quietly questioning whether ceding their independent interest rate policy was worth the risks. The PIGS generally do not seem economically congruent to Germany and other first tier European states and anything short of a full economic union will create the potential for mismatched interest and fiscal policy throughout the Union. Greece clearly has troubled times ahead, the outcome of which may depend more on the actions of external forces than choices made by the Greek government itself. The Union will surely only assist Greece in a manner suggests an even playing field for all PIGS. The Greek executive may, therefore, only grudgingly accept assistance from the EU as this may require an impingement on Greece's fiscal independence. Orwell's character Squealer, himself a pig, sums up the quandary well: *"Do not imagine, comrades, that leadership is a pleasure. On the contrary, it is a deep and heavy responsibility. [The leader] would be only too happy to let you make your decisions for yourselves. But sometimes you might make the wrong decisions, comrades, and then where should we be?"*

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