Third Quarter Analysis

by Andrew Hunt

Predicting is Difficult – Especially the Future

It is now exactly ten years since we began writing our Sparinvest Quarterly Reviews and, in many respects, we believe that this is one of the most difficult reviews that we have had to produce. The reviews began simply enough by calibrating and discerning the likelihood of success for the various policy responses to the Post NASDAQ Bubble / 9-11 Crisis and we then moved on to tracking the extraordinary credit boom in global capital markets in the mid-2000s, and its impact on the various real economies. The Global Financial Crisis then emerged as the prior credit boom turned, predictably, to a bust. But even then, the task was not overly complex in that we knew that the politicians were desperate for a successful policy response to the Crisis. Indeed, 2009 was largely concerned with deciphering whether the response would work and for how long it would operate before it caused inflation in the Emerging Markets. We may not always have been correct with the timing and with some of the minutiae of the detail, but there was, at least, a framework that we could draw upon and, importantly, a set of rational assumptions about policymakers' likely reactions that were generally transparent. Today, we do not feel that the same degree of clarity exists with regard to what policymakers actually want to achieve, and this situation makes discerning the outlook for the next quarter a much more difficult affair.

United States and Disunited States

In the USA, the politics of the budget deficit and the proximity of the next presidential election have clearly created a degree of uncertainty within the realm of policymaking that is unhelpful, although we continue to believe that, at their core, the parties will ultimately do what is in the best interests of their *Union of States*. Unfortunately, in the European Union, we are not certain that the policymakers will do the best for their *Union of States*.

The key fault-line within the Euro has always been the mis-match between the political and monetary boundaries of the Euro. In recent months this fundamental fault-line has come to dominate decision making within the system. At its most basic level, as a result of its previous policy errors that led to weak competitiveness in the peripheral countries, the Euro needs either higher inflation in the core countries, such as Germany, or a bout of painful and destructive deflation in the periphery. However the German government will not accept either of these two options, with the result that the Euro project is floundering. We do not believe that Germany's opposition to inflation is merely mythical or historical. Instead, we suspect that it stems from the simple fact that only a minority of German voters are wage earners. Hence the bulk of voters simply do not want higher rates of wage inflation that would increase their cost of living.

Germany versus Periphery

Consequently, Germany's government – and its representatives in the EU and ECB infrastructure – are obliged to fight against those calling for a weaker Euro and higher inflation rates in the region. In the highly-indebted periphery, meanwhile, deflation is seen as a painful, wasteful and destructive process which, in any case, history shows that democracies cannot tolerate. Hence, the periphery countries threaten to form a 'coalition of the afflicted' that is explicitly designed to force easier debt-repayment terms or debt defaults, a lower Euro and a more pro-growth strategy for the Euro Area.

The result of these differing aims has been a gaming of the system through press briefing and counter briefing; inconclusive Euro Zone summits; and a steady undermining of the Euro project in the eyes of the Euro Zones residents, with the result that many savers in the periphery are now deserting their domestic banks in favour of deposits either in Germany or in non-Euro denominated assets. In turn, the result of this flight-of-capital has been a new banking crisis and destructive debt-market problems in the countries affected. If these problems are not resolved, then we fully expect that the political backlash that they will cause will cause the Euro to fracture.

Thinking the Unthinkable

A break up of the Euro was unimaginable to many even a few months ago, and this is important – not only in terms of the change in financial market sentiment that it has engendered – but also in a very practical sense. It is estimated that there are around EUR60 trillion (more than 4 times Euro Zone GDP) of Over-the-Counter bilateral interest rate derivative contracts in existence within the Euro System. Back in the time when these were created, they were designed on the basis that the Euro would survive in its current form. However, the likelihood of these trades being settled completely and smoothly in the event of even only one country leaving the Euro is remote. Indeed, work presented at a recent economics conference in the US suggests that, if these OTC markets were to fail, then the global financial system might only survive a few hours before it either seized or was nationalized – at huge expense to tax payers now and in the future.

The stakes with regard to the Euro's survival are simply immense. But, with no clarity as to whether the Europeans will put aside their narrow national interests for the sake of the union, this increased level of uncertainty has caused a paralysis within the world's banking system. Hence, credit markets are freezing, risk assets are deflating again but central banks are largely powerless to act. The US Federal Reserve and even the Bank of England have attempted to ease their implied policy stances. However, with their 'client' commercial banks effectively frozen by the counterparty risks potentially threatened by the Euro Crisis, the transmission mechanisms between the central banks' actions and any effects that they might hope for in the real economies has been jammed.

Therefore, we have not seen an effective policy response, even outside the Euro Zone, to the economic slowdown in the global economy; a slowdown which, in our view, has been caused primarily by the removal of the various fiscal stimuli that were enacted in 2009 at the G20 Meeting. It seems that the initial 2010 Greek debt crisis scared the world's politicians into an unintended, coordinated and overly severe fiscal austerity path. This has led the world to the brink of a new recession that, so far, the central banks have been unable to counter for the reasons described above. Even China's economy, which hitherto seems to have been unaffected by global events, would likely suffer under such a scenario, given that China now has its own property market and banking system worries of its own to contend with.

A Binary Outlook

If this disturbing situation continues, we believe that the world economy will continue its recent descent into a recession and, if the Euro were to break up, a depression would be the highly likely outcome. Such an event would favour the US dollar and perhaps the Yen, while damaging equity market prospects and perhaps even the debt markets as the fear of sovereign defaults would increase. However, if Europe's policymakers can agree a successful compromise and an easing of policy, the cost of their actions might be a weaker exchange rate and higher inflation in the Euro Zone but the benefits might be an un-jamming of the global financial system, the creation of the potential for a successful counter-cyclical policy response from the G20 and a sharp revival in risk asset prices.

It seems to us that the outlook for the global economy is quite binary at present and the outcome will likely depend on the decisions made over the next few weeks by Europe's squabbling politicians. Rationally, they should do the right thing and accept higher inflation in the Euro Zone and it is the thought that there is a rational solution that makes us perhaps more optimistic than we appear. But the recent actions of Europe's politicians have been anything other than rational, in a collective sense, and it is this that makes forecasting the next quarter so difficult.

About Andrew Hunt

Sparinvest works with independent economist, Andrew Hunt, of Hunt Economics. In his Economic Review, he gives a precise and unreserved analysis of world economic developments. As we at Sparinvest do not claim to be able to predict economic trends, we pass on Andrew's Economic Review to illustrate the degree of uncertainty about the economic future, which also serves to emphasise the importance of maintaining thoroughly diversified portfolios.

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