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RAPID RESPONSE NOTE

This Note covers some of the issues surrounding the latest Euro-zone crisis.

What are the main scenarios?

The coming 2-3 months look decisive for Europe, against the backdrop of recession in 8 EMU member states and rapidly growing popular discontent.

Best case – Europe adjusts its policies and successfully ring-fences the problems in Greece, allowing the current investor panic to subside while the Euro economy gradually recovers later this year, led by a strong Germany.

Bad outcome – Greece leaves EMU causing a major shock to markets but the event is relatively contained due to a considerable degree of support by central banks.

Worst outcome – Greece and perhaps other countries leave EMU in a disorderly manner, causing a considerable amount of capital flight, brushing aside the best efforts of policy-makers, the equivalent of the 2008 financial crisis.

What is the House view?

The House View remains unchanged. In asset allocation terms, we are light euro assets. While there may be better value in the region, eg in shares, we do not yet see the triggers to release this. Nor has our view changed on whether or not a country such as Greece might leave EMU. From an economic point of view, there are still many arguments against such an event, notably the massive pain to Greece and the contagion effects on other economies. From a political viewpoint, the arguments are growing, at the very least for a major change in EMU policy, potentially for a crisis causing a break-up if too many parties refuse to compromise. The clash between these economic and political arguments was sharply brought home by the recent Greek elections.

What are the key dates?

- EU Summit – 23 May - then 28-29 June
- Fiscal referendum in Ireland – 31 May
- ECB monthly meeting – 6 June and 5 July
- Parliamentary elections in France– 10 and 17 June
- Elections in Greece – 10 or 17 June
- European finance minister meetings – 21 June (probably continuous by phone!)
- European Stability Mechanism (ESM) created – July

Will Greece leave EMU?

We cannot say yes or no - it has become 50-50. On the one hand, the collapse in the vote of the centrist parties is very worrying, on the other hand, opinion polls suggest about 75% of Greek voters want to retain the euro. This is a very febrile atmosphere. Such analysis can explain why one broker sees a 5-10% probability of Greece leaving EMU this year, another puts it at 50-75%.

What would be the impact of a Greek exit?

There are no precise counterparts to draw on, although the default in Argentina a decade ago is a useful comparison. Economic analysts suggests that if Greece left EMU it would suffer a further recession of say 20% of GDP on top of the approximately 15% decline already experienced. This reflects inter alia the size of the current account position and the state of the Greek banking system.

The external impact of such a recession should be minor (Greece is only some 2% of Euro-zone GDP) but the impact on capital flows could be major. A large devaluation would lead to major losses; the IMF has estimated that total Greek external liabilities (household, corporate, banking and government) are around €420 billion. Capital flight from other EMU members is a risk. The external liabilities of Portugal are about €480 billion, Italy and Spain about €2.3 trillion. Even moves of a few percentage points would be sizeable. Another potential source of disruption is via the mechanism whereby European central banks provide liquidity to each other (de facto whereby the Bundesbank provides liquidity to weaker ECB members). As deposits in Greek and Spanish banks, for example, have fallen, so their central banks have provided funding to their commercial banks. At end-March the Bundesbank had lent about €645 billion to the rest of the system, in effect Spain and Italy €280 billion each and Greece €100 billion. Other factors would include overseas investors, for example, withdrawing funds from European investments etc.

Are firewalls strong enough?

The honest answer is no one knows. The German Finance Minister Wolfgang Schaeuble was quoted as saying that the system was much stronger. In one sense this is true, with the EFSF/ESM up to €550 billion and the IMF recently gaining agreement for an increase in its resources, albeit it must be emphasised that neither is yet fully paid up. The general consensus is that while the authorities might be able to cope with a small "Greece" or 'Portugal' they do not have the resources to deal with Italy or Spain, for example, without the ECB adopting full blown QE

What is priced into the markets?

A lot of bad news is priced in, ie European share prices are down about 15% from their recent peaks,

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alongside the jump in bond yields/ CDS, but it seems clear that neither a Greek exit nor a collapse in European earnings has been fully priced in. The currency is still holding up, although under increasing pressure while equity volatility is well below crisis levels. Intrade electronic markets currently price in a 42% chance of any country leaving EMU in calendar 2012, versus 23% a week ago prior to the Greek elections. The latest Gallup survey of fund managers showed a degree of pessimism among investors, but no shift towards panic – State Street cross-border flows data similarly support this view. Put another way, Greek households are not yet pricing in an EMU exit; data still show a gradual decline in bank deposits, rather than the capital flight and bank runs seen for example prior to the Argentinean default in 2001.

What timeline can you see?

A timeline for a Greek crisis can be sketched out, although the details remain fluid. After a further election in June, a Greek coalition government of left-wing parties might refuse to accept the Troika proposals for fiscal austerity.

A poker game begins:

A) the Troika blinks. It accepts that there needs to be another default on Greek debt, this time involving official means, e.g. the ECB and not just private bondholders. At the same time, various proposals are put forward to stimulate growth in the European economy, a combination of a milder glide path for spending cuts plus more loans from the European Investment Bank, for example, to kick-start enterprises plus tax reforms. Additional measures could include introducing a pan-euro area banking deposit insurance scheme to prevent bank runs. Most important of all would be the ECB's support.

B) the Greek government is backed into a corner and refuses to budge. Its rebuttal of the Troika austerity plans and a debt default inexorably leads to Greece leaving EMU. This might occur in a very disorderly manner, eg massive capital flight and social chaos. It might occur in a less disorderly manner, eg secret plans to create a new currency are revealed, capital flight is prevented through strict capital controls, the ECB and other central banks adopt massive QE, bank liquidity programmes, government bond buying and currency swaps, all of which calm down market tensions.

What other countries should investors worry about?

France - the jury is out on whether Francois Hollande and Angela Merkel will either quickly form a strong alliance or alternatively mark a new low in Franco-German post-war relations. It is unlikely that Hollande will backtrack much on his more extravagant statements until after the parliamentary elections in June. However, the pressure is growing on Germany too, after the Christian Democratic Union's poor showing in recent state elections. The Bundesbank has considered out loud whether or not German inflation should be higher to help Europe to adjust. If 'muddle through' continues, then it is possible to see a way forward for both countries, adding a growth compact to the existing fiscal rules, which anyway would continue to be ameliorated in order to ease the pain of fiscal austerity. This process has already begun in the Netherlands and Spain, for example. **Spain** - the slow motion car crash which is the Spanish property market continues to develop. The government has finally accepted that bad debts will be higher and banks will need more capital; figures closer to €100 billion rather than €50 billion are being talked about. This may be a better estimate but could still be below the final figure. A bank asset valuation review has been set for two months hence. The Bank of Spain admits to just over €300 billion of 'problematical debts', and losses in some other countries have reached some 50%. Questions are moving on to where such capital might come from - government resources are too small, while the national debt would balloon under the sort of figures mentioned before. A positive outcome would be agreement that EFSF/ESM funds will be used to capitalise the banks, directly or indirectly. This would break the vicious circle of growing bank debts/worsening government credit ratings, but could potentially involve a major loss of sovereignty for the Spanish government, as 'Brussels', for example, determines the future regulation of a large part of the Spanish financial system. **Italy** - This is currently off the radar with many investors as Mario Monti is seen to be pressing forwards with structural reforms while 10-year yields remain (just) below the 6% level which usually triggers concern for the markets. Nevertheless, under the surface there are worries, again about the lack of support for parties who in turn support Monti in parliament. Both Italy and Spain supposedly will cut their cyclically adjusted deficit in 2012, keeping them in recession.

Looking into 2013

If the euro is to survive the current crisis, then the logic is that Germany must press ahead with federalism (ie collective responsibility on fiscal policies, bank guarantees and Eurobonds) this side of the 2013 election. Again, this may require the ECB buying more time. The political positioning in the run-up to the German election in autumn 2013 may come to dominate market attention in coming months.

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June 2012

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