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FEATURE ARTICLE

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The current financial crisis

There is no doubt that the current market volatility is a cause for concern but I believe that it is not a time to panic.

My view is that investors should focus on their long term goals and not short term volatility. Basically investors should not be scared away from equities.

Background - What has caused the current setbacks?

In terms of the current correction I will look at this in terms of four main headings; debt, confidence, contagion and growth.

Debt:

It must be noted that government deficits are not in themselves "bad" provided that the debt produces sufficient economic growth to service the debt. In simple terms "bad" debt is debt that you cannot repay or indeed is subject to the perception that you are currently, or may in the future, be unable to repay the debt or pay the interest on the debt.

Confidence:

The market needs to have confidence that a sovereign nation can service its debt, if the market does not have such confidence then investors sell the debt (or are unwilling to purchase it), forcing the price of the debt down as demand falls and/or supply increases - thus increasing the interest rate on existing debt and future debt issued by that Government.

Contagion:

What we have seen is that within the Eurozone certain countries have been "targeted" by the markets questioning their ability to service their debt. The focus recently has been on Greece but this fear has spread to larger economies such as Spain and Italy = "contagion"

The countries most at risk from contagion are those that rely on foreign investors to fund their government sector.

The market is concerned that with a country such as Greece although the European Community in the form of the European Financial Stability Facility has tried to help Greece, most recently on the 21st July by reducing the interest rate and extending the maturities on various debt, this has not dealt with the fundamental problem in terms of the overall debt levels.

The market uses the term “kicking the can” meaning that although the current agreements have helped with the cash flow situation and as a result Greece has sufficient liquidity to last until 2014 this is merely a “sticking plaster” rather than a solution to the overall debt problem.

Growth:

Historically when a country such as Greece has been in financial difficulties one solution has been for it to devalue its currency by printing money to pay the interest on its debt – in simple terms this results in internal inflation and external devaluation. However being part of the Euro means that this option is not open to Greece and other members of the Euro.

For countries within the Euro there are limits on the level of public sector debt that a country can run, this is an annual 3% deficit as measured against GDP. With Greece however at the beginning of 2010 it was discovered that they had paid Goldman Sachs and other banks to arrange transactions that hid the level of actual borrowing that the Greek Government was undertaking.

Such accounting irregularities led to a loss of confidence because, as that legendary exponent of the English language, Donald Rumsfield, would have said, “unknown unknowns” suddenly became “known unknowns”.

The fundamental problem is that within the Euro there are 17 countries with the same currency, the same interest rate but all with different public spending plans and no one individual or institution in charge.

As Greece and other Euro members do not have control over their currency and interest rates the only real way that they can deal with debt issues once the market has lost confidence that they will be able to fund these is to reduce their expenditure and/or increase their revenue (increase taxes). This might not be an issue if the country is experiencing reasonable levels of growth but when a country is at or near recession and needs growth to solve its problems the implementation of such policies may tip the economy into recession (it will certainly reduce near term growth) meaning that the debt problem is not solved through growth and we enter a negative spiral.

Why have these problems come to a head now?

The current "crisis" has come to a head for a number of reasons.

The first is that in terms of the most recent "bail-out" package for Greece, which was brokered on the 21st July, unfortunately last week the European Commission President, Jose Manuel Barroso, indicated that this had failed to stem the spread of the debt crisis and indicated that elements of this package could still change – markets do not like uncertainty, which in turn affects confidence.

Second, if banks holding Greek debt (mainly German and French) have to write down sovereign debt from Greece and potentially other EU countries that affects their balance sheet and thus their ability to lend. UK banks are part of a global economy/banking system. If certain large banks in Europe can't borrow or lend due to the fact that due to a reduced balance sheet they are forced to reduce their activities then that impedes the British banks ability to lend to us and slows our economic activity.

At the same time in terms of growth and debt last week saw the USA nearly default and the fear emerge that the spending cuts that were agreed to avoid all out default may tip the USA back into recession. In addition the political wrangling between the Democrats (who control the Presidency and the Senate) and the Republicans (who control the House of Representatives) meant that the USA has lost its AAA Standard and Poors risk rating. This means that debt issued by the US government becomes potentially less attractive to investors and may mean that going forward debt issued by the USA may be more expensive in terms of the interest that has to be paid, again slowing economic recovery.

Conclusion:

Ultimately in Europe we are seeing a showdown between the disciplined economies/governments of France and Germany and the so called "Club Med" southern European countries of easy going and overspending EU member states.

I do not believe that the Eurozone can continue to simply "kick the can" and patch the underlying debt issues up – a fundamental change needs to take place and in my view this will take one of two forms.

First, either certain countries will be allowed to leave the Euro and thus regain control over their monetary policy. They will default on their debt and there is no doubt that that will be potentially painful but not in my view necessarily catastrophic. Europe would need to act in terms of new stress tests followed by recapitalisation of weak financial institutions.

The alternative is that the current position where the 17 members of the Euro do not have control over monetary policy but do have control over fiscal policy has to end. The Euro needs to become more like a United States of Europe with central control over public spending allowing the issue of a

Eurozone Bond backed by the whole group which would end the current position of individual countries being "targeted" by the market. This solution would however be difficult to implement, especially in Germany where elections are due next year.

The fact is that until a permanent solution is put in place we are likely to see continuing volatility in the markets but ultimately if the politicians "grab the nettle" then markets could recover from their current predicament very quickly. As I said earlier my view is that investors should focus on their long term goals and not short term volatility.

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