



Investment Briefing

September 27 2011

Can a plan to make a plan be a turning point?

Brian Parker CFA

Investment Strategist

As I write this, world share markets have fallen by around 20% from their 2011 highs, and the local market has fared moderately worse – currently around 22% off its 2011 high. Various measures of market risk appetite remain at near panic levels. The announcement by the US Federal Reserve of a plan to sell shorter dated Treasuries and buy longer dated bonds, a move designed to lower the cost of long-term borrowing, came as little surprise, and did little to ease market fears of a renewed global recession. Elsewhere, the slow motion car crash that is economic policymaking in Europe continues to unfold. At a time when the world in general and Europe in particular is crying out for courageous and intelligent political leadership, we find that political courage is an extremely scarce commodity. The continent is ruled by politicians who either get it, but can't do anything about it, get it but won't do anything about it (for various reasons) and those who don't get it, and certainly won't do anything about it. Is EU decision making so utterly dysfunctional that it will take a full-blown banking and financial crisis to force the required changes through?

Over the week-end, the World Bank and International Monetary Fund annual meetings in Washington produced little of any immediate consequence, but a range of media reports talk of the Europeans working on a plan that would recapitalise European banks, and construct a firewall to protect (particularly) Spain and Italy. To borrow a phrase from Bridgewater, the Europeans are working on a plan to make a plan, but at least they are being more diligent about it. The Europeans have been in denial for way too long. Here, in not quite chronological order, is what I think needs to be done in the Greek context, but the conclusions also apply to Ireland, and probably Portugal at some point. None of these steps are easy or costless. There are losers at every point. However, continuing to force more and more austerity on the populations of Greece and elsewhere merely drives those economies further towards depression and in the process makes an already dire fiscal situation worse, not to mention the enormous social costs.

1. *Debt restructuring.* Returning the public finances of Greece to something that resembles sustainability probably requires a reduction in public debt outstanding of well over 50%. In other words, Greece's public debt to GDP ratio needs to fall to no more than 60% of GDP from around 140% currently. Exactly what combination of principle reductions, maturity extensions, and cuts to coupon rates is required to achieve this is a second order issue. The important thing is that Greece's public debt servicing burden has to be massively reduced.
2. *Bank recapitalisation.* In *preparation* for the Greek default, Europe's banks (including the Greek banks) need to either raise capital from financial markets or from the European Financial Stability Facility (EFSF) or from their respective Governments directly. Needless to say, trying to raise capital *after* a Greek default will be tricky to say the least.
3. *Austerity, public finance reform.* Don't think for a moment that default lets the Greeks off scot-free. A big part of the reason Greece got into this mess is that the tax system has been dysfunctional. The days when a substantial percentage of the Greek population treated paying tax as an option they would prefer not to exercise are long gone. The reform task is still enormous, but is significantly easier without such a massive debt servicing burden. Moreover, selling such much needed reforms is easier when the population knows that the burden of adjustment is being shared – particularly with foreign bondholders.
4. *Eurobonds.* There has been much talk about how the Euro system has a number of serious flaws in its design that rendered a crisis such as the present one inevitable. One such flaw is the lack



of a fiscal union to accompany monetary union. In other words, the system lacks a central borrowing authority to act on behalf of all member states. Why doesn't it have one? In short, probably because the core countries, particularly Germany, were most reluctant to effectively subsidise the fiscal reprobates on the European periphery, whose commitment to sound public finances was shaky to begin with, and has now been shown to be non-existent. Now, in return for commitments and actions on public finance reform and austerity measures (albeit less severe) the German taxpayer is going to have to be convinced to provide just such a subsidy, because there is no chance of Greece returning to world markets as a credible stand-alone borrower any time soon.

5. *Repeat 1-4 for Ireland and Portugal.* Greece is the worst offender, but it is not alone. Rather than hope the problem will simply go away after dealing with Greece, the Europeans would be far better off (as would the world) if EU policy makers would just accept that they cannot only respond when there is a crisis. What is required is a pre-emptive approach. If they are prepared to address Greece, and the Ireland and Portugal in relatively quick succession, they stand a very good chance of preventing contagion to Spain and Italy.

At this point, the above steps represent something of a minimum requirement to head off a full-blown crisis. A key issue I haven't addressed here is the fate of the Euro itself, and more immediately, whether it is in the interest of the Greeks (and eventually others) to leave the Euro, adopt their own currencies (New Drachmas anyone?) allow them to sink, and accept the massive short-term economic costs, in the hope that a flexible currency at least provides them a way back to economic growth. It's a view I have considerable sympathy for, and eventually, it may prove to be the ultimate solution. However, a default and an exit from the Euro still leaves the problem of how to finance Greece. The German taxpayer is already extremely reluctant to throw more money at Greece – they are scarcely likely to be more willing to fund Greece outside of the Euro. Does the IMF have the resources to step in? At this point, it probably does, but not if Greece, Ireland, and Portugal need massive funding all at once.

None of this is pretty, I must admit. Europe is a mess, and the global economy is extremely fragile – that at least, is something the attendees at the IMF and World Bank meetings could agree on. However, there is a chance that maybe, just maybe, the crisis facing Europe is getting large enough to force the EU policy makers into action. They are most unlikely to come up with a perfect solution, even if they can find a way of restoring confidence in the European banking system that would represent progress. Moreover, global equity markets at current levels appear to have priced in a good deal of bad news. Valuations are looking reasonably attractive; our equity managers have been selectively buying, while also largely avoiding the worst of the pitfalls this latest bout of market volatility has produced. Similarly, our debt managers have also cushioned the blow. Our exposure to the debt of the European periphery remains minimal, and the portfolio continues to have an overwhelming preference for very high quality corporate issuers, rather than sovereign bonds.

Important Information:

Any advice in this communication has been prepared without taking account of your objectives, financial situation or needs. Because of this you should, before acting on any advice in this communication, consider whether it is appropriate to your objectives, financial situation and needs. You should obtain a Product Disclosure Statement or other disclosure document relating to any financial product issued by MLC Investments Limited ABN 30 002 641 661 and MLC Limited ABN 90 000 000 402 and consider it before making any decision about whether to acquire or continue to hold the product. A copy of the Product Disclosure Statement or other disclosure document is available upon request by phoning the MLC call centre on 132 652 or on our website at www.mlc.com.au

An investment in any product offered by a member company of the National group does not represent a deposit with or a liability of the National Australia Bank Limited ABN 12 004 044 937 or other member company of the National Australia Bank group of companies and is subject to investment risk including possible delays in repayment and loss or income and capital invested. None of the National Australia Bank Limited, MLC Limited, MLC Investments Limited or other member company in the National Australia Bank group of companies guarantees the capital value, payment of income or performance of any financial product referred to in this publication