Macrobites

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Ian Kernohan, Economist at RLAM, charts how the fortunes of the German economy have changed over the past decade and reviews the pivotal role it now plays in determining the future of the Eurozone.

Robert Talbut, RLAM's Chief Investment Officer, discusses the dangers of the Government's proposals for the creation of a new regulatory body, the Financial Conduct Authority.

Derek Mitchell, Manager of the Royal London UK Opportunities Fund, gives his view on how unrest in the Middle East could impact equity markets.

Ian Kernohan, *Economist*

In the early years of the last decade, Germany was viewed as one of the weaker European economies. GDP growth was slow, unemployment was on a rising trend (see chart 1) and during the decade post unification, competitiveness had deteriorated versus the rest of Europe (chart 2).

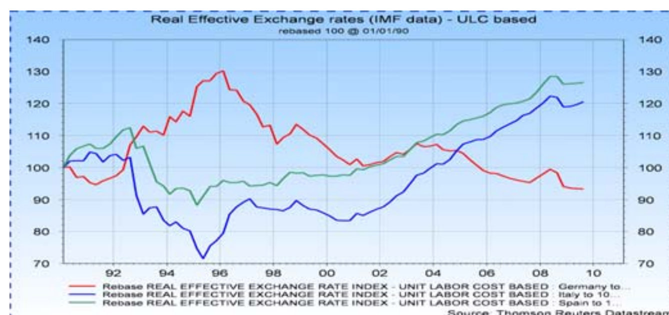
This situation began to change in the mid-2000s, as competitiveness improved and the country began to benefit from its role as a major supplier of capital goods to the fast growing economies of the east. This trend was interrupted as Germany suffered a very short, sharp recession in 2008/9, with global trade volumes seeing one of the fastest declines on record. However in mid-2009, things picked up where they left off, as the global economy began to recover, buoyed by very strong growth in emerging Asia.

So far so good, yet the flip side of improving competitiveness has been a squeeze on German labour, as the wages share of GDP has trended down (see chart 3) and so, for the rest of Europe, the problem has been that growth has been export rather than domestic led.

The recent fall in the unemployment rate and a pick-up in household spending and investment suggest that the mix of growth is changing. Yet it is hard to envisage Germany as a major importer rather than exporter of goods and services, with strong consumer spending and perhaps a housing boom.

Higher unit labour cost inflation relative to the rest of Europe would go some way to reversing the improvement in Germany's competitive position and in theory at least, would help to resolve the Eurozone's one-size-fits-all problem. It remains to be seen whether the German electorate would be happy to vote for economic policies which would result in a major shift in the mix of economic growth, although they may have little choice in the matter if the ECB continues to keep interest rates lower than an independent Bundesbank would have done in similar circumstances. Such is the tension between politics and economics which characterises all economies, but is particularly potent in the Eurozone, where there is one monetary policy in search of a federal government.

History suggests that changing trade patterns play a major role in determining a country's foreign policy. With the emerging block now accounting for a rising share of German trade, their appetite for the whole European project, which has been the key driver of foreign policy since the end of WW2, must have taken a knock. In its latest monthly bulletin, the Bundesbank has been noticeably lukewarm on plans for establishing a European Stability Mechanism to succeed the current European Financial Stability Fund, and calls on individual countries to take the necessary action to address the root causes of the sovereign debt problem. During the next few years, it will become clear just how much of a price Germany is prepared to pay to keep the Eurozone afloat and whether the single currency area will split into two parts.



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Robert Talbut, *CIO*

It is my view that the current proposal for the new Financial Conduct Authority is detrimental to the health of the UK system and will weaken our role in driving European regulation.

In the attempt to create a single regulatory body, we risk conflating issues of consumer protection with the regulation of wholesale markets. Trying to bestow a single purpose on an organisation that straddles both credit cards and wholesale financial markets is fraught with danger. An organisation that leans towards being a retail consumer champion might fail to provide the appropriate degree of understanding of oversight and risk assessments for wholesale participants. Equally, if the focus is upon the healthy and efficient functioning of wholesale financial markets, then the necessary attention to consumer issues could be missed.

As the source of future regulatory initiatives, we must also consider Europe's view on the issue. Europe clearly recognises the difference between retail consumer issues and those pertaining to wholesale markets and accepts a risk differentiation between the two. It would be wrong to see everyone as a participant in financial markets no matter how tangentially, believing that there is a continuous spectrum of interest. Instead we should accept that there are clear distinctions that can and should be recognised. Based on this understanding, Europe has clearly separated out the retail consumer and the wholesale participant and has a regulatory structure to match. If we in the UK fail to recognise this reality and proceed to organise ourselves in a different way from the lead regulatory bodies, we will simply weaken our ability to influence events. Attempting to tighten up the regulation of wholesale markets from the perspective of a consumer champion will inevitably lead to alternative markets being established in other European jurisdictions.

That is why we should strongly advocate a single markets authority covering both primary and secondary issues: a body that will have the clarity of purpose to ensure that the wholesale markets (in which the UK still dominates the rest of Europe) receive the correct level of oversight, while allowing a consumer champion, linking with the various European bodies that have such responsibilities, and leading the interests of consumers in the products and services that they buy.

On the subject of banks, I'd like to share my perspective as an institutional shareholder. There has indeed been considerable engagement with management regarding appropriate remuneration in the context of establishing the parameters for sustaining internationally competitive banks over the medium term. These issues appear far better appreciated elsewhere in the world where relatively strong and competitive banks are understood as a precondition of any healthy economic recovery. The solution to any remuneration issue has to be addressed globally, given the nature of the industry: a parochial approach will simply undermine UK based banks to the benefit of other countries. While the size of these institutions relative to the UK may be out of kilter, we need to better understand what would replace them if they were significantly smaller. I would also question the attractiveness of the UK as a base if we didn't have any globally competitive banks to support them.

Derek Mitchell, *UK Opportunities Fund Manager*

Set against a backdrop of sharply improving economic, corporate revenue and labour market stories, the deteriorating geo-political situation in the Middle East could have wide ranging ramifications for the equity market.

What is happening in Egypt matters at every level, and it is hard to see a positive outcome. Mubarak was a loyal and helpful ally to the West and, with him gone, it will be a hard ask for the army to hold things together until the elections later in the year. It will be an even bigger ask for them to 'manage' a result that suits the populace, Israel and the West.

In Bahrain, the home of the US 5th Fleet, the country's strong links to Saudi Arabia should ensure that the kingdom doesn't fall, but the authorities' tough approach to dealing with demonstrators has not endeared them to the West. If the Saudis are getting worried about the situation, then so too should the West. Elsewhere, demonstrations in Algeria, Libya, Yemen, and Iran merely emphasise the broad nature of the uprisings.

From an equity perspective, these are worrying developments. Year to date, all attention has been focused on the extent to which the market could rise, driven by strong earnings growth, and helped by an asset allocation switch from bonds. However, until uncertainty in the Middle East fades, the oil price is unlikely to decline, with the concomitant threat to inflation, and margins. With the risk of war in the Middle East rising, it is certainly not the time to go underweight the oil sector in the portfolio, and perhaps those over-looked defensive stocks such as Imperial Tobacco or Glaxo could become fashionable once again.

Source: rlam as at 21 February 2011 unless otherwise stated.

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