Macrobites

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Ian Kernohan, RLAM's Economist, predicts some form of Euro break-up in the medium term.

Robert Talbut, RLAM's Chief Investment Officer, calls the ECB to move towards a more interventionist policy to resolve the Eurozone crisis.

Eric Holt, RLAM's Head of Credit, sees a protracted period of high volatility and limited domestic inflationary pressures.

Ian Kernohan

Economist

We keep saying that the Euro debt crisis must reach some kind of denouement, and yet it drags on week after week. People are now beginning to talk about the European Council meeting in December as the next big political crunch point, but I've lost count of the number of grand solution summits we've been through. Markets don't appear willing to operate to the same timetable as Frau Merkel and the ECB, and the pressure has already spread to the so-called core countries. What good is the EFSF, if states like France are downgraded?

What is to be done? The ECB needs to buy time and put moral hazard concerns to one side for a bit. Direct financing of deficits is of course illegal, but the same strictures apply to the Bank of England and they have already engaged in massive QE, under the guise of just another tool in the monetary policy toolbox. This is why the recent run of very poor economic data from the Eurozone may actually turn out to be a blessing in disguise, since it makes a monetary policy response more likely.

Next, we need a growth strategy that will have to involve surplus economies, such as Germany, acting as a source of demand. How else are deficit countries going to improve their current account positions? Austerity and internal devaluations alone will turn out to be counterproductive. Finally, we need a firewall big enough to prevent constant market speculation about a Euro break-up. This would have to involve some form of fiscal union and cross guarantee of debts, backed up by moves towards political union.

And there's the rub: in my view, political union is not a sustainable proposition, for the very simple reason that electorates are unlikely to support it. So even if humpty dumpty is put together again, some form of Euro break-up now looks likely in the medium term.

Robert Talbut

CIO

I have been of the view that a more permanent resolution to the current Euro crisis required fundamental restructuring of the affected economies to improve their competitiveness, combined with a far more interventionist policy from the ECB. Essentially the ECB would have had to shift from its policy of 'limited and temporary' purchases of bonds to potentially unlimited purchases, in order that the countries that were restructuring could be assisted through this lengthy process by lower market interest rates and less market pressure.

The two have to go together and the alternative view held by the Bundesbank and some other influential voices in Germany that restructuring alone will restore market credibility is, I believe, both fundamentally incorrect and potentially incredibly dangerous if it proves to be wrong. The danger as I see it is that deteriorating confidence can easily feed upon itself, will spread to more countries and that falling growth estimates brought about by fiscal cuts are undermining the ability to deliver fiscal improvement. This is my assessment of where we are today.

However the potential mistake that we are making is in framing our view very much from the Anglo-Saxon perspective of market intervention and economic stability. I increasingly think that this may prove to be wrong and that the German perspective is very different. The current opposition to further ECB-led measures from Germany appears fundamentally to be about creating what they would see as a smaller grouping within the Euro – one that is more homogenous in nature and hence more likely to prove sustainable. This would have to be the conclusion drawn from the reluctance to support, through market intervention, the current restructuring in a growing number of countries. While the smaller grouping would almost certainly face a recession in 2012 as the new Euro rises appreciably, it may be that this policy is better than putting the responsibility for continual support on a range of other countries that will never be able to become 'German' enough with regards to their breadth of industry, focus on exports or general conservatism of policymaking.

However the Germans may have underestimated the price to be paid in terms of economic dislocation within Europe if the Euro were to break up in this manner. No-one can know the costs that may disrupt the whole continent if breakdown were to occur. Would this price prove higher than that which would accrue to further intervention as described above? In addition can we be sure as to who would be in the new core of countries? The markets may already be concluding that France, instead of being similar to Germany, is actually more like Italy and Spain. We've already seen French bond spreads widen out significantly and further economic weakness which is highly likely to occur on unchanged policy will threaten much higher spreads. Indeed this may be the best chance of bringing about a change of heart. The ERM crisis was not addressed when the UK left the system, but instead was deferred until France was threatened. Therefore French bond spreads may prove the indicator to watch as the catalyst for the required change in policy. Alternatively it may just be a case of outvoting the German contingent on the ECB board as the crisis continues to rumble on.

Eric Holt

Head of Credit

While the strains within the Eurozone continue to make the headlines almost daily, causing market volatility to rise to exceptional levels, the underlying issues - the need for the consumer and financial sectors to rein back their indebtedness and for governments to progress towards fiscal balance - remain paramount. Herein lies a dilemma; economic growth is the ideal remedy for the latter, but problematic in the context of the former, even though developing countries are underpinning positive global economic expansion. High unemployment levels add to the mix.

Nevertheless austerity seems likely to remain the watchword for Western industrialised countries. From a market perspective, 10 year government bond yields of around 2% in Germany, the US and the UK reflect the attraction of liquidity given current market conditions, prospects for short term interest rates and perhaps the impact of quantitative easing in the US and UK. While volatility may well remain high, the pricing of other asset classes appears relatively appealing from a medium term perspective, especially as we believe robust income generation is presently a very attractive investment characteristic. For bond investors, of course, inflation is the greatest common threat – undermining the real value of future income. Doubtless there will be plenty of '20/20 hindsight' on the outcome over the longer term, but the decline in annual CPI from the UK's near 20 year 5.2% peak in October seems assured in the months ahead as recent higher food and energy prices drop out of annual data and the VAT hike rolls off. Domestic inflation pressures seem remote.

Source: rlam as at 22 November 2011 unless otherwise stated.