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Global Macro Highlights

The Eurozone: ‘til default do us part…

The prospect of a country leaving the Eurozone and its potential impact, here and abroad…

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The Eurozone: *'til default do us part…*

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Why we are where we are: *An unlevel playing field…*

Before we explore the impact of a country leaving the Eurozone, we need to understand, and be quite clear, why, under current EMU treaties and arrangement the prospect of one or more countries leaving the Eurozone is not just a possibility but an inevitability.

Due to years of chronic economic mismanagement - multiple policy errors within the Eurozone and outside it - peripheral European countries are suffering from solvency problems that make defaults unavoidable and exits from the euro highly likely. Not today, or tomorrow, but in time.

Short of Germany (*and others*) committing themselves fully to fiscal and capital transfers to the periphery in perpetuity the current structural, economic and social imbalances are simply incompatible with an enduring single currency and monetary union. Without a change to the current rules regarding bailouts and fiscal transfers, the Eurozone can only break up.

The current policy of ignoring the underlying structural deficiencies and kicking the can down the road with ever more audacious and inventive conjuring acts does nothing other than to delay the inevitable, weaken faith and credibility in European policy makers and their ability to manage European economic and financial interests prudently and, ultimately, exacerbate the scale of financial, social and economic costs by the time this monetary union breaks.

Like many a fixed exchange rate regime that preceded it in history, especially with so many diverse cultures and basic barriers to social and economic cohesion, it will break. It is no longer a case of "if", but "when". The key for Europe will not be so much in the mechanics of an exit from the euro, but how to manage the process and the aftermath.

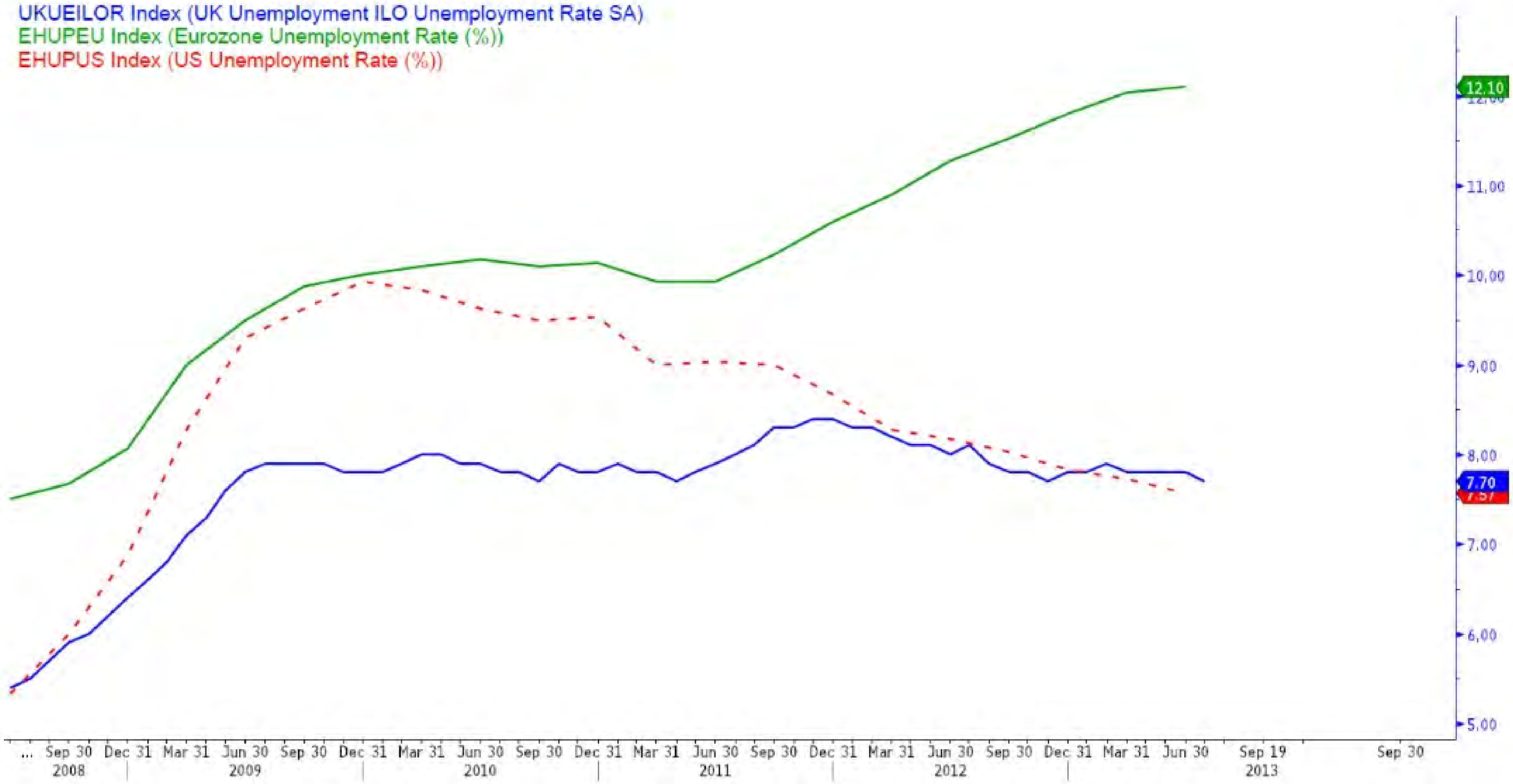
The economies of Greece, Portugal, Ireland, Cyprus, Spain and Italy have collapsed, and are mostly either still contracting or are having weak "technical" upticks (*from extreme low data points*) that, in reality, will not generate a GDP growth rate capable of dealing with these long term structural imbalances and the horrendous backdrop of ever-rising debt and unemployment.

Indeed, unemployment has reached shocking levels; 28 per cent in Greece, 26 per cent in Spain, 16 per cent in Portugal, 13 per cent in Ireland and 12 per cent in Italy. Amongst the young, these numbers are utterly unconscionable (*29% in Ireland, 37% in Italy, 38% in Portugal, 55% in Spain and 58% in Greece*). This, over any length of time, will become socially unbearable.

Other than to refinance their unsustainable borrowings, little or nothing has been done to address the structural problems of these weak economies — while committing them to a degenerative spiral with little or no possible redemption within a time scale that is socially realistic or manageable.

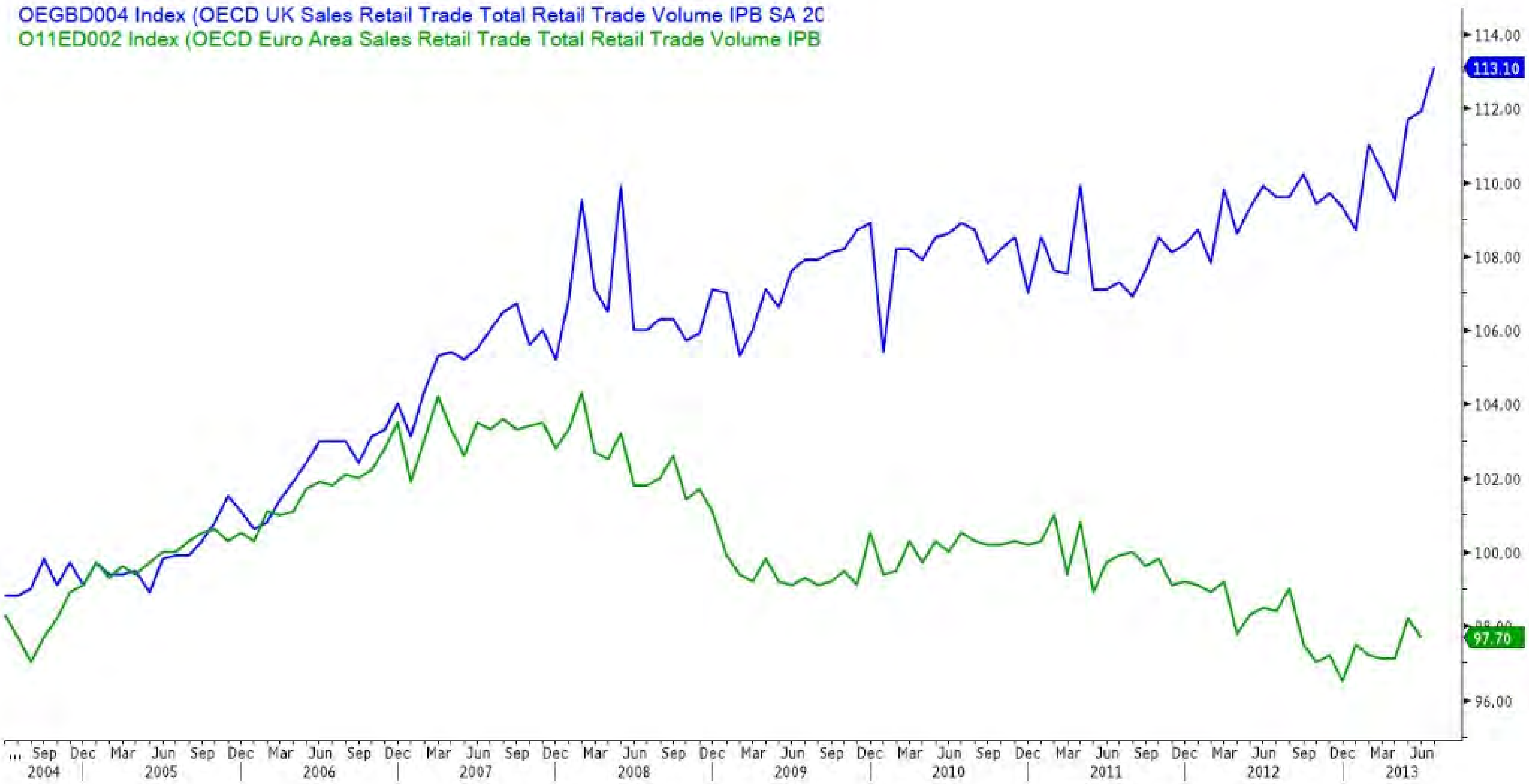
Policies have consequences: *A socially degenerative spiral…*

Unemployment



The wrong way: *Mind the gap…*

Retail sales: UK & Euro area



Flawed thinking: *Theory versus practice…*

In short, the Eurozone has become in an insurmountable mess – financially, economically, politically and socially. It is a political dream, based on theoretical ideology, which now has virtually no chance of survival in practice. Fixed exchange rates in history have had an appalling track record of durability at the best of times. The Eurozone, where language and mobility of workforce barriers act as an impediment to social and economic cohesion and where cultures, ambitions, values and work ethics are in such stark contrast to one another, we doubt that this one will be any different.

Had the Eurozone architects undertaken proper financial, economic, political, fiscal and welfare reforms over the past 15 years and disciplined themselves to a strict convergence timetable towards a level playing field on all levels, then "maybe" there might have been a slight chance that this project could have worked for an extended period of time.

As it is, this hasn't happened and the reality is that the entrenched disparity between some economies – especially of competitive grounds - is simply too far gone to be able to recover. Consequently, this crisis will rotate from a financial, economic and sovereign debt one into a political and then a "social" one, which is where, in a democracy, it all ends.

The major flaw in this political dream is in Europe's politicians not appreciating that they remain in office for as long as "the people" are prepared to tolerate them or (*the consequences of*) their policies. It is self evident that "the swing of the pendulum" has already started to swing hard in a number of countries against austerity, against enforced erosion of cultural heritage and against "the one size fits all" monetary policy.

After all……. not everyone in Europe wants to become a German – either economically or socially.

At this juncture, the only way to perhaps save the Eurozone in its present form would be for the introduction of euro bonds and an absolute "all-for-one and one-for-all" attitude and commitment. Without this, it simply isn't possible or credible.

Whilst joint euro bonds would not deal with the deep rooted cultural differences or economic divergences between Germany and the periphery, it would at least put an end to market pressures which, otherwise, will keep coming back again and again. Markets exploit weakness and, unlike politicians, understand it well when something which is unsustainable.

However, since it seems clear that there will be no common fiscal backstop, as the Germans will not countenance such, it is inevitable that we are headed for a breakup sooner or later.

In conclusion, whilst European policy makers have successfully, thus far, managed to kick this can a long way down the road, do NOT be fooled by this. They will, eventually, run out of road. If a structure is unsustainable ……. this means that it shall not be sustained.

End game: *Jump or be pushed…*

The really interesting question in all this is how the break up unfolds – do the weakest ones leave……?...... (one by one …..or as a group) or does the elephant leave the room……? The market has always assumed the former, it may actually be the latter.

In many respects, the departure of Germany (*with a few smaller Northern allies*) would be far less disruptive. It would then leave a hard euro and a soft euro (*and at the margins, depending of how debt obligations are then calculated, just possibly, no defaults*).

However, the major problem for policy makers is how to prepare for such an event. Clearly, governments and central banks cannot publicly contemplate such an event. For them there is a dangerous catch twenty-two. Any whiff of official preparation might, in itself, indeed trigger a chain reaction in markets that would culminate in a chaotic implosion and break-up.

On the other hand, stumbling into a collapse, ill-prepared, would exacerbate the sense of crisis in financial markets, thereby deepening the economic impact of such an event globally .... merely ensuring a much wider and more costly break up than would otherwise might have been the case under a well-prepared and well managed emergency plan.

With the Eurozone accounting for 13% of global GDP…. the potential contagion stands to make any global financial crisis to date pale into insignificance by comparison. One has to hope, therefore, that credible contingency plans have already been drawn up. As fund managers, though, it is our responsibility not to assume anything and to manage these known risks prudently.

Quite apart from the legal uncertainties – and markets abhor uncertainty – preparing for a country to leave the euro is not necessarily logistically possible immediately……..For instance, it will not be possible to have new notes and coins immediately for a country exiting the euro……….indeed there are many practical issues which will be extremely difficult to manage and control.

Given politicians' historical inability to admit their mistakes and "draw stumps" until it is already too late, such an event, to my way of thinking, is more likely to come to a head by social unrest and/or the ballot box rather than by careful planning and design.

As in the Middle East and North Africa, I fear that the European policy making regime will likely fight to the end to try and keep this dream together. Having dug deeper and deeper into this hole, politicians are likely to exhibit significant degrees of combat refusal – even when it has become quite apparent to most observers that the union, in its present form and structure, is untenable.

Global policy errors: *Chaos and disunity - each to their own…*

However, the timing and progress of the euro-zone crisis to its ultimate conclusion will depend exclusively on economic performance.

A growing economy hereon in will make it much easier to meet budget obligations and buy time – but not alter the end game. By contrast, if output continues to shrink and unemployment continues to rise, then austerity measures are likely to make economic conditions worse and merely accelerate the point of exit.

However, the financial market landscape has changed dramatically in recent years. Faced with significant global economic, political and social challenges, Central Banks are engaging in ever more unconventional ways with untested policy tools.

These evermore bold and dramatic policy measures (be they excessive quantitative easing or currency intervention) are creating an increasingly false, fractious and unbalanced marketplace – giving rise to horrendous moral hazards as well as compromising traditional econometric models and methodologies for pricing risk.

Traditionally tasked with setting the rules and acting as referee, many of the major Central Bankers are now playing the game at the same time. Whilst the benefits of their measures are front loaded, the costs are clearly going to be back-loaded.

However, their actions are fraught with danger and risk the wellbeing of future generations should they go wrong. In effect, Global Sovereign Debt has become a giant Ponzi Scheme on a scale so large now that failure is no longer an option. In many cases, Sovereign Debt has itself become "too big to fail".

The key factor to point out is the sheer scale of disunity, not only within Europe, but within the whole of G20. This makes global policymaking in a world where globalisation has advanced in leaps and bounds virtually impossible – especially in a crisis.

It therefore makes the whole financial system, which in reality is dependent upon one another, highly unstable when major nations and economic areas "go it alone" and pursue their own policies.

It is, perhaps, a perennial occupational hazard of financial markets to place global policy makers on too high a pedestal and, perhaps, to attribute too much faith in their intellect and ability to manage their economies appropriately and prudently.

The reality is that a catalogue of policy errors helped set the stage for the "Perfect Storm" for the global markets in 2008 and Central Bankers have been chasing their tails ever since – making up the rules as they go along and juggling an ever larger number of balls in the air.

Demographics: *A ticking time bomb…*

Again, it is the lack of policy coordination and cohesion within G20 that guarantees that we will lurch from one major crisis to another. QE in the US was done with little or no regard to the implications elsewhere around the world.

As a consequence, a tidal wave of cheap capital poured its way into emerging market debt and investors chased ever diminishing yields. Now that we are on the cusp of tapering, we have tremors rippling through emerging markets as the fallibility of their economic models becomes plain for all to see. Major issues lie ahead.

In China, off-balance sheet bank lending and local government deficits have become out-of-control under the former administration's prescribed policies. With total credit now estimated as being over 200% of GDP, growing its way out of debt in not going to be easy. Its financial system – now some 220% of GDP – has grown 8 fold in the last 10 years.

With companies having to pay $1 trillion in interest payments over the next year, the drag on growth will be material - as liquidity is used to repay debt and interest rather than finance output. With Private domestic debt at 160% of GDP too, the new leadership understand that unless they tackle the shadow banking and credit/debt issues now, when at least they can exercise a good degree of control, they will almost certainly be facing a major crisis within 5 years. Advisers are advocating having some pain now rather than a calamity later.

With the era of double-digit growth in China likely to be over for the foreseeable future, the pressure on the emerging market sector will intensify.

In Japan – the "3 arrows" approach of Abenomics (*aggressive monetary easing, a massive fiscal stimulus and structural reforms to boost Japan's competitiveness*) is an audacious roll of the dice. BOJ holdings of JGBs are estimated to rise from 93 trillion yen ($956bn) at the beginning of the year to 190 trillion yen ($1,952bn) by the end of 2014. This is massive.

An integral part of the problem all over the developed world is the aging of societies. The old-age dependency ratio, that is the number of persons aged 65 or above per 100 persons of working age, in Germany was 14% in 1950.

It is now 31% and will increase to 57% in 2050: and in Japan these respective figures are 5%, 35% and 70%. In the more developed regions, life expectancy was only 46 years in 1900 but is currently 76 years. Statistics indicate that is that two-thirds of all those who have ever reached the age of 65 years are alive today.

By 2020, 33% of the population of advanced economies will be over 55 years of age. Just pause and think for a moment:
in seven years' time, one-third of the entire population of the advanced economies will have either retired or will be saving for retirement.

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In European developments, the International Monetary Fund in July identified another $11bn (£7bn) black hole in Greece's finances that it warned may have to be written off. Wolfgang Schäuble, Germany's finance minister, said that Greece would need a third bail-out to supplement its €240bn (£205bn) rescue. However, Mr Schäuble has specifically ruled out a second debt restructuring, or "haircut", that would involve creditors taking a write down on their holdings of Greek debt. He said such a move could "destabilise" the whole Eurozone.

Instead, in a plan pushed hard by Finland and with the strong backing of the ECB and the IMF, Eurozone officials are considering a big overhaul of Greece's sputtering privatisation programme that would move most of the state-owned real estate intended for sale into a Luxembourg-based holding company managed by foreign experts. The prospect of handing over the assets to a foreign-based holding company has already raised hackles in Athens where the plan is seen as "a blow to national sovereignty and dignity". Good luck with that one.

However, as the IMF has pointed out, the reality is that without such a plan, Greece can only be returned to sustainable debt levels if EU bailout lenders accept significant losses on their existing loans to Athens. This leaves Greece with two options.

The first is to reform and default inside the Eurozone – a strategy that requires willing accomplices in other European capitals and in the European Central Bank.

The second is to reform and default outside the Eurozone – a decision Greece could take unilaterally, provided the macroeconomic conditions are right. The second has not been possible – until now. But Mr Schäuble's option of reforming and not defaulting makes sense only from his point of view. It is not an option for Greece.

Elsewhere, Italian politics has remained as combustible as ever, Slovenia is in very deep trouble too now and Cyprus remains a total basket case whose big economic idea to restart the economy was to open a whole load of new casinos. It is like watching a very major motorway pile up happening in slow motion.

Of course, the realisation that a departure from the Eurozone may be economically feasible, or even advantageous, may count for nothing. A country may decide to stay inside the Eurozone for political or security reasons. But surely we are at a different stage of debate when an exit becomes economically viable.

We should not be deluded by recent upticks in European economic data – they represent a rally in bear market for all but Germany, where no matter how hard other Eurozone constituents try, Germany's competitive advantage in the single currency union just will not seem to go away.

Competitiveness: *Germany dominates…*

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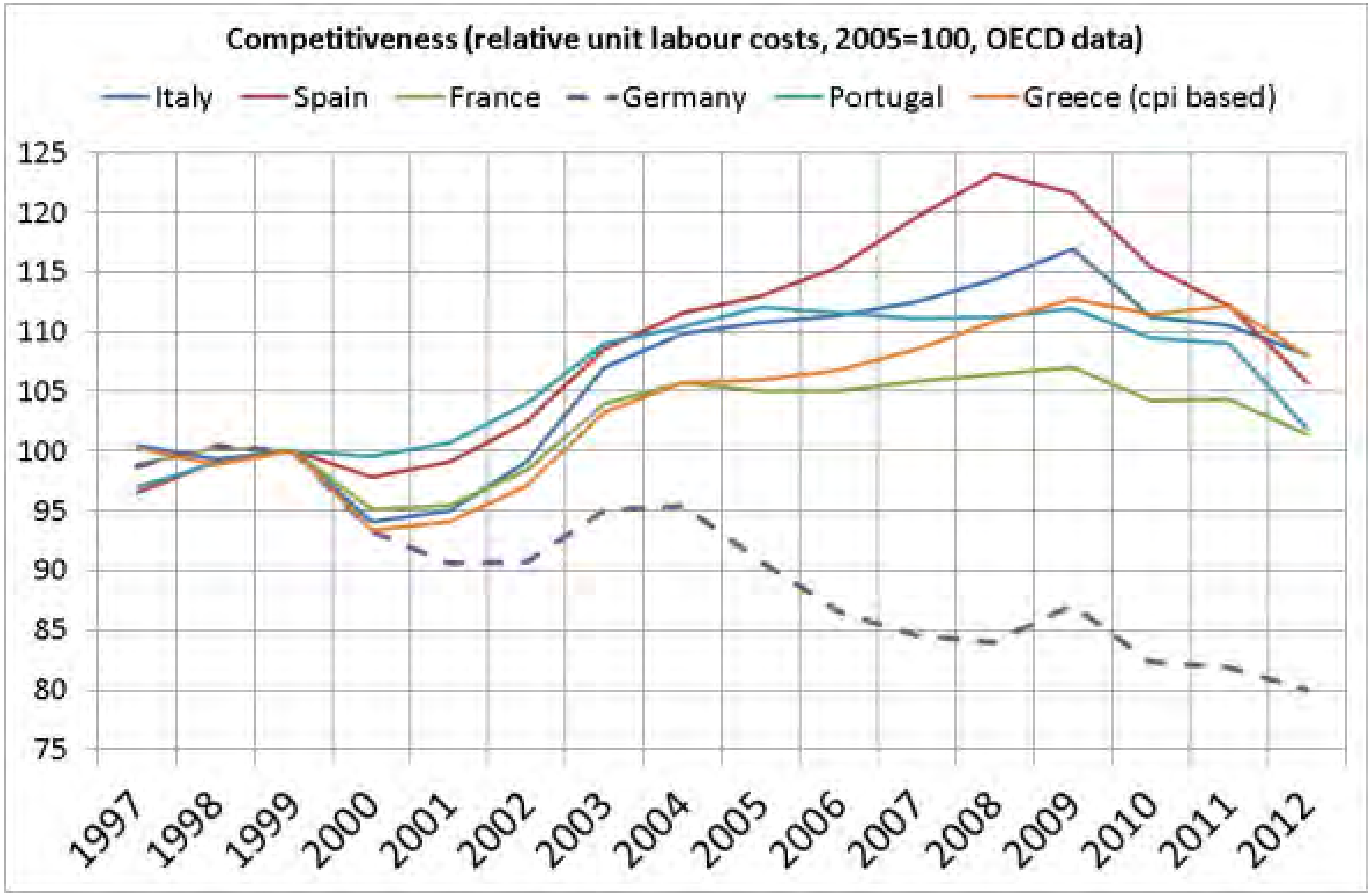
Always one step ahead…



It ends where it started: *France and Germany…*

Even France's long term economic outlook is horrendous. The public sector has grown faster than the private sector in every year since 1987. In the process, it has effectively pillaged from the private sector thus creating a self-reinforcing cycle of economic decay that has lowered corporate profits, fed into reduced private investment and resulted in low economic growth and rising unemployment.

With Government spending accounting for 57% of national output and unlikely to fall, especially with Hollande as President, the burden of adjustment will have to be borne by the private sector…….yet again. No wonder the optimism levels of French small businesses are at their lowest.

Despite this harsh reality, François Hollande has promised to "invert the curve" of unemployment by the end of this year. But he has dropped any pretence that it will happen organically: Instead, the President has launched a series of initiatives to create tens of thousands of state-sponsored jobs and training schemes. As if the public sector wasn't big enough.

As demographic trends compound the problems over coming years, France's ability to ever balance its budget – something that hasn't happened since the early 1970s – becomes even less achievable.

With the prize for the most delusional statement by a European Finance Minister, Pierre Moscovici proudly told the world that France was "*leading the Eurozone out of recession*", despite revising down growth for this year, estimating gross domestic product will end up somewhere between -0.1 % and 0.1 %. Whoopee!

The reality is that, short of an unexpectedly big resurgence in eurozone annual growth of 1.5 per cent, the level needed to bring down unemployment, a sustainable economic recovery in France looks some way off.

In perhaps the understatement of the year, Jens Weidmann, Bundesbank president, pointed out that the reform course in France appeared "*to have floundered*" and called on the French government to stick to its agreed targets. Calls for more austerity in France is cutting no ice with the socialist ideology, with Hollande saying a policy of more austerity would lead to "*the explosion of Europe*". Indeed. If the French fall out with the Germans, politically, the euro project, as we know it, will be over.

So, in examining the global outlook on a macro-economic basis over coming years and the lack of many of the primary drivers of growth, it is hard to see a sustained Eurozone economic recovery of the calibre and duration needed to avert a euro break up. US political antics of late serve to highlight further the type of global economic obstacles that lie ahead.

Moving on to any actual breakup, disentangling a nation or nations in any euro exit could pose a serious threat to the ECB's capital base and, most of all, to Germany.

A cursory look at a chart of the recorded imbalances in the Target 2 payments system (*an interbank payment system for the real time processing of cross border transfers within the EU*) prior to the introduction of OMT says it all. Whilst the introduction of OMT has narrowed the gap slightly, as at the end of last quarter, Germany's Target 2 claims were still over €570bn, whilst ECB claims against the peripheral banks still stand at over €500bn.

Even if only Greece chose to leave the euro and default, this could easily wipe out the ECB's capital of €10.7bn. That the ECB hold collateral against these loans is irrelevant. If, as would be highly likely, any euro exit were to be accompanied by a major sovereign default, this collateral would be worthless, leaving the ECB insolvent. However, the longer this goes on, the deeper the ultimate losses are that Germany will have to bear. The first rule of holes: "*when you are in one, stop digging*" seems to have passed Eurozone policy makers by.

It is a given that, howsoever this tragedy unfolds, the immediate costs for any one country of a euro exit are going to be enormous. A total break-up and reversion to national currencies would be immensely disruptive and costly for all over the first few years.

In a complete break-up, deficit countries, like Greece, would have to default on debts, public and private, and be forced to cut public expenditures below current revenues and imports below exports.

Surplus countries, like Germany, would be in grave danger of finding their banks going bust (*as their asset crumple in value relative to their "mark to market" liabilities*), and their exchange rate appreciating far enough against their indebted neighbours as to cause deep recessions.

It is small wonder then that Europe's domineering politicians and policy makers have (*and will likely continue to*) put off the day of reckoning for as long as possible. However, it is perhaps worth remembering that it will only take one country to vote to bail out of the euro and this show will be over.

So, what "is" the likely impact of a country or countries leaving the euro ….?

The answer to this entirely depends on shape this takes, the sequence of events that follow and how well prepared and adept – or otherwise – not just European, but "global" policy makers are in managing the process and controlling the outcome. Policy makers would have to co-ordinate with one another, quickly and decisively.

Doing the maths: *Who owes who what…*

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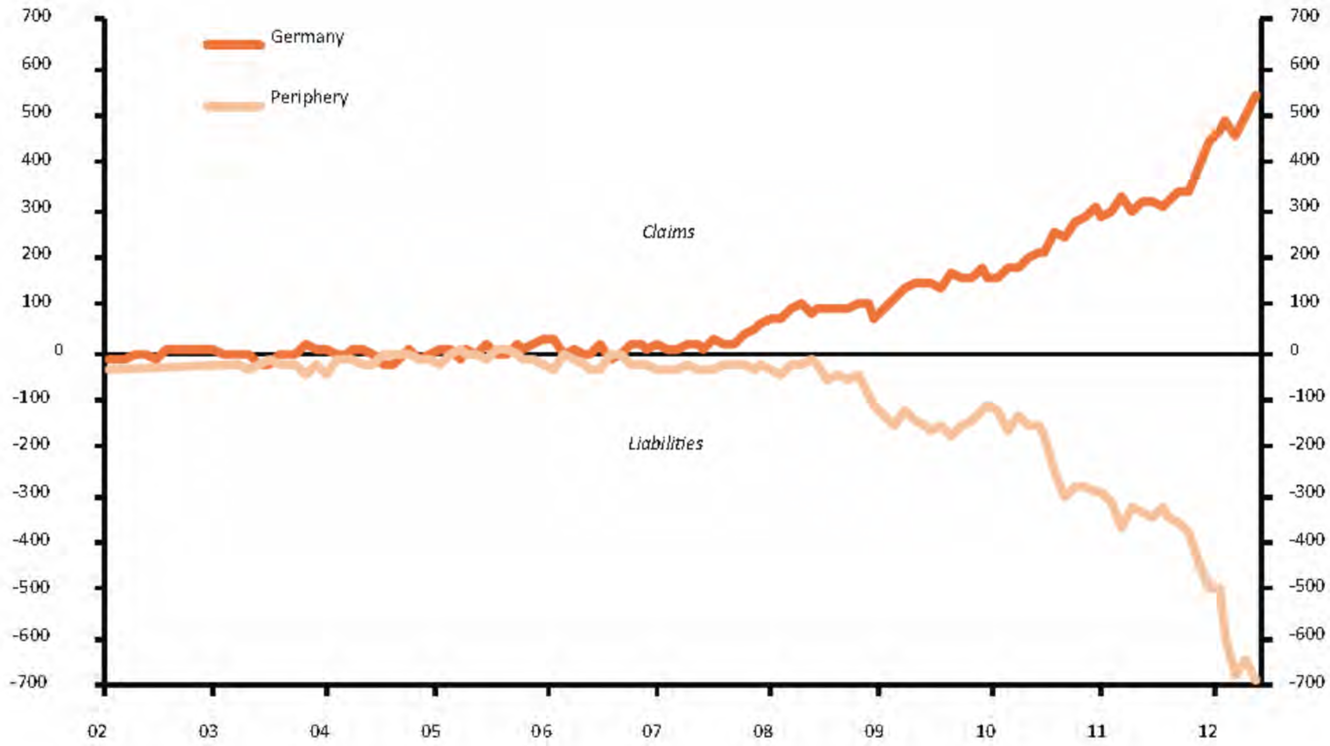
TARGET 2 balances (€bn)



Source: National central banks

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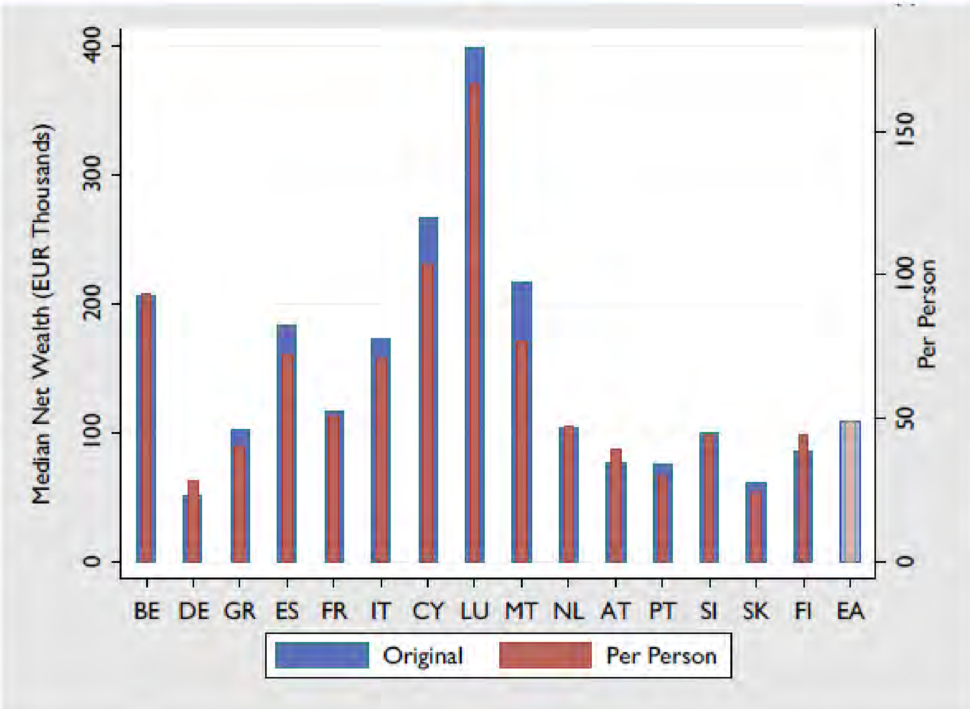
Chart 4.4 Median net wealth and the role of household size



Notes: This chart shows the breakdown across countries of the median value of net wealth per household and per person. The medians were calculated using household weights. The scales of the two statistics differ; they have been chosen so that they perfectly overlap for the euro area figures.

Source: ECB

Despite Angela Merkel's protestations that the these statistics from the ECB are distorted, it is still likely to enrage Germans - as if they needed any further razzing up on the subject of other Eurozone citizens getting rich off the back of a free-for-all, having entered the euro.

Germans are already acutely aware the public sector pay inflation disparity between them and their counterparts in the PIIGS over the past 15 years – before the bailouts.

They now have data showing them that they have the least net wealth per household or per person within the EMU.

Is this, one wonders, quite the model the olive branch of Europe will want to emulate…..? Me thinks not!

DE in the charts is Germany.

Note Cyprus (CY)……… No wonder Germans have an entrenched problem with the notion of fiscal transfers from Germany to other countries which have been profligate, fiscally irresponsible and, most of all, tolerated a culture of tax evasion.

Dispelling the myth: *Fixed exchange rates do not work…*

Any break-up is likely to be extremely painful for any exiting nations in the near term and will likely result in a highly disruptive transition period. Nevertheless, a limited break-up, were it to trigger a swift and decisive step to further integration of the remaining core, could put an end to the crisis and set the stage for future stability, continued cooperation and prosperity.

Up until now, electorates in the periphery have not wanted to be the ones that bring this show to a close (*with most countries in opinion polls still advocating a preference to remain in the Eurozone*) but as solidarity against austerity and the "one size fits all" permeates towards the core – as it will – this will change.

Whilst the breakup of the euro would be an historic event, it is worth pointing out that over the past century, there have been 69 such currency breakups from fixed exchange rate regimes. In the past, the key danger for countries departing such regimes has been hyperinflation due to poor fiscal and monetary policies. Orderly defaults and debt rescheduling, coupled with devaluations are inevitable and form the basis for recovery.

Indeed, if past experiences in emerging markets after defaults and devaluations (*Asia in 1997, Russia in 1998 and Argentina in 2002*) are anything to go by, any exiting European periphery countries stand to emerge with de-levered balance sheets and begin the path to sustainable growth in relative short order.

In actual fact, leaving the euro might well be one of the best things to happen to some of the periphery countries. It might be their debt, but, after all the refinancing since this crisis began, this is now other people's problem.

However, the reality of a country ..... finally ..... leaving the euro – thereby dispelling the myth that the Eurozone is an "irrevocable" union – may have a more profound impact that some would believe. If one today, why not another tomorrow – especially if the impact of the exiting country on its people and its economy proves to be less calamitous than that promised by Europhiles.

However, where the real risk global financial and economic risk lies is in Europe's politicians being behind the curve on any sequence of events towards a euro exit.

The soundest foundation, as put forward by many a contributor to this debate, for managing a euro exit presupposes that European politicians and the ECB can (*between them all*) calmly, rationally and prudently:

- firstly agree that a euro break up is now unavoidable and necessary,
- secondly to agree a plan for an exit (*which may include introducing a new monetary system*),

- thirdly, to do this in absolute secret without markets getting a single whiff of any such preparations and,

- fourthly, to execute it over a predetermined period when market markets are closed and capital controls can be imposed, avoiding excessive market disruption, contagion and legal uncertainties.

Yes, I know, PIIGS might fly!

This is where previous exits from fixed exchange rate regimes have, perhaps, been more manageable and supports the theory that the prospect of Europe's leaders acting unless or until a breakup is already a "fait accompli" is remote.

As and when this does become a reality, an immediate and substantial recapitalisation by remaining member states of their banking systems will be needed, as knock-on mark-to-market losses, exacerbated by extensive global market turmoil, mount inexorably.

In such a scenario, it is clear that any of the current bail-out funds, the European Financial Stability Facility (EFSF) and its successor, the European Stability Mechanism (ESM) would need to be expanded by several multiples of its current firepower. These measures would almost certainly need supplementing by additional support from the IMF and others.

However, such support is not a given. Some contributory members of the IMF are already sick and tired of the Eurozone's inability to deal with the underlying issues and sort its own problems out once and for all – given that , in one way or another, it already has the ways and means of doing so itself.

For many IMF members, there is a distinct aversion to fund to something that the likes of Germany aren't prepared to countenance doing themselves – rightly or wrongly.

It seems, therefore, that yet another Eurozone crisis moment will be much more severe next time around and be the straw that breaks the camel's back. I suspect that this time around, global markets and international policy makers will demand that the remainder of the Eurozone, were it wish to survive in any form of monetary union, should take immediate and decisive steps towards some form of definitive economic and political union (*to include joint liability bonds and guarantees*) in order to lay to rest, once and for all, misgivings that any contemplated bailout was not merely yet another kick of the can down the road.

More likely, given the present constituents and their entrenched opposing positions on such issues – a much deeper, wider and more sustainable, long term solution would need to evolve and have to come into play to prevent a total systemic break up.

This may involve a splitting of the euro constituents into two groups (*Germany, Austria, Finland, the Netherlands and Belgium in one camp and another led by France*) and, in so doing, creating a two-tier euro structure (*in effect, a hard euro and a soft euro in a manner which, although still very expensive for Germany, would be technically capable of avoiding a whole series of costly defaults*).

Given the requirement of all constituent members of the Eurozone to pass new treaties to move forward with any new arrangement, it remains, of course, entirely possible that a number of countries may choose to leave the Eurozone given the opportunity of doing (*perhaps in a perceived "safety in numbers" approach, once the taboo of a country leaving the Eurozone was no longer in play*).

Based on current overvaluations, were there to be a "total" reversion back to national currencies for all, against a benchmark of leading major currencies, new currencies in Greece and Cyprus would likely drop some 55-60%, Portugal 45-50%, Spain 35-40%, Italy and Ireland 30%, Belgium 25%, France 10-15%, the Netherlands 7-10% and Austria and Finland some 5%.

Germany's position is less clear. On the one hand a flight to quality and panic redistribution of capital (*especially within Europe*) would likely see the German currency surge higher in the first instance, but on the other, once the scale of unrecoverable Bundesbank and German bank losses had been fully assessed, not to mention the immediate outlook for the German economy going forward (*given the immediate loss of competitiveness against its major regional trading partners and the lack of demand from others as an economic shock wave ripples through the entire financial matrix and saps global aggregate demand*), it is likely that any initial gains would be relatively short-lived.

Equally, further out, as markets begin to settle down and peripheral Eurozone economies start to rebalance and take advantage of their newly found competitiveness, and as global investors pick over investment opportunities in stock markets, new bond markets, corporate and property sectors, one is likely to see an eventual recovery from the initial panic lows in currency values to more moderate levels.

As for the UK and the UK fund management industry: this is a real risk for which all managers of other people's money should now plan – if they haven't already. Currency losses in any of these scenarios clearly stand to be considerable and fund managers of European assets should ensure that they have a clear risk management strategy for such an event and, if appropriate, suitable currency hedging or overlay facilities in place. Not to do so with such a prominent and known risk on the table is unlikely to be viewed upon favourably by investors or regulators, especially for those managing risk rated funds.

One final thought: *A major wealth tax to preserve the euro…?*

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Something I have been asked about quite a bit recently, following events in Cyprus is: Might we at some point see a major wealth tax across Europe as a possible endgame to try and preserve the euro and in order to redress unsustainable government debt levels?

Unthinkable….? Maybe not. One has to remember that, unlike the US and the UK, Eurozone member nations cannot print their way out of trouble. As things stand, there are (*supposedly*) no bailouts; no print and spend. Rules are rules and, unless changed (*almost certainly necessitating a change in the German Constitution*) the money will have to come from somewhere.

The Cyprus example to tax creditors on their savings shows us the way German policy makers has perhaps steered the debate behind closed doors. Retribution perhaps for the bailout counties where their citizens have been the main beneficiaries of their incompetent and mismanaged sovereigns.

It shows me that, actually, there are no limits, no boundaries, no taboos when dealing with the spiral of debt. We all need to be very careful about where we keep our wealth – and in what.

The Boston Consulting Group came up with an interesting notion as to the potential quantum of any wealth tax that may become necessary in order to deal with a future financial crisis and deal with the government debt burden, both in the US and Europe. Their assessment assumes that a sustainable debt-to-GDP ratio for a country's total debt is 180% - double the Reinhart-Rogoff model that suggests 90%. Currently the amount of debt above this 180% level is about US$11 trillion for the USA and US$7.4 trillion for the Eurozone and $1.7 trillion for the UK.

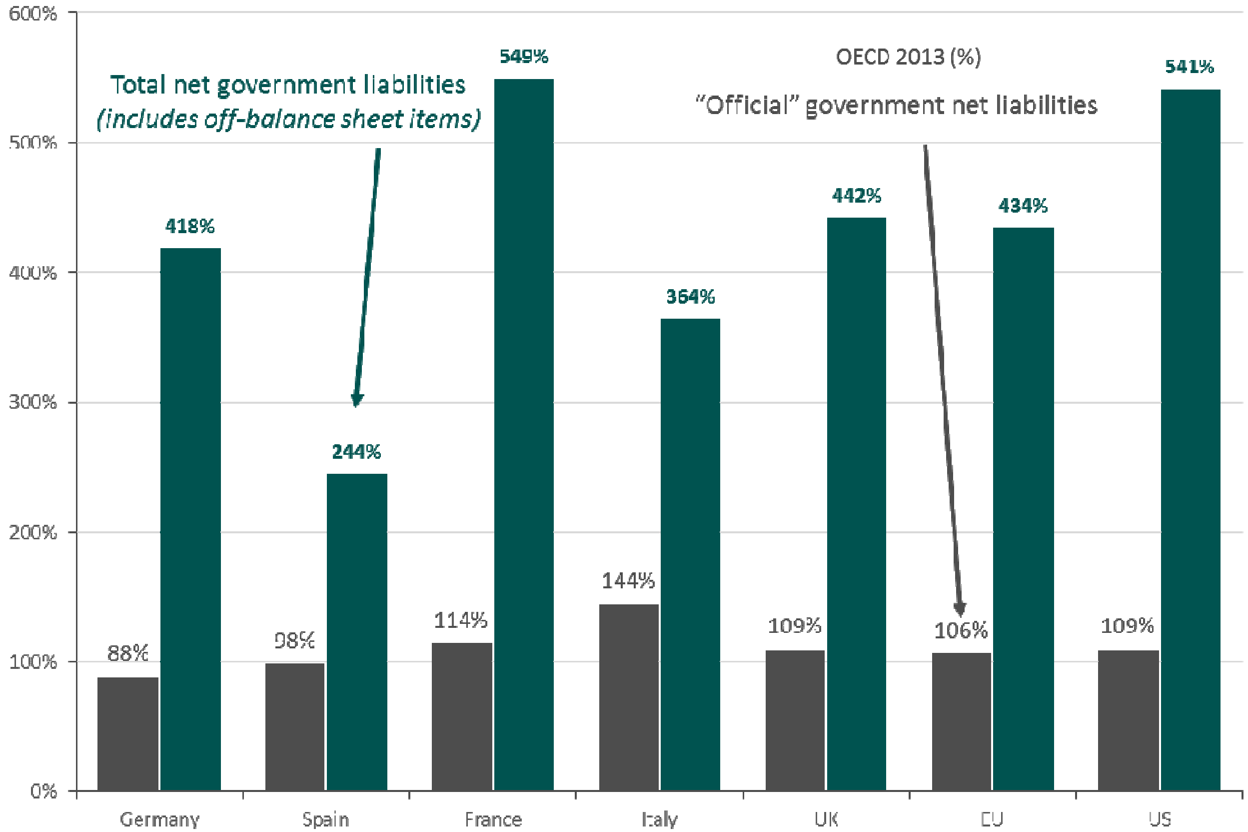
Consequently, when push comes to shove in Europe in the years ahead, if the rules of engagement are not relaxed, a wealth tax may be the only viable option for some nations to stay in the club.

	Wealth Tax Needed ($bn)	Financial Assets ($bn)	% Tax on Wealth Required
United States	$11,216	$43,134	26.0%
European Union	$8,329	$24,493	34.0%
United Kingdom	$1,704	$6,314	27.0%
Total	$21,249	$73,940	28.7%

Sovereign debt: *A global phenomenon…*

As bad as this excessive debt burden is, it gets even worse when the off-balance sheet liabilities, covering items that are largely age-related, such as pension obligations, social security and health-care programs are included. Under any realistic economic scenario most of these liabilities simply cannot be repaid. Over coming years, this will test Eurozone deficit rules to the core.

In summary, excess global debt is at such a high level that realistically it cannot be repaid. The situation is made worse by the aging of societies in advanced countries. No government in advanced economies is addressing the real issues: cutting entitlements and spending sufficiently so that future spending is less than revenues.



All that governments are doing (*can do under conventional wisdom*) is tinkering at the edges. The financial system will not be able to cope under today's "rules"; a new crisis period will come.

Under the current financial system, a combination of high debt levels and changing demographics condemns advanced economies to much slower growth. It is a simple fact and a matter of maths. Only the actions of central banks have prevented most economies from re-entering recessions.

In fact, what distinguishes this period from previous recessions is that the world is suffering from the aftermath of a monster credit crisis which has mutated into a government balance sheet depression in Western advanced economies.

In simple terms, global aggregate demand continues to wane amid continued deleveraging in the corporate and private sectors whilst government debt soars. QE is simply creating an illusion of growth and prosperity – the reality is very different.

Corporates and private households are using low rates to pay down debt. In many instances, it is not creating a "real" growth or jobs. It is like blowing hot air into a balloon that has a big hole in the back of it. It gives an illusion of reflating, but as soon as you stop blowing it deflates again.

Markets are excited about the prospects of the next big puff of hot air (*Japanese wealth*) flooding world markets. However, the "real" issue is not the supply side, it is aggregate demand.

The BRICs have cushioned some of the blowout from 2007/8, as have the rest of the Emerging Markets, but now that these areas are themselves facing saturation and imbalances that require major consolidation in parts, it is not clear who will pick up the baton. The survival of the Eurozone depends on global growth.

The massive QE inspired capital flows into Emerging Markets since 2008 were simply too big to be efficiently absorbed by many of these recipient countries. The 'global liquidity tide' has only just begun to recede and yet, already, the likes of India, Indonesia, Brazil, and Turkey are already fearing crises in the making for when the US begins to taper QE. We are early in this process and the global liquidity conditions will likely deteriorate, ironically if Developing Markets recover.

In reality, much of the nominal GDP growth enjoyed by Emerging Markets in the past decade was not due to real growth but (i) local inflation and (ii) currency appreciation. For example, between 2003-2011, the Nominal GDP of Brazil expanded by 346%, about ten times that of the US (35%). But only 11% of Brazil's incredible Nominal GDP growth came from real GDP growth, while 89% came from the dollar price changes.

So if the terms of trade and capital flows reverse, these nominal factors that have flattered Brazil could easily reverse, exposing the "real" (*and less than impressive*) level of GDP growth. The same point applies to many other Emerging Markets economies.

In many ways, Emerging Markets are a microcosm of the world, highlighting the problems and the dangers of international monetary linkages, incoherence between interest rates and the underlying economies, and bad governance. Just as it took a while for the world to realize that Greece was not the only problem in Europe, it will take a while for investors to understand that India, Brazil, Turkey, and South Africa are not the only problematic countries amongst Emerging Markets.

As Fed tapering ultimately unfolds, money will haemorrhage out of Emerging Market fixed income and equity funds. Having joined this party in wave after wave over so many years and at so many levels along the way, the rush to the exit is going to be ugly. The dangerous part is that Emerging Market Credit / Fixed Income funds are very, very stretched and there is virtually no liquidity for these fund managers to exit.

Summing up: *What goes around, comes around…*

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Bearing in mind that currency movements are triggered by relative performance of one country against another, we feel that we are running into a sweet spot for sterling. Against a progressively more stable outlook in the UK, there are significant (*and growing*) imbalances elsewhere – in the Eurozone (*especially between Germany and the Euro periphery*), in China, the rest of the BRICs and much of the Emerging Market sector.

Clearly, when the euro eventually breaks, we will all know it and market movements will be seismic. In the meantime, the ebbs and flows in risk toward Emerging Markets do not alter our bearish view on many of the EM currencies looking into next year when QE tapering gets underway and believe that events here will have a knock-on negative spill over effect on commodity currencies.

For years, money has chased BRIC investments, tempted by the countries' fast growth, huge populations and explosive consumer hunger for goods and services. However, the reality is that there is not always a strong correlation between growth and investment returns. Chinese nominal GDP growth may have averaged 15.6% since 1993 but the compounded return on equity investments was minus 3.3%.

In any case, economic growth is ratcheting lower with growth in Brazil and Russia broadly flat and Indian growth at its weakest in ten years. In Russia, rising discontent carries the risk of hitting the broader economy. Money that went into the BRICs and other emerging markets was indiscriminate – so too it will be on the way out, with the good getting thrown out with the bad.

Pre-2008, the capital flows to Emerging Markets were 'pulled' by the perceived superior economic fundamentals and potential of EM, but post-2008, they were 'pushed' out by the G7 central banks when they adopted QE. This latter type of flows were highly flawed and inferior in nature, compared to the earlier flows. As the US and European economies recover and their tail risks recede, EM will face the danger of large capital outflows.

From a UK perspective, a stark misalignment closer to home (*on both technical and fundamental grounds*) remains with EUR/GBP. Whilst the UK gets on with its domestic-led recovery (*and perhaps becomes the European outsourcing country of choice for many a foreign firm*), we envisage a progressively unstable Eurozone, teetering from one crisis to another. In the long run, this is not a viable or safe investment proposition, and we see the euro falling considerably as the economic, financial, political and social divergence expands over time. Money has to go somewhere and, like it or not, the UK is likely to become a safe haven for European funds in a euro breakup.

Against sterling, the euro already stands to retrace significant ground back towards 0.75 (some 12%) over the next two years but, in the event that we do actually start to see a real break up in the Eurozone, we would expect to see EUR/GBP drop precipitously and much more extensively. Even without a break up, we would still expect to see EUR/GBP settle back to somewhere between 0.72 (15%) and 0.68 (20%) by 2018. UK export dependent corporates should take note and seek to lock in current favourable exchange rates whilst they last.

Chart of the Day: *What goes up, eventually comes down…*

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