

IPS View: Reality Bites

We wrote back in April ([IPS View: Climbing the Wall of Worry](#)) that it was remarkable how resilient equity markets had proven to be in the face of a number of serious economic problems. Well, this August, reality has bitten. The FTSE 100 was down -9.8% last week. This is the second worst week in the last decade and a bigger loss than the market took in the weeks before or the week after the Lehman default.

The worst weeks for the FTSE 100 since 1/1/2000

Date	Weekly Change in FTSE 100
21/11/2008	-10.7%
05/08/2011	-9.8%
12/07/2002	-8.5%
06/03/2009	-7.8%
07/05/2010	-7.7%
20/02/2009	-7.2%
05/09/2008	-7.0%
16/01/2009	-6.8%
21/09/2001	-6.8%
14/09/2001	-6.2%

Source: Bloomberg

What makes this surprising is that the reasons are so familiar: at the heart of market worries are continuing poor data from the US and the steady, inexorable worsening of the Eurozone crisis. Indeed, they are the same two worries that were dragging down the markets almost exactly a year ago. Then, QE2 came to the rescue and equities markets subsequently rallied sharply from their lows. One explanation of the current sell-off is that, with QE2 now over, markets are just sliding back to more normal levels. The speed of this reversal was still shocking though. How likely is it that the slide will continue?

First, let's revisit how we got here. The 2008 credit crunch was a gradual liquidity squeeze on the finance sector which culminated in the bankruptcy of Lehman Brothers and governments effectively stepping in to underwrite all the liabilities of their respective banks. In 2011, a similar liquidity squeeze is unfolding. This time, though, the run is on Eurozone governments. As we wrote in July ([Italy is Dragged into the Crisis](#)) the spreading of the crisis to Italy was a new, bad development. The Italian economy is about 4 times the size of Greece, Portugal and Ireland combined and its government debt market is the world's third largest. Italian 10 year government bonds now yield a little over 6%. To put this into context, this is what Greek 10 year government bonds were yielding in March of last year. The logic of a liquidity squeeze is that of a vicious circle: prices fall, buyers dry up as they fear further falls and falling numbers of buyers trigger the very price drops they fear.

What is to stop Italy not being the Greece of 2012? Why won't France be dragged into the crisis? Either of these events would be very bad for equities and risk markets more generally. The ultimate answer is that either the Eurozone will either gradually disintegrate, losing its weaker fringe members. Or, it will be drawn into a much closer, genuine fiscal union. This would be a world where Italian government bonds were a joint liability of all the Eurozone countries leading, in effect, a United States of Europe. In this outcome it would not be possible for markets to pick off the weakest member states one by one. This, we believe, is where many of the EU leaders want to end up. The problem is that the markets will not give them the time they want (years, not weeks) to do it. Do you have faith in EU leaders doing enough to convince markets they will get there eventually and by doing so stopping the contagion? We thought not. In that case, be prepared for the volatility to continue for a while until the Eurozone is glued closer together or falls apart.

The other issue that has caused the sell-off has been the continuing disappointing economic numbers coming from the US. As one of the engines of world growth (the other being China) a slowing US is bad for us all. The problem is that the American consumer is focussed on paying back the debt accumulated in the good times. In 2009 and 2010, the US authorities partly compensated for this lack of growth by fiscal stimulus and QE. The appetite for both is waning. The recent debt ceiling deal highlighted the fact the future for the US government is one of spending cuts rather than stimulus. More QE is possible but, like a drug, the beneficial effects of each dose are likely to be less each time it is applied.

Ultimately, though, the markets are looking to policy makers to address both problems. It remains possible that we will have a sharp rally if authorities do manage to do the right thing as happened with the QE-driven rally in August last year. This is not, however, our base case. Instead, here are the opportunities we currently see to make money for our clients:

- First, reflecting our generally bearish near-term outlook we cut our long only equity exposure to around 15% for most clients around the end of April. At the end of June we reinvested some of the proceeds in gold mining shares and Asian equities. Gold miners should benefit from the rising popularity of gold as an alternative to the US dollar or Euro and so far this has been a profitable investment. Asian countries have underperformed over the last 12 to 18 months. As they are not burdened by high levels of government or consumer debt we think they are due for a rally.
- Secondly, at the end last month we raised our cash levels, which we remain ready to use as the picture becomes clearer or if some assets (including equities or high yield bonds) simply become too cheap. For now, though, we remain on a watching brief.
- Finally, we retain our focus on trading based funds that we believe can profit from continuing volatile markets. These have made money for our clients and we continue to think they are the right sorts of asset to own in uncertain markets.