JMFinn&Co

The Investment Letter

September 2011

A PERSONAL VIEW

A Banking Crisis Disguised as a Sovereign Debt Crisis!

Contents

Economic Focus	2
Editorial	3
The Home Page	4
Collectives Commentary	5
Selected Equities Commentary	6–7
Stock in Focus	8
Company Meetings	9
Fixed Interest Commentary	10
Technical Analysis	11
Market Monitor	12

"Today no nation or group of nations, not even the most powerful, can protect itself from threats by turning itself into an impregnable military fortress. No army can prevent capital movements, stop the spread of AIDS, reduce the impact of global warming, halt the flow of information, or reverse the spread of radical violent ideologies which threaten us all.... For good or ill, we live in an age of interdependence, and we must manage it collectively."
Taken from a message delivered on behalf of UN Secretary General, Kofi Annan, for the Second Interdependence Day in 2004.

There is now a much wider appreciation of the underlying structural problems facing the single European currency zone. If the European Union cannot find a way to stabilize monetary flows between vastly differing economies through the unification of both its fiscal and political policy, then its current structure is simply untenable and economic stagnation and the collapse of the Eurozone look like the only outcome.

Both Chancellor Merkel and President Sarkozy emerged empty handed from their Paris summit as differing national interests continued to clash over the best way to deal with the crisis. Their half measures and political bluster is only helping to roll the crisis forward, speeding up the likely collapse of monetary union, giving wind to the likelihood of a European banking collapse.

Since its inception the single currency has rendered the peripheral Eurozone economies uncompetitive. With no mechanisms in place to allow for debt restructuring or the ability to devalue or default, growth – the only panacea for the region – has become almost impossible. The €444bn European Fiscal Stability Facility created to buy the debt of weaker southern countries cannot be deployed without debilitating the economies of the north, exacerbating the current problems.

The European Central Bank (ECB) seems to have forgotten how to act in the collective interests of the Eurozone and instead is choosing which individual members to rescue. This makes the ECB an important cause of the current crisis. If a united fiscal policy isn't developed quickly, the inter-banking markets will collapse à la Lehman and the Eurozone disintegrate.

The inability of both European and ECB leaders to develop a collective answer to the crisis is already having an effect on the economies of the larger northern countries. Germany reported GDP growth of 0.1% in the second quarter versus expectations of 0.5%, with France having already reported zero growth for the same quarter. The paralysing disagreement between European leaders on how to create conditions for growth may ultimately undo the structures of the Eurozone they are fighting so hard to keep.

Individual European cultures and political systems were distinctive entities well before the Euro came into existence and it is foolish to think that a hard working German saver would be happy to accept a declining standard of living to continue to bail out the peripheral European states.

The European Union has been destined to collapse since its inception and the implementation of a single European currency just makes this more certain. Setting a single interest rate across countries with quite different economies could never have worked without fiscal union and mechanisms for reallocating taxes to harmonise differing economies. Fellow European countries traded productively before a single currency was introduced, but they have never been able to act collectively to truly develop a federal European Union. All are interdependent, so this failure to act signals the inevitable collapse of the European Union project.

The most probable outcome is beginning to look like a slow disintegration of the Eurozone, the effects of which will be felt across global markets. In my opinion, as the West enters a period of 'Japanisation', investors should be defensive, seeking a progressive income from international stocks where the UK has a number of good representatives.

James Meysey-Thompson
Investment Manager

ECONOMIC FOCUS

Angela in Euroland

If you over-borrow, you have two main choices. Take it on the chin, petition for bankruptcy and default – or work hard, save hard and repay your debts. Default is unpleasant for a year or so, but then leaves you debt free and able to rebuild your life. Save and repay involves perhaps a decade of boredom as you cut back on spending and save every penny for repayment. The same is true for governments.

Euroland has avoided default and has gone for repayment. So don't be surprised if the rest of this decade is economically boring, relative to the past. The middle ground between (a) default and (b) save and repay is (c) to restructure, involving creditors taking a smaller hit than default in exchange for a greater chance of save and repay working. Life for the debtor is less unpleasant with smaller debts to repay.

But in Euroland there's not much restructuring. I see their governments taking over private sector bank problems by buying problem debt. The problem is being transferred from the private to the public sector, not restructured in the sense that creditor banks take some kind of a hit. Restructuring will probably take place between governments at a later date.

Governments have a variation on the save (ie higher taxes) and repay option – inflation. Print currency to pay off your debts. Saving more via higher taxes reduces your real income, as does price inflation when it is greater than your wage inflation. Politicians can find inflation easier as they can be directly blamed for higher taxes.

So where's Euroland heading? There are two viable plans afoot. The Euroland Bond ("EB") is one idea. The EBs would be backed by all of Euroland's governments. But without strong rules to enforce fiscal discipline this would leave Germany picking up the tab. Strong rules need to be enforceable, so Euroland nations would have to cede sovereignty to a Euroland Finance Ministry. Thus, Germany would cede its own sovereignty to a Euroland quango and would be permanently bound by something that would probably encompass the inflationary traditions of Southern Euroland, as the constitution would be drafted by consensus, not by Angela's government. Added to which, German banks are part of the problem through their excessive lending to the reckless governments of Southern Euroland. That weakens the German negotiating position and it means they can't impose their will.

Plan B involves the European Central Bank (ECB) and/or the European Financial Stability Facility (EFSF) – as the central bail-out fund is more properly known – buying-in troubled Euroland government debt. Such action will generate a need for Euros. Political pressure from German voters and reluctance from hard pressed Southern Euroland governments may lead to some kind of inflationary fudge. Euros needed to buy-in troubled Southern Euroland debts could be generated via something that resembles quantitative easing.

If Germany is given the choice between (a) EBs and subscribing to permanent Euroland structures, allowing Southern Euroland to entrench their inflationary prone tendencies on a permanent basis, or (b) a temporary financing of the ECB and EFSF with inflationary finance, Angela is going to opt for the less permanent option.

Ideas like chucking Greece out of the Euro are probably non-starters. Greeks would default on their Euro debts. That would scare investors into withdrawing cash from other troubled nations like Portugal and Ireland who would see a run on their banks. The only way to stop this would be to guarantee Greek debt in a Greece-out-of-the-Euro world which leaves you in the same position as supporting Greece today.

So, the save-and-repay option leads me to expect boring growth from Euroland, but with high volatility around a dull trajectory until we learn to factor in smaller changes proportionate to the smaller growth rates. Inflation may be reluctantly tackled in a half-baked way by a less politically independent ECB, but helped also by Chinese purchases of Euros.

Angela is discovering that Euroland is a different place from Germany and that the final outcome is going to be one that encompasses Southern Euroland's inflationary tendencies. European solutions need to be drafted by all of Euroland, not just Germany.

The Euro's founding dreamy promise of delivering Teutonic fiscal discipline to Southern Euroland by removing inflation-prone governments' abilities to print money looks like being swept away by a rising tide of inflationary prone solutions aligned, in part, with the economic traditions of Southern Euroland.

John Royden
Research Officer

EDITORIAL
A Pact at the Crossroads...

Slight was the thing I bought, Small was the debt I thought,
Poor was the loan at best, God! But the interest!
Paul Laurence Dunbar – *"The Debt"*.

In Asia they call this the "Atlantic Crisis". 1998 saw them the principal perpetrators of the "Asian Crisis", but this looks far bigger and more comprehensive for the USA and Europe. It took the Asians years to recover and for their equity markets to rekindle. As we head towards rehab, it may be more painful and require longer. The Asians, however, mainly think that their economies and markets are okay, probably even as frisky as ours in the late 1990's or over 2006-2007. Frankly, they look right.

Most of the financial, economic and social problems making headlines in the West today focus on Europe and the USA. The West has reached the point of saturation and its economies and societies can no longer afford to guarantee an ordained standard of living for their citizens in exchange for their votes.

The Western nations are similar. They are largely socialist democracies which have evolved into overwhelmingly consumptive societies, diminishing in the process their own goods producing sector, itself a generator of any nation's real wealth. This has stymied job creation ability and eroded real wealth and the tax base. The problems have arisen because governments have continued to "deficit spend" and over-tax – chasing wealth and job creation offshore. This leads to a trend of borrowing to meet the expectations of the populace.

This is a downward cycle ready to crash in the central banks of Europe and the United States. They cannot continue to print and guarantee the balance sheets of the banks and broader government debt caught up in this maelstrom. It is the exception that a country in this sphere is not caught up facing long or short term insolvency. Witness the budget fights in Washington DC and the failed attempts to pass austerity packages in the various capitals of Europe.

Western Europe has been dominated by the failed philosophies of both socialism and Marxism. Social democracy itself was a devil's bargain, based on the assumption that the engine of prosperity – capitalism – would always produce wealth and revenue for the government, creating a voting base to sustain the arrangement. However, Asian economies have taken over manufacturing and innovation activity, previously dominated by the West. The West will need to change its politics and economic philosophy to re-establish a manufacturing base, as these economies are cannibalising themselves in order to maintain their flawed societal commitments.

"IF I'D KNOWN THE ENTIRE FABRIC OF SOCIETY WAS GOING TO COLLAPSE I'D HAVE BORROWED MORE."

The riots in Greece, France and lately the UK have their roots in the socialist mindset established through the ruling classes in these countries. It is not the case that complaints and the usual platitudes for income redistribution will wash. This is an irrational solution that would only exacerbate the original dilemma and create more upheaval and demand that cannot be met. One of the most damaging socialist policies of the Left has been to create a layer of low paying service jobs. There is little opportunity for upward mobility towards better paid jobs in the goods manufacturing arena. As manufacturing has dissipated so much, this avenue to promote entrepreneurial creativity no longer exists. An employment trap has emerged.

The European contingency, through its bail-out fund, the EFSF, sat at €440bn, but was established before the €1,900bn of Italian debt became a problem. France's high indebtedness, too, implies that Merkel and her electorate may have to fund triple the current estimate at €1,500bn or more to be effective. In that process German exporters would emerge strongly within the Eurozone, but their electorate's domestic real income growth would plateau, challenging Merkel's political stability. Above all, the Germans fear inflation.

It is possible that the US can change, but for Europe the problem looks mostly intractable. There may have to be a complete collapse of the European economy, and of the Euro (which was created on the backs of the Germans), as well as more social unrest before reality sets in. The US can avoid this, but supporters of Obama, who considered the Standard & Poor's downgrade on the US dollar as political, have not yet grasped the issue.

Geordie Kidston – Associate, CFA UK
Senior Research Officer

Market Monitor

What a difference a few weeks can make! In our last newsletter we were highlighting the steady performance from markets, despite a seemingly continuous flow of bad news. With the benefit of hindsight it did appear too good to last. Eventually equities did buckle under the strain. August turned out to be a most uncomfortable month for investors. September has hardly started in a calm fashion.

Fears over the strength of the economic recovery in developed countries – most notably the US – and the continuing sovereign debt crisis in Europe, coupled with international banks looking increasingly fragile, have combined to unsettle markets and send investors scurrying for safer havens. Gold has prospered as a result, as have gilts. It is a brave person who stands against the crowd in these volatile and difficult conditions. The future looks particularly uncertain as we head into autumn. In Europe we face the consequences of debt refinancing, which may absorb all the firepower of the European Central Bank and the bailout fund put in place, while the indications are that the sluggish performance of the Southern economies may be spreading into the better placed Northern nations. The most recent figures from Germany, as an example, were a disappointment.

So what might we expect from markets as the nights lengthen? Volatility has certainly returned as a feature, which hardly leads to a comfortable ride for investors. So far we have been fortunate in seeing corporate results hold steady, but there is no guarantee that even this can be sustained against a background of weakening economic performance. However, the emerging world continues to outpace the over-indebted West and many businesses now focus on these faster growing areas. For the present care and a steady nerve appear the watchwords.

	27/06/2011	05/09/2011	% change
FTSE 100	5722	5133	-10.3%
FTSE 350	3047	2725	-10.6%
S&P 500	1280	1174	-8.3%
Nikkei 225	9578	8784	-8.3%
CAC 40	3797	3000	-21.0%
Xetra Dax	7108	5246	-26.2%
Hang Seng	3135	2768	-11.7%
FTSE UK Gilts Government All Stocks (Total Return)	2526	2676	+6.0%
GBP USD	1.60	1.61	+0.6%
GBP EUR	1.12	1.14	+1.8%
GBP JPY	129.45	123.94	-4.3%
NYMEX Gold $	1496	1877	+25.4%
Dated Brent Crude $	106	112	+6.0%

Registered Office: 4 Coleman Street, London EC2R 5TA
T 020 7600 1660 F 020 7600 1661 DX 119521 Finsbury Square
www.jmfinn.com

LONDON BRISTOL LEEDS BURY ST EDMUNDS IPSWICH CARDIFF

JM Finn & Co is a trading name of J. M. Finn & Co. Ltd which is registered in England with number 05772581.
Authorised and regulated by the Financial Services Authority.