

Market Update

Europe enters the 'Endgame'

September 2011



The current global market sell-off and fear-driven environment (fuelled largely by developments in Europe), provides an important reminder to investors about how markets oscillate between extreme outcomes, overshooting one way then back the other depending on the latest headlines and rumours.

Day to day, the market is looking at every bit of news – from fundamental economic data to political posturing, from the significant to the trivial – and trying to make sense of it. And, frankly, we believe that often the market is over-reacting.

At times like these, investors need to learn (and often re-learn) how to look through the tremendous amount of market 'noise' and distinguish the credible risks from mere rumours, and determine if anything has changed in the underlying fundamentals, or their specific situation, to justify a review of their long term investment strategy.

Current market developments

Since the initial recovery from the market sell-off of early August (triggered by renewed Eurozone contagion and US debt default fears, then a US downgrade by Standard & Poors), global equity markets have stepped down in progressively lower ranges, before breaking through to either retest the recent lows of early August (e.g. Australian and US

markets), or make entirely new lows for the year (e.g. European markets).

At the time of writing the Australian share market (S&P/ASX200 price index) has fallen more than 7% in September, though still remains 4% above the lows of early August. This reflects the general market weakness around the globe at present, with major markets around 4%-7% lower so far this month, and with a wide divergence in terms of how they are faring relative to the lows of early August (European markets well below, US & Australian markets still above, and some emerging markets at either extreme).

Risk & Investor Emotions

As we take a closer look at the financial markets and the events transpiring at present, and over the past several months, it's clear that uncertainty continues to be inserted into the market ... and seemingly at every turn!

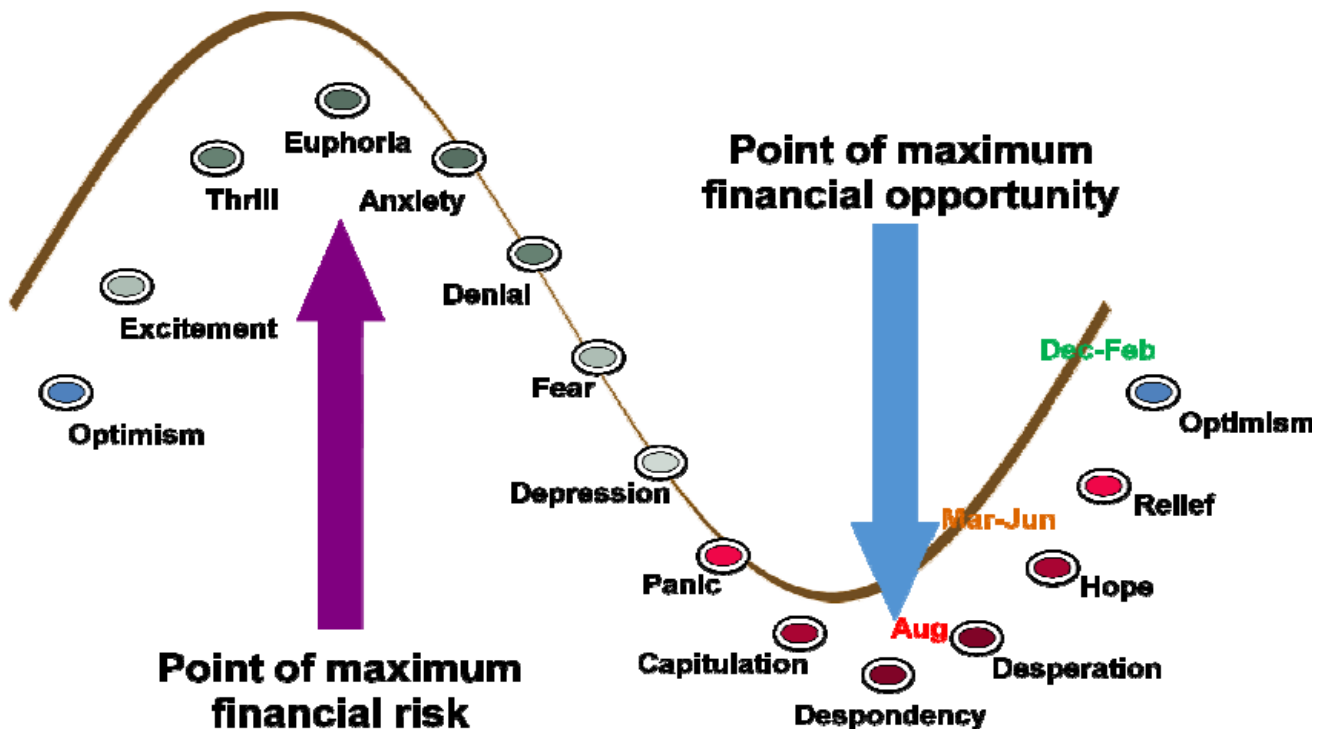
The current market gyrations demonstrate that markets are moved primarily by shifts in expectations, i.e. the 'perception' as to what the underlying market and economic/political fundamentals are saying about the future for corporate earnings, interest rates, currencies and so on. From this standpoint, risk is related to the 'possibility' that things turn out worse than expected, causing prices to adjust downwards.

While risk is often equated with volatility and uncertainty, it is important to remember it is the



same thing. A good definition of risk is the “possibility of incurring loss or misfortune”. While volatility and uncertainty have both increased, it is not clear that investors have become more likely to lose money in ‘risk’ assets such as equities. Indeed, it is quite possible losing money has become less likely in equities due to the dramatic fall in valuations, and more likely in ‘safe’ assets like government bonds due to their extreme over-valuations.

Think about this in terms of the Cycle of Investor Emotions. Position really depends on which ‘market’ you are talking about. Equity markets are nearer the point of maximum opportunity, while government bond markets are nearer the point of maximum risk.



Source: Russell Investments

Putting the past 9 months into perspective, 2011 has really been about sliding up and down the ‘wall of worry’. That is, after a great start to the year where stock markets were more optimistic (albeit unrealistically so), renewed Eurozone fears gripped the market again in the June quarter (with markets oscillating between ‘hope and optimism’) before things got far worse in Europe and the US chipped in with a possible debt default and S&P downgrade in the September quarter (moving the market down to the ‘hope to desperation’ range, not generally to the ‘capitulation to despondency’ area - though this is the case in certain selected markets, especially in peripheral Europe).

The broader economic perspective

But while markets may have run well ahead of fundamentals, there is no denying that there are risks to the global economic and market outlook, and some of these risks (mostly from Europe) come with the prospect of extreme contagion events. In this respect, it is important not be naive about the risks facing markets, but instead viewing them in a balanced manner, balancing the risks with the opportunities, and keeping market reactions in perspective.

That said, it is fair to say that if it weren’t for the Euro debt issues, the global economic outlook could be described as being generally ‘robust’ – though global growth is not expected to accelerate in a dramatic way any time soon.

Europe is, and will remain, the global ‘basket case’ for some time to come until clear financial



and economic steps toward a final resolution are put in place.

However, looking more broadly to get a larger perspective, we can build a picture that is far from the 'end of the world' scenario that markets are pricing in as an almost certainty:

- The **US** is expected to grow at or just below trend levels (2%-2.5%pa), with the energy price pressures and Japanese supply disruptions that contributed to the second quarter 'soft patch' now abating;
- **Japan** is in the midst of a post-earthquake "V-shaped" recovery (all be it from very low levels);
- **China** should continue to grow at an 8%-9%pa pace (supported by continued huge investment in public housing and infrastructure, with continued strong manufacturing growth and signs of inflation peaking); and
- There are early signs that **Australian** consumers may have reached a 'savings peak' and may return to bolster the non-mining sector going into 2012 (which may be backed up by RBA rate cuts if the central bank wants to take out some 'insurance' near term). This together with the expected surge in mining investment, and a soft landing in China that underpins the mining boom, paints an improved picture for growth next year.
- Though the **IMF** has come out this week to cut its global GDP forecasts for 2012, it is still expecting growth in the vicinity of 4%pa on average.... though with one obviously large potential risk... European contagion!

The Eurozone: Welcome to the 'Hotel California'

The Eurozone is a bit like the old Eagles song 'Hotel California', i.e. you can check in any time you like... but you can never leave! The political will to maintain the Eurozone is expected to ultimately drive action to resolve the crisis ... it just might take a while yet.

No matter what case can be built for the

continuation of a grinding global recovery associated with solid (yet unspectacular) returns to growth assets, there remains the obvious risk of a Europe-driven 'tail event'. Specifically, markets are preoccupied with the chances of a Greek default triggering a chain of reactions that bring in the larger economies of Italy and Spain, and therefore impact the entire European (and ultimately the world) banking system.

While most market commentators and strategists place a relatively low probability on the collapse of the Euro and the European financial system more generally, it is the ramifications of such a scenario that mean such a risk takes on oversized importance relative to its actual prospects of occurring.

In fact, because the resolution of the Euro-crisis is as much politically-driven as financially driven, the vagaries of the European political structure and the public unpopularity of bail-out measures in core Europe, leave markets unsure that common sense will prevail (though most expect it will). This in turn drives uncertainty and fuels extreme market volatility based on who says what... about who... and when!

Generally speaking, market rebounds will not be ultimately sustainable until there are clear signs that concerted action to once and for all address Europe's structural problems are in train. Signposts to look for in this regard include:

1. **Controlled partial Greek default**, i.e. a 'managed default' that ensures Italy and Spain, and German and French banks more specifically, are insulated by the ECB and EU from any severe contagion effects. The intent here would be to reduce the debt/GDP ratio of Greece to more 'manageable' levels of say 60-70%, versus an unsustainable 150% currently.
2. **Firm action on the part of the ECB** to act as a 'lender of last resort' (providing as much funding for Italian and Spanish bond purchases as required to maintain stability) and to provide sufficient stimulus via reductions in ECB interest rates (anywhere from 50 to 150bp of rate cuts would send a strong signal to markets of the ECB's determination to see this crisis through as soon as possible).



3. **Expansion of the European Financial Stability Fund (EFSF)** to provide a sustainable capital pool for bail-out requirements and financial ‘emergencies’. This would need to be funded from core European countries in particular, and require firm parameters around its use, ongoing funding and conditions on recipient nations.
4. **Building the ‘United States of Europe’** where there is true fiscal and monetary integration, controlled by centralised Pan-European authorities such as the ECB and a European Treasury. This is the ultimate path to sustained resolution of the euro debt crisis, but is also the most difficult to achieve given it is so politically sensitive.

The first and second signposts are likely to be more ‘easily’ achieved near term – though certainly by no means easy! But even if they are carried out, they are still more tactical in nature, hoping to provide a short term circuit breaker to extreme market risk aversion and volatility. The ultimate resolution lies in the third and fourth signposts. However, these involve political co-operation on a pan-European scale, and as such will most likely take longer to achieve.

We view the Euro crisis as now having moved from a ‘kick the can down the road’ scenario to an ‘Endgame’ scenario. That is, the time for continuing with short term reactive responses is fast coming to an end. The crisis has now reached the stage where it will either blow up in Europe’s face (NOT our main scenario) due to political incompetence and lack of coordination across the region, OR Europe’s politicians and monetary officials will be forced to make the hard calls and finally take concrete steps such as those above. Our view is that the latter is most likely to occur, though it may take things becoming a bit worse yet in Europe to force the hand of policymakers and politicians.

Looking ahead

The reality is that the global economic recovery is still fragile. The uncertainty of the Euro endgame creates the very realistic possibility that if it

ends ugly, or if the uncertainty is prolonged or heightened indefinitely, the economy may be driven into recession because of a crisis in Europe or sentiment.

This is still NOT our expectation... but because politicians are involved, it can’t be dismissed (look at the US congressional bickering over raising the debt ceiling and budget cuts as an example ... ultimately resolved but unnecessarily ‘last minute’).

It’s important to remember that extreme volatility like this is going to continue to happen until the underlying problems in Europe are resolved. One way to put a near term circuit-breaker into markets is for the ECB to take the ‘easier’ steps available in an attempt to placate markets somewhat and start the road to ‘believability’. If the focus on Europe can be diminished at least somewhat, then this will help with consumer and business confidence in the real economy globally, and put more emphasis on the rest of the world where the corporate and economic picture is somewhat brighter. However, any such tactical measures must be followed up by demonstrable steps toward the establishment of a fully funded and operational stability fund, paving the way for a ‘United States of Europe’ that is fully integrated fiscally.

What should investors do?

- Whenever there are large market-driven movements, it is likely there will be continued volatility for a while until things settle down again and some degree of confidence is restored.
- The key for investors is not to panic. We remain confident that while market conditions will continue to be volatile over the rest of the year, now is not the time to make knee-jerk reactions and run to cash (as many did in the depths of the GFC – with terrible results in the ensuing recovery).
- Though contagion risks from the Eurozone will continue to fuel anxiety for a while yet, it must be remembered that markets have priced in the end of the Eurozone and the collapse of the European banking system as an almost certainty.



- In our view, the markets have got way ahead of themselves, which in turn provides some seriously attractive valuations (in markets around the globe) for long term investors to take advantage of, and reap the benefits in the years to come.
- Europe is obviously a major concern as the implications of a 'tail risk'/low probability event are so far-reaching. However, the rest of the world is comparatively in much better shape (especially on a medium term view into 2012/13), and it is this fundamental outlook that will take centre stage when steps to address the euro crisis start to occur (which we believe will be sooner than later given we are now into the 'endgame' scenario). When this happens, the reaction of markets that have priced in 'end of the world' outcomes will be violent and aggressive to the upside – history reinforces this time and again.
- Keep your head, stick to your long term strategic plan, and look through the current noise to keep headlines in perspective (especially against the backdrop of market valuations and broader economic fundamentals). As usual, if you are concerned about how the current market volatility affects your strategic investment plan, or have a change in your financial situation of any significance, it is important you discuss this with your financial adviser.