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The race to the bottom

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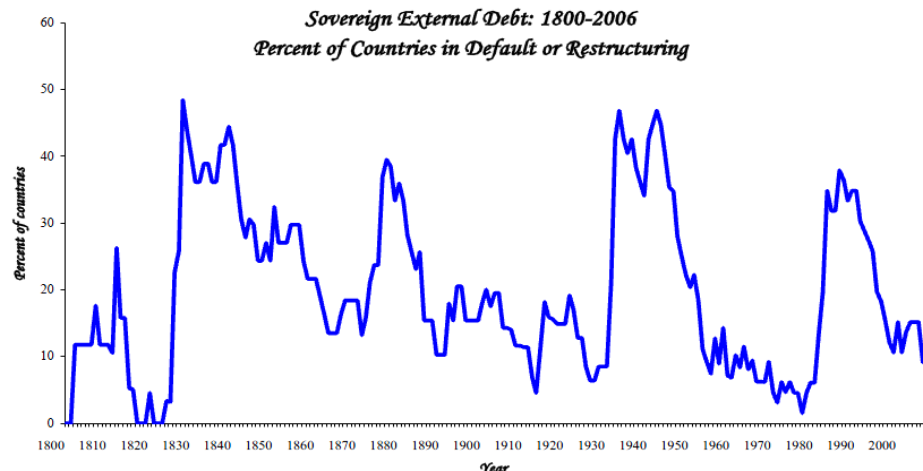
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Atlantic Asset Management is a specialist fixed income asset management house providing leading edge income solutions for both the retail and institutional product market.

Will it be with fondness that we one day look back at this time of crisis and remember how we all struggled to make sense of what was happening at the time? And yet, with the benefit of that hindsight, we will then know and see and comprehend the true nature of the crisis. For surely a crisis understood will be a lesson learned? If only that would be true, then we would not have to resort to that time-honoured quote ascribed to Mark Twain of "history may not repeat itself, but it rhymes a lot." What he did in fact write was: "It is not worthwhile to try to keep history from repeating itself, for man's character will always make the preventing of the repetitions impossible." (*Mark Twain in Eruption: Hitherto Unpublished Pages About Men and Events*).

Why is it that we struggle to comprehend, and yet, for sure, we have seen similar crises before? Similar? What is the comparison here? The Great Depression? The Savings & Loan crisis in the 1980's? The Asian crisis of 1997-98? These are just a handful at the top of mind. We could go on and on, and yet, there lies the point – such crises come and go, we have seen this movie before. We should not deny that, as Kenneth Rogoff and Carmen Reinhart so pointedly say: "...serial default on external debt – that is, repeated sovereign default – is the norm throughout every region in the world, including Asia and Europe." See the chart from Rogoff and Reinhart's study below for a reminder of how common crises and defaults are:



So what then is at the core of such crises if we have not our history lesson learned? The deep dirty secret to the life of a crisis lies in denial. For it is in denial that anything is wrong that allows a market or economic dynamic to become disturbed to the point that a disequilibrium is reached. Malcolm Gladwell wrote eloquently of this disequilibrium in his best-selling book, "The Tipping Point":

The Tipping Point, he says, is "the moment of critical mass, the threshold, the boiling point where the unexpected becomes expected, where radical change is more than possibility but already a certainty. It is when certain ideas, products, messages or behaviours suddenly turn into something of an epidemic, where everyone or a majority of the people all of a sudden gets caught up in it without warning. We know right away that a certain trend has become an epidemic: its spread demonstrates contagious behaviour, little changes had affected its growth tremendously, and it happened fast."

Does this sound familiar – it sure does to the Greeks. So in examining the nature of this current crisis we need to ask where the denial lies? Does it lie in the life of the worker who gets up each morning to go and earn their living and goes about their daily life of consumption undisturbed by the market chaos? Does it lie in the corporate boardrooms, where executives go on with their optimistic economic forecasts to determine how best to grow their profits? Does it lie in the backrooms of parliamentary precincts where politicians make their policy choices trying their best to ensure they have a seat at the next election? The answer, sadly, lies in the collective. It is in the collective nature of society that the denial exists. We are all to blame. We should all be pleading *mea culpa*, and acknowledge that the crisis stems from a collective failure to address imbalances in our way of life, in our business models, and in our policy choices.

So if we were to examine the most recent chapter in this crisis – namely that of the Greek tragedy, it becomes apparent how strong the denial pattern is. All and sundry seemingly recognise that a serious imbalance exists within the Greek economy: It is over laden with debt, this a result of past political policy choices, a population who cared nought for their civic duty of paying taxes, and corporates who enjoyed the fantasy of an extremely low cost of capital. Yet despite this, all deny their role in arriving at the point they are at today. This continues in the reaction to the austerity measures introduced there in order to finally address the crisis – they are resisted by force and massive social unrest. It is denial of the highest form.

But wait, let us not stop there. For this crisis has also engulfed other, less-peripheral European sovereign states, such as Portugal, Spain, Italy and Ireland. There too, similar patterns of denial exist. So then, if crises by nature come and go, we may ask how does this crisis unfold further? The answer is a painful truth. It is when, having exhausted all avenues of denial, of delaying tactics, and of procrastination, that finally, the bitter medicine is swallowed, the pain and humiliation is accepted, and the policy choices (on an individual, corporate and political basis) of the past are rolled back, a new tipping point is reached and the pendulum can begin to swing the other way.

In the Eurozone over the past few weeks we have the biggest or rather the most expensive act of denial we have ever seen. This lies in the massive EUR750bn bailout package announced recently to provide emergency funding for Greece and other Eurozone countries whose debt dynamics have become too large to carry.

The denial lies at two belief levels: Firstly, the belief that by providing access to cheap funding, they will help Greece and the other severely debt-compromised sovereigns; and secondly, the belief that the crisis is singularly a debt or solvency crisis. These two beliefs are wrong: Firstly, making the cost of capital cheaper to a country whose disequilibrium lies in precisely the inappropriate use of debt capital is like giving free sweets to a diabetic. Secondly, what we are dealing with here is a currency crisis. There is no acknowledgement of this. More denial. This crisis would end far sooner if it were recognised that the burden that Europe carries is one that has been carried before, and solved before.

Typically, as Rogoff and Reinhart show in their study “This Time is Different”, a default by a debt-laden sovereign is usually followed by currency devaluation, allowing for the levers of the economy to begin their recovery work. In particular, a devalued currency allows for the cost of manufactured goods to become internationally more competitive thus providing the basis of an export-led growth recovery. As we know, Greece does not have this luxury of being able to devalue its currency, and therein lies the issue of this being a currency crisis, for it is not only Greece that suffers, but a number of European countries.

The initial painful medicine that would work, and has been shown to work repeatedly in the past, is denied. The result: More pain in the future. One can deny the inevitable only for so long. As it is, the current Euro bailout creates more debt, and calls for growth-reducing austerity measures. As such the debt to GDP ratio increases not decreases! Postponing the inevitable adjustment (through an ultimate currency revaluation or through actual default) into the future only makes the future more unpalatable. Throw in Europe’s demographic pitfalls of an aging population and one begins to understand how inevitable the painful adjustment will be on an even smaller tax base. Just in case we believe that Europe alone will have to deal with its denial, we should also point out that Japan most likely faces an even worse situation. Its day of reckoning will come, as sure as the sun rises every morning.

In looking forward, and in understanding the nature of man, what then are we likely to see going forward?

- An increase in coalition politics, (already witnessed now in the UK), as unpalatable and unavoidable policy choices mean that politicians are forced to stand together even when such coalitions may in the past have been anathema. It will be difficult for politicians to be elected on the basis of a painful prescriptive economic policy.
- This will in turn lead to heightened social unrest – especially in countries where the domestic population is not necessarily a homogenous one.

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- This will, in turn force politician's hands to increase the social safety net at precisely a time when austerity measures to bring budgets into balance will mean increasing demand for such social safety. This makes balancing the budget even harder.
 - This will cause policy response to fall into the necessity of increasing taxes in order to sustain revenue outlays. This of course provides a further negative feedback loop into the lot of the man in the street.
 - A restructuring of the Eurozone. This will facilitate the currency adjustment that defaulting countries will require in order to escape the debt trap.
 - An attempt to keep currencies weak against major trading partners by keeping short term interest rates as low as possible, creating a race to the bottom effect.
 - Rising long bond yields as rising risk of defaults requires increased credit risk premium and rising long term inflation prospects (from currency devaluations and increased money supply) feed into increases in the inflation risk premium.
 - A sharp rise in the price of gold and silver, as fiat money currencies finally show their true (lack of) colour.

Glacier Research would like to thank Arno Lawrenz from Atlantic Asset Management for his contribution to this week's Funds on Friday.

Arno and his team manage a number of funds available on the Glacier platform, including the Atlantic Enhanced Income fund.