

INVESTMENT REVIEW

'The chapter on the fall of the rupee you may omit. It is somewhat too sensational.'

Miss Prism's command to her ward in *The Importance of Being Earnest* was for a laugh, but there is nothing very funny about the subsequent chapter on the fall of the euro. I have returned from a 10 week sabbatical in the North East of England with fresh impressions of the investment world, uncluttered by the day-to-day narrative of market movements since 31 March this year. The bulk of the review will be taken up with an assessment of Europe in general, and in particular, its artefact currency, the euro.

The subject is difficult and boring, much like the seven times table for the preparatory school aspirant, and while many wise and wonderful commentaries have been written about the current situation, the mischief has not unusually been their complete unreadability. Here's hoping on this one!

The starting point, a crucial one in considering the issue, is that much of the outstanding debt is *kaput*, as the Germans might put it. This is not quite the same thing as being in default, which requires recognition of its *kaput*-edness, and is definitely not the same as an assertion that the debt is worthless. The hope of a bailout gives these shadowy assets a present value; a bailout which haphazardly benefits the particular owner of the asset can illustrate that the hope was not a vain one.

The second step is to understand that a debt which is *kaput* does a different kind of harm to a debt which has defaulted. The latter causes a crisis, whereas a *kaput* debt engenders a queasiness; the malaise is no less powerful. The most toxic of poisons tend to work by bypassing the alarms in the digestive system which cause the poison to be evacuated. The European authorities, politicians and central bankers alike, have acted in a similar fashion. Interest rates have been reduced almost to nothing, and this hides the true nature of the unhealthiness of the debt. Inability to service a debt is always a catalyst for default but tiny interest rates means that uneconomic debts can be serviced, even when it is clear that the capital is holed below the waterline. Japan has learnt how dangerous this was; twenty years after the crisis the malign effects are still apparent. Europe is different to Japan in crucial respects, but in their unwillingness to acknowledge the true status of their compromised indebtedness, they are twinned.

So much for the finances: what of the politics? The European dream grew out of the despair of post-war society: France and Germany seemed unable to live together. After 1945, Germany was losing 2-1 – how long before they came back for the equaliser? Visionary men, Adenauer, Monnet and others looked to unify the Continent and, amazingly, they achieved it. The Treaty of Rome in 1957 was a great moment for the peacemakers, but now its architects are dead, as are pretty much all those who felt the visceral despair in the darkness of the late 1940s. That hope has been replaced with a sort of Communism: power divorced from economics. Just as Russia could not keep control when the figures didn't add up, nor can Europe. It is only a question of time.

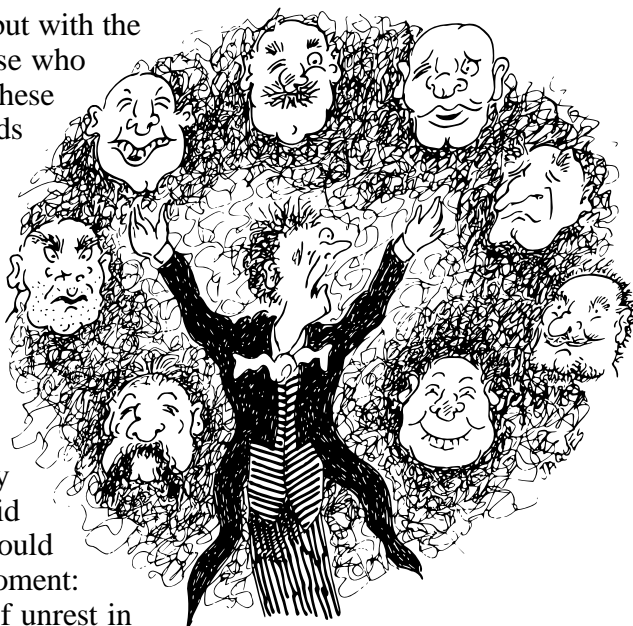
So, when does it all end? I think it is a mistake to try and guess. Observers of 1980s Russia fell into two categories: those who thought things would continue as they were forever, and those who could see the pressure, the inconsistencies, and imagined that the crisis would strike a week on Thursday. Nevertheless, it is striking on my return to find how far the *status quo* has shifted in Europe since March. It's the same tune, to be sure, but the violins have been replaced by cellos.

So when will it happen? Perhaps a better question is, 'in what way will it happen?', because it elicits the obvious answer that it ends when people have had enough and express their intolerance in extreme ways. Imbalances in a national balance sheet do not end a regime, but when the regime stops paying civil servants, the police, the doctors, and the army, the end comes, and comes suddenly.

When looking for its signs it is worth keeping an eye on two separate things: are depositors taking their money out of the banks, and are the taxpayers paying their taxes? Once an inflection point is reached, both these bad dynamics unravel quickly and it has to be said that in certain countries these things have already happened. The tax take in Athens is already down by 20%, and in those countries where taxes are always to an extent voluntary, the inflection point will come sooner rather than it otherwise would.

In Spain, the first five months of the year (arguably before the crisis had set in), bank withdrawals turned out to be frighteningly higher than expected: just short of €100 billion. The sinister thing about these figures is that they were largely represented by corporate withdrawals, not domestic individuals. The reason for this is, of course, that companies have the sophistication and the contacts to be able to move their money internationally. The peasant in Toledo is as beady as the CFO of a Spanish trading company – probably more so – but he does not yet have the access to the escape hatch. If he has the desire and the will to stab the Spanish economy, it will not be long before he finds the knife.

We are dealing here not with economics, not with politics, but with the dynamics of human behaviour (decent economists, and those who lived in the nineteenth century and before, understood that these three things were pretty much the same). When the crowds take dramatic action, it comes later than one would imagine, but then happens in an instant. The storming of the Bastille was spontaneous, if it is possible to talk like that of events which had been leading inexorably to that conclusion for two generations. So with the fall of dictators, and the officers of the EU are collectively just that. One factor suggests that it will not happen on Thursday. Many nations have recently been to the polls – an open invitation to express disquiet in a nicely ordered way. Greece nearly did, but in the end, didn't: everybody else, France, and Germany (state elections), pointedly did not. Those who understand the nature of inflection points would argue that the electoral booth was not the way – not the moment: they are right, but it is nevertheless a gauge on the levels of unrest in parts of Europe at the moment, and the verdict was for the *status quo*.



THE DYNAMICS OF HUMAN BEHAVIOUR

When things blow up, these chronic problems become acute and the defaults, always a reality, become manifest. It never happened in Japan, but it did in Argentina in 2001, and Nick Carn of Carn Macro Advisors has done an excellent piece on what happened. Their guarantees came and went, different exchange rates were imposed on different segments of society. That sham was soon swept away and the ordinary man was left with banknotes of no great value, his local currency bank deposits equally compromised, and his sound currency bank accounts frozen. So it will be that Southern Europe will discover the dubious pleasures of living in a subsidised economy when the subsidy is submerged. It is the moment when the promises of government bonds will be tested. The markets have already taken their view on those of Mediterranean nations.

Widespread dismay will be expressed by a flight from cash. It is fanciful that this will be anything other than universal – although Japan's ability to withstand a consensus move is unparalleled. (As investors there, we would hope in this environment that Japan would suffer similar inflation to others: the one place where it would be relatively benign.) Governments who have issued index-linked bonds will share the dismay – although they will obtain a benefit on the repayment of their existing conventional debt. Although that capital is already spent, the cost of rolling the debt over on maturity will be correspondingly cheaper.

That is why we hold US and UK index-linked bonds. Inflation will boost their claim on government's resources and we believe that these governments will honour their obligations. Nevertheless, it will be a testing time for all. Oscar Wilde was, teasingly, right about the rupee. He was right about something else as well, having observed that a stockbroker was someone who knew the price of everything and the value of nothing. If we return to an unstable world, the price may be as difficult to follow as the value.

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