Quarterly Newsletter / Autumn 2012

Lacomp plc is an independent investment management company providing portfolio management services to private investors worldwide.

Just after we penned our last quarterly newsletter in late July, European Central Bank President Mario Draghi – or Super Mario, as he is often called – announced that the ECB would do "whatever it takes" to save the euro and thus protect the eurozone from collapse. To be specific, what he actually said was this: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

It is the second sentence of that statement that raised a few eyebrows. Sure enough, markets reacted positively to Super Mario's assurances: the German DAX and the French CAC indices were up 2.8% and 4.1% respectively the following day, and markets were also higher in the US, the Dow Jones going up by 1.2% and the NASDAQ by 0.9%.

So Signor Draghi says "believe me, it will be enough". Haven't we heard similar statements over the last three years or so? First we had the Securities Market Programme (SMP), introduced back in May 2010, which was closely related to the Greek debt crisis and meant to provide the liquidity so badly needed by various periphery nations of the eurozone. That worked for a while, but not for long.

Whilst the ECB is not legally allowed to provide *direct* support to eurozone governments, it can do so through the back door, namely by lending to eurozone *banks*. Enter a new version of the long-term refinancing operations (LTRO) which, although something of a misnomer, used to provide a short-term liquidity cushion to banks with two-week, one-month or three-month maturities. Following the credit crunch in 2008, the ECB extended the maturities to one year and, in December of last year, to three years. More importantly, these loans were available at a record low of 1% per annum interest. More than 500 eurozone banks took loans totalling nearly €500 billion. A second offering on similar terms in February of this year was gladly taken up by over 800 banks that helped themselves to loans amounting to some €530 billion.

In case you are thinking that all this should be enough to take care of the eurozone banks' financial wellbeing, you will be interested to know that there also is something called Emergency Liquidity Assistance (ELA) which operates under the infrastructure of the European System of Central Banks (ESCB). The ESCB is composed of the ECB itself and the *national* central banks of the EU member states. Essentially, each national central bank can help a financial institution in distress with loans against collateral. Greek banks have made use of that facility long ago, and other nations' banks have done likewise. Bizarrely, whilst the national banks are obliged to inform the ECB of any such dealings, there is no requirement to make any data relating to ELA activity public.

Eurozone politicians and ECB officials keep assuring us that all these measures are sufficient to solve the problems in the eurozone, but like so often before, they only ever appear to work for a short time. In early September, Mario Draghi introduced yet another acronym – OMT – which stands for Outright Monetary Transactions. OMT gives the ECB the ability to buy bonds of the distressed member states (the PIIGS countries) in the *secondary* market. In essence, OMT is very similar to the former SMP (Securities Market Programme). Acronym follows acronym, but in truth it is yet another example of kicking the can down the road or, as one observer put it, adding yet another sticking plaster on a gaping flesh wound.

Of course, all these money-supply taps being opened led to hopes that banks, at long last, might lend to small and medium-sized enterprise (SME) businesses thus stimulating economic growth, but those hopes proved largely illusionary. Most banks are using these funds to cover their own maturing debts or increasing their capital ratios by shoring up their balance sheets.

Talking of shoring up balance sheets, it is interesting to note that many large business concerns are doing exactly the same thing, albeit for slightly different reasons: they simply don't want to be reliant on banks to renew or restructure their borrowing requirements. According to *The Economist*, the average amount of cash held by Europe's 300 biggest companies back in 2000 was just over $2 billion, and that figure has now risen to over $9 billion.

A handful of companies have gone even a step further. Take Siemens, for example, a very large multinational electronics and electrical engineering company with headquarters in Munich. Siemens managed to obtain a banking licence in late 2010 which, given their nuts and bolts core business, at the time seemed a rather strange thing to do. Siemens reasoned that their banking arm was to be used as a sales support tool, allowing it to provide credit to not only its own customers but also to SME businesses who found it difficult to raise finance from banks which were reducing their lending activities more and more. In this, they followed the example of General Motors which, nearly a hundred years ago, set up GMAC (General Motors Acceptance Corporation, latterly renamed Ally Financial) to provide finance to its automotive customers, followed by widening its field of operations to include mortgages and insurance. However, another fillip of becoming a bank was the fact that Siemens now could place money with the safest of banks, namely the ECB. They did so, at times sheltering up to €6 billion there! A clever move by Siemens, particularly as it also allows them to tap into the ECB's low-cost borrowing facilities, should they ever have the need to do so.

Whilst eurozone politicians talk a lot and loudly, their words sadly don't have much substance. Ever since the first cracks appeared in the politically driven ambition for EU integration and the single currency, they always appear to be reacting to events rather than trying to shape them.

Without wishing to sound too unkind, one could say that the same applies in America and at home in the UK, although the fundamental problems are different. Whereas the EU faces the risk of systemic failure, in both the US and the UK the problems can be summed up with two four-letter words, namely "debt" and "jobs".

In three weeks' time, the Americans will elect their president. The challenger Mitt Romney wants to cut the debt, whereas Barack Obama wants to increase the job numbers. However, neither of them is giving us clear outlines of what exactly they intend doing about the problems. America's debt stands at a staggering $16 trillion, and over 20 million people are not in full-time employment. Ever since the financial crisis, US politics have become increasingly polarised, as was evidenced by the emergence of the Tea Party movement. Whatever the outcome of the election on 6 November, Washington will remain a deeply divided town.

In the UK, the ruling coalition and the Labour opposition also display profoundly contrasting philosophies. George Osborne wants to stick with his so-called Plan A to substantially cut the deficit, even though the economic reality forced him to extend the time horizon in which he had hoped to achieve this. During the recent annual Tory party conference, he introduced new ideas to cut a further £10 billion from the benefit budgets. Labour has long argued that the austerity drive was hurting the economy, and the International Monetary Fund seemed to agree last week when it effectively suggested, only hours after it had downgraded Britain's growth outlook, that countries with room to manoeuvre, including the UK, should further slow down their deficit-cutting measures, which is music to Ed Balls' ears!

After a poor second quarter for financial markets, mostly triggered by concerns about the eurozone crisis, the third quarter of 2012 saw positive performance in all major markets with the exception of Japan which was down 1.5%. The UK struggled somewhat (up 3.1%), but the American S&P 500 managed 5.7%, the DJ Eurostoxx 50 8.4% and the MSCI Asia Pacific (excl. Japan) an excellent 9.5%.

Housekeeping

Clients with an offshore Client Account at Fairbairn Private Bank in the Isle of Man will, subject to regulatory approval, see a name change to Nedbank Private Wealth on future bank statements. In effect, Fairbairn is being branded in line with its longstanding shareholder, Nedbank.

To give you some further information, Nedbank's heritage dates back to 1834 and the bank is completely untainted by the sub-prime and sovereign debt crises. It currently employs 27,000 employees, has a market capitalisation of £6 billion and remains majority owned by Old Mutual plc, a FTSE 100 and Fortune 500 company.

In a few days, we will write to you separately to tell you about something you may well have read about in the press, namely the Retail Distribution Review (RDR) which comes into effect on 1 January 2013. RDR will affect the whole financial services industry in the UK and entail some changes, but we hope you will be pleased to learn that very little indeed will change in your relationship with Lacomp.

Bagshot 19th October 2012