Quarterly Newsletter / Spring 2011

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

The events of first quarter of 2011 have been truly mind-blowing. We have witnessed uprisings and riots in North Africa and the Middle East which until recently would have been barely imaginable, Japan suffered an earthquake and a tsunami of biblical proportions and, nearer home, several member states of the EU continued to have financial problems that have been leading to a crisis which could yet seriously threaten the euro as a currency.

So, what brought about the turmoil in North Africa and the Middle East?

Tunisia, a relatively wealthy country in that region, had been ruled by a corrupt and oppressive elite headed by President Ben Ali, his much hated wife and her family, since 1987. Its citizens, however, had become increasingly frustrated by extremely poor living conditions, high unemployment, and the lack of free speech and other political freedoms. Whereas in the past the Tunisian Government had been able to censor or suppress information reaching its citizens, the internet and Wiki Leaks changed all that, resulting in a greater awareness among younger Tunisians. Things came to a head in the middle of December when a young street vendor, in a desperate and dramatic protest about harassment and humiliation by the authorities, set himself on fire. This self-immolation provided the catalyst to what followed: people taking to the street, initially in largely peaceful protests, which in turn were dealt with by heavy-handed police units, triggering additional civil disturbance and more violent riots resulting in, sadly, over 200 deaths. Within a month, President Ben Ali, his family and his cronies fled to Saudi Arabia (seemingly one of the retirement homes of choice for deposed dictators – remember Idi Amin?) where he officially resigned from his position.

The events in Tunisia did not go unnoticed in other countries, and we soon had similar protests, riots and civil disobedience in Egypt, where President Mubarak resigned on 11th February after 30 years in power, followed by yet more of the same in Yemen, Bahrain, Jordan, Syria, Algeria, Libya and as far afield as Swaziland, Africa's only remaining absolute monarchy whose king also chose to rule an authoritarian state, including banning any opposition parties.

How was this possible, with all traditional media outlets tightly controlled or censored? Anyone who ever travelled in the region knows that whilst one can buy Western publications like the American *Newsweek* or the German magazine *Der Spiegel*, Western journals are usually not worth buying as large parts of the text and pictures have been completely blacked out.

The reason that this contagion of anger was at all possible lies in the proliferation and technological improvement of mobile phones, internet-driven media, and social networks like Twitter, Facebook, and YouTube. Despite the authorities' best efforts to electronically jam or hinder their use, enough got through to make people elsewhere aware of the upheavals.

The interesting question – interesting both politically as well as economically – is where all this will lead. Regime change, political freedom, freedom of speech and democracy are the obvious aims of the protesters in the hope that achieving them will also lead to better standards of living in every sense. This will not be easy since the oppressive nature of these regimes made it virtually impossible for any structured opposition or properly organised political parties to exist.

Take Tunisia as an example: officially a multi-party country with a bicameral system before the revolution, it was totally controlled by the state on a local, regional or national level through a secular party called the Democratic Constitutional Rally. As a gesture towards democracy, at least 25% of the lower house's seats had to be held by members of opposition parties. There were six opposition parties represented in the parliament, and they came in different hues: among them were a People's Unity Party, Socialist Democrats, a Liberal Party, and a Green Party. Even if they had all agreed among themselves, they could never have had any real influence on policy. Just to complete the picture, there are also several other parties that do not sit in the lower house, including a Communist Party and two others that are influenced by the Muslim Brotherhood.

Somehow, all these splinter groups will have to try hard and cooperate in order to establish a better and more democratic system of government.

The Tunisian regime had long been supported by France and, to a lesser degree, America, ever since President Bourguiba, Ben Ali's predecessor, adopted a pro-Western stance during the Cold War. French, American and other Western leaders were very much aware of the blatant corruption and authoritarian methods employed by the state, but they largely turned a blind eye to the grim truth by subscribing to the "Yes, they are bastards, but they are *our* bastards" rule of diplomacy.

If you think we have spent quite a lot of space in this Newsletter analysing the situation of Tunisia – both before, during and after the revolution – we have done so for a reason, namely to highlight the problems faced by virtually *all* the other countries that have seen similar protests and civil unrest.

True democracy is difficult to achieve anywhere, and in this context, it is interesting to look at the so-called "Democracy Index" which is compiled by the British weekly *The Economist* and tries to rank 167 countries' state of democracy by taking into account various aspects to the countries' political culture. The 167 countries fall into four categories, from "full" and "flawed democracies" to "hybrid" and "authoritarian regimes". According to the latest index (2010), Norway comes top and North Korea occupies the lowest position. There are 26 "full democracies", 53 countries fall into the "flawed" category, 33 are deemed "hybrid regimes", and the last 55 are called "authoritarian regimes". None of the Middle Eastern nations can be found in the top grouping, and only one is in the second "flawed" category (Israel in 37th position), whereas Lebanon (86) and Iraq (111) are judged "hybrid regimes". A*ll* the other countries in the region fall into the "authoritarian regimes" section (Kuwait 114, Morocco 116, Jordan 117, Bahrain 122, Algeria 125, Qatar 137, Egypt 138, Oman 143, Tunisia 144, Yemen 146, UAE 148, Afghanistan 150, Libya and Iran jointly 158 and finally Saudi Arabia at 160). The index paints a grim picture of the region's political systems, and democracy – in whatever shape – may be a long way off. By the way, and in case you are wondering, the UK occupies the 19th position.

Clearly, the rest of the world is very concerned about the political developments in North Africa and the Middle East, and it would be naive to suggest that this has nothing to do with the region's oil reserves.

A contagion of a different sort was spreading across Europe or, to be more precise, the Eurozone. After Greece's financial woes were revealed last year, Ireland followed suit and, more recently, Portugal had to hold its hand up and admit to similar problems.

Greece and Portugal share comparable problems: sluggish economies, bloated public sectors, and heavy indebtedness. Ireland's woes are slightly different as they battle a banking crisis (Anglo Irish Bank irregularities, false accounting, hidden loans, and the mystifying "Golden Circle") against a background of falling property values. Last year, Irish house prices fell by 14%.

Only a week ago, the crisis intensified when it was mooted that Greece may not be able to repay its debt on time. Interest rates on the 10-year Greek bonds rose to 13% which is staggering when you consider that, at the same time, the German equivalent bonds' interest rate stood at 3%. Interest rates on the Greek 2-year bonds this week exceeded 20%!

It looks increasingly likely that holders of Greek bonds face a "haircut", meaning they will not be fully repaid. Bearing in mind that the sovereign debts of these three limping PIG countries are largely held by Eurozone financial institutions – China recently also has been a buyer – you can understand that this situation is focussing the minds of both the Central European Bank and the leaders of other EU member states.

This comes as no surprise to us. Indeed, as long ago as 1992, when we considered the repercussions of the Maastricht Treaty and the proposed economic and monetary union (EMU), we predicted a two-tiered Europe. The Maastricht Treaty's criteria for economic convergence and monetary union among member states (since then amended by further Treaties signed in Amsterdam, Nice and Lisbon in 1997, 2001 and 2007 respectively) were akin to a Utopian plan that we always considered unrealistic.

We now live with the harsh reality of these predictions, and the member states of the EU (above all others, Germany and France) together with the IMF (International Monetary Fund) had to bailout Greece, Ireland and Portugal with unprecedented rescue packages potentially amounting to €110billion, €85billion, and €80billion respectively.

The UK is also affected by these generous handouts. At the very end of his tenure as Chancellor of the Exchequer – *after* the General Election but *before* the new coalition was formed - Alistair Darling committed the UK by agreeing to underwrite part of the Greek bailout package – as a quasi guarantor – which is likely to cost the British taxpayer in excess of £10billion. Since then, we are also likely to have to shell out another £7billion towards the Irish bailout (important trading partner, interconnected banking sector etc.) and now it looks like we are also potentially on the hook for yet another £6billion to provide a loan to the EU "disaster fund" to help Portugal.

It is interesting that politicians and bankers use the term "disaster fund" when addressing economic and financial problems when you consider the very real, natural disaster that befell Japan's north-eastern coast. The loss of life, the massive destruction of property, and the seeping radiation from the damaged Fukushima nuclear power plant are truly disastrous, and it will take the Japanese nation a considerable amount of time – and lots of money – to recover to its former state. The stoicism displayed by the Japanese in the face of this catastrophe has been quite remarkable, particularly as this calamity followed two decades of economic decline. The Japanese psyche has never been easy for Westerners to understand, and recent events may well have made people review any preconceptions they may have harboured.

Whilst the loss of life following the tsunami that struck Thailand on Boxing Day 2006 was far greater, the cost of repairing the collateral damage in Japan dwarfs those of other recent natural disasters. The World Bank estimates that the damage in Japan is in the region of US$235billion, far greater than the Kobe 1995 earthquake ($100bn), Hurricane Katrina in 2005 ($81bn), the Haiti earthquake last year ($14bn) and the Thai tsunami ($10bn).

The long-term effects of the radiation leak are impossible to predict, and that aspect of the disaster is the only one that saw Japanese citizens grumble, and they only did so because they had difficulty in believing what the authorities - both politicians and the operators of the power plant - were telling them.

The political turmoil in North Africa and the Middle East, the sovereign debt problems in the Eurozone and the Japanese earthquake and tsunami all affected financial markets, and performance in the first three months has been muted. The FTSE 100, for example, has moved a whole 9 points (or 0.15%!) and other markets have also had lacklustre performance. The one exception was America which has seen the Dow Jones record its best quarterly performance in 12 years (up 6.4%). It is interesting to note, however, that Standard & Poor's has just this week cut its outlook on America's credit rating from "stable" to "negative", which promptly sent the Dow lower!

The UK doesn't seem to know either where it is heading. Only last week, several chief economists of major financial institutions (HSBC, RBS, BNP Paribas, Deutsche Bank et al) voiced gloomy opinions about Britain's stop-start economy, with some of them halving their previous growth forecasts. However, only two days ago, the latest figures show inflation has fallen for the first time in eight months and the trade gap has shrunk, the latter suggesting that exports are picking up. In addition, the employment rate in the three months to February actually has risen, despite job cuts in the public sector.

In just one week, therefore, we have commentators' views being proven somewhat debatable. It just proves that economists don't make mistakes. They simply make revisions.

At Lacomp, we intend retaining our rather defensive stance until we have more clarity about the Eurozone debt crisis and the outlook for the global economy.

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