



Quarterly Newsletter / Spring 2012

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

The fallout from George Osborne's March 21st Budget shows little sign of receding as commentators of all political hues draw attention to the unintended consequences of policy making 'on the hoof'. The reduction of the 50% rate, the so called "Granny tax" and the infamous "pasty tax" have all highlighted the difficulties of constructing a coherent policy when there are marked divergences from Coalition partners. Imagine if the UK was governed by a coalition of seventeen.....

Plus ça change..... Once again, the overriding issue seems to have been the current state of the Eurozone bond markets and the possibility for a break-up of the single currency. Positive market moves are *despite* European problems, negative moves are *because* of them. The Eurozone crisis remains as a bell-weather for investor sentiment despite a seemingly imminent solution at the time of our last Newsletter.

A solution to the Greek issues, seen as crucial during the winter months, was pushed to the wire as the northern finance ministers took an increasingly harsh line ahead of the refinancing deadline. The whole deal nearly fell apart for the sake of a further €375 million of budgetary savings, despite the fact that Greece had already announced €3.4 *billion* of cuts. Arguably, ministers were able to demand a sterner approach because the austerity packages put together in Spain and Italy now offered the prospect for limiting contagion. By mid-February, Spain had issued 30% of its planned debt restructuring for 2012 at a sub 5% yield, providing the rationale for taking a tough stance.

The Greek parliament was made to vote in favour of further cuts (amounting to barely half a percent of total Greek debt) in order to comply with the demand for "no disbursement without implementation". The markets rallied briefly, only to dip again when Luxembourg's Prime Minister, Jean-Claude Juncker (as President of the European Council) enforced a further delay because of "incomplete paperwork". There was also the insistence that the deal be approved by *all* Greek politicians, regardless of the outcome of any future election, in order to forestall attempts to renegotiate any agreement. At least one contender for the premiership, Antonis Samaras of New Democracy, had announced his intention to seek a renegotiation.

Even when the Greek parliament acceded to pressure, there was still the need to gain acceptance of the extent of the 'haircut' on private investors. Equally important was the reaction to this by the International Securities and Derivatives Association (ISDA) which would decide if a default had occurred, thereby triggering derivative contracts known as credit default swaps (CDS). This was actually a crucial issue since, if private investors could not expect insurance protection in the form of CDS's, what incentive would there be to participate in the forthcoming debt restructuring by the perceived risky peripheral economies? Ironically, the argument flipped from 'a Greek default will threaten the euro' to 'denying a default will threaten the euro!' On 9th March, ISDA decided that a 'credit event' had occurred. The resultant payments under the CDS contracts were, in the greater scheme of things, not huge, and fortunately did not trigger a further crisis.

To many commentators, this aggressive posturing was less about Greece and more about establishing a backstop for the entire system, but it was in everyone's interests to bully Greece into compliance. The Greek economy contributes around 3% to Eurozone's gross domestic product. Of far greater concern was the outcome for Spain (12% of Eurozone GDP) and the third largest economy, Italy (17%). Further worries came from Hungary which, whilst not a Eurozone member, presented a significant problem for Austria if it elected to default on the €40 billion of debt held by Austrian banks.

Given the size of the Greek economy, it is easy to understate the impact of its withdrawal (or expulsion) from the Eurozone and to criticise the European Union for failing to take decisive action. The crisis had brought home the fact that all sovereign risks are not equal and, therefore, if Greece left, the default risk of the remaining members, particularly the weakest, would inevitably rise. National banks are only as sound as the sovereign behind them, and so increased sovereign risk would also lead to some deposits being exposed to credit risk. Given that it is likely (though not inevitable) that it is the weaker members who are likely to leave, exchange rate risk increases for those remaining whilst inflation risk would also rise as those who exited would have an incentive to engage in the controversial practice of "monetizing their debt". The implications for the entire system would be potentially grave once it started to unravel, hence the need to be *seen* to be tough with Greece whilst avoiding a walkout.

The big positive impact on markets was felt when the European Central Bank (ECB) announced its second tranche of Long Term Lending Operations (LTRO) to Eurozone banks. The ECB is forbidden to openly engage in quantitative easing (QE), as seen in the UK and US, which would be construed as direct financial support. Unlike QE which removes liquidity from the system in order to push banks towards more risky assets intended to feed into the real economy, the ECB bought up illiquid assets, allowing the banks to direct funds into distressed government bonds. Countries were able to take up cheap three-year lending in order to purchase sovereigns with high current yields. A neat compromise, which saw the yields on peripheral sovereign debt steadily fall whilst the capital values rose. The two LTRO issues had amounted to around a trillion euros, equivalent to 6% of Eurozone GDP. Not surprisingly, by the end of February the ECB had not had to make any further bond purchases to prevent spreads widening.

Markets collectively breathed a sigh of relief at this apparent success in addressing Europe's liquidity crisis, conveniently ignoring the fact that the underlying issues remained. At best, the LTRO bought valuable time to address the issues. By the end of March, the Dow Jones Industrial Average had recorded its best first quarter return for a decade, and even Japan seemed to have recovered from its travails of 2011.

Standing outside the Eurozone and the LTRO, the UK markets have also seen some appreciation in the first quarter but the alternative policy response, namely QE as practised by the Bank of England, is not without its critics. They argue that purchasing quality corporate bonds would have had a more measurable impact on the real economy. They point out that the Bank now owns some 30% of all government debt and that it will be faced with massive difficulties when it comes to unwinding this position. Some have even argued that, since one government entity (the Bank) holds the debt issued by another (the Treasury), it should simply be written off as an accounting exercise. This would, they argue (tongue in cheek!), both reduce government debt and cut the spending requirement to service that debt, thus reducing the deficit. The reaction of the ratings agencies towards such a move would be very interesting, to say the least, particularly as Moody's have already assigned a 'negative outlook' tag to the UK's triple A status (which indicates a 30% downgrade risk over the coming

eighteen months) in light of “materially weaker growth prospects”. Indeed, as we have learned today, Britain has slid back into recession, the first double dip since the seventies.

As we have noted before on numerous occasions, the performance of markets does not necessarily follow economic indicators – the fastest growing economies are often the worst market performers (as with China in 2011) and, in this case, even European markets have made considerable gains despite the truly dreadful statistics that emerge on a regular basis. The Greek agreement, for example, is based on a return to positive economic growth despite the fact that Greece contracted by 7% during the fourth quarter of 2011 alone! Spanish unemployment, particularly amongst the young, is at record levels and only the most optimistic prognosis would assume a return to growth anytime soon across large areas of the region. Overnight deposits at the ECB remain worryingly high, a sure indicator of market concerns, and only the continued strength of Germany, helped in no small part by the weakened euro, offered a positive theme. Any sign of a global slowdown (with an inevitable impact on German exports) will be further cause for concern.

There has been plenty to be concerned about on the broader international scene, not least the increased tensions in the Middle East and the potential threat for global oil supplies. Continued unrest in Syria, the Sudan and Yemen has added a further complication to the standoff with Iran which was threatening the passage of oil in the Strait of Hormuz. The presence of the US 5th Fleet would probably prevent any prolonged dispute and outright closure of the Strait through which 30% of global oil supplies must pass, but the ongoing tensions are sufficient to keep oil prices firmer than could be expected in the face of slowing global growth. Slow growth and high energy prices do not make for a happy combination, particularly in the United States where gasoline prices are an integral element of consumer confidence.

Investor sentiment in the United States has swung from the recessionary fears of late 2011 towards greater optimism, at least in the short term. The psychological relief at the apparent solution to the issues in Europe has seen a steady rise in indices but, longer term, the resilience of this recovery will depend more on market fundamentals. It is important that the modest falls in US unemployment continue (unemployment was still 8.3% in January) and that the promise of growth materialises. This is important for more than mere national prestige or the electoral hopes of President Obama – in the furore over profligate European government spending it is often forgotten that the US has a huge deficit problem of its own. In a recent ‘fiscal responsibility index’ compiled by Stanford University, the US ranked 28th out of 34, not far ahead of Ireland, Portugal and Greece! Having chosen to grow its way out of the problem, the US cannot afford too many mistakes or it will draw the inevitable attention of the bond market traders and speculators.

The US earnings reporting season that is currently underway has so far been mixed, and the earlier market confidence has been undermined by a succession of negative trading sessions of late whilst the Eurozone issues have shown the first signs of re-emerging.

At the time of writing, the Dutch Government is in turmoil following the failure to agree budgetary measures and Chancellor Merkel’s ally during the crisis, Nicolas Sarkozy, faced a massive protest vote in the first round presidential contest at the weekend. He now faces the task of raising support from sufficient numbers of people who had voted for Marine Le Pen in order to carry the second round. He is not popular with the far Right and cannot rely on this whilst those on the Left who voted for Melenchon will largely move to support Francois Hollande in the second round. The prospect of a pro-growth, anti-austerity socialist in the Elysee in June will surely upset markets yet again.

Lacomp remains negative in its view of European markets and generally cautious at the prospects for global growth, but we have steadily increased the exposure to the US which traditionally performs well during an election year. However, the worries over Europe are never far from the headlines and come to the fore whenever China's economy appears to have avoided that other perennial worry, a hard landing. For this reason, we expect market volatility to remain, particularly if earnings disappoint or the energy supply situation worsens.

Housekeeping

Please remember that, where applicable, your year-end tax statements are enclosed with your valuation. You will need to refer to these if you complete a Self- Assessment tax return.

Bagshot 25th April 2012

Lacomp plc

77 High Street, Bagshot, Surrey, GU19 5AH, England.

Tel: (Intl. +44) (0)1276 475123 Fax: (0)1276 475273 e-mail: info@lacomp.co.uk website: www.lacomp.co.uk & www.lacompeifunds.co.uk

Registered in England No. 1851201

Authorised and Regulated by The Financial Services Authority (FSA)

Lacomp plc produces this information for private circulation. Whilst we have taken great care to ensure that the information it contains is correct we cannot be held liable for any errors contained herein or for actions taken as a result of this information.