# Quarterly Newsletter
# Winter 2011/2012

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

Whereas the Queen last year could enjoy her grandson's wedding and her husband's 90th birthday, investors had a torrid time and could call 2011 their own "annus horribilis".

With the exception of the US Dow Jones, which went up by 5.5%, every other major stock market index fell, the worst being the BRIC index which recorded a negative 24.8%! UK gilts were an exception (up 11%), the rise signifying that investors were looking for a safe haven. Gold, another traditional safe haven, recorded its 11th consecutive positive year (up 11.2%) but it had a rough ride during the year's second half when the gold price dropped by 26%. UK house prices managed to defy gravity and remained largely flat, despite the economic uncertainties and announced austerity measures. Mind you, the headline figures only look at properties sold and mortgages taken out, ignoring the large stock that remains on the shelves of estate agents.

Geopolitical events in North Africa and the Middle East, the squabbling among American politicians over the debt ceiling, earthquakes in New Zealand and Japan, the latter unleashing a tsunami of biblical proportion and triggering a major nuclear scare, all ensured that we had to accept a high degree of volatility in financial markets, often with pretty erratic reactions to what was happening. Probably the biggest worry that kept spooking markets worldwide was the ongoing crisis surrounding Europe's single currency, the euro.

Three months ago, we wrote our last quarterly Newsletter on the eve of the Brussels summit that was meant to solve the problems concerning the Eurozone's single currency, and much was expected from the Eurozone member states' leaders on that occasion. All were agreed that time was running out for the euro and that urgent action was needed. In that Newsletter, we speculated what options were left to deal with the euro's woes. Interestingly enough, the three solutions we deemed worthy of consideration were all given an airing, and there was talk that a combination of the various alternatives might do the trick. Yes, there was talk of much needed and substantially deeper integration of the euro's member states, but there was little constructive action!

The agreement to increase the firing power of the EFSF (European Financial Stability Facility) to €1 trillion was briefly hailed as a solution to the problem, but that optimism quickly vanished once it became known that Italy also faced a potential bailout scenario. Italy's debt dwarfs what little of the EFSF money is left after other commitments. To make matters worse, Standard & Poor's only this week stripped the EFSF of its coveted triple-A status.

Since then, we have seen a series of conferences and summit meetings, and whilst everyone was agreeing at all times that the situation remained profoundly serious, nothing of real substance has been done to stop the crisis. Efforts to get the ECB (European Central Bank) to engage in quantitative easing have fallen on deaf ears, and the new ECB President, Mario Draghi, clearly stated that the ECB should not be seen as lender of last resort, particularly as EU laws forbid central banks funding governments. Just before Christmas, though, the ECB saw fit to open the lending tap by making nearly €500 billion available to banks in the form of three-year loans. The money is cheap – currently 1% – and the hope is that the banks will buy Greek, Italian and other suspect Eurozone debt. We shall see!

The major stumbling block remains the same today as it was in 1999 when the euro was adopted as a single currency by the then eleven original member states: economic convergence was never going to happen by simply setting targets (à la Maastricht) without proper fiscal integration and an overarching political authority to keep the member states on the straight and narrow. The two-speed Eurozone we predicted many years ago has now become a reality, and the voters of the economically stronger countries are not happy for their political leaders to sacrifice what they have worked for in order to support the troubled member states, whose citizens often are viewed as irresponsible at best and plainly cheating at worst. Indeed, Finland, the only Eurozone country besides Germany still enjoying a triple-A credit rating, saw the anti-bailout stance of the "True Finn" party victorious in last year's national elections. In Germany, a recent poll showed that 59% of the population were against further Eurozone bailouts.

As a result of the turmoil we have witnessed some changes on the political landscape among some of the PIIGS countries. In early November, buffoonish Silvio Berlusconi resigned, making way for a caretaker government which is being led by Mario Monti whose nickname is "Super Mario". Two days later, George Papandreou was replaced by Lucas Papademos as head of a new coalition cabinet. Both new Italian and Greek Prime Ministers are European technocrats, the former an EU Commissioner for nine years, the latter a Vice President of the ECB from 2002 to 2010, and both undoubtedly approved of by Mrs. Merkel.

The question is this: with Frau Merkel and M. Sarkozy ("Merkozy" for short) banging on about the "fiscal compact" – their latest idea, which in reality is a euphemism for demanding that the PIIGS countries embrace extremely strict austerity measures – are technocrats the right people to head governments of countries that need strong and inspirational leaders? In any case, imposing austerity measures on the weaker nations this late in the day will do absolutely nothing to help the euro. It will guarantee, though, that these fragile economies remain in recession or go into depression, possibly for a prolonged period. A cynic might suggest that Merkozy could have a hidden agenda for trying to elegantly unload one or two of the struggling member states from the euro train.

Although Merkozy and other Eurozone leaders simply refuse to publicly talk about the euro failing – that really is the great unmentionable! – it is inconceivable that the policy makers have not considered a plan B. What exactly plan B would consist of is anyone's guess. At least, Europe has some experience in this area. After all, it first created the ECU (European Currency Unit) which consisted of a basket of currencies before it changed the ECU into the euro. Retaining the current euro with fewer, albeit stronger member countries is another option, but that would create its own problems as dealing with existing contracts that are denominated in euros would be quite a challenge, to put it mildly. It would also see the "dropped" nations returning to their old currencies which would have to be heavily devalued. At least these countries would then have their own central banks back, allowing them to print money and set interest rates to suit their individual circumstances.

Defaults are nothing new, and two recent examples, Russia in 1998 and Argentina in 2001, saw their economies recover relatively quickly afterwards. However, Argentina's debt was only a third of what the Greeks owe, and their agricultural exports helped them out of the mess, just as commodities and oil did the trick for Russia. Greece, by contrast, relies heavily on services (mainly tourism and shipping) and whilst it would become a truly cheap holiday destination, it unfortunately has very little to export. Time is running out for Greece as it has to cover €14.5 billion of maturing bonds in March, and failure to do so will automatically result in default.

The situation in Greece is truly dire. Having cooked the books for ages – we have previously written about how Goldman Sachs helped the Greek government to artificially reduce the debt mountain through clever use of derivatives, and how future income streams were securitised to make them look like current earnings – the harsh reality is hurting the population with unemployment soaring, particularly so among the young. Measures taken so far include the abolition of guaranteed 13th and 14th monthly salaries for public sector employees (the former for Christmas and the latter for next year's holidays, you understand...), and 800,000 civil servants will have to forego claiming a bonus for simply turning up for work on time! Only a week ago, talks between the Greek government and the IIF (Institute for International Finance, a body created in response to the international debt crisis of the early eighties) broke down or, to give it its official term, "have been put on pause". This does not bode well for the arrival of the so-called Troika inspectors (EU, ECB and IMF officials) who are this week looking at the Greek welfare payments which, according to reports from the Greek health ministry, are being outrageously abused. Unusually high numbers of claimants (asthma, mental illness, blindness, severe disability – you name it!) have been identified, reckoned to be the result of doctors being bribed to provide the necessary paperwork. Tax evasion and fraud are believed to rob the Greek economy of around €35 billion per annum, which equates to 10% of Greece's debt mountain.

Italy's debt, by comparison, is considerably larger at €1.9 trillion, and tax evasion has long been considered a favourite Italian pastime. Silvio Berlusconi's conservative coalition has always been thought to be soft on tax evasion, and some of his opponents went as far as saying he personally condoned it. Be that as it may, the new Prime Minister must have sanctioned what could be described as a "razzia" by officers of the Guardia di Finanza (a quasi police force of the Italian tax authorities) who normally are tasked with tackling financial crime and smuggling. Just before the New Year, they descended on Italy's smartest skiing resort, Cortina d'Ampezzo, where they found evidence that all sorts of businesses (hotels, restaurants, night clubs and boutiques) were seriously under-declaring their earnings. It wasn't just businesses, though, that caught the carabinieri's attention: among other things, they established who owned 133 of the top-of-the-range motor cars – we are talking about Ferraris, Lamborghinis and other exotica – that were in the skiing resort at the time. Further investigation revealed that nearly a third of these car owners – 42 to be precise – declared incomes of less than €30,000 a year! It gets worse, and a nationwide investigation came up with the following jaw-dropping statistics: among the Italia ns who declare an annual income of less than €20,000 (i.e. less than £17,000, and therefore less than a UK traffic warden or road sweeper earns), 188,000 drive up-market cars (Mercedes, BMWs, Ferraris etc.), 42,000 own yachts and 518 even manage to fly in their own private planes or helicopters!

In our last Newsletter, we suggested that Italy would present a much better debt to GDP ratio if one could take into consideration the black economy. A recent Italian government study agrees with our opinion: Italy's black economy for a year, including tax evasion, is reckoned to be in the region of €275 billion, which equates to 17.5% of GDP! Another study found that, had Italy managed to collect taxes for the last four decades as diligently as the US and Britain, its national debt would be around 80% of GDP rather than 120%!

So, next time we face a tax demand, we maybe should take comfort from the fact that we are doing our bit for the greater good of the country. And if we could have stopped stupid and profligate public spending by some of our past Chancellors, we would really be in clover!

Indeed, whilst France has now has been stripped of its triple-A status, at least the UK has managed to hang on to this coveted credit rating, much to the displeasure of various French and German politicians who felt differently about it. It must have been doubly galling for this to happen so shortly after our Prime Minister vetoed the latest EU treaty at the Brussels summit on 9 December – yes, yet another one of those summits! David Cameron had little choice. Partly motivated by political reality at home following the revolt of 81 of his own backbenchers who had voted in favour of a referendum on Britain's EU membership, he had asked for certain safeguards concerning the City of London whose financial services make a major contribution to the UK's GDP. The EU Tobin tax (a levy on all financial transactions) and other anti-City measures proposed by both France and Germany were too much for our Prime Minister to swallow. Merkozy would have reacted in exactly the same way had Germany's automotive/engineering industry or France's agricultural sector been targeted in a similar way. Cameron did not get the assurances he had asked for, and a veto, the first for a British PM, was inevitable. Nicolas Sarkozy appeared quite happy with the outcome, having seemingly achieved what he had gone to Brussels for. It is self-evident that he and Mrs. Merkel want the Franco-German axis to become even closer, and it is equally clear that Britain is less enthusiastic about fuller European integration.

Some City bankers were quite alarmed by the veto, fearing that it might unleash other European attacks on their industry, but they since have been assuaged by news that further talks between Chancellor George Osborne and the Hong Kong Monetary Authority point to the City of London becoming the major Western centre for trading the Chinese currency, the Renminbi (also known as the Yuan). Such a development would bring huge amounts of new business to the UK, create many jobs and further enhance the reputation of the City. Of course, it also signifies that China is removing the barriers to its currency being traded and allowing it to become a major global currency. Who knows, but the Renminbi could become the reserve currency of choice at some point in the not too distant future. Even the IMF has suggested that this could happen "one day", as they put it.

What is the outlook for 2012, though? Short of a complete collapse, we believe that most of the worries concerning the euro are already reflected in market valuations. If a Greek default were to become reality, it would undoubtedly cause short-term turbulence and could easily lead to another credit crunch as banks in many countries would face great difficulties. We cannot see interest rates going higher, whereas inflation should fall. Returns from cash deposits will remain very low, and we believe asset backed investments, particularly those that produce a decent yield, are the best place to be in these uncertain times. Not everything is doom and gloom by any means, but we are sticking to our defensive stance for the time being.

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