Quarterly Newsletter
Winter 2014/2015

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

In the January editions of our quarterly Newsletters, we usually cast a backward glance at the preceding year's stock market performance. After a short-lived sell-off last spring, most global equity markets resumed their upward trend whilst largely ignoring a number of potential problems such as the Russian annexation of Crimea in the Ukraine, resulting sanctions against Russia, the ISIS situation in Iraq/Syria as well as the continued economic slowdown in China. In addition, the oil price started falling dramatically, and other commodities did not fare much better. It all made for a muted outlook for global growth.

Nevertheless, the US market (as evidenced by the S&P 500) performed strongly, posting a succession of new highs as the year progressed.

Things changed a bit in October when weak US consumer sales figures and a resurgence of worries over the ability of Greece to meet its debt repayment schedule provided the catalyst for a sharp dip with the S&P losing 4.5% in a day and Treasury yields briefly falling below 2%.

The Eurozone was slowing down further, with even Germany recording flat growth figures and narrowly avoiding a triple-dip recession.

Overall, stock market performance last year has been lacklustre, with only America recording decent results. The Dow Jones was up 7%, the S&P 11.4% and the Nasdaq 13.4%, the Eurostoxx 50 managed just 1.5%, the FTSE was down 2.7% and Japan's Nikkei 225 was even worse at minus 6.6%.

All this should come as no surprise to regular readers of our Newsletter. For quite a while, we have been getting increasingly worried for different reasons (geopolitical events, sustainability of the global recovery and EU/euro woes, particularly about the continuing inaction by the ECB) and our views were reflected in a much more cautious approach to portfolio construction and asset classes spread.

Right at the end of the year, the Greek government was brought down when parliament refused, at the third time of asking, to endorse the presidential candidate proposed by Prime Minister Samaras' coalition, resulting in a snap election next Sunday. With just a few days to go, the left-wing Syriza party has a slight lead in opinion polls. Under its leader Alexis Tsipras, the party line has been "anti-austerity", i.e. against the measures insisted upon by Greece's creditors, in particular the so-called Troika (European Commission, ECB and IMF). This sentiment clearly resonated with many Greek voters, and the party came first in last year's European election.

We cannot help but feel sympathy for those voters who have seen their economy collapse, their country's debt balloon to over 180% of GDP, youth unemployment running at around 60% and, if the austerity regime has to be adhered to, are faced with a decade or two of destitution and misery. And let's face it, the people who have been affected the worst are not the ones one could blame for what caused the problems in the first place. The responsibility for the overall malaise lies much more with corrupt civil servants and politicians in Greece and, let us not forget, an unbelievably lax approach to due diligence by the European Commission and the ECB when Greece was invited to join the "euro club". It is a bit odd to see that Greece's bookkeeping was not subjected to closer scrutiny, seeing the nation had defaulted on its sovereign debt obligations at least five times in the last 200 years.

When Syriza first came to prominence, there was fighting talk that they would pull Greece out of the EU if ever they won power. A new word was coined for a Greek exit: "Grexit". However, what would-be governments say in opposition before an election and what they actually can do once in power often are very different things. We have seen many examples of that elsewhere, including the UK! Recently, even Alexis Tsipras has softened his rhetoric, but he still insists that the terms of the bailout have to be renegotiated.

If a Syriza-led government succeeded in obtaining more favourable terms from the Troika, one has to assume that it would have a domino effect, leading to other Eurozone countries under the austerity cosh asking for similar favours.

As neither Syriza nor the Samaras-led coalition can possibly achieve an overall majority – their respective share of the vote runs in the low thirties percent – deals will have to be done to cobble together another coalition. The worst outcome following Sunday's election would be the inability to form a new government. That really would be disastrous for Greece and its citizens.

What makes the whole situation in Greece even more poignant is the fact that the ECB will meet on Thursday this week, just three days before the election. Instead of mixing with the great and the good at the annual World Economic Forum in Davos, ECB president Mario Draghi is putting the finishing touches on the latest ECB stimulus measures. The man who said in July 2012 that the ECB was "ready to do whatever it takes to preserve the euro" is rapidly running out of options. He has tried offering cheap loans to banks in an effort to get them to engage in lending. With a similar aim in mind, he introduced negative interest rates to stop the banks parking their money with the ECB. Finally, he took a tentative step in the direction of quantitative easing by purchasing covered bonds and asset-backed securities. It was referred to as "QE light" as German opposition stopped him from going the whole hog and buying sovereign bonds.

Legal challenges ensued, and only last week the European Court of Justice appeared to give the ECB the green light to buy sovereign bonds. However, over the weekend a new row erupted, so now we still do not know who can buy what bonds! Mario Draghi would like the risks shared equally across the Eurozone member states, but that still goes against the views of German officials who do not want to effectively underwrite southern European countries' sovereign bonds. To be fair, who would want to buy Greek sovereigns only days before an election that could presage Greece returning to the Drachma and defaulting on its debts?

We have long argued that QE was necessary to get the Eurozone economies into a healthier state, and we have been dismayed by the ECB's – and the politicians' – repeated refusal to tackle the problems head-on. The Eurozone economies have hit the buffers, and deflation has become a reality. It only is due to the fact that there are no other options left to kick the can further down the road that proper QE (*not* QE light!) is at long last being contemplated. To make matters worse, whatever the ECB decides to do now, in our view it will be too little too late.

The Eurozone's economic wellbeing depends on small and medium-sized companies, and it is highly unlikely that those companies will be major beneficiaries of what is about to happen. It is reckoned that it takes two to three years for any benefits to trickle down into the real economy, and we cannot imagine European banks will be happy to provide much needed funding to Italian, Spanish and Greek SME businesses.

Someone else who has decided this would be happening, or *not* happening, as the case may be, is the Swiss National Bank (SNB), and they took the financial markets by complete surprise when they dropped the peg to the euro by abandoning the Swiss franc's exchange rate floor of 1.20 francs to the euro.

Central banks like to do things that are not anticipated by financial markets, but according to many observers, the Swiss have gone too far, and they have done so in a very heavy-handed fashion.

The peg was introduced in September 2011 in an effort to counteract the upward pressure on the franc which, for a long time, has been seen as a safe haven. A few weeks ago, the SNB also announced charging negative interest of 0.25% on sight deposits (usually overnight deposits or other deposits that can be removed without serving notice) and only recently it stated that it was prepared to purchase foreign currency in unlimited quantities to defend the euro-cap. Ominously it went on to say it would also "take further measures, if required"…

Unfortunately for most traders and speculators, they did not think that might mean dropping the peg! When the announcement hit the market, it caused chaos. The franc briefly appreciated by a staggering 40% against the euro before it settled at an uplift of 20%. Swiss exporters, whose main market lies in the Eurozone, were outraged, as were the Swiss tourist industry. However, it did not just affect Switzerland. There were some big losers the world over. Several foreign exchange trading houses, derivative trading and spread betting firms as well as hedge funds have taken big hits, with one large American hedge fund facing losses in excess of 1 billion francs, leading to its demise.

It has also damaged individuals in many countries who had taken out mortgages denominated in Swiss francs. That seemed like a good idea: a stable currency and a very low mortgage rate. These mortgagors are now licking their wounds, and Swiss stability, in their eyes, is no more!

The SNB have further increased the *negative* interest rate from 0.25% to 0.75%. In case you are feeling sorry for people who have some money on deposit in a Swiss bank, the negative interest rate only applies to positions in excess of 10 million francs (roughly £7.5 million).

Denmark also introduced negative interest rates, and even Turkey has lowered its rate, even though it still is very much in positive territory. Are we seeing the beginnings of a "currency war" which is tantamount to a beggar-thy-neighbour policy, designed to promote your own country's economy at the expense of others?

The euro will weaken, that is for sure. Good news, you might say, if you are planning a holiday in a Eurozone country, but bad news for British manufacturers/exporters that will be losing any competitive edge once the currency alignments have materialised and revised exchange rates are being applied. With imports from the Eurozone becoming cheaper and our own inflation rate already on a downward trend, one has to start thinking whether all this could lead to deflation in the UK.

We are two days away from hearing what the ECB will do, and three days after that we will get the result of the Greek election. Both events will have repercussions for all of us, and the worrying times continue.

Bagshot 20th January 2015

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