

GREECE, OIL AND US LIQUIDITY

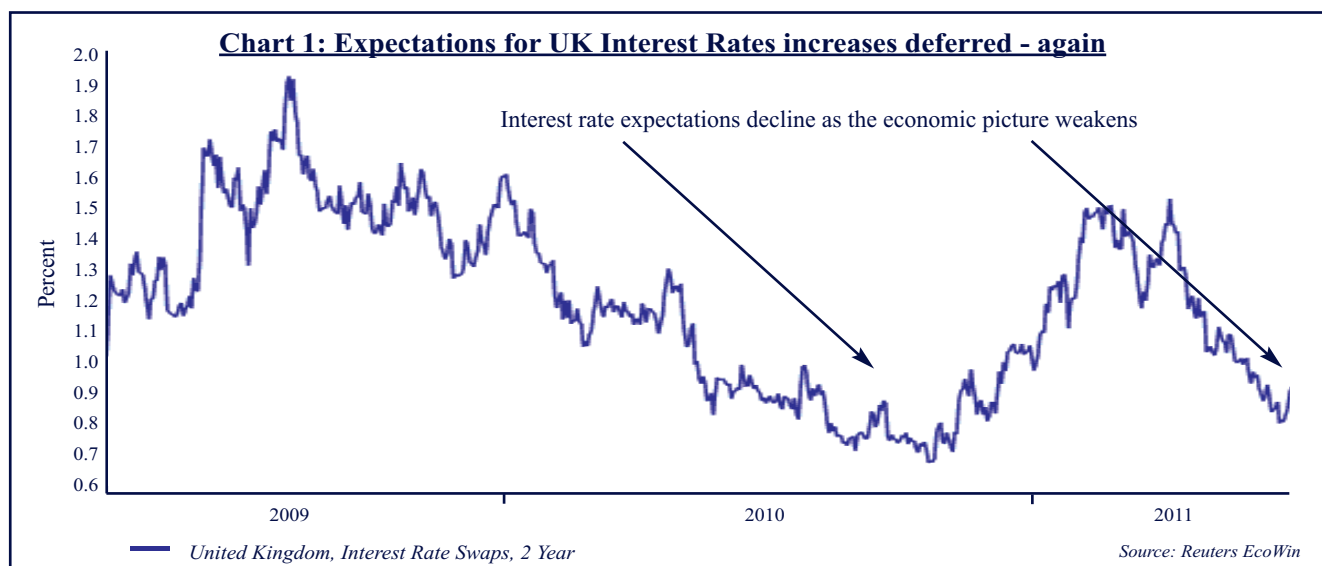
In our January update note, we suggested that 2011 might share a number of similarities with 2010 as the world economy endured another year of post-crisis muddling through. For 2011 so far, this is proving a reasonable prediction. In the same vein as last year, we have seen early optimism on the economic recovery and growing expectations of higher interest rates evaporate amid concerns about the weakness of growth and employment. As in 2010, this has caused equity markets to fall as investors have retreated to the safe haven of high quality government bonds.

Further parallels between the two periods are apparent in the reigniting of sovereign debt crises in the eurozone and persistent inflation concerns in developing markets. These similarities beg the question, 'Will the second half of this year see a welcome repeat of the improvement in economic data and equity markets witnessed in the second half of 2010?' We believe that this is quite possible. In this note, we explain why, but also consider three key risks that could undermine the global economic recovery and equity markets. On balance, we conclude that, while there are significant challenges in the near term, maintaining allocations to equities remains appropriate.

Why we expect an improvement in the economic outlook

The improvements in economic growth and equity markets in the second half of 2010 were driven by US policy intervention, namely the announcement of further fiscal stimulus, tax cuts and a second round of quantitative easing. While these factors are unlikely to be repeated, there are four key drivers that may produce a similar result this year. These are: (i) lower interest rate expectations (ii) lower oil prices (iii) an ending of monetary policy tightening in China and (iv) the unwinding of the supply chain disruption that impacted global industrial production during the first half of the year due to the tsunami hitting Japan.

Chart 1 below illustrates the first of these drivers. As confidence in the economic outlook ebbed through the first half of 2011, expectations of higher interest rates evaporated. The deferral of interest rate increases in the US and UK should work to boost economic activity in the second half of the year by keeping borrowing costs down and by removing the uncertainty created by potential interest rate increases.



In terms of the second driver, the oil price is behaving in a similar way to interest rates; as the economic outlook deteriorates, oil prices fall. This can be seen in chart 2 on page 4 (chart 2 also illustrates a point in the section on Oil Prices and the Middle East). Lower oil prices should boost disposable income and reduce costs for businesses.

Turning to our third driver, the Chinese authorities raised interest rates earlier this month. This was the fifth increase in the current rate tightening cycle. They have also increased the amount of reserves that banks are required to set aside to a record 21.5%. This is another form of monetary tightening. In June, Chinese Premier Wen Jiabao wrote in the FT that China had defeated inflation and that the overall price level was now expected to drop steadily. Such an outcome would see the end to Chinese monetary policy tightening and would be very helpful for the global growth outlook.

The final driver is straightforward. Global production was hamstrung in the first half of the year by supply chain disruption resulting from Japan's tsunami and resultant nuclear disaster. As these disruptions clear, we should expect an element of catch up in growth.

In conclusion, there are good reasons to expect an improvement in the economic fundamentals. However, there are three key threats to this positive scenario, which we set out below, together with our thoughts on why we do not believe that they will derail global economic growth.

Three Risks – the Eurozone, US and Oil

At present, the positive factors for the global economy are being overwhelmed by negative sentiment stemming from what, in our view, are three key political and financial market risks.

Risk 1 - Greece and the worsening eurozone debt crisis

The eurozone's fiscal crisis is seemingly getting worse by the minute, though Thursday night's agreement between European leaders for a new €109bn Greek bailout offers some respite. In the past week, Italy has been drawn into the vortex, with its ten-year bond yields rising above 6% for the first time since the euro was introduced in 1999. If recent press comment is to be believed, it now seems more likely than not that Greece will default on some or all of its debt, resulting in the European Central Bank refusing to supply the Greek financial system with liquidity in exchange for lodging Greek government bonds as collateral. Can the situation be salvaged? We believe it can. The problem is essentially a political one and the current, seemingly endless, rounds of summits, meetings and negotiations are all part of the process of negotiating a solution that is acceptable to all parties. At present, northern European states want private sector holders of Greek government debt to share in the pain of restructuring. The holders, including many European banks, are, unsurprisingly, less keen. Similarly, the voters in the core of soundly financed eurozone nations do not want to subsidise those in the periphery, who they regard as profligate and ill-disciplined. By contrast, the populations in the periphery appear willing to undergo the austerity and restructuring required to regain competitiveness. However, there will be limits to how much austerity can be borne by the people in the struggling peripheral economies. These are all matters to be addressed by a political process. What is clear is that, contrary to presentation of these issues in the press, there are solutions available as set out on the following page.

- (i) The newly formed European Financial Stability Facility (EFSF) has authority to issue up to €440bn in debt to support troubled eurozone member states. Its bonds are rated AAA and the €5bn bond issued to support Portugal in June carried a coupon of just 3.49%. The bonds are jointly guaranteed by eurozone members. There is no reason why the €440bn limit cannot be increased.
- (ii) The ECB has the power to buy the government bonds of peripheral eurozone nations as it did with Portugal in May. It is likely to do so again if bond prices continue to fall.
- (iii) As part of a long term solution, the bailout packages granted to Greece, Ireland and Portugal can be extended and turned into long term loans, as was proposed on Thursday night. Lower borrowing costs of c3.5% p.a. for up to 30 years would mean that a portion of their debt is removed from public markets and the interest burden is reduced.

The financial firepower of the EU is not in doubt; but perhaps the political willpower is. Clearly, Thursday night's bailout proposals are a step in the right direction but obstacles to their implementation may still arise. However, our view is that the political process will achieve an outcome that is acceptable for all parties. Finally, when considering incentives, we should bear in mind that further loans to Greece are not being granted out of European largesse but rather to protect the European banks that hold the Greek sovereign debt.

Widening this discussion to other troubled eurozone members, in our view, does not materially change the argument. Clearly, Italy does have a lot more debt than Greece in absolute terms, but it is a much larger economy – one of the top ten in the world. If its bonds trade on a yield of greater than 6%, one would expect the EFSF, which can issue debt at much lower coupon, to extend loans to Italy, enabling expensive debt to be replaced. If it does this in sufficient quantity, it should satisfy investors that Italian debt costs will not spiral out of control.

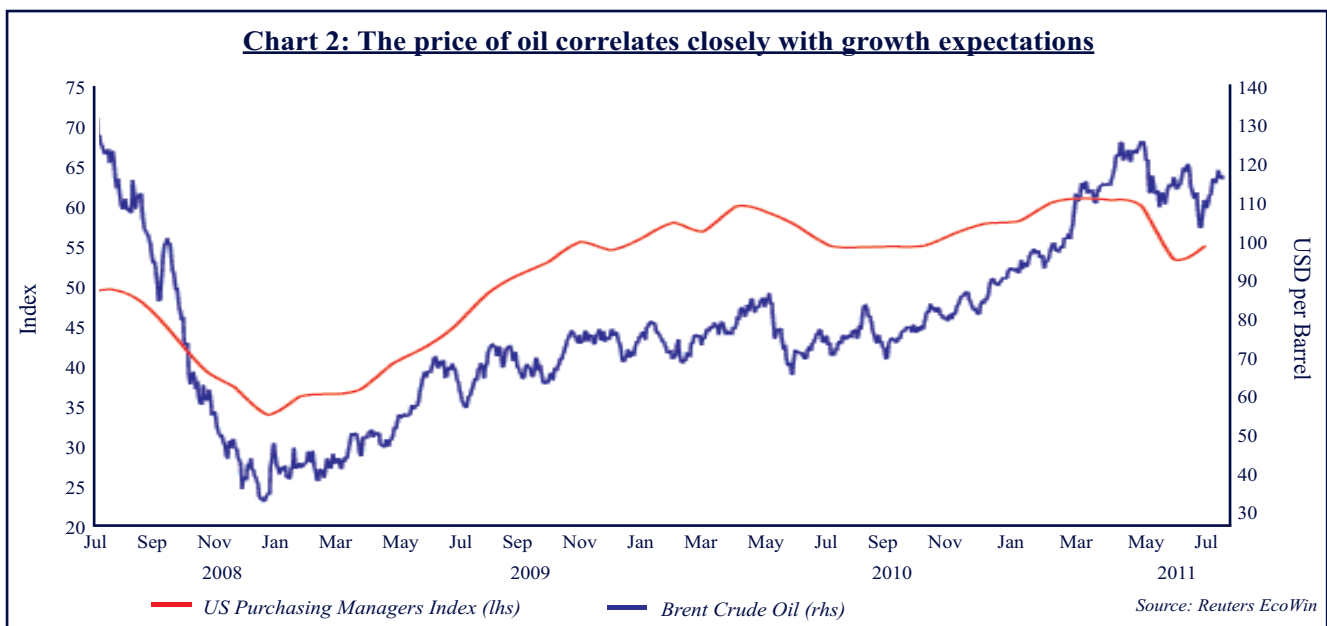
Risk 2 - US government debt

The prospect of a rating downgrade on US government debt is also hanging over investment markets. By 2 August, Congress must agree legislation to increase the legal limit on total US debt, currently \$14.3trn, or face the closure of certain US government functions and the loss of the US's precious AAA-rating for its government debt. While the political parties on Capitol Hill appear as far apart as ever on the question of tax increases versus spending cuts, we do not believe that either camp would be so destructive as to repeat the partial shutdown of government that occurred in 1995-6 under the Clinton administration. That shutdown is widely believed to have cost the Republicans the subsequent presidential election. The loss of the AAA-rating, along with the temporary disablement of some of the functions of the US government, would impose real costs on the US population. As we saw in the 1990s, this is not something voters will forgive lightly. We therefore regard the matter as a peculiarly American game of 'chicken' and strongly believe that, when the deadline approaches, both parties will make compromises to arrive at a solution.

Risk 3 - Oil Prices and the Middle East

A further challenge to economic growth comes from the unrest in the Middle East and North Africa, not least the loss of Libya's 1.5m barrels of oil production per day. The potential for a supply-side driven spike in the oil price is, in some respects, the greatest risk facing the global economy. It would undermine consumer purchasing power and increase business costs and would thereby condemn the global economy to even slower growth or, perhaps, even renewed recession. Such an outcome would come at an extremely unhelpful time, given that so many nations are struggling with the burden of high public debt – for which economic growth is the most palatable cure.

We believe there is room for optimism. Oil prices currently appear to be extremely sensitive to global growth. Chart 2 below shows the oil price plotted against the ISM survey of US business optimism. We use the latter as a proxy for US growth. The survey results show a close relationship with the oil price; when the outlook for US growth dips, as it did earlier this year, the oil price falls. Thus, the price of oil appears to be working as a pressure release valve for global growth. This means that an oil price spike would quickly reduce growth expectations and, thereby, reduce the expected demand for oil and, finally, the oil price itself.



The relationship between economic growth and the oil price is not lost on the major oil producers. Earlier this month, Saudi Arabia increased oil production to cover lost output from Libya, and meet the expected increase in demand in the third quarter of the year. Saudi Arabia, which produces 9m barrels of oil per day, would be the major beneficiary of higher oil prices. However, the Saudis are fully aware that high oil prices undermine global economic growth and thereby destroy future demand for oil. By acting to mitigate oil price rises in the short run, Saudi Arabia is protecting its long term interests. We therefore believe that, barring major disruption in the Middle East, oil prices should not present a threat to the global economy.

The risks discussed above are all bearing down on investor sentiment and equity markets. However, in our view, they do not present insurmountable hurdles to the continuing recovery from the economic crisis. We are, therefore, recommending that current allocations to risk assets are maintained.

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