

Mind the gap!

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Spain has become the 4th country to join the bailout club and there is a growing acceptance that it will

not be the last.

Those most in denial seem to be eurozone politicians, and rhetoric emanating from the likes of Spain's Prime Minister Mariano Rajoy is serving only to prompt stock market rallies that are over faster than anyone can have time to comment on them.

Sunday 17th June's Greek election result makes possible the formation of a pro-austerity coalition. Yet the good news lasted barely 90 minutes before the FTSE 100 gave up its 2% jump and slipped back into the red. By mid-day, Spanish yields had risen from below 6.9% to a high of 7.285%.

The ratcheting up of the gears of rhetoric is something with which we have all become depressingly familiar with summit after summit after meaningless Euro-summit. One can be forgiven for thinking that we had entered a new era of straight talking when Mariano Rajoy first appeared to turn his back on all the nonsense by scaling back agreed EU austerity targets for something more realistic that markets could credibly accept. Alas, it was but a mere negotiating ruse ahead of a EUR 100 billion bailout (or "Spailout"). Even this figure is hopelessly wide of the mark; conventional wisdom across the financial industry has the true figure as being something of the order of four times higher at EUR 400 billion. This is a big gap. And it's a gap frequently overlooked in the scramble to come to grips with every short term twist and turn in the eurozone drama. Let's look at just one example of how quickly the imbalances have grown since the birth of the Euro over the past decade.

From the euro's physical inception on 1st January 2002, bond yields, across the eurozone, were narrowly correlated for some years up until the Lehman collapse in 2008, it being treated as a properly pan eurozone single currency. However, the effect of having a single currency had already started taking its toll on Spanish and Italian industrial production as early as 2005, this in spite of increased government spending and all the money pouring in from EU subsidies. What actually happened was that Spain and Italy became increasingly less competitive due to, among other things, rising labour costs.

Before the euro, these countries would have naturally devalued over time as central bank policies and markets allowed, thus weakening their currencies and restoring the competitive balance.

Unfortunately, without this flexibility, Italian productivity actually fell around 18% in the years to 2012 as Germany's went up by a similar amount, resulting in a yawning gap of over 35% in the space of 6 years. Spain fared even worse, losing around 27% between 2008 to 2012 - almost as much as Greece.

Now, of course, there are other factors at play - such as not having a central banking regulator or common fiscal pact or, indeed, political union, but these fundamentals illustrate how an uncompetitive

country can become imprisoned within a single currency. Without the ability to distinguish by currency, markets now allocate theoretical values by country through bond yields which has led to an enormous and unsustainable gap between the yields of core and peripheral eurozone sovereign debt.

It is astonishing to now have yields of Spain 10-year bonds of 7.25% whilst the German equivalent trade at 1.40%. Shorter term debt in Germany trades at negative yields where investors are paying for the privilege of receiving zero percent. Thus giving rise to a German euro currency tracking negative yields in non-euro Switzerland (with a euro peg that will surely break). Even the Danes are now worried about negative yields as money flows into the Krone. Sadly, a bit like a fixed exchange rate mechanism, as the UK found out in September 1992, no currency peg holds forever and, when they break, they break badly.

So where does this leave us? We believe only one outcome is credible; some form of fiscal union in the eurozone and the backing of peripheral eurozone debt by the European Central Bank. When this happens we estimate that the yawning gap between eurozone bonds will close. German bund yields will rise towards 3.5% (given they undoubtedly will be on the hook for the largest contribution) and Spanish (and other more peripheral nations) yields will fall. Such a scenario would be very positive for equity markets.

But when will this happen? Germany is the final arbiter in this regard but Angela Merkel said there should be no fiscal union until there is political union. François Hollande said there should be no political union until there is a banking union. And the Bundesbank said there should be no banking union until there is a fiscal union. If it were up to Angela Merkel, this triangular deadlock would not be broken until being returned to power in German elections in autumn 2013 when it would be easier to throw in the towel to the pan-European (indeed, global) demand for eurobonds. However, as the markets will not wait that long, the EU strategy has been to deliver just enough sticking plaster to heal a gaping wound and usually at one minute to midnight in any new crisis's darkest hour.

We cannot predict when this will occur. Next week, next month maybe not until 2013? But what we can predict is that there will be further bailouts, further summits and further market volatility.

We expect the 'safe haven' trades to continue until the scenario outlined above occurs; Gilts, Bunds, Treasuries will remain unattractive for long term investment given that they offer negatives real yields. Equity markets will likely remain dislocated from underlying fundamentals with periods of strong performance followed by declines. From a geographical perspective we are avoiding European exposure; focusing on US, UK, Japan and other emerging markets - albeit in a limited fashion. Our core strategy will

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