The Absolute Return Letter

July 2005

Summary

Since the EU referenda in France and the Netherlands about five weeks ago, the future of Europe has been panned by most observers. Some have even questioned whether the euro will survive.

Whilst we do not disagree that Europe is in a terrible political mess, we would argue that this will probably create opportunities which investors should be aware of. Furthermore, the weak euro is helping markets. Export businesses are important to the wellbeing of corporate Europe, and the recent move in the EUR/USD exchange rate is providing substantial relief for European exporters. Finally, there are signs that the European Central Bank may finally bow to pressure and lower interest rates (and about time too).

All of the above is bullish for European equities and we conclude that European equities should continue to perform quite well for a while yet.

In our second article this month, we look at the twin deficits of the U.S. and why the issues are less straightforward than often portrayed.

There will be no letter next month as the beach is calling, but expect us to be back in force in early September. Enjoy the summer.

Does Europe Have a Future?

If you are a keen student of financial literature, you would be forgiven for thinking that Europe is on the road to disaster. Rarely have we seen as much negative commentary as has been the case since the no-vote in France five weeks ago. Every newspaper, left or right-wing, pro or against Europe, has been stuffed with articles suggesting that Europe is on the verge of collapse and that the euro is at risk of disappearing altogether.

Now, we human beings have a remarkable ability to see things as whiter than white when times are good and blacker than black when we find ourselves in stormy waters. Hence it is no surprise to see that most commentators are describing the current political crisis as if there is no tomorrow.

Whichever way you look at it, Europe is undeniably in its worst political crisis for at least a generation. At the same time, European equity markets continue to perform remarkably well. In fact, all European markets (with the exception of Slovenia) have outperformed the U.S. market year-to-date. Why is that? Have these markets just lost all sense of reality only for it all to end in tears?

Table 1. Equity Market Performance:
(First Half 2005 - selected countries only)

Austria	+26%
Iceland	+23%
Denmark	+20%
Norway	+17%
Finland	+16%
Sweden	+11%
Netherlands	+11%
Switzerland	+10%
United Kingdom	+10%
Germany	+8%
Spain	+8%
France	+7%
Luxembourg	+7%
Belgium	+6%
Ireland	+6%
Italy	+4%
Portugal	+2%
United States	-2%

Like everyone else, we have our favourite economists, analysts and columnists that we read regularly. Most of these observers have been negative on European equities for a while, and the recent political crisis has only reinforced this view.

It is actually not hard to build a very negative case for European equities. The political crisis is only the latest hiccup in a long string of setbacks for the old continent. Unemployment is rising. The consumer has virtually stopped spending. Several countries are now openly flirting with recession. And, to top it all, the demographic outlook is absolutely awful.

The problem with this line of thinking is that it is all old news. Very old news. Markets do not react to old news. Only proper news counts. The no-votes in France and the Netherlands were certainly proper news, but they sparked a political crisis, not an economic one, although it was portrayed as an economic crisis in the making by the majority of financial reporters.

Now, we would not hesitate to suggest that the collective brain powers of global financial markets are superior to those of the average financial reporter. Hence it is probably fairly safe to conclude that we should seek the answer to our opening question in the stock market's reaction to the crisis and perhaps quietly ignore all the doomsday reports.

Stephen Roach of Morgan Stanley is one of the leading advocates of the view that something good may come out of this crisis. Last week he wrote the following lines:

"I continue to feel that the angst over Europe's political disappointments is obscuring the meaningful progress being made on structural reforms. The failure of the EU constitutional referenda in France and Holland, in conjunction with the acrimonious ending to the recent European summit, does not undermine the case for structural change."

We would go one step further and argue that the two referenda should actually strengthen the case for structural change. Not so much because of the no-votes themselves, but because the political process is likely to be changed as a result. Most importantly, we think several countries will have no choice but to become more inward looking, paying closer attention to popular demands. Effectively, the economic policies in several major countries will become more focused on growth.

The icing on the cake was delivered by the Prime Minister of Luxembourg who suggested that a re-vote should take place so "voters could give the right answer". That freaked even the most pro-EU of Europeans. In Luxembourg (and nobody is more pro-EU than the good people of Luxembourg), close to 50% of the electorate is now against ratifying the new EU constitution. An entire generation of narcissistic politicians effectively committed political harakiri in front of all of us, and that is the best that could possibly have happened.

Not that we particularly dislike the current generation of European leaders (well, perhaps we do, but that is a different story altogether). The fact is, Europe sorely needs new leadership. Chirac and Schröder have both run out of ideas. They may not be prepared to admit so yet, but their time is up.

The people of both Germany and France are asking for change. Some of the change required will be painful, and that requires strong leadership. Only time will tell if the next generation of leaders have it in them to force those changes through. Perhaps markets are telling us that things are not looking too bad in that department.

If you cast another look at the table above, you will notice that the Nordic countries have performed comparatively well. Admittedly, rising oil prices have supported both the Norwegian and the Danish stock markets (the latter due to Mærsk accounting for approximately 1/3 of the KFX index). Yet, a large part of the explanation should be found in the way these countries have increasingly embraced the Anglo-Saxon economic model.

Yes, we know what you are going to say now and we fully agree. It is indeed a lot easier for a small country like Finland or Iceland to adapt to change than it is for Italy, France or Germany. But the UK did it, so it can be done. We believe markets are warming to early signs that the people of Germany in particular are ready to accept changes.

June was a surprisingly good month for European equities considering all the bad press. This also reflected on the Absolute Return Multi-Strategy Fund, which had another good month. If our assessment is correct, *European equities should continue to do well for a while yet*. Over the next several months, though, we would advise you to gradually move your exposure away from the Nordic region over to the larger markets such as Germany, as investors start to reward these for making structural changes.

The Weakening Euro Should Help Growth

Secondly, unlike in the U.S., the export sectors are very important to corporate earnings in Europe. With the political crisis igniting a major sell-off of euros (since the French referendum, the EUR/USD exchange rate has moved from 1.26 to 1.19), the competitive position of European companies has strengthened significantly over the last few weeks. Because of the tendency to at least partially hedge any FX exposure, it may take 6-12 months for European companies to fully benefit from the weaker euro, but benefit they will.

Furthermore, the EU crisis has sparked a debate about the very existence of the euro. Some have gone as far as to suggest that the euro may disappear eventually. Six months ago, we would have laughed at such suggestions. We still find them a bit far fetched, but we do not laugh anymore. In Italy, there has been a public debate whether they should pull out of the euro and re-introduce the lira. In reality they cannot afford to, but that is a topic for a future newsletter. We bring it up only because such discussions help to push the euro further downwards. And a weaker euro is likely to result in higher stock prices.

Is the ECB Changing Attitude?

Thirdly, the European Central Bank (ECB) is gradually changing its body language. Since it was first established, the ECB has effectively pursued a policy designed to address the average requirements of its member countries. This policy worked adequately, if not brilliantly, for a while. However, with some of the largest member states (i.e. Italy and Germany) lagging further and further behind, the shortcomings of this "middle of the road" policy have become increasingly evident.

The only alternative open to the ECB is a policy designed to tailor to the weakest link. In other words, rates will be set to meet the requirements of Italy and Germany regardless of the effect such rates may have on faster growing countries. It may take a while, but we think the ECB is heading in this direction. A change of guard amongst European political leaders will only accelerate this change of mindset.

An important point lost on some people is that certain countries in Europe are actually doing quite well at the moment. The ECB is forced to operate one rate of interest across all member countries despite dramatic differences in economic performance (which tells you that Europe wasn't quite ready for a uniform interest rate policy, but let's not go there).

In some countries (e.g. Spain, Finland, Ireland) the current EURIBOR rate of 2% is highly accommodating. But unlike the 1980s or early 1990s, where such a policy would spark a significant rise in inflation, these countries get away with it because we are in an inflationary "sweet spot" at present (see our June 2005 letter for a discussion on inflation). The ECB should count itself lucky. This is a global trend totally beyond their control.

However, given the relatively weak economic outlook for Europe combined with the fact that globalisation is only likely to intensify, there is nothing to suggest that inflation will become a problem anytime soon. *This is an open invitation to the ECB to change strategy* and start pursuing a policy of supporting the weakest link.

If the ECB were to become more aggressive with their rate cuts, European equities should continue to do well. If you are a euro based investor, a weakening euro can only be an advantage. If you are sterling or dollar based, you can hedge your currency risk with forward contracts. Because sterling and dollar rates are both higher than euro rates, you actually get paid for doing so. Not a bad risk/reward.

Niels C. Jensen

Be Careful What You Wish For

Not too long ago, on Capital Hill, a Senator representing Michigan waved a piece of paper in the face of Alan Greenspan. The paper apparently listed the current size of overseas holdings of U.S. treasuries. The Senator in question demanded that Greenspan take action to solve this problem. Poor Greenspan has heard many stupid things on Capital Hill, but this one must rank among the classics.

The above is a good example of people attempting to discuss issues without a basic understanding of how the mechanics underlying those same issues actually work. One can, to some extent, forgive politicians. After all, it is their job to speak about things they know little or nothing about.

However, it is more worrying when a large group of commentators seem to ignore certain fundamental principles of economics when they should know better. I am referring to the sometimes incoherent debate regarding the twin deficits in the U.S.

Before I make my points, let's take another look at the so-called "accounting identity" (and please do not drop out here – this is important):

Government Fiscal Deficit =
Balance of Payments Deficit + Private Net Savings

It is important to remember the effect the three components have on GDP. An *increase* in government deficit is *good* for GDP, an *increase* in savings is *bad* for GDP and an *increase* in the balance of payments deficit is *also bad* for GDP.

One important lesson from this equation is that you cannot forecast the different components independently. If, for example, the U.S. government takes steps to reduce the fiscal deficit, it is obvious from the accounting identity that it will impact either the balance of payments deficit or private savings (or both).

For instance, the U.S. experienced healthy GDP growth throughout the 1992–2001 period. This happened in spite of a rising balance of payments deficit and an improving government deficit (both bad for GDP). In other words, GDP growth over that period came exclusively from a dramatic deterioration in net savings.

Then, in 2001-03, private savings recovered somewhat, whilst the balance of payments continued to deteriorate, both of which were bad for GDP. Under normal circumstances, this would have set off a recession; however, due to a rapidly growing fiscal deficit, continued economic growth was secured.

Secondly, with virtually no growth in Europe and with certain Asian countries refusing to play even remotely by the rules of free trade (stealing billions of dollars worth of intellectual property and keeping their currencies pegged to the dollar), a U.S. balance of payments deficit appears inevitable.

Thirdly, assuming that we all have an interest in continued U.S. GDP growth (the global economic engine), calling for a reduction in the "irresponsible" U.S. government fiscal deficit is a bit counterintuitive (or outright stupid if you prefer non-diplomatic language). As we now know, GDP growth will decline in the face of an improving fiscal deficit *unless* the balance of payments deficit shrinks at the same time or private savings decline. The Bush administration has called for a dramatic cut in the fiscal deficit. Because of the accounting identity, this could cause a severe recession. Be careful what you wish for.

Mads P. Hansen

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