The Absolute Return Letter
September 2010

Beggar thy Neighbour

"I am deeply ashamed to know that I won't be able to pay our staff. They have got mortgages, children. What am I supposed to do?"

Jesus Manuel Ampero, Mayor of Cenicientos (Spain)

It has been an unpredictable summer. Investors have been wrong-footed by surprisingly strong growth emanating from Europe (read Germany), whereas the US economy – habitually the locomotive for the global economy – has gone from one disappointment to another[1]. Not many would have predicted that back in early summer.

The endless series of bad news has led many commentators to speculate on whether the US is about to catch a bout of the Japanese disease. The most comprehensive analysis on the subject that I have come across has been conducted by the Global Economics and Strategy team at Bank of America Merrill Lynch (they have to get that name sorted out)[2]. They make the following observations in terms of what can be learned from the Japanese experience:

1. Economic growth and bond yields will remain low until banks start lending and house prices start rising.
2. No secular bull market can be expected in equities until bond yields start rising.
3. Until such time that the secular bull returns, expect plenty of volatility in equities.
4. In a low growth, low interest rate, environment, investors crave yield, growth and quality.
5. Growth is likely to outperform value.
6. The secular bull doesn't return until the central bank can hike again.

There are indeed many similarities between the situation experienced by Japan and the challenges now facing the US, but there are also significant differences. However, whether you agree or disagree with all these observations, I believe it is worth paying careful attention to Michael Hartnett when he states the following in his conclusion[2] (and I paraphrase): From a portfolio allocation point-of-view, the first rate hike will be the pivotal moment – the point in time where investors should shift their focus from bonds to equities.

Too much optimism on Europe

Now, despite the string of disappointing US macroeconomic data, it appears to me that investors have become too bearish on the US growth

[1] *Please note that the bad macroeconomic news emanating from the United States has not yet transplanted itself to the corporate sector, but this may only be a question of time.*

[2] *Source: "Is the US Becoming Japan?", August 2010, Bank of America Merrill Lynch.*

outlook and too optimistic on the European. Most of Europe has basked in the German sunshine, with little or no fundamental justification.

One of the most important lessons learned from the Great Depression was that those countries which devalued first also recovered the fastest. Back then, devaluing effectively meant coming off the gold standard. Despite being promoted by some as the *only solution* to today's freewheeling fiat money regime, there is no denying that back in the 1930s the gold standard created a monetary policy regime which was unnecessarily restrictive and caused much pain around the world.

Fast forward to 2010 and the parallels are there for everyone to see. The European Monetary Union is the gold standard anno 2010 and, over the next few years, much of Europe is likely to endure the same painful experience as the countries which held on to the gold standard in the 1930s did in the belief that it was the prudent thing to do.

I am in no doubt that the euro can be saved. It probably even deserves to be saved, but not necessarily in the current form, as the world needs an alternative to the US dollar. The question is what price are we, and should we be, prepared to pay and over what period of time? A Japan-style slow-motion adaption (most likely leading to a 'lost decade') or a sharp but relatively quick, and painful, adjustment? The sad reality is that the whole affair has become a political elephant with nobody in Brussels or Frankfurt prepared to have a proper and honest discussion about the economic sacrifices which shall be required in order to save the euro.

Instead all the energy is channelled into a series of attempts to convince the world that the situation is very much under control, the most laughable of which was the recent stress test of European banks, which not even the most bullish of commentators gave much credit.

The export boost

And whilst most investors have completely missed the true lesson of this crisis – a point which I will get back to in a moment – the Germans are laughing all the way to the bank. Despite having recovered somewhat from the lows of early June, the euro is still down almost 12% year-to-date against the US dollar, giving Europe's largest exporters a phenomenal boost at a critical juncture.

Chart 1: Euro Area Export Exposure

Euro Area Export Exposure

	Total Exports as a % of GDP	Extra-EU27 Exports as a % of Total Exports	Extra-EU27 Exports as a % of GDP
Germany	37.3	37.1	13.8
France	20.6	37.8	7.8
Italy	9.9	94.6	9.4
Spain	25.4	19.6	5.0
Portugal	30.2	19	5.7
Greece	22	12.1	2.7
Ireland	49.5	39.2	19.4

Source: BCA Research

Scarcely needing it (the Germans already run a huge current account surplus), the German export sector has not been slow in taking advantage of the weak euro, and I suspect it is only the beginning, given the usual time lag between movements in exchange rates and the effect they have on exports and imports. Of all the European countries in need of some good news, only Ireland's exports to the rest of the world (i.e. to countries outside the EU-27) account for a bigger share of GDP than Germany's (see chart 1).

Meanwhile, Southern Europe is characterised either by relatively modest export sectors (such as Italy) or they export mostly to other European countries (e.g. Greece, Spain and Portugal), in which case a weakening euro makes not one iota of difference. Ireland should benefit immensely from a weak euro but is too small to matter in the bigger scheme of things. Of the bigger countries, only Germany stands to make a home run from the weak-ish euro.

The true source of the crisis

Now to the point which I believe has been shamefully missed by many if not all investors. Contrary to popular belief, the financial crisis of the last 2-3 years is not the result of some excessive mortgage lending to wannabe real estate owners in the US. The reckless lending was only the symptom of a much deeper and wider problem which is rooted in the global imbalances which have been allowed to escalate over many years.

Countries such as China, Germany and Japan have been running huge current account surpluses (building up massive foreign currency reserves in the process) whereas other countries such as the US and the UK have suffered from large current account deficits. Hence Germany is about the last country in the world which needs the added help of a weak currency. At the same time it illustrates the irony of the situation - the country which needs to pursue a 'beggar thy neighbour' policy the least, is the one which is enjoying most success in its pursuit of it.

If these imbalances are not addressed once and for all, it is only a question of time before we have a re-run of the recent crisis. So, when Ms. Merkel notes that Germany should continue to do what it does best – export its goods to the rest of the world – it illustrates a fundamental lack of understanding that almost defies belief.

The accounting identity

In March of this year Rob Parenteau[3] wrote an important paper which was published by John Mauldin in his weekly 'Outside the Box'. In it, Rob made the following statement:

"*The domestic private sector and the government sector cannot both [delever] at the same time unless a trade surplus can be achieved and sustained. Yet the whole world cannot run a trade surplus.*"

What lies behind this slightly cryptic, yet important statement is the following national income accounting identity:

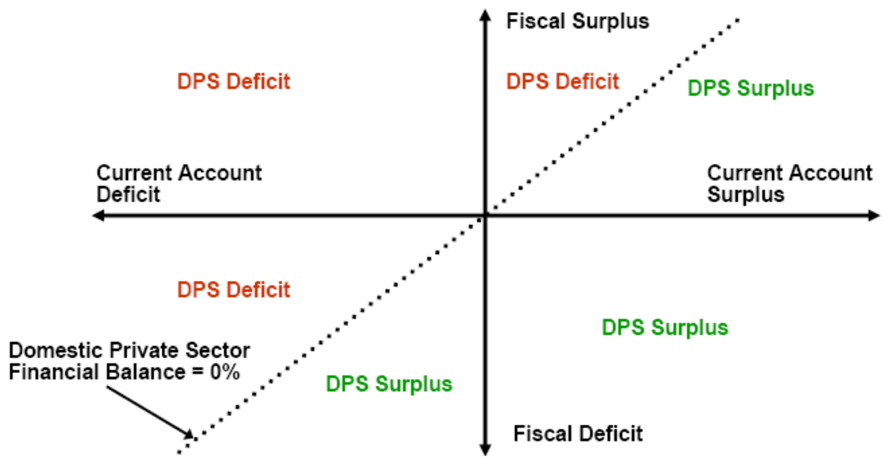
Current account balance = Dom. private sector balance + Public sector balance

Please note that this must *always* be the case. Rob illustrated the accounting identity graphically, a chart which has subsequently been reproduced by James Montier at GMO - see chart 2 overleaf. The 45-degree line marks the point where the domestic private sector balance is zero. Along this line the current account surplus (deficit) will by definition equal the public sector surplus (deficit). To the right of the 45-degree line the private sector is in surplus (green) and to the left it is in deficit (red).

Why is it that this will always be the case? Think about it the following way: If our government runs a surplus (fat chance!), tax revenues exceed public expenditures, which is a net drain on the private sector's savings. If the current account (the balance vis-à-vis the rest of the world) is in balance, it is therefore perfectly logical that a surplus in the public sector must equal a deficit in the private sector and visa versa.

[3] *Rob Parenteau is editor of the Richebacher Letter.*

Chart 2: The Financial Balances Map



Sources: Rob Parenteau, James Montier, GMO

Spain is in a difficult position

Now, let's look at Spain. Last year it ran a current account deficit equal to 5% of its GDP. The public sector was 12% in deficit and the private sector saved approximately 7%: -5 = 7 – 12. Voila! The obvious implication of this accounting identity is that ***only if*** a country can run a current account surplus is it possible for the domestic private and public sectors to net save on a combined basis.

It also means – and this is the truly important message – that when our beloved political leaders stand up in front of us and promise that they are committed to reducing the public sector deficit, they cannot do so without important implications for the other two sectors making up the accounting identity. It is simply not possible to tinker with one of the three sectors without implications for the others. Either they don't understand it, won't understand it or they simply ignore the fact!

So, when Cameron, Merkel and Zapatero (and soon to be Obama) give in to the pressures of the bond market vigilantes and promise drastic spending cuts, they ought to tell us what they are in fact promising. As current account balances do not change dramatically in the short term, the only variable which ***can*** make up for a swift tightening of public spending is the domestic private sector balance. In plain English, either the savings rate must come down swiftly (i.e. consumers must spend more) in order to compensate for lower government spending, or GDP will fall rather spectacularly.

Back to the Spanish example: Zapatero's government has committed to an austerity programme which, if implemented successfully, will reduce public spending to 3% of GDP which, by the way, is a very tall order considering that the structural (i.e. cyclically adjusted) deficit in Spain is about 8% of GDP. As Spain is part of the eurozone, it does not control its exchange rate the way the UK or the US do. Hence it is not an option for Spain to play the currency card, which basically means that the current account will only improve slowly, if at all[4].

As a result, the 9% promised reduction in public spending must be compensated for through an equivalent rise in private sector spending (private consumption plus investments). If not, the effect on GDP will be ugly. With the Spanish people still licking their wounds following the dramatic fall in property values, and with the unemployment rate

[4] *There is one caveat – should Spain as a result of the austerity programme fall back into recession, the current account deficit will most likely improve somewhat as a result of lower imports.*

continuing to rise and now at 20.3%[5], are the Spanish ready to lever up their household balance sheets again? I don't think so.

The only way out

The implication of all of this is straightforward. All those countries facing harsh austerity programmes over the next several years will sooner or later come to the realisation that the ***only*** way out of the current predicament is through an improvement of the current account (i.e. higher exports and/or lower imports). However, as our American friends have found out in recent years, reducing imports is easier said than done; hence the focus must be on growing exports, assuming you produce stuff which the rest of the world wants to buy, but let's ignore that assumption for now.

This requires improved competitiveness, which is usually achieved in one of two ways. Either productivity must be increased or the exchange rate must fall (or a combination of the two). Of the major industrialised countries, only Japan and Germany seem to understand how to improve productivity without facing a general strike every couple of weeks, undermining all the good work.

Most other countries, and that includes both the UK and the US, seem to have resigned themselves to the fact that the exchange rate is the premier weapon. That leaves those poor souls who happen to live in countries that are neither particularly competitive nor have the exchange rate weapon at their disposal (because they signed up to a pact years ago without understanding the true implications).

When the harsh reality finally sinks in, the European (much over-hyped) solidarity will be seriously tested as the 'Beggar thy Neighbour' mentality takes hold. We already see signs of this mindset in America with parts of Capitol Hill demanding much tougher trade sanctions against China. Unless Germany takes measures to reduce its enormous trade surplus with the rest of Europe, a similar attitude could, and probably will, develop here in Europe.

In the ensuing political calamity, the euro could experience a crisis significantly worse than the one it underwent earlier this summer. However, for now, markets seem to believe that the 'wunderbar' news coming out of Germany will eventually drive all of Europe forward. I have my doubts.

The world is flat

More than five years ago, Thomas Friedman (author of *The World is Flat*) made the following observation in the International Herald Tribune:

"…French voters are trying to preserve a 35-hour week in a world where Indian engineers are ready to work a 35 hour day. Good luck. I feel sorry for Western European blue-collar workers. A world of benefits they have known for 50 years is coming apart, and their governments don't seem to have a strategy for coping."

Those words are as true today as they were when first written. I feel sorry for the Spanish mayor, when he says that he doesn't know where to find the money to pay his staff[6]. Although of scant consolation, he won't be alone. Fiscal austerity means lower economic activity, unless you can lever up the private sector (not likely given the current level of private sector leverage) or you can improve the current account; however, we cannot all export our way out of our problems – somebody will have to do the imports.

The lower economic activity will again lead to lower tax revenues for the public sector; it is a very unfortunate and rather unpleasant vicious spiral which, by the way, is also ***very*** deflationary. The chances of inflation

[5] *As of July 2010, according to Eurostat.*

[6] *See the full story here.*

rearing its ugly head anytime soon in Europe (with the possible exception of the UK) are extremely remote ***unless*** the euro is abolished, in which case governments across Southern Europe will be tempted to inflate their way out of current problems. But that is a story for another day.

Niels C. Jensen

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