# The Absolute Return Letter
# March 2011

## From Dublin to Tripoli

*"Experience is the name everyone gives to their mistakes"*

Oscar Wilde

*A remarkable month*

Two remarkable events unfolded during the month of February. One cleared the front pages all over the world. The other one barely got a mention - outside of its home country that is. Both have the ability to derail the economic recovery currently unfolding. The first one is not surprisingly the uprising in the Middle East and North Africa. The other one is perhaps less obvious; I am referring to the Irish elections.

*A new dawn in Ireland?*

Let's begin in Ireland where the electorate has finally had its say on the banking fiasco, which has taken the country to the brink. Fianna Fáil, having been at the helm of Irish politics for the past 14 years, was severely punished by the voters in last Friday's elections and had its number of seats cut by 58 to 20 (its worst result ever). Fine Gael gained 25 seats to 76, making it twice as big as the second biggest party in the Dáil (the lower house and principal chamber of parliament), yet not with enough votes to secure outright majority in the 166 seat parliament. This leaves the Labour Party – usually only the third largest party in Ireland – in a strong position with 37 seats, a gain of 17. According to Irish media reports, Fine Gael and the Labour Party are already in advanced talks to form a coalition government.

How Ireland ended up in this mess is not the objective of this letter. For that I suggest you turn to Michael Lewis (author of Liar's Poker), who has recently produced a blinder of an article about Ireland's predicaments, which you can find here. It comes strongly recommended. What I want to focus on instead is how the Irish may decide to challenge the EU leadership and the effect that may have on financial markets.

Now, the Irish are not like the Greeks. One should not expect to see them on the barricades just because they have been robbed of any chance of prosperity for at least a generation. The Irish vote with their feet instead. Following more than a decade of net immigration, the tide has turned and Ireland is again losing tens of thousands of people every year – mostly the young and the well-educated - which is a rot that must be stopped, as the Irish will need all the economic growth they can muster in the years to come in order to work their way out of the current mire.

**Table 1: Irish Bank Deposits (€ billion)**

| | Deposits from Irish Residents | | | Deposits from Non-Res. | | Deposits |
|---|---|---|---|---|---|---|
| | MFIs | Govt. | Private | NR - € Area | NR - RoW | TOTAL |
| Jan-10 | €133.9 | €3.1 | €175.2 | €29.4 | €202.4 | €544.0 |
| Jan-11 | €124.7 | €2.9 | €155.6 | €17.1 | €109.0 | €409.4 |
| YoY | -€9.2 | -€0.1 | -€19.6 | -€12.2 | -€93.5 | -€134.6 |
| YoY, % | -6.9% | -4.6% | -11.2% | -41.6% | -46.2% | -24.7% |

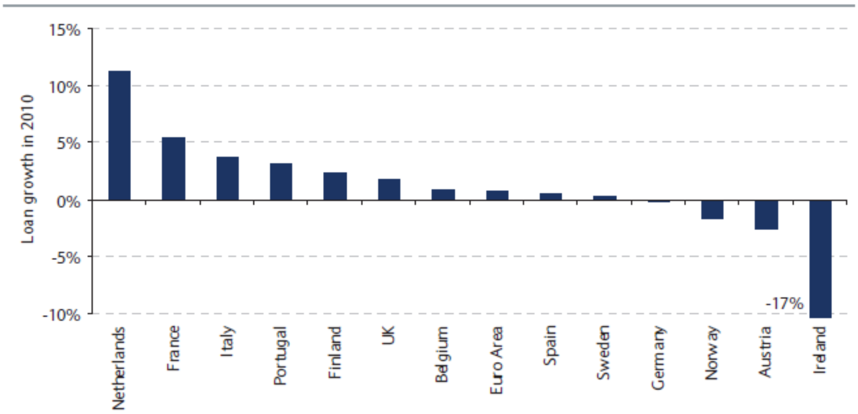
*Source: Central Bank of Ireland. Note: Domestic market credit institutions only. MFIs are monetary financial institutions.*

*An industry in meltdown*

Of even bigger concern near term, though, is the near meltdown of the Irish banking industry. It took me a while to get to the bottom of this, but what I found was truly astonishing. The Irish banking industry is a complex beast. About 450 financial institutions operate in the country, but only 20 of those serve the domestic economy. Table 1 represents those 20 'domestic' banks, and the picture is horrifying. Over the past twelve months, €135 billion pounds, or one-quarter of all deposits, have left the country. In an economy with a GDP of €155-160 billion that is a very large number indeed.

Obviously, with a deposit drain of that magnitude, the Irish banks have had to scale back their lending. Despite substantial emergency funding being provided by the Irish Central Bank and the ECB (to the tune of about €145 billion), loan growth has gone into reverse with a fall in total loans outstanding of approximately 17% last year (see chart 1), and with further declines to be expected for 2011.

**Chart 1: Loan Growth by Country (2010)**




*Source: Barclays Capital, various central bank websites*

Facing this harsh reality, it was no wonder that Fine Gael in the weeks leading up to last Friday's election let it be known that it favours a restructuring involving a haircut for holders of Irish sovereign bonds. The Irish intent was clear; if it is so important for the EU leadership to keep Ireland afloat, then the EU should damn well pay for it. This sparked frantic activity in Brussels and Frankfurt with several statements being issued aimed at damage limitation. Applying some unusually strong wording, various EU leaders made it clear that Irish dissent would not be tolerated.

*A surprisingly strong hand*

In reality, though, the Irish have a stronger hand than generally perceived. With their banks sinking faster than other European investors can offload their exposure to Ireland, what would Ireland actually lose from calling the EU's bluff and let bondholders take a haircut? Perhaps even walk away from the euro and go back to the punt? Usually, one of the strongest arguments *against* leaving a currency union is the inevitable run on the banks. But if the bank run is already in full bloom, that argument loses much of its power.

If the deposit drain continues at the current rate, the day will soon come where the price of leaving the euro will no longer be punitive. At a minimum, the new Irish government should push aggressively for a renegotiation of the rate of interest it pays on the emergency funding. At 5.8% there is plenty of scope for improvement of terms.

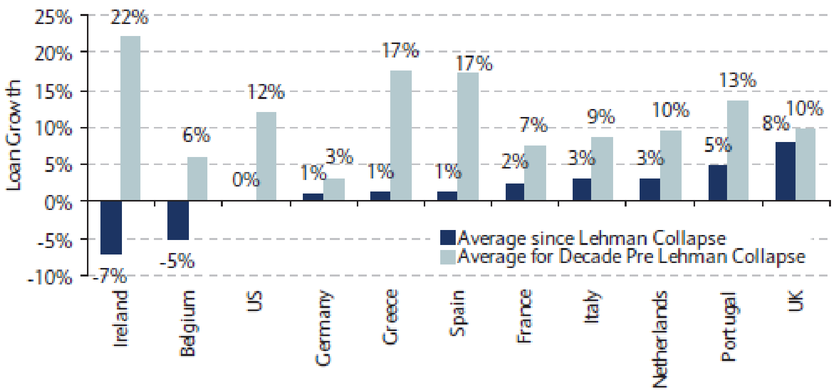
After all, the EU's main concern is *not* Ireland. No, what the EU is desperate to maintain is the illusion that the EU's banking sector in general, and Germany's in particular, is sound and healthy. In reality, the German landesbanks, together with the Spanish cajas and the Austrian banks, are amongst the weakest in Europe in terms of their capital base, and the German banks have plenty of exposure to Ireland. In other words, keeping Ireland afloat is a critical part of Merkel's strategy to keep its own banking sector alive. This very fact, which the German government is doing everything in its power to conceal, provides Ireland with a once-in-a-lifetime opportunity to renegotiate its borrowing terms.

*It's food prices stupid!*

Now, let's shift gear and move our attention to the Middle East momentarily. Recent events have been portrayed in the international media as a mix of religious warfare and a cry for political freedom. In reality it is none of them. It is the result of rapidly rising food prices combined with high youth unemployment throughout the region. However, for now, developments are serious enough to drive up energy prices to levels which are capable of doing significant damage to the fledgling economic recovery.

Many commentators, especially those punters eager to express extreme views of more or less dubious quality on the internet, have been only too willing to declare the recent increase in commodity prices a function of the 'money printing' policy applied by central banks in the western hemisphere following the credit crisis of 2008-09. The fact is that the Fed and other central banks can 'print' trillions of dollars, euros or pounds without it having *any effect whatsoever* on present or future inflation. What really matters is what the commercial banks, whose balance sheets are boosted by the QE, do with the money, and the overwhelming evidence is that overall lending activity has moderated quite dramatically since the credit crisis (see chart 2). Hence the notion that QE is to blame for the current spike in inflation is pure and simple nonsense.

**Chart 2: Loan Growth, Pre and Post Lehman Collapse**




*Source: Barclays Capital, various central bank websites*

In reality, we need not look any further than to the link between the US dollar and Asian currencies to find an explanation for the current boom in commodity prices[1]. With most Asian currencies tracking the US dollar, low US interest rates have led to low Asian interest rates (otherwise they couldn't track the US dollar); in fact much too low for the type of growth these countries currently enjoy. It is therefore fair to say that we are paying the price of our own stupidity. If we had put our foot down years ago and stopped the manipulation of exchange rates in Asia, the current economic boom in Asia would have been more modest, and the rise in commodity prices would probably have been less dramatic, but that is all water under the bridge.

*Don't expect the 70s to return*

Looking forward, and as I have frequently pointed out, rising commodity prices are going to have a much bigger impact on emerging economies than on more established economies (and for that reason we have underweighted emerging markets in our global asset allocation in recent months). Within the OECD area, unless unions manage to regain

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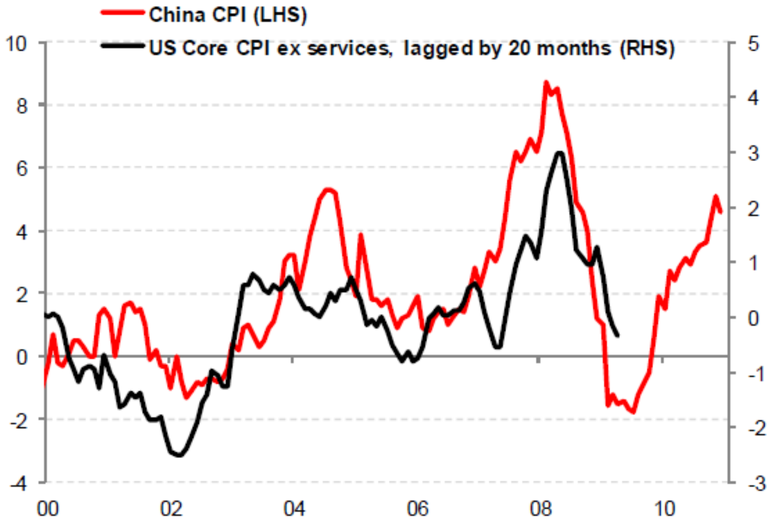
[1] *The rapid growth in index-linked commodity products has also had a significant effect on commodity prices in our opinion. See the May 2010 Absolute Return Letter for an in-depth discussion of this issue.*

the strong position they enjoyed in the 1970s, there is little chance of a labour market induced inflation spiral like the one we experienced in the late 1970s and early 1980s. Commodity price induced inflation is not nearly as dangerous; it is effectively a tax on consumption, and will eventually go away again, as the economy cools down.

**Chart 3: From Chinese CPI to US Goods Prices**




*Source: Societe Generale Cross Asset Research*

That does not imply that we shouldn't take that type of inflation seriously, and it certainly doesn't imply that inflation cannot rise further in the short to medium term. As discussed in last month's Absolute Return Letter, China is currently facing a serious bout of inflation, and we will almost certainly import some of that inflation eventually. Albert Edwards and his colleagues at SocGen wrote an interesting piece[2] about three weeks ago, where he pointed to the strong link between Chinese and US consumer price inflation - with a lag of about 20 months (see chart 3).

**Chart 4: US 10-Year Bond Yields Still In a Down Trend**


*Source: Societe Generale Cross Asset Research*

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2 *"Prepare for a major over-reaction to higher US core CPI inflation", SG Cross Asset Research, 10/02/2011.*

**Chart 5a: UK Yield Curve (0-50 Years)**

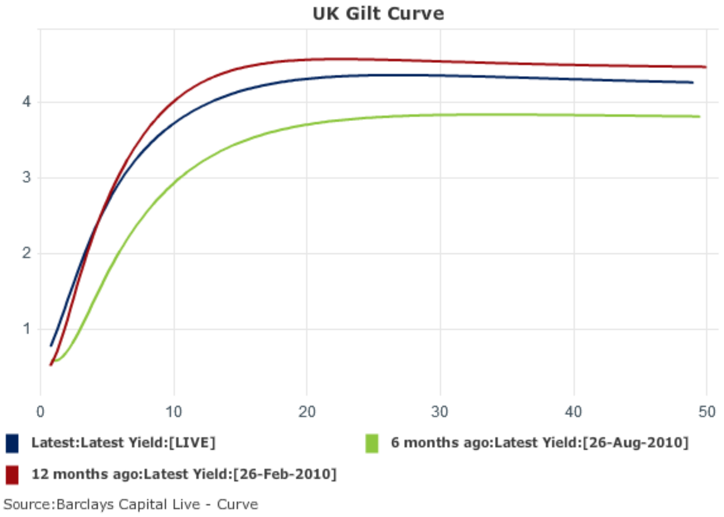



**Chart 5b: US Yield Curve (0-30 Years)**

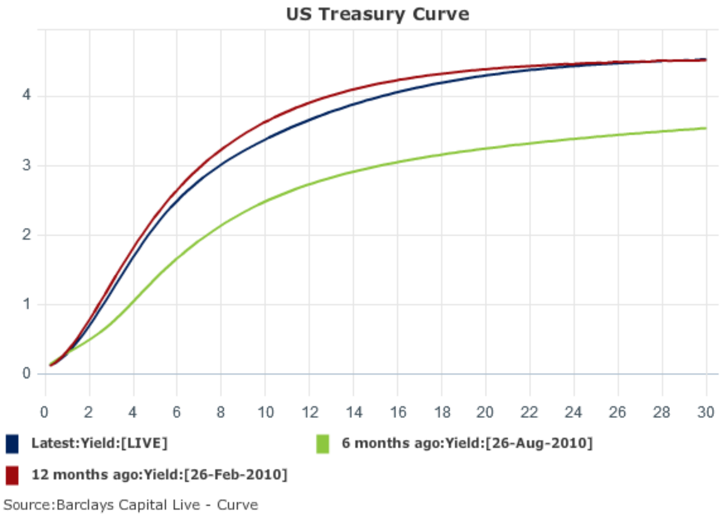
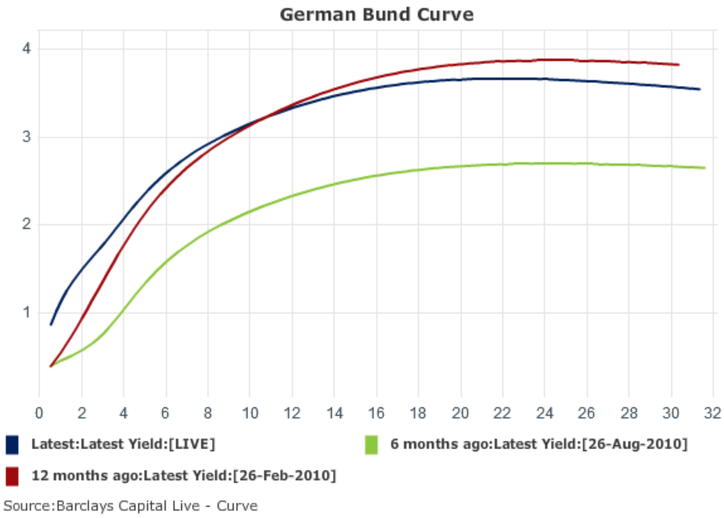



**Chart 5c: German Yield Curve (0-32 Years)**




*Source: Barclay Capital*

*Could bonds overreact?*

Now, despite what the perma bears are telling you, consumer price inflation rising from near zero to 2% is in fact good news. For the past 2-3 years we have experienced a somewhat unusual environment, which has been characterised by strong inflationary and deflationary forces pulling in opposite directions and, for the record, we fully expect that to continue for several more years. However, at least for now, the consensus is building that inflationary forces will ultimately prevail, and the bond market is thus likely to overreact to bad news on the inflation front, or so goes Albert Edwards' argument. We would agree with that logic.

Despite all the noise coming from the bond bears' camp, in reality, bond yields are still trending down (see chart 4) and they remain below the levels of a year ago in both the UK, the US and in Germany (see chart 5a-5c). Admittedly, they are higher than the levels experienced six months ago, but if I had told you this time last year that the global economy would surprise with better than expected growth in 2010, the US and European economies would both surprise on the upside, commodity prices would generally be strong and energy prices would be particularly buoyant, would you have bet on bond yields being lower a year later? No, you wouldn't.

*Conclusions*

So what does all of this mean? The honest answer is that I don't know! Ireland could try to keep the show running for several more years before it eventually gives in, defaults on its debt and leaves the euro, but it could also take the bull by the horns, call the EU's bluff and negotiate much better terms. Much depends on the bargaining skills of the team that the new government sends to Brussels to negotiate with the EU later this month. And EU peripheral bonds could be the best investment in the world over the next twelve months, or the worst, depending on how those negotiations turn out.

Meanwhile, the situation in North Africa could deteriorate quite badly with Saudi Arabia being the $64,000 question. Should the civil unrest spread to Saudi, anything could happen, including $200 oil prices. We could end up with not one but ten or twelve 'Irans' on our hands – or the regimes in North Africa and the Middle East could accelerate their reform programmes, and new markets could open up to export companies in Europe and North America, much like the reforms in Eastern Europe twenty years ago created entirely new opportunities. I just don't know.

What I do know, though, is that much depends on how our governments and our monetary policy authorities react to all of the above. As far as the inflation outlook is concerned, I certainly hope that Ben Bernanke remembers his own conclusion from a research paper he produced back in 1997 and doesn't overreact to the current spike in oil prices:

*"Our results suggest that an important part of the effect of oil price shocks on the economy results not from the change in oil prices per se, but from the resulting tightening of monetary policy."*

"Systematic Monetary Policy and the Effects of Oil Price Shocks", Ben Bernanke et. al., 1997

In terms of possible overreactions, I suggest you to take another look at chart 5c, representing the German yield curve. The key thing to note is the fact that, unlike in the UK and the US, short and medium term yields (those with a maturity of less than 10 years) have actually risen in Germany over the past twelve months, leading to a modest flattening of the yield curve versus a year ago. The market is essentially taking the view that the ECB will be the first major central bank to tighten monetary policy significantly. Given the fact that several countries in peripheral Europe are on life support, such a move will probably go down in history as one of the biggest policy mistakes of all times. Pay attention!

On the same theme, the Lex column in this morning's FT pointed out that the US yield curve has flattened by about 20 basis points since early

January. Again a sign that markets have begun to prepare for the end of 'easy money'.

For all those reasons, we are taking risk off the table in our bond portfolios (see also the changes we make to our risk scatter chart on page 8). Not because we have become inflation hawks, because we haven't, but because we cannot get comfortable with all the unknowns. There are too many possible outcomes, not only in Dublin and Tripoli, but in Lisbon, Athens, Madrid, Tunis, Cairo, Amman, Manama, Muscat, Sanaa and Riyadh to mention but a few.

***Niels C. Jensen***

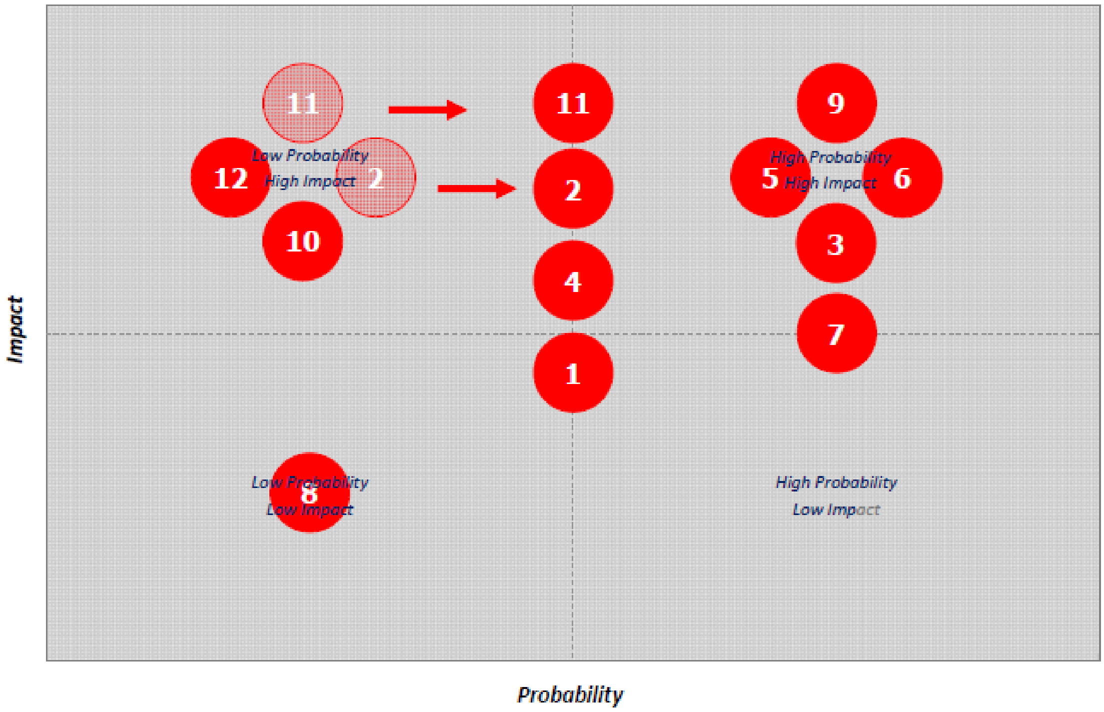



*'Don't you have any cheaper petrol from a country still ruled by a ruthless dictator?'*

*Source: Daily Telegraph*

# The ARP Risk Assessment Chart

## Next 12 Months




1. High yield priced for perfection?
2. Double dipping in Europe/North America
3. Japan running out of fiscal options
4. Beggar thy neighbour mentality
5. Capital flows into EM countries leading to inflation and other problems
6. Chinese hard landing
7. Food inflation induced civil unrest
8. Twin deficit problems in India
9. European contagion and solvency risk
10. Massive refinancing programme of sovereign and bank debt
11. Premature withdrawal of monetary support
12. Israel launching a pre-emptive strike on Iran's nuclear facilities

We introduced the ARP Risk Assessment Chart in the December 2010 Absolute Return Letter, and have made it a regular feature since.

This month we are raising the probability of two risk factors – the risk of double dipping and the risk of premature withdrawal of monetary support.

Both of those changes are a function of recent events. Inflationary pressures are rising, even if temporarily, and that may force the hand of monetary authorities in both Europe and North America at a time where the recovery is still too fragile to be able to withstand such monetary tightening.

Furthermore, having raised the probability of food inflation induced civil unrest in mid January, we continue to monitor this risk factor closely. For now we are comfortable with classifying it as a medium impact risk factor. However, if the civil unrest spreads to some of the larger oil producers, we will increase the impact factor immediately.

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