JCP Investment Partners - European Tour 2012

European Tour Insights

August 2012

In July 2012, Michael Fitzsimmons (Chief Investment Officer) and Craig Shepherd (Senior Economist) travelled to Germany, Spain, France, Italy, Belgium, Ireland and the UK to meet with economists, politicians, Government bodies, journalists and local companies across a range of industries. We saw this process as fundamental to gaining a better insight into the circumstances unfolding in Europe. This report provides a summary of the impressions and analysis that have transpired as a result of these meetings. Importantly – we also consider how best to capture these views in our client portfolios going forward.

The economic forces which threaten the euro were clear in our minds before we left Australia. We felt existing contacts and research lacked both context, and country specific details that better explained what helped create and perhaps could help sustain the euro going forward.

In meeting with more than 50 people from diverse backgrounds over 10 days, we found the social and political context more compelling. With hindsight we had overemphasised the weighting towards the economics. If one was to list possible motivations for the European project as social, economic and political, we are now aware that the economics would, in the short term at least, come in a distant third.

The implications for the market and our client portfolios relate to timeliness, uncertainty and growth. The social and political forces at work require many years of reform. We see these years marked by crisis, periods of apparent progress, and yet more crisis. The complexity of the solution and constant forces of the market reduce the likelihood of ultimate success. Throughout, growth in Europe will suffer and investors will be sapped of confidence, creating an environment which is not conducive for stronger markets.

Simply a balance of payments crisis?

Economics suggests the European crisis is simplistically an internal balance of payments crisis, a North and South, Germany and the periphery issue. Discussions confirmed Germany had benefitted from the emergence of Asia in a way other parts of Europe could not. Unification, a decade of reform, a deeply integrated SME sector, and arguably a weak euro all helped to generate strong surpluses for the Germans. The euro, perhaps unintentionally, provided both a market for German goods, as well as an outlet for capital which otherwise may have driven domestic inflation. On the other hand, the compressed bond yield spreads which globally characterised the Great Moderation, combined with housing booms and often government neglect, allowed huge deficits to accrue to the periphery.

As booms unwound and debt markets moved to better price risk, the precarious combination of recession, overextended banking sectors, and unsustainable budgets fuelled the crisis. In the absence of a mechanism such as the federal structures of the United States or Australia which ultimately allow for transfers between states to redress such imbalances, the euro is potentially facing the risk of terminal stress.

Economics is not politics, and based on our discussions, alternative paths are not apparent to many European policy-makers, contrary to our belief before embarking on this tour. Critically, a euro breakup dismantles many salient country specific motivations which otherwise tend to reinforce the currency union.

Belief in the European project – and a perceived lack of alternatives

Call it availability bias or the product of education and experience, but an overwhelming response we received on the continent was that the euro and the EU would survive - and that austerity reform and increased integration of institutions was the roadmap for survival.

Other options such as exit and devaluation were not given the consideration we expected. Opinions from economists and politicians alike resonated a view that devaluation is not a viable option for any country in the European area. Devaluation may assist in the short term, but it is believed that any benefit would quickly dissipate through higher wages and delayed reforms. We found this an interesting contrast to Australia, where the RBA has a firm belief in the power of floating exchange rates.

On most paths forward, our contacts discussed further forms of integration (“more Europe”); banking regulation, central fiscal oversight, debt mutualisation or other ECB quantitative easing measures. But “more Europe” doesn’t get any easier from here. Thomas Klau – European policy expert and economist, noted that in many ways the easy work has been done. What comes next is removing the last piece of real power (budgets, fiscal & monetary policy) from the nation’s parliaments. This is fine in theory, but the proximity of taxes and decision making are core to the place of parliaments in history. The next moves are real sovereign issues, and we found each country faced this issue from a different perspective. For instance in Spain we were asked to imagine the relative ease by which you would pass banking regulation across to the EU if you had experienced Spain’s banking problems of the past decade.

Nearly all suggested the euro can survive a Greek or Finnish exit but any breakup in the core of France, Germany, Italy and Spain not only would mean the disintegration of the euro but also the end of the EU. Without a currency union, the political support for free trade of goods and the movement of people would disappear.

Specific country motivations

Many individual objectives of the member states that wouldn’t be addressed outside of the euro are seen as viable within. That is, the euro provides critical benefits for different countries. Our discussions suggest these include:

- The need for reform within the confines of the euro, especially in Spain and Italy.
- The potentially volatile mix of German mercantilism and its need for very low inflation.
- The internal need for France to have a global political role, one leveraged within a stronger Europe.

- The link between Europe and stable democracy for Spain.
- More control over regionalism - stability issues within countries in the euro are important, whether Cataluña in Spain, the north in Italy, Bavaria in Germany or even Scotland in the UK.
- For Ireland, it's the ability to leverage access to the European market, in a small English speaking country with strong links to America.

The urge to reform within the euro

Addressing public sector employment and broader labour market rigidities would lower deficits and improve competitiveness for a number of European countries. Europe may grow faster with consistent labour laws and additional institutional support for higher labour mobility across countries.

Labour is a perfect example of where the tension emerged when the euro was created, back when labour markets remained the responsibility of individual nations within the euro. As pointed out to us by Nobel Prize winning economist Chris Psaaridies – the natural outcome would be the balance of prices and unemployment across countries. Indeed the high Spanish unemployment rate occurs in a country with a high reservation wage, whilst the repressed wage growth in Germany sees a lower rate of unemployment.

But governments pushed at the edges of this process. In countries which tended towards higher unemployment, more government jobs were created in good times, exacerbating fiscal imbalances. In countries which tended to lower wage growth, the improved competitiveness was baked into export prices.

Reversing this process was seen by most to only be possible in the euro under the sceptre of austerity. Reform and austerity were seen as symbiotic. Nations who are fiscally extended and suffering from high wages would respond better with external reinforcing, while lower wage growth countries would engineer wage inflation and higher consumption more easily in a weak euro where global competitiveness wasn't at risk.

In the labour market we saw the same issues that will confront banking reform, fiscal union etc. Time is required for reform. Coordination across all member states is required, governments need to rally their people for support, and the ECB needs to maintain the economy at the same time. That is, the reforms may work and save the euro, but only if there is time and a happy circumstance.

Other motivations

The remaining motivations which we won't elaborate on are also critically tied to the perceived importance of the euro's survival. For each, they stem from a country's 'fear' of a future where an objective of competitiveness, control, democracy, stability or relevance, potentially being denied. This was extremely palpable and we suspect also incredibly relevant.

The importance of staying in the euro to reform was strengthened by a tremendous lack of trust in local institutions. Additionally countries which historically had benefited from investment (both EU transfers and foreign direct investment) reinforced the importance of not seeing this investment devalued or curtailed.

Underpinning the capacity for reform is the power of the family unit, the depth of informal economies in much of Europe, and an enormous resilience in places like Ireland and Spain. Meeting a former Prime Minister of Ireland we were reminded that in many ways incomes and activity did get ahead of itself, and a rebasing of wages and incomes might not be such a bad thing.

The art of the possible – can a path through be navigated?

The first problem is that the rest of Europe believes that Germany will come to the party, both in terms of direct support and in allowing just enough inflation. However, for the Germans conditionality is paramount - whereby all supportive moves are accompanied by strict enforceable change. Conditionality is vital for German political support.

This tension is problematic. Even with initial German support we were reminded by a former IMF director, Donal Donovan that we shouldn't assume that the German capacity to respond is unlimited either.

So why will the crises continue to re-emerge even if the euro survives long-term? Take Spanish banks as an example, acquiring a new Pan-European regulatory structure will do little to solve current problems and will have implications for the Spanish sovereign. Banking experts, such as Robert Tornabell, noted a number of bailouts will be required in the coming years - if not sooner.

Events which test the resolve of the euro will emerge across a range of issues in Ireland, France, Italy and Germany. The path to "more Europe" has a number of steps which might prove too difficult. In fact according to Wolfgang Munchau (FT journalist) it is the combination of complexity, the weak institutional framework and haste actually required, which create a fertile environment for mistakes and disintegration. This theme was often repeated and the conundrum created was well expressed by a sentient that "if only we had started the work on new frameworks for more integration (banking,fiscal, monetary etc.) before the crisis we would be much better placed."

Institutional difficulties heightened by underappreciated social risks

Relatively early in our meetings in Europe it was clear that the muddling through or "more Europe" solution will shift the burden of adjustment to the poor relatively more than to the rich. Instead of promoting a moderate level of inflation to inflate away debt, or a defaulting on the debt, internal devaluation appears the most likely path in the short term.

But is Europe simply making the same mistakes of the past two centuries? [Assuming the disenfranchised and/or poor will bear the brunt of this adjustment.] Many commented that the level of unrest has been surprisingly small; others noted that political support for extreme views is unlikely to go above 20%.

Perhaps more concerning was the explicit calibration of austerity measures against "what people can take", on the assumption that austerity was the only solution.

As a fund manager concerned with identifying and quantifying risk, we believe the risks that; i). politicians make mistakes in 'calibrating policies'; and ii). 'smart' politicians currently seen as extreme will exploit the environment with radical solutions, appear greater than we initially appreciated.

Growth will be the casualty, especially in the short term

When austerity and reform are symbiotic, and when conditionality is central to solutions, we suspect markets will take a long time to adjust its expectations for a "silver bullet" to a more incremental solution perspective.

As they do however, the reality of lower incomes in the hands of ordinary Europeans, failing credit in affected countries, and industry reform which will ultimately challenge business models will emerge. For our client portfolios, the impact on underlying growth will be significant, which in turn will mute growth in the rest of the world.

A standard question

In each of our meetings we asked participants to quantify the future of the euro, presenting them with only two scenarios; i). a muddle through scenario in which the euro survives with stronger more integrated institutions and the other; ii). in which various challenges ultimately lead to disintegration of the euro.

The probabilities were about 70% for a continuation versus 30% for a break-up. We adjust this outcome for status quo bias down by say 20%, meaning it's probably a "toss of a coin". JCP tends to err on the side of a failing euro, reflecting our belief that economics and a lack of strong leadership will eventually win out over the political and social imperatives, and that the required transfers and austerity will prove politically too difficult.

Direct implications for our portfolios

Should our analysis prove correct, the market is likely to gyrate around events in Europe, constantly looking for a simple solution that is unlikely to emerge. Eventually the market may come to terms with the muddle through, and like Japan grow accustomed to the new paradigm. But in the meantime euphoria may present opportunity for selling risk, and crisis an opportunity to buy risk. This type of volatile market suits our process, providing opportunities for valuation arbitrage/volatility capture.

For companies, specifically those with European exposure (like Brambles and Amcor), the impact on the underlying growth rate within Europe is the most important influence. The ability of the political elite to enforce austerity is high. When coupled with endemic stress in the banking system, positive organic revenue growth for companies operating in Europe will not be assumed as our base case. For the Australian banks, the current trend to source funding domestically will need to continue. Even if credit demand becomes much stronger (which we doubt), the euro complications with ongoing reform, bailouts, and the risk of break-up means funding might not be available for some time as credit markets remain in turmoil.

On the following page is a list of the contacts we met with on our European tour.

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Meeting List:

Frankfurt

Philipo Di Mauro, Head of Research (European Central Bank)

Michael Klein, Regional Head Investor Relations (Commerzbank)

Lars Von Cleff, Corporate Relations (Deutsche Bank)

Stefan Krause, Chief Financial Officer (Deutsche Bank)

Dr Bernhard Speyer, Head of Research (Deutsche Bank)

Stefan Schneider, Chief International Economist (Deutsche Bank)

Wim Koesters, Independent Economist

Claudia Comrad-Kreml, Director (Interel, PR firm)

Josef Joffe, Independent Economist

Brussels

Daniel Gros, Director (Centre for European Policy Studies)

Wolfgang Munchau, Journalist (Financial Times), Director (Euro Intelligence Unit)

Mario Fleurnik, CEO Melotte NV

Paris

Mark Lewis, Head of Energy Research (Deutsche Bank)

Flora Benhakoun, Equity Research - French Banks (Deutsche Bank)

Bruno Hallak, Head of Investment Banking (Deutsche Bank)

Jim Bitterman, Correspondent (CNN)

Romain Ranciere, Professor of Economics (Paris School of Economics)

Agnes Benassy-Quere, Professor of Economics (University of Paris), Director (CEPII)

Thomas Klau, Head of the Paris Office and Senior Policy Fellow at the European Council on Foreign Relations

Milan

Alberto Martinelli, Professor of Political Science (University of Milan)

Enzo Corsella, Head of Research (Deutsche Bank)

Stefan Micossi, General Manager (Assonime - Italian think-tank and business association)

Marco Cacciotto, General Secretary & Co-Founder (Italian Association of Political and Public Affairs)

Paolo Zanetto, Politician and Advisor

Madrid

Fernando Fernandez, Professor of Economics (IE Business School)

Miguel Brunuel, Professor of Economics (Universidad Autonoma de Madrid)

Sebastian Mariz, Public Affairs Consultant (EPPA)

Ricardo Rico-Martinez, CEO (Equipo Economico)

Luis Bruelman, Real Estate (The Noble House)

Edward Hugh, Independent Economist

Robert Tornabell, Banking Expert & Academic

London

Dario Perkins, Economist (Lombard Street Research)

Rachel Lomax, Economist

Andrew Lilico, Principal, Europe Economies

Jonathan Portes, Director, National Institute of Economic and Social Research

Chris Psarrides, Economist & Nobel Prize Winner

David Bennett, Director (Europe Analytics)

Julian Garran, Global Commodities & Mining Analyst (UBS)

Nick Pink, Head of Research (UBS)

Paul Donovan, Chief Economist (UBS)

Timothy Cogden, CEO, Economist & Politician (International Monetary Research)

Amit Kara, UK Economist (UBS)

Emily Benn, Research Sales (UBS)

Sir David King, Scientific Advisor (UBS)

Andrew Dempster, Sales (UBS)

Alexander McGee, Sales (UBS)

Willheim Butier, Chief Economist (Citibank)

Dublin

Ronan Lyons, Academic Economist, Author and Blogger

Donal Donovan, Former Deputy Director (IMF)

Karl Whelan, Professor of Economics (University College Dublin)

John Bruton, Irish Prime Minister (1994-97)

Declan Murphy, MD (Strategy Partners), former ICT EU Advisor

Tony Moroney, Principal Consultant (Saburai Consultants)

Alan Dukes, Chairman (Irish Bank Resolution Corp.)

John Kelly, Consultant (King Research), former economist at Bank of Ireland

Dan McLaughlin, Chief Economist (Bank of Ireland)