

Causes and possible consequences of the Eurozone crisis and some implications for investors

We are not macro investors: we do not take bets directly on the possible outcomes that could occur as a result of movements in currencies, interest rates or anything similar.

However, with every investment decision, a critical part of the assessment of a company is an understanding of the market in which it operates and the likely factors that are going to affect demand for its products in the short, medium and long term.

There are always possible macro headwinds that one can point to, but overall the world economy has done very well over the two hundred years since the industrial revolution got under way. However, within this period there have been times, such as the 1930s and 1970s, when negative macro developments have been so significant that otherwise sound investments have been destroyed.

In the current environment, there are two particular negative macro issues which we have to take into account when analysing any company. The first is the general deleveraging that is happening in the Western World as individuals, banks and governments attempt to repair their balance sheets. The second is the specific fate of the Euro. In this newsletter, we thought it was worth spending a little time setting out our views on the Euro and how we think about it in relation to investments.

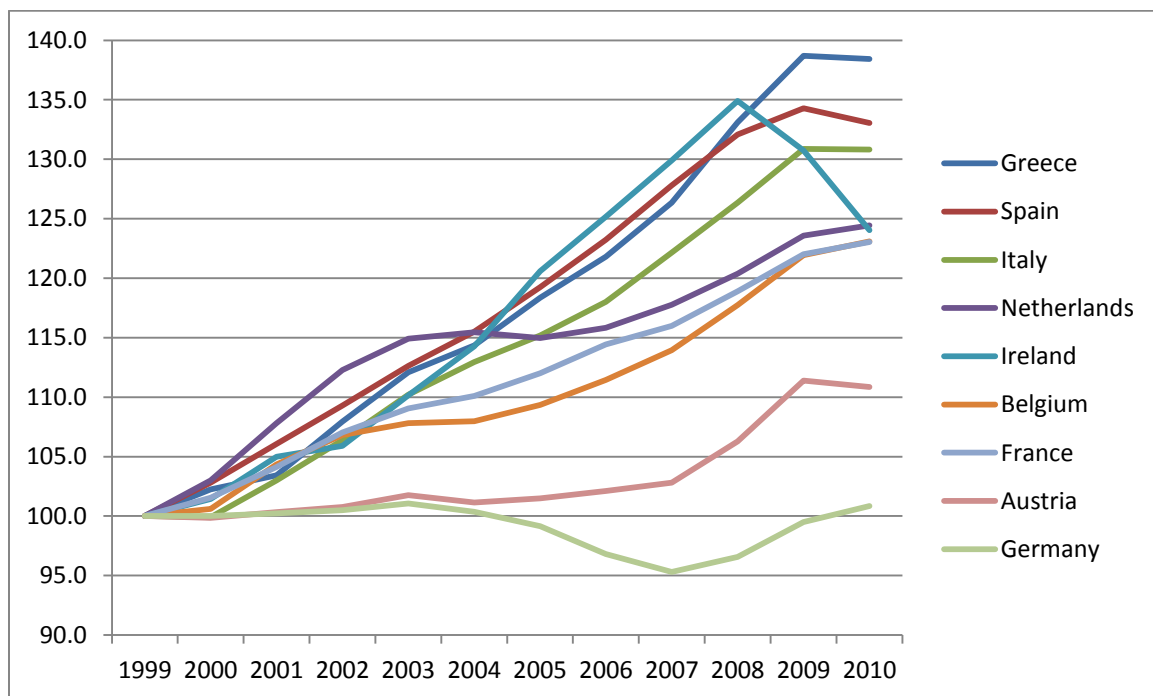
The Euro was, from the outset, a political construction. There were some economic arguments in its favour around making cross-border trade within the EU slightly easier by removing currency risk and transaction costs. However, countries were trading with each other cross-border and cross-currency both within the EU and outside it with very little drag for many decades before the introduction of the Euro. The modern financial system had reduced the costs of doing business in foreign currencies significantly over time through hedging and cheap electronic payments. The EU could have tackled transaction costs directly by passing laws on the amounts banks could charge in fees and commissions for intra-EU transactions, use of ATMs, etc. in the way that it has with mobile phone charges.

The real impetus behind the Euro was that it was regarded as a major plank in the development of the “ever closer union” laid down in the Treaty of Rome and re-emphasised in all subsequent treaties. This is a development dear to the European elite that has had, at best, patchy support from the peoples of Europe. France only just passed the Maastricht treaty (which set the foundations for “Economic and Monetary Union”) in a referendum with 51% in favour. Perhaps most critically, in Germany where referendums are not allowed on these sort of issues under their basic law, opinion polls showed a consistent majority against replacing the Deutsche Mark with the Euro.

To meet the criteria for EMU each country had to achieve a degree of “convergence” but this was relatively superficial in that it only covered certain headline numbers at a particular point in time: budget deficits, debt to GDP ratio etc. The idea was that once all the countries had the same currency, there would inevitably be much deeper convergence, a form of “ever closer union” in the economic sphere.

There were always good reasons to think that different parts of the Eurozone might move in different directions at the same time – in fact this was inevitable as the business mix of each economy was quite different. This would have led some countries to be in recession while others were experiencing a boom but with the disadvantage that there could only be one monetary policy and one interest rate for the whole zone.

As it turned out, what happened was worse than that. The peripheral countries continued to award themselves higher wage increases unfunded by productivity growth. In contrast, Germany, in an effort to recover its competitiveness after the pain of unification, did the opposite. The result was that over the last 10 years, unit labour costs have moved as follows:



Source: OECD

In a pre-Euro world, this would have led to a gradual strengthening of the German DM and a gradual devaluation of the Italian Lira, Greek drachma and indeed all the other currencies. But in a world where all the economies shared a single currency, the result was that Germany has ended up with a currency that is undervalued and has become more and more competitive in world markets, while the other countries have a currency that is overvalued and are priced out of world markets. The inevitable result is that Germany has a large balance of payments surplus and the peripheral countries have a large balance of payments deficit.

With a current account in deficit, the capital account has to be positive and the countries in question did not have sufficient external investments to fund their required capital inflows so they have increasingly been living off money borrowed from abroad. It is these balance of payments deficits that are the source of the debt problem as the peripheral countries have required very large and increasing loans both to their governments (through sales of bonds) and private sectors (visible in the dependence of their banking systems on external finance). Many of these funds came from within the Euro system from the creditor countries (e.g. German banks) who acted as though, with a single currency and therefore no perceived currency risk, a loan to the Greek government or a Greek bank had the same risk profile as a loan to the German government or a German bank. Funds also came externally, from outside the Euro, for example, from US money market funds.

Given the current perception of serious currency risk, external funds have now dried up completely and internal funds from private sources have also stopped, so Eurozone banks are relying almost entirely on loans from the ECB. European governments, being unable to borrow from the ECB directly are hoping that European banks buy sufficient government bonds to continue to fund their deficits and roll over their debt. The ECB has therefore had to create money on a large scale which can be seen from the way that its balance sheet has ballooned in recent months.

This is not the sort of problem that can be solved by a summit of political leaders. As the key problem is competitiveness, there are only 3 solutions:

- A. A rebalancing of labour costs within the Eurozone whereby the Germans increase their wages to make themselves less competitive and/or the other countries decrease their wages to make themselves more competitive and then an adjustment to the level of the Euro in international markets to leave the overall zone in a competitive situation; or
- B. The labour cost imbalances remain, leaving high unemployment and deficits in the peripheral countries but this is paid for with an increasing flow of money from the ECB and creditor nation taxpayers which would require a large degree of fiscal integration and a commitment that Germany will underwrite the debts of peripheral countries; or
- C. A partial or complete break-up of the Eurozone and the re-introduction of independent currencies which can lead to a devaluation for some and revaluation for others, thereby re-pricing labour costs in each country to the correct (market-clearing) levels.

As regards (A), so far, with the exception of Ireland, where there have been substantial wage cuts in parts of the economy, there has been very little rebalancing of labour costs in the zone. Although there is a theoretical commitment in the 2011 “Euro Plus Pact” to reduce central collective wage bargaining and the automatic indexation of salaries, there has been very little real wage reduction. Given that the European labour markets are some of the least flexible in the world with powerful unions and strong labour protection laws (both of which also make productivity improvements less likely), this is not surprising. Instead, the pain is focussed on those people, particularly the young, who do not have jobs at all. As a result, youth unemployment is very high in many countries of the Union, particularly in Spain where it is 46% and in Greece where it is not far behind.

Regarding (B), it does not appear that there is any inclination or political will in Germany to take on the (very heavy) debt burdens of the peripheral countries. The German word for “debt” is “Schuld” which is also the German word for “guilt”, which perhaps goes some way to explaining what Germans think of those who get themselves into trouble by taking on too much debt! In any case, as previously noted, there never was popular support for the Euro in Germany and, especially after the costs of German unification, there is no popular support for a “transfer union” in which Germany would pay the role of permanent transferor.

The reality is that politicians in Europe will do everything they can to support the Euro, but there are some things that they understand their populations are unlikely to accept. Once politicians move away from complex and technical solutions into explicit acts like issuing jointly guaranteed Eurobonds, they become afraid that they (and perhaps the EU itself) will not survive the popular backlash.

The politicians have therefore focussed on trying to solve one of the more pressing symptoms of the problem by attempting to cut government deficits and build bail-out funds to carry governments through the period before they regain their credit-worthiness in markets. But even if deficits are substantially reduced (no easy task in a period of slow growth or recession) it won't solve the basic competitiveness problem.

The current round of treaty negotiations is born out of a belief in Germany that the problem is primarily one of government profligacy in the periphery. In fact, this is not true: Ireland, Spain and Italy all had small deficits before the crisis and the first two had lower debt to GDP ratios than Germany did. The “solution” that is proposed takes no account of the private sector deficits in these countries and does nothing to correct the core competitiveness problem.

Germany may itself perhaps be motivated partly out of guilt as the previous rules that were put in place to keep Euro governments on the straight and narrow (the “European Stability and Growth Pact” adopted in 1997) was relaxed in 2005 after Germany broke the 3% deficit rule several years in a row. Germany unlocked the stable door, the horse bolted and now Germany is trying to fix the door again, but in the meantime the stable has caught fire and is burning down.

The most likely outcome seems to us to be a further period whereby the imbalances remain but some of the symptoms are covered up by the ECB providing cheap money to the region's banks, followed by (C): the break-up or partial break-up of the Eurozone.

The problem for us as investors is working out what the likely timing for this would be and what would be the ultimate effect. It is very difficult to be confident on the timing as it is not clear what a catalyst for a break-up will be.

One scenario is that a government such as Greece or Italy will simply not be able to roll-over its debt and the bail-out fund or ECB is no longer able to prop it up. This would lead to a default which would cause a serious crisis in the European and global banking systems. In this event, the ECB, the IMF and probably the Fed would probably have to step in.

Another scenario is that, just as the Euro came to life by agreement between the political elite, so it may end when they fall out with each other. This could happen with the election of a nationalist government anywhere in the Eurozone that refuses to accept that economic policies should be controlled at a European level. There has been an increase in the popularity of extremist parties throughout the Eurozone in recent years and this is likely to continue - how Marine le Pen does in the French Presidential election may be an interesting indication.

If the Eurozone does break up, it is not at all clear whether the Euro that is left will be a strong or a weak currency, as it is not clear who its members would be (if any). What is certain is that the dislocations, particularly in the form of banks going bust as their Euro denominated assets defaulted would be enormous.

In many ways, it would be better if a break-up happens sooner rather than later as although it will be painful, there are numerous examples in history of countries introducing new currencies and things settle down fairly quickly thereafter. Greece, Italy etc will start to grow again once they have a competitive exchange rate that prices them back into world markets. In this eventuality, anyone who has lent them money in Euros will suffer a significant haircut.

The bottom line for us as investors is that while we do not feel that anyone can predict the fate of the Euro accurately its problems are so deep that we do not believe that it is likely to end happily. Rather, there is likely to be a period of slow growth (which could last for years) caused by exchange rates being too high for many countries in the zone and by government austerity plans, followed by a major dislocation, but the form this takes and its timing are unknowable.

With this threat on the horizon, what are we doing to try to ensure that our portfolio and our investors are as protected as possible? The task is not easy given the uncertainty of timing and the fact that the Eurozone is such a major part of the global economy. However, it is focussing us on four things:

Firstly, we are only investing in businesses with very strong balance sheets. All of our investments have net cash or low levels of debt to EBITA.

Secondly, we are only investing in businesses that have strong market positions. If there is going to be a crisis, we want to make sure that our investments survive and are long term winners in their markets.

Thirdly, we are using cautious growth rates in our valuation models for companies that we are considering, on the basis that the overall economy is likely to be at best subdued for the next few years.

Finally, we are requiring a larger margin of safety (gap between what we believe a business is worth and its current market price) before we make an investment

The effect of these four points is to raise the bar for potential investments to a higher level. The result of this is that we have to look harder to find potential candidates, and are therefore sitting on a larger percentage of cash than we otherwise would expect to (currently slightly over 30%)

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Along with Jonathan Mills, Simon Denison-Smith is the Investment Manager for the SF Metropolis Valuefund. The fund has been set up to make long-term investments in a concentrated portfolio (10-20 holdings) of listed securities using a value-based approach, which draws extensively on the methodologies of Benjamin Graham and Warren Buffett.