

Who will rescue the rescuers?

It appears the brewing 2011 crisis has the potential to be bigger than the Global Financial Crisis (GFC) of 2008. While a systemic US banking system failure appears off the cards today, a new European banking crisis is growing. European bank spreads are now wider than those during 2008. Volatility remained the theme in August, led by Europe's deterioration, and S&P's downgrade of US government debt to AA+ status. All asset classes experienced dramatic price swings over the month:

	Aug 31 Close	Monthly Change	Trading Range
Equities		(percentage)	
Dax(Germany)	5785	-19%	1937
Italy MIB	15563	-16%	4597
FTSE (UK)	5394	-7%	1123
Nasdaq	2580	-6.40%	465
S&P 500	1219	-5.70%	206
Dow Jones	11614	-4.40%	1676
S&P ASX 200	4424	-2.89%	501
Bonds		(basis points)	
US 2 year	0.20	-16	23
US 5 year	0.96	-40	63
US 10 year	2.23	-57	88
US 30 year	3.60	-51	88
Australia 3 yr	3.76	-70	93
Australia 10 yr	4.37	-53	67
		(percentage)	
Gold	1825	12%	309
WTI Crude	88.75	-8%	22.8
Copper	419.9	-16%	4597
\$/A\$	1.07	-2.37%	0.05
Eu/\$	1.44	-0.20%	0.05
\$/JPY	76.61	0.20%	3.46

As the table above displays, not only were risk assets crushed, but volatility hit highs not seen since May 2010. Despite US Treasury downgrade, US Treasury bonds rallied. 10-year US Treasury yields fell 57 bps to historical lows, while Australian bond markets priced in 150bps of rate cuts over the next six months.

The extreme volatility and negative sentiment were triggered by a series of events including:

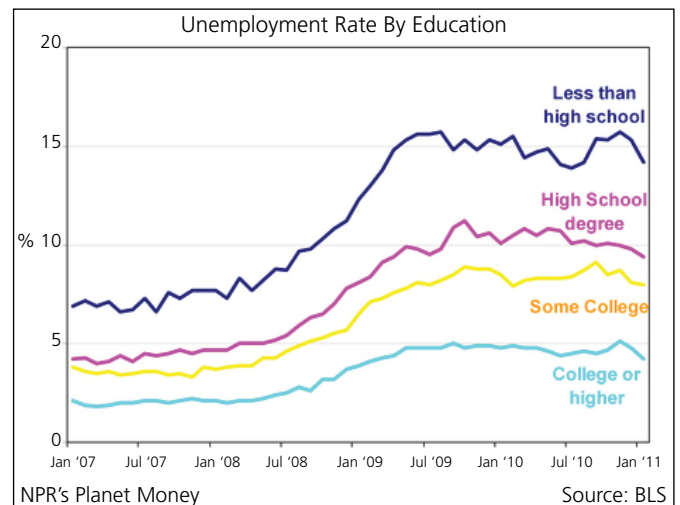
- 1) The US congress waiting until the last moment to temporarily increase the debt ceiling.
- 2) The subsequent downgrade of US debt by S&P.
- 3) Continued economic weakness in the US data (high unemployment, weak housing and weak payroll numbers).
- 4) Continued turmoil in Europe – triggered by widening of sovereign spreads in the peripheral countries, such as Greece, Portugal, Ireland, Italy and now even Spain and France.
- 5) The lack of a clear message from US and European policymakers on plans for tackling high debt and deficit levels.
- 6) Political gridlock making budget measures difficult to pass.
- 7) Decrease in the marginal impact of monetary policy, as the short term rates in most western economies (with the exception of Australia and a few countries) remain at or near zero.

Who will rescue the rescuers?

As policymakers lose control, the question to be asked is who will rescue the rescuers who have so far failed to deliver economic recovery? Ultimately future taxpayers will pay for burgeoning debt and deficit levels. The long-term result will be a painful tightening of belts by all sectors of the economy, an increase in taxes, and government spending cuts by governments in order to start the painful process of balancing budgets and generating growth. While we expect this problem to be many years away, there remains the risk that this process begins too quickly, causing global economies to fall back into a deep recession. Policymakers have a difficult balancing act in both fiscal and monetary policy.

Possible solutions

- 1. Job growth is the key – encourage small businesses to hire by providing tax incentives.**
A local business is more likely to hire local employees. A global business is more likely to be facing competition from global labour pools and hence be more conservative in their hiring. To create domestic job growth, the government should encourage small business job creation through tax incentives for hiring.
- 2. Invest in infrastructure.** After World War II the United States invested heavily in building freeways, schools, airports and other infrastructure to modernise the US economy. 65 years later, much of the US infrastructure needs massive repair. **Give every citizen a shovel in the morning and teach them computers and math in the afternoon.** While this statement is a bit tongue and cheek, in a globalised world, worker skill and productivity must improve. The US education system has fallen well behind global counterparts, especially China and India. By investing in infrastructure, the US can generate jobs to rebuild parts of America. Simultaneously they can further educate citizens to compete with Asia.



3. QE3 should target the home mortgage market.

Quantitative Easing 1 (QE1) in 2008 targeted purchasing of debt and equity in companies, such as banks, insurance, autos and home loan providers to stop global financial Armageddon. QE2 targeted lowering consumer borrowing rates through Treasury bond purchases.

However, today about 50% of US homeowners have negative equity in their homes. With negative equity, homeowners can't reduce their mortgage payments through refinancing, despite the record low interest rates. Even homeowners with positive equity find that banks have tightened their lending standards and find it more difficult to refinance. By allowing borrowers to lower their borrowing costs, policymakers can help put a bottom to the US housing market. A housing market recovery is essential to bringing back consumer confidence.

4. Europe needs both political and economic union.

A monetary union without political union doesn't work. To remain competitive, structural reform – removing labour, regulatory and capital barriers was essential. While Germany and much of Northern Europe achieved great success, much of Southern Europe struggled with rigid labour markets and lack

of reform. Thus, a monetary union doesn't allow weaker countries to adjust for their lack of competitiveness through currency devaluation. While structural reform remains critical, a unified borrowing program (a single Euro Government bond market) as a central authority to facilitate the needs of its member countries may help solve the current borrowing problems of the peripheral countries.

Portfolio implications

1. Expect increasing volatility in bond debt and equity markets.
2. Remain concerned over the formation of government bond market bubbles. In our view governments are borrowing at teaser rates, although this may continue over the year.
3. Government bond markets should be segregated into two buckets:
 - a. the 1 to 5 year maturity bucket which will perform well due to long-term low central bank rates, and
 - b. 5+ year maturity bonds which will eventually underperform as they begin to factor in 'inflationary risks'.
4. Asian economies and currencies will benefit over the coming years, as their economies are in much better shape than the West and might even be used as substitute for 'reserve currency' status by large central banks with huge US dollar reserves.
5. Due to expected high interest-rate volatility, we continue to prefer floating rate assets as opposed to fixed rate assets.
6. Corporates are in much better shape than governments, hence our preference of credit to sovereign debt.
7. Risk assets, including equities remain at risk of a steep correction as economic data will fail to meet expectations. Owning lower quality debt as substitute for equities (preferred, convertibles, Tier 1 and Tier 2 bank capital) makes a case for good risk adjusted returns.