



“ It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest.  
– **Adam Smith** ”

**When economies fall apart, it isn't just the guilty that get punished. Exports make up forty percent of Germany's GDP, so they can ill-afford to go back to a strong deutsche mark. The talk of a Eurozone break up is overdone as the ECB will step in as lender of last resort and buy European debt. In keeping with 'never let a good crisis go to waste', Mrs. Merkel's intransigent stance is to extract the best deal for Germany in a dangerous game of who blinks first. The bottom is not going to fall off the markets in 2012 and US equities are preferred over European equities. Swap lines from central banks will keep the credit crisis in check but high sovereign indebtedness means books have to be balanced; a recession in Europe will follow and our best hope is for it to be a shallow one. As more money is printed, Gold still looks good. China's desire to shift to domestic demand-led growth will be a key decision impacting global markets. It will cut rates and it will cut reserve ratios too and this should engineer a soft landing in China.**

#### **'La dolce vita' has soured**

Why does the world care about Italy?

- After the US and Japan, Italy is the world's third largest issuer of debt;
- Foreign investors hold nearly 46% of the € 1.6trillion Italian debt;
- French banks hold Italian debt worth about one-fifth of Italian GDP.
- US Banks are exposed to the Eurozone through direct claims and CDS (credit default swap) contracts.
- €469 billion of Italian sovereign bonds mature over 2012-14 with €197 billion maturing next year.

So, what happens to Italian debt matters and the role of the ECB as 'lender of last resort' cannot be over emphasized in preventing a crisis which will not only destroy the Eurozone, but cause global misery.

Monday was 'BTP-Day' in Italy, when Italian retail investors rallied to support Italy's battered debt and Italian banks, and purchased government bonds, or BTPs. The next 'BTP-Day' is on December 12. Such days of economic patriotism are not going to lower the bond yields that are in excess of 7 percent to a more manageable 4-5%, but it does underlie the sentiment prevailing in Italy, where, much like other parts of Europe 'la dolce vita' or the sweet life has soured. Italy is now the focal point of this crisis in Europe and the ECB buying bonds is the only way out.

The talk of contagion is now the reality. The Eurozone debt crisis has reached the core as witnessed in last week's failed auction for German Bunds and rising yields

of the triple-A sovereigns such as Austria, Finland and the Netherlands indicate. Yields on Italian debt have reached Euro era records. The ECB has to step in and cap the yields. There's no point in overplaying their 'price stability' mandate, if there is no Eurozone to stabilize! And, when economies fall apart, it isn't just the guilty that get punished.

#### **Sow the wind; reap the whirlwind**

We have seen changes of government in all GIIPS (Greece, Ireland, Italy, Portugal and Spain) nations, austerity, and more commitment to fiscal and structural reform. Fiscal scrutiny and discipline have been endorsed and now there is even talk of agreeing on a legally binding pact to centralize control of national budgets without getting into time consuming European treaty changes. Once this is done, the ECB has to step in and perform its role of 'lender of last resort'. Buying small amounts of European debt on the secondary market is not an effective use of its power to stem a crisis. By leaving it late the ECB risks creating a whirlwind which could become uncontrollable.

A page from history may be helpful to the ECB. Walter Bagehot's *Lombard Street* (1873) provides a great summary of how the Bank of England (BoE) halted history's first modern financial panic. Quoting one of the BoE's senior Directors: "We lent it by every possible means and in modes we have never adopted before; we took in stock on security, we purchased Exchequer bills, we made advances on Exchequer bills, we not only discounted outright, but we made advances on the deposit of bills of exchange to an immense amount, in short, by

every possible means consistent with the safety of the Bank, and we were not on some occasions over-nice [to the borrowers].”

### **Mrs. Merkel, the time to take the plunge has arrived.**

However as they say - never let a good crisis go to waste and therefore Mrs. Merkel intransigent stance looks like a game of who blinks first, an economic version of Cuban missile crisis, in order to extract the best deal for Germany. In this version, Germany will blink first as there is no alternative scenario worth fighting for.

The political will to save the Euro clearly exists in Germany and a rational analysis underpins it— replacing a strong Deutsche Mark with a weak Euro has kept prices competitive in Germany and led to consistent export growth since 1999. Mrs. Merkel gets it, but she seems to prefer to be thoughtful and wait, much as she once did as a twelve year old school girl. At one swimming lesson she spent the entire time shivering at the wrong end of the diving board carefully weighing the pros and cons of the dive ignoring the cajoling of her schoolmates. Only when the final bell sounded did she gather the courage to take the plunge. She later said “I am not spontaneously courageous. I am, I think, courageous at the right moment,” but “led too much by my head”.

She seems to be re-living this now in a diving lesson of a different kind – with slightly higher stakes. Mrs. Merkel, the time to take the plunge has arrived, again.

### **What to make of the markets and where to invest?**

The global economy is not going to fly any time soon, therefore investments that generate yield or income, be it dividends from equities, coupons from bonds or selling volatility via income structured products - are the most prudent ways to invest today..

Interest rate rises are not on the horizon anywhere, anytime soon. Therefore, corporate bonds are still good to hold.

In equities, I continue to prefer US equities. The share of US exports going to the whole Eurozone is 13.8%. The US is not a major exporter, with exports accounting only 10% of US GDP. Therefore, even a pretty severe contraction in the Eurozone GDP should not have too negative an impact on the US.

China's desire to shift to domestic demand-led growth will be a key decision to impact global markets. It will cut rates and it will cut reserve ratios too and this should engineer a soft landing in China.

EUR/USD could stay weak but will ultimately bounce back as the ECB starts buying European government debt and over bearishness gives way. EUR will also find support from actions by European banks to shrink their balance sheets i.e. selling noncore or expensive funding assets (USD denominated) and converting them into Euro.

Gold prices have been volatile as speculators and short term momentum traders make their multiple entries and exits. However, debt cannot be deflated away, only inflated away. Inflation, though not imminent, will be tolerated at a later stage as the monetary base is only going to grow with the ECB joining the Fed and the BoE in 'printing money'. What level could Gold prices rise to? I refer to the numbers crunched by SG (Societe Generale) analysts:

->USD 1900/Oz: To close the gap with the monetary base increase since July 2007, gold would have to rise to \$1,900/oz, assuming full transmission from the monetary base increase to the gold price.

->USD 8500/Oz: If gold catches up with the increase in the monetary base since 1920 (as it did in the early 80s), its price would rise to USD 8500/Oz.

I am bearish on commodities (except Gold) as the slowdown in China is looking more and more likely and a soft landing is the best possible outcome.

To conclude, I don't think the bottom is going to fall off. 2012 will most certainly not be the start of a bull run but plenty of important events – The Olympics, Euro 2012, The French election, US Presidential elections and for the sartorial and those living in 1960s: the fifth series of Mad Men, will bring some cheer. If I were to make one prediction for 2012 it will be that, while the UK may be in a recession, England will win Euro 2012.

On that note I wish you the best for the festive season of Christmas and New Year.

Best wishes



Manish Singh, CFA

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### United Kingdom

9 South Street  
London W1K 2XA  
United Kingdom

### Singapore

One Temasek Avenue  
23-05 Millenia Tower  
Singapore 039192

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