



What we think, or what we know, or what we believe is, in the end, of little consequence. The only consequence is what we do – John Ruskin



The last EU summit was a change from the cul-de-sac policy responses we have had so far. Hopes of an exit to a US TARP-like solution to the European banking crisis were raised but details remain sketchy. The concessions that Ms. Merkel has made are unlikely to be a perpetual shakedown for Germany's cash at every forthcoming summit meeting. Eventually she is likely to pull a Miss Havisham on peripheral Europe's Great Expectations. There have been reports that Ms. Merkel does not expect the concept of Eurobonds to see the light of day during her lifetime. Perhaps then, the Euro is dead, but for the burying. One reason the crisis is dragging on is that there is no incentive (or penalty for that matter) for Germany to resolve the debt crisis quickly. The Euro helps Germany, so it will keep it as long as possible. The sub 50 reading of June US ISM manufacturing number is the clearest sign yet that the slowdown from weak economic activity in Europe is now hitting the US too. The Q2 earnings season is expected to be a weak one. I have a feeling it could be a tough July, like the one we had last summer. It is likely the US FOMC meeting on August 1 could be the point Equities find favor again. If I were on holiday now, I would not hurry back..

Great Expectations

In the Dickens novel, Great Expectations, Pip, an orphan and a young man of modest means worked at blacksmith Joe Gargery's forge and expected Miss Havisham, a wealthy spinster to offer her beautiful daughter Estella's hand in marriage. In Europe the indebted peripheral nations, having lived beyond their means, now expect Ms. Merkel to lend them Germany's strong balance sheet so they can ride out their troubles. Pip remained single and in debt. I suspect peripheral Europe is in for the same fate as Ms. Merkel is likely to pull a Miss Havisham on their Great Expectations.

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Leading into the summit, Italy's PM Mario Monti and Spain's PM Mariano Rajoy (aided by French President Françoise Hollande) started throwing toys out of the pram demanding Merkel make concessions. At the summit, Merkel largely stuck to her guns and made only small concessions.

The concessions that Merkel has made are unlikely to be a perpetual shakedown for Germany's cash at every forthcoming summit meeting. Words are cheap but capital, on the other hand, is expensive and Ms. Merkel will not commit capital as easily as she lets words of compromise slip into EU summit statements. Expect more prevarication and a false sense of triumphalism in the future.

It was the nineteenth EU summit since the crisis began, and let's see what we got; there was no rabbit out of the hat, even though some of the weekend press would have you believe otherwise.

- Debt mutualisation and Euro bonds are still firmly off the table and were not even on the agenda
- The EFSF's loan to Spain of €100bn won't become Senior even when they are transferred to the ESM. However, Merkel made it clear this is one-off i.e. she opposes a lifting of the ESM's preferred status, and rightly so. If weak country banks can prop up their governments, and in turn be propped up by the ESM, this is tantamount to debt mutualisation
- No direct help to banks before a single supervisory mechanism is established involving the ECB (European Central Bank); this will be only by the end of the year. A single supervisor will require large transfer of sovereignty in banking matters. This could become fresh ground for disagreements.
- The total sovereign debt of Spain and Italy is over two trillion. €240bn in usable funds remain in the EFSF that will be transferred into the ESM. The ESM has a ceiling of €500bn. Combine that with the fact that nearly 30% of the ESM's debt is guaranteed by Spain and Italy. The firepower of EFSF/ESM to bailout Spain and Italy is questionable. It looks more like a water pistol than the bazooka everyone wants it to be. And so the crisis drags on...

One reason the crisis drags on is that there is no incentive (or penalty for that matter) for Germany to resolve the debt crisis quickly. The Euro helps Germany so it will keep it as long as possible. It is in Spain, Italy and France's interest to force a solution – either by getting Germany to bear the cost of keeping the Euro or by acting on its threat of a break up.

Political union or bust

Europe is faced with a full-fledged political union or bust.

Centralized control over fiscal matters – taxation and spending- is the minimum requirement to political union and debt mutualisation. Will the peripheral nations give up the control of taxation and spending to a German-controlled European body and carry out structural and labour reforms to become competitive again? I would rather bet on somebody draining out Lake Como using a ladle than bet on peripheral Europe carrying out reforms and agreeing to Germany's conditions for debt mutualisation.

Talking of reforms, let's list what have we got so far:

- Greece has failed to implement many of the structural reforms agreed as a condition of its two bailouts and the new Greek government is vowing not to lay off a single civil servant, despite the previous government's commitment to cut 150,000 jobs by 2015.
- Italy's reform effort quickly ran out of steam the moment the ECB made its offer of LTRO
- Spain offered only a half-baked reform of its banks.
- President Hollande within weeks of his election, fulfilled the electoral promise of lowering the retirement age from 62 to 60

Despite all this, fortified, in equal measure, by European ideology and bureaucratic stubbornness, the EU juggernaut rumbles on, ignoring the reality that separate countries with separate budgets and fiscal management, need separate currencies.

I am reminded of this quote from Churchill - "Men stumble over the truth from time to time, but most pick themselves up and hurry off as if nothing happened." The Eurozone leadership having stumbled upon the truth that a currency union without unified monetary and fiscal policy, and free mobility of labor, is ultimately doomed, they have chosen to ignore this and continue to provide lip service to fiscal and political union.

The banking union that has been proposed will be the test

case for political union. I look forward to discussions Europe will have when they envisage what it will mean for nations and their economies and the relationship they have had with their banks so far. Gone will be the lever to force national banks to lend to local business, or even tax them and regulate them at will. Imagine a scenario where the European regulator stops a large Spanish/Italian bank from making a loan to local businesses on the grounds of poor credit. How will this go down with the people and polity?

Germany has been prudent but it cannot come out scot-free. An EU financial collapse has become a tiger and Germany is now forced to ride it. It's fair to say Germany doesn't want a Euro break up as it clearly benefits the most from it. However, it will not sign a blank cheque for this privilege and impale its taxpayers further. If there has to be a political union, then Germany will set the rules of the game, and if it is not allowed the satisfaction of this, it will have no other option but to take its bat and ball and leave the game.

There have been reports that Ms. Merkel doesn't expect Eurobonds to see the light of day during her lifetime. Perhaps then, the Euro is dead but for the burying.

Equities: I know what you did last summer

We are at the beginning of another summer. At this time last year, the US debt ceiling debate was heating up and eventually the US lost its AAA credit rating. Investors took the opportunity to sell the 29% rally in the S&P 500 index and sought refuge in the safety of government bonds. The US Treasury 10y yield collapsed from 3.18% to sub 2% and the S&P 500 fell 17% in a month starting the first week of July.

What do we have this July?

So far this year, we have had a mini correction (10% in the S&P 500 between early February to end of May), but the S&P is still up 25% since October 2011: a rally kick-started by the LTRO measures announced by the ECB.

However the economic news is getting worse. The June US ISM manufacturing number out this Monday dropped to 49.7; the first time the reading has fallen below 50 in almost three years. A reading below 50 indicates contraction of the economy. This seems to be the clearest sign yet that the slowdown from weak economic activity in Europe is now hitting the US too. New orders – that measures future activity- declined 12.3 points (from 60.1 to 47.8), the steepest decline since October 2001. The Manufacturing numbers in Europe are not better either.

The European PMI (manufacturing index) recorded a reading of 45.1 in May (a three year low). Even Germany's manufacturing number is contracting and so is China's.

The Q2 earnings season starts July 10, and it is expected to be a weak one as analysts continue to lower forecasts for the companies they cover. The Q2 earnings for the S&P 500 are now expected to decline 1.1% versus Q2 2011. Cyclical sectors - Materials, Energy, Consumer Discretionary and Financials have seen the biggest downward adjustment in earnings expectations.

I have a feeling it could be a tough July like the one we had last summer and since the crisis trigger response began. It is likely the FOMC meeting on August 1, could be the point Equities find favor again. If I were already on holiday, I would not hurry back and would extend until the end of the month.

The ECB and the BoE (Bank of England) are expected to renew their easing stance this Thursday. The BoE is expected to embark on a new round of QE (Quantitative Easing) and the ECB is expected to overcome its aversion to 0% interest rates and cut the base rate by 0.25% to 0.75%. However, these monetary responses only address the liquidity i.e. insufficient supply of credit. The problem seems to be that of insufficient demand of credit instead.

My equity bias of US over Europe stays, however given attractive valuations, large cap European Industrial stocks (Alstom (ALO FP), Thyssenkrupp (TKA GY), BAE (BA/ LN) provide good bets too. I have a positive bias to UK and Emerging Market stocks due their central banks' loose monetary policy. A new round of QE in the UK and further rate cuts in Emerging Markets should help these equity markets rally as cheap money creates new bids.

BONDS

With yields at record lows and yield curves very flat, core sovereign bonds do not offer commensurate returns. Besides, any 'risk-on' spurred by short-term policy measures will bring misery to core sovereign bond holders. Therefore, corporate credit offers a better risk/reward. Both US and European investment grade bonds offer a good investment and so does US high yield. The USD-denominated Emerging Market (EM) bonds provide better returns than EM local currency bonds since pressure on EM currencies is likely to stay. The Indian Rupee, in particular, is suffering from policy paralysis and lack of decision-making.

If the ESM's recapitalization of European banks comes to pass, European financial bonds will become an attractive

bet.

GOLD

Like I have said before, Gold is not a trade for one season or one quarter or even just one year. Gold is a secular long trade. Inflexible labor markets, inefficient bureaucracies and unaffordable welfare systems; one or all of these problems plague most of the western nations. Gold is a good trade if you believe the only way to finance burgeoning deficits - to pay off gigantic pension obligations and benefits - is by printing money i.e. devaluing the currency. The US and Europe have promised themselves benefits that they don't create enough wealth to provide. Here is a Link to Germany's pension troubles. Printing money or inflation is the only way out. Gold is therefore a solid investment.

In Q2 despite the volatility, Gold was down just 4.2% while silver, a precious metal with industrial use, lost 15.8%.

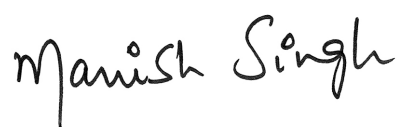
CURRENCIES

The unfinished business in the Eurozone means EURUSD will continue to be erratic. The currency pair will continue to test the upside at 1.28/30 when hope springs eternal and slide to 1.22/20 when it recedes.. A short term Put spread 1.26-1.20 is a good trade. JPY is likely to weaken both due to BOJ's (Bank of Japan) weak Yen policy and the passage of the bill to double the consumption tax (same as VAT) in Japan. I prefer GBP and USD to EUR and CHF. CAD has suffered from weakness in the Oil price but with oil prices well below 100, the fundamental strength of the economy should hold and any building of rate rise expectations should push CAD higher.

OIL

Oil continues to look soft despite the summer season, a period of peak demand. The EU sanctions on Iranian oil kicked in this week and they have given some support to the price. But weak economic data in US, Europe and China doesn't make the case for bullish Oil. Dismal growth projections are the most daunting challenge to commodities in general and USD strength is also known to exert downward pressure on Oil.

Best wishes



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