

# Newsflash: Euro-Decision

7<sup>th</sup> November 2011

Last week, we drafted a briefing outlining the possible outcomes of the proposed Greek referendum on the European bail out deal.

Within five minutes of finishing the first draft, it was out of date! First, the referendum was reported to be cancelled, then potentially back on, before finally being called off over the weekend following a confidence vote in the Greek government.

Less than two weeks ago, European leaders announced what was meant to be a comprehensive solution outlining how they were going to deal with the crisis that had engulfed the Eurozone. Markets reacted with relief, with the FTSE 100 rapidly rose to over 5,700.

Plenty of commentators at the time said that, whilst this was great in theory, the proof of the pudding would be in the eating and there was a certain amount of risk in terms of actually implementing what had been agreed.

Nobody predicted that this “implementation risk” would manifest itself so soon! However, the Greek Prime Minister’s announcement that they would put the deal to a referendum sent yet another shockwave through markets.

The immediate assumption was that the Greeks would vote “no” in a referendum, rejecting austerity measures they had to agree to in exchange for funding. Certainly, austerity measures are far from popular and Greece has been somewhat paralysed by general strikes in protest at cuts already imposed.

However, other European leaders made clear that to reject the bailout deal would be to reject the Euro, and Greece would be asked to leave the single currency.

Leaving the Euro would have major financial implications to all Greek citizens. While leaving the Euro would allow Greece to regain control of exchange and interest rates, UBS predicts the new currency would drop 60 percent. The cost (to Greeks) would be as much as €11,500 per person in the first year outside the Euro and €4,000 in following years.

The Greek Prime Minister backed down, withdrawing his call for a referendum and instead calling for a unity coalition, where both governing and opposition parties work together to pass the austerity measures.

These actions may have resolved the Greece situation (for now), but we’ve always said that Greece isn’t the big issue. Greece is small, it’s problems manageable. Italy, by contrast, is the third largest economy in the Eurozone after France and Germany.

Concern over Italy is growing such that for their government to borrow money from the bond market will cost them around 6.3% over one year. This is a “spread” (or premium) over Germany’s borrowing costs for the same period of 6.05%!

The Italians maintain that, despite a debt to GDP ratio of 120%, they can manage this level of debt. They have a trade surplus, an economy that has been growing at relatively healthy levels, and plenty of wealth amongst their citizens.

However, with interest rates greater than 6%, their debts can rapidly become unmanageable unless steps are taken to balance the books.

The problem is that there is very little confidence in the Italian government (or rather, Prime Minister Berlusconi) to sort this out. This is the man who twice fell asleep during last week’s G20 and had to be nudged awake!

It seems strange to say this, but perhaps the Italians should take a leaf out of the Greek books and form a unity coalition to agree a cross-party plan for dealing with their debt issues. It seems certain that Berlusconi will have to go before any confidence returns to markets. Unfortunately, Mr Berlusconi appears to disagree!

Given all this uncertainty, it is perhaps surprising that markets have not fallen further than they have. The FTSE 100 fell back to 5,421 at close on 1 November, before rallying back to around 5,500 as I write.

If this situation is resolved then we expect markets to continue the rally of last week. We would anticipate a rapid movement if Mr Berlusconi does do the honourable thing and falls on his sword. However, as this saga rumbles on the FTSE could well fall back to around the 5,000 level again.

For our discretionary clients we have recently sold one of the tracker funds we bought at market lows, for a small profit.

This money is now held in cash and if markets do fall back further we may invest this back into equities. We have set a “trigger point” of 5,150 on the FTSE 100 at which point we will review if this is still the right thing to do.

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