# Newsflash:

## 18 August 2011

As I write, the FTSE 100 Index is down 247 points today, a drop of around 4.6%.

Once again, there is very little that has changed since the day before. We have covered our views on markets and economies extensively in the past few weeks. Suffice to say, fears of a second financial crisis (or rather a second part to the same crisis!) refuse to go away.

Rather than address the latest non-news, we thought instead it would be useful to answer some of the specific questions you have raised.

**FEEDBACK AND FEARS**

I and my colleagues have enjoyed many conversations with clients over the last few weeks hearing their views on what is happening and debating the possible outcomes.

Thank you to all of those who have responded to these updates. I am glad they are appreciated and that you find them worthwhile.

Here are a few of the questions we have been asked:

1- Is this the shortest bear market in history or the beginning of Armageddon?

2- Will the Euro implode?

3- If the consensus is that this is a buying opportunity, who’s selling?

4- If Euro bonds are the solution, what’s holding them back?

5- Is this a repeat of the credit crunch? Could things get as bad as last time?

6- How can banks not know how much sovereign debt exposure they have?

The last two questions are perhaps the most important. The credit crunch and the effect it had on portfolio values, is at the forefront of all of our minds.

I will do my best to share our thoughts and answer these questions. Unfortunately, the crystal ball is a little cloudy right now but here goes:

**Question 1) Is this the shortest bear market in history or the beginning of Armageddon?**

I believe that this is a short term market drop and also the beginning of the end! In other words, I believe that in 6 months or less markets will be above 5900. I also believe that this is the beginning of the next phase in the credit crunch.

However "crunch time" may not come until as late as 2013, when many analysts believe is the critical time for multiple sovereign debt refinancing.

**Question 2) Will the Euro implode?**

No! I do not believe the Euro will implode but I do believe that a break up is inevitable. I am convinced that this can only happen when stability has returned and an organised, calm break up can take place over a number of years.

A break up now could lead to a global depression of catastrophic proportions which is not in the interest of any country in the world. Globalisation is too firmly entrenched.

In other words we are all in this together!

**Question 3) If the consensus is that this is a buying opportunity, who's selling?**

Banks! Let's pretend that to keep the regulators happy you have to keep at least £2bn in so called safe assets. You have been given some new freshly printed cash by your government as part of quantitative easing. Adding this to your pot you have £3bn, so you decide to invest the extra £1bn in the stock market or commodities.

Then you realise that, due to exposure to sovereign debt and write downs from the "PIIGS" (especially Greece), your £2bn has fallen to £1.6bn As a result, to top up your required capital you need to sell £400m of equities, not because you want to but because you have to! Imagine every bank going through the same process.

Obviously it's not just the banks but they are certainly a significant player in the current game.

**Question 4) If Euro bonds are the solution, what's holding them back?**

It is not yet politically acceptable for the Germans to bail out the rest of Europe. In the future, as we get closer to the brink, as we realise how interwoven our countries and lives are, then I believe that this will form part of the solution.

**Question 5) Is this a repeat of the credit crunch? Could things get as bad as last time?**

Yes and No! A true politician's answer I'm afraid. Yes, it is a repeat in that the concern is focused on banks and international debt levels. No, because we have already taken a lot of the pain. Companies are in much better shape and I hope that we learnt the lesson from the impact of Lehman Brothers collapse that some things are just too big to fail – and countries are about as big as 'big' gets in this context!

In addition the majority of banks are much better capitalised than they previously were.

**Question 6) How can banks not know how much sovereign debt exposure they have?**

Whilst banks will know how much sovereign debt they own directly they will not know their total exposure. If Bank A lends money to Bank B, then if Bank B has a very high exposure, this increases Bank A's exposure as well! This was exactly the problem in the credit crunch, where banks became afraid of lending to each other. We are back to the theme of being interwoven.

If all banks declare their hands and a few have very high exposure, then potentially it will restrict their borrowing ability and it could lead to further bank bailouts. One as-yet unnamed European bank has already had to borrow
from the ECB at a much higher rate than the usual commercial rate. This implies they could not borrow from other banks.

This is one of the issues that has driven down markets today.

**CORRECTION AND APOLOGY**

I apologise that a major error crept in to our update on 11 August ("Fear, Francs & Frustrations") we incorrectly stated that a cautious portfolio excluding the cash held by clients would have cash of 29%, balanced 22%, and adventurous 20%. These were in fact the total cash INCLUDING the amounts held personally by a typical client.

As we have previously mentioned, we are holding significantly higher cash amounts than usual and the current cash holdings of all our standard models are shown below (EXCLUDING your own personal cash):

- Cautious – 23%
- Balanced – 16%
- Adventurous 14%

**SUMMARY**

I believe that this drop will be short lived but, to pinch the phrase from a previous briefing, the Euro issue will be kicked down the road for a number of years yet.

The phrase "sell in May and go away, come back again on St Ledger day" has never been more true this year.

Roll on September 10th and let's hope for a Santa rally before the year is out!