



Holland Macro Views

What you get if you marry a Quaker

The Euro Crisis is tough for investors but a wonderful moment for other professions as the political decisions being made are laced with self interest and many other biases. We have suggested for a long while that Greece should have been the weak calf whose sacrifice would have made the Euro herd stronger but others it seems will not contemplate this route. As a result and due to a desire for integration and consistency of message at all costs, instead a number of southern European countries look likely to be pushed into a deflationary economic slump. We discuss this below and other issues including how to win money off Lord Wolfson, the trouble with marrying a Quaker and the extent some people will go for a divorce.

At least someone is enjoying themselves

Many investors are having a tough time understanding current European stock and credit markets but any historian or psychoanalyst worth his salt is surely having the time of their lives. The most fascinating bit of economics is when the simple forecasts and models don't work because of the involvement of an altogether less reliable model, the human brain and ego. As political and central banking decisions (and indecision) drive us mad on a seemingly daily basis we should try to remember what in turn drives them. It is rarely perfect logic or unbiased advice we might hope they are receiving but all too often influenced by the personal biases each decision maker possesses. Add to this a few standard psychological traps listed below plus the dreaded committee process and the mire we find ourselves in becomes far more understandable. That is the bad news. The good news is that this is nothing new.

The psychological traps and biases

As the Euro crisis unfolds we list a few of the psychological traps and biases we are witnessing:

- Consistency bias – Evident in nearly all EU politicians and Euro sceptics who have staked careers on either greater Euro integration or its collapse. Neither side being keen to give up ground or lose face now
- Pain aversion – The most basic of all human traits - Avoidance of defaults has been paramount even though a small Greek one would have been logical and likely cleansing
- Herd behaviour – Many others are doing 'X' or agree with me so it must be right
- Failure to consider second order effects – We discussed this in the summer. Most of the market based interventions up to now to 'fix' the crisis have failed to consider the knock on effects they will likely cause
- What would I do if I were a horse? – Less well known trait but common amongst smart people who think that if they would do 'X', logically so would someone else - Arguably Germany's continued expectation of Southern European fiscal rectitude shows this trait at work
- Recency biases – An example will follow

[But this is not as new as we all think](#)

There are likely even more biases at work we have not considered but there are plenty enough above to explain why the path we have taken through this crisis is not as logical as we might have hoped. Those who study economic history and try to predict the future are mostly (and rightly) concerned of the consequences of this flawed thinking and highly political decision making. Clearly the current suggested policy of keeping all Euro nations together but implementing severe and enforced fiscal rectitude may cause severe deflationary conditions on a number of countries, the implications of which we will discuss later on. But before we get too despondent it is worth reminding ourselves that it was always thus; our economic and political histories are littered with the personal biases and short comings of those in charge and their consequences. Examples are plentiful but include President Nixon's decision to leave Bretton Woods in 1971 or further back Henry VIII's decision to leave the Catholic Church. Why? Just so he could get a divorce! Importantly society and economies survived and even prospered despite such decisions. Our job is therefore not to throw up our arms and complain that "it's outrageous" or "the markets are impossible" but to consider what plausible outcomes of current events are and how would we be best to sensibly invest as a consequence.

[Recency Bias - Fighting your own Demons](#)

Before leaving psychology to look more closely at the European problem it is worth considering the one bias we listed on page 1 but did not expand upon - Recency bias, i.e. the tendency to be more affected by events in your recent past. This has arguably been highly evident in both German and US economic policy for some years now with US policy of money printing explicitly designed to avoid another 1930's deflationary depression and German policy being obsessed with the exact opposite – i.e. avoiding an inflationary spiral. That neither the US Depression or the German experience with hyper inflation are in anyway 'recent' events however shows just how ingrained such national fears can be not just at the political level but at the academic level too and consequently the important role they can play in setting the agenda.

Dear Lord Wolfson – An application for your prize

Lord Wolfson via The Policy Exchange has offered a prize of £250,000 for anyone who can solve the Euro Crisis or more specifically how a country could exit the Euro. A greater mind than your authors is likely required for such thinking but we submit the views below nonetheless and have plenty of charities in mind we will direct the winning monies to were they to flow in our direction.

[How did we get here?](#)

Having witnessed Europe's economic development over the last 20 years first hand, we feel too few who seek to solve today problems give adequate enough consideration to how we arrived at this point. We consider this is a crucial omission.

[German generosity](#)

There seems to be a generally accepted view amongst numerous economists and politicians that the current structure of the Euro is in some way unfair because it works so obviously in Germany's favour due to the huge surplus of exports it possesses against others deficits. This rightly suggests that depressed economies cannot hope to export or compete their way out of trouble. But what is now seemingly forgotten is that Germany was the big giver at the start of the Euro experiment, for it was the Bundesbanks' credibility that the whole Euro area benefited from in lower borrowing costs at the time of the EMU/Euro establishment. As a result many, many countries and multiple political leaders over almost two decades have had the benefit of cheaper borrowing costs because they were aligned with Bundesbank credibility. In turn

hundreds of millions of people have benefited either directly, due to cheaper loans and mortgages, or indirectly via the economic growth and prosperity their countries achieved as a result. This was the bright flame that all southern European moths were drawn to many years ago. In all the thousands of hours of commentary on the current EU crisis in recent months this crucial starting point however is rarely mentioned.

A wasted inheritance

Clearly there was very good reason why Greek, Italian or Spanish bond yields were twice those of Germany before the Euro was created as the past economic history of such countries did not warrant lower funding costs in the eyes of those that lent them the money, bond investors. (Does this sound familiar?) By contrast Bundesbank credibility had been hard won over many, many years and all those that became linked to it gained immediate access to the great asset its' credibility threw off – an almost unlimited supply of cheap money. This in itself did not create the problem. The problem was what such countries chose to do with this windfall.

Clearly there were two sides of this euro model when it was established. The lower funding costs made available to all, described above, and the fixed exchange rate which gave Germany (and others) a wider market for goods and services to be sold to. Hindsight suggests to many now that the Germans got the better deal but that was not seen to be the case when Germany was growing at much slower rates than others due to its less consumption orientated economy. That Germany has now seemingly come out of the trade part of the Euro on top is not by some chance or fiddle either, it is by hard work, a focus on efficiency and productivity and most telling the use of cheaper borrowing carefully for productive uses.

This last point is surely the key one. All countries joining the Euro had the same opportunity to compete with each other assuming the starting exchange rate was right, but some used access to cheaper funding and a wider market to progress to greater efficiency (Germany and Slovenia). Most others used low funding costs to borrow and consume more or to build houses they did not need. They also used a European market to build a better safety net around the current standard of living they tried to preserve. Each country's actions were different but we observe most have been strangely consistent with their historic cultural behaviour.

UK + US: The poster children + A challenge for you, but be discrete.

When mid January arrives and thoughts return to the difficult realities of many people's lives take a moment to listen to a taxi driver or the odd person at a dinner party as they discuss their personal circumstances or give their view on the wider economy. See how many people you can find that admit to errors of their own making. There will not be many we suggest. Too many will observe the trouble 'the banks' have caused but too few will accept the personal mistakes they have made. Many, many people borrowed money to either fund consumption or to live in a bigger house than they could ultimately afford. Were banks, regulators and politicians at fault in many Western counties in allowing such a consumer bubble to develop? Yes of course they were, but no one held a gun to average Joe's head and made him take the credit card or mortgage loan, he did that all by himself. Collectively hundreds of millions of people spent money they did not have on the single weak premise that 'everyone else is doing it'.

Southern Europe's own wasted inheritance

Similar forces were at work across large part of Mediterranean Europe. We doubt you will be able to find an honest voice in many of those countries either that says “the Germans did us a massive favour by lending us their central bank credibility and we totally blew it”. Southern European countries could and should have used such an opportunity to invest in more efficient plant, lower the burden of state dependency or promote research and development but too many borrowed and spent when they should have invested and worked harder.

The Hangover

So today we find ourselves in strangely familiar place where arguably many countries are just reverting to type. The current state of Europe is presented as in some way shocking, but is it really? If we look at history – Greeks have rarely chosen to be far away from default, Spanish unemployment was often 15- 20% pre 1995 and the Italians have never played cricket. Why? Because they do not know what a straight bat is! Maybe history will judge the last 15 years as the oddity when many such countries suddenly looked rather prosperous and stable. Consider how each economy would have looked however in those years had they constantly had to prove their metal to bond markets at a national level. They would not have been so prosperous, we suggest without leaning on Bundesbank credibility. In short, like Western consumers, the debtor nations of Europe have over-consumed and spent their inheritance and now it is payback time. This means that regaining recent (pre 2009) levels of growth or employment are likely impossible.

3 Options

The laws of economics give these countries three options and plenty of precedents as to what they can do next: They can stay in the Euro and deliver on austerity properly or they can default and devalue or print money. Printing money leads to devaluation anyway but it also helps to erode the value of domestic debts too as it (hopefully) creates inflation. [Sadly for my submission to Lord Wolfson there is nothing new here, but anyone who tries to claim there is anything new in economics is likely not to be trusted anyhow]. There is clearly a problem with the printing money option as you need to control you own currency to do that – Oops, it seems no one considered that drawback when there were salivating over access to Bundesbank sponsored cheap money!

The mob screams Print, Print, Print

This was the title of recent High Tech Strategist newsletter that captures the current Global and European mood well we suggest. Many countries that control their own currency have chosen the print and devalue option with some success thus far. That markets and debtor nations alike now beg for Germany to endorse money printing shows how far into Alice in Wonderland we have come. This is like being happily married to a Quaker for 10 years and then when your having a mid-life crisis being furious she won't go to Vegas with you! Germany's ethics and economic model are sound and have not changed a bit... neither should they. As a result southern Europeans have a decision to make between devaluation, deflation or many years of austerity and drive to get to a more efficient and competitive position at their current Euro exchange rate. All are in theory opting for the last category but whilst Ireland is making progress in this regards it is unlikely many others will achieve this goal.

A German cheer leader

Readers of the above will see us as German cheerleaders suggesting they have not put a foot wrong. In many ways we are. From a longer term perspective Germany has done many things right; credible central banking, conserving a strong industrial base, fostering a research driven culture and the avoidance of excessive consumerism and debt. Whilst the last point is obvious it should be remembered that the German economy grew at far slower rate than others in the EU, the UK or US when our consumer boom was in full swing. Those with honest, as opposed to selective, memories may remember a few UK or US economists lecturing the Germans on what they needed to do to get their growth rate up to ours! So yes we are fans, fans of sensible, prudent thinking when it comes to long term sustainable economic policies. But...

Germany's big failure

We believe Germany has made and continues to make the one error that is often present in those with a highly logical mind, that of failing to properly consider how someone else with a different perspective will likely act. This was the trait we listed on page one- "what would I do if I were a horse?" The latest EU Crisis summit (No.4 at last count!) brought the prospect of a new treaty with greater fiscal integration. Despite the UK's veto and the important lack of a concrete definition on what fiscal 'enforcement' actually meant one other point was telling. The speed at which all others subscribed to this new treaty.

Some in the investment or political world took comfort from this sign of solidarity and commitment to the closer integration of the EU but the truth is likely far more mundane; Turkey rarely vote for an early Christmas. Countries such as Italy, Spain or Greece that have for decades spent more than they could realistically afford surely should have thought long and hard about the social and economic consequences of such a commitment. The fact they agreed so readily suggests that their current leaders either just played along yet again knowing they will ultimately not comply or they think like many 'in charge' do, that they can be the one to get the voters to see things differently.

Sadly – Real pain is likely for real people

The scale of fiscal cut backs that are going to be required in such countries from a starting point where they are not competitive at current labour rates combined with a high starting debt burden is surely a recipe for lasting slumps and deflation. Importantly in most cases none of these countries (with the possible exception of Ireland) has any history of stomaching such hardship before.

Germany's and therefore the Euro area's current failing, is thus not realising that whatever may or may not be agreed to in a summit meeting or new treaty is meaningless unless it can actually be delivered upon at street level. For decades politicians have passed on the benefits of the Euro to those that elected them such as minimum wage, the shorter working week, the Social Charter and of course low borrowing costs. At the same time they have constantly fallen short on their commitments to Europe on fiscal rectitude and limited debt levels. The perspective on all this surely can be seen by the fact that the Stability and Growth pact, originally designed to ensure the current situation never occurred(!) was signed in 1997 (15 years ago). With the exception of a few boom years that helped balance budgets the German/creditor nations have been seeking greater fiscal discipline from others in the EU ever since. However their partners have always over promised and under-delivered.

So today the Germans are either gullible or very, very smart – gullible if they actually believe others will fulfil the promises made today; or smart because they realise this is the case but are happy to stay in a currency union with such countries just as long as they don't have to guarantee their partner's debts. Two things suggest the Germans are far from gullible. The first is the lack of arrival of any genuine Eurobond and the second is the current usage of the IMF as a conduit for national state bailouts. The reason why the IMF is an interesting route is that the money comes not just from Germany and the IMF has real teeth to enforce the sort of fiscal rectitude that Germany wishes to see its partners undertake.

So what happens next – 2 options?

1. The 'Body' is finally delivered to markets

This is the route we suggested last summer where an expulsion from the Euro was made with a proper default and devaluation (Greece). This option has always been greeted with horror by all concerned but is still seen as quite logical by us. The domino effect could be significant but would have been less so if done 6 months ago and could still be contained if markets really believed other countries would not be following suit. This would create both a possible line in the sand for markets to recover from and also a precedent for those that remain inside the euro to comply with budget requirements 'or else' thus making the Euro more, not less, credible. We did lay out some less expected consequences of this route i.e. that a post-bankruptcy Greece with a depressed currency just might, in a few years, act as an example to others of what it looks like outside the fence. If this then resulted in wider exits and defaults as others followed that would clearly be unpleasant for market losses. This was and remains however the route we think most logical but on current news trends not the one we now expect to take place.

2. The Union survives with some deflation and we get a Patsy or two

Arguably it is feasible for the EU to carry on as it is providing ongoing emergency financing to those that need it with others (say Italy) having to pay current market rates on debt that is renewed. In time debt rates in such countries might ease a little as short term default becomes less expected but overall rates paid by such countries would still likely stay high relative to those in Germany. Equally the IMF might provide funding to some such countries to help them continue in their current form. The clear problem here that we have already discussed above is the application of fiscal contraction on countries that are uncompetitive at current exchange rates, carrying too high a debt burden to start and arguably in need of stimulus not cuts. The result of which is a likely lasting deflationary slump. With this conclusion we could assume that this outcome is unlikely therefore but sadly our earlier consideration of political biases suggests otherwise. Populations could put up with such a slump as they see no other option and believe it to be temporary. Equally their political leaders believe they can deliver the economic miracle of greater competitiveness. What will be fascinating, but appalling, to witness is just how long such populations will put up with such terrible conditions before they hit the panic button electing officials with more extreme views.

This option also has two other problems:

- a) It will always be vulnerable to a change in sentiment of those providing the emergency funding in either Northern Europe or via the IMF. At any point any of these providers could decide they no longer want to play ball
- b) That the markets will see the economic state of such countries and make funding hard for them for some time. Banks have significant lines of credit to businesses in affected countries and without clarity and a credible plan for recovery many such lines might now not be renewed, thus bringing ongoing credit crunch conditions to countries that already have huge economic headwinds

A European conclusion – A two speed Europe

Like others we are disappointed by much of the decision making the European crisis has brought and we think an expulsion would have been a far better route to have taken earlier this year. With a weakened calf sacrificed to the lions we suggest the remaining Euro herd would have been far stronger. That said the status quo is maybe more possible to maintain than some would have us believe. Current Spanish 10 year borrowing costs are 5.2% vs. a range of 3.4%-6% since 2000. French 10 year rates are 3.1% vs. a 10 year range of 2.5%-5%. Clearly these rates are well in excess of both what Germany or the US needs to pay but they are not high in absolute terms and therefore not immediately unaffordable. As such Europe can muddle through with the price of doing so ultimately being paid by those on the streets of Greece, Portugal, Spain or Italy via even worse job prospects.

A Wider Global conclusion (More Bullish) - A least we have a patsy

Our global conclusion for investors however is rather different, unless of course the deflation we have long since worried about finally goes global. When a crisis like the EU one is unfolding all global eyes are on it for fear that the repercussions will spread. Some do, some don't, but if the status quo can be maintained and Europe becomes more accepted as a two speed bloc, the rest of the world may have a lot less to fear than it thinks. Europe's problems could become an old story one day. Interestingly while Europe has dominated the headlines US Employment and housing data has been gradually, but steadily, improving. We are minded as to how such data would have been interpreted in the spring of 2011 when EU concerns were not to the fore and markets were rising. As such the contrarian in us does wonder whether it's not right to be more Bullish.

We have used our poker game patsy analogy a few times before but it is important we think. In world where there is only so much growth to go round currency debasement and money printing can work a lot better if you have someone to steal growth from. The lower and left half of Europe looks like the Patsy.

With apologies and the target rich environment

We have indulged ourselves a little and hope you are still with us. For a long while now we have fished (invested) with a better net, only looking for companies that we think can weather a wide range of economic and market environments and are pleased thus far by the resilience of many of those we have indentified. We persist with this approach, and when doing so globally continue to find a surprisingly long list of companies that meet our criteria - high quality and well managed, priced at modest valuations. This is always the value investing contrarians' dilemma; to invest when others will not. The world, as ever, is uncertain but at the same time fascinating but it also remain in places the 'target rich environment' we observed in the summer.

With Best wishes to all for an enjoyable Christmas

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