

Mirror, mirror on the wall, will the Euro stay or fall?

A view from the RSM Tenon Investment Team

For some time we have zero weighted European bonds and equities in our portfolios due to a fear that the single currency would be the undoing of a number of European economies. This has been a somewhat lonely view until recently!

Our thinking was simple; we had an allocation budget for developed market equities and bonds and we preferred the US to Europe, partly based on historical higher returns on capital in the US and partly on the idiosyncratic risk represented by the Euro.

These days, our view is significantly more widely held and one of the burning questions for investors is what will happen to the Euro?

We will start by exploring how the economies of Iceland and Ireland have reacted to the financial crisis. Both economies held too much private sector debt and had financial sectors which were massively over-leveraged. Looking back we can see that Iceland has done a very fine job of extricating itself from a serious financial mess. The Krona was devalued by over 60% vs. The Euro making the economy significantly more competitive and this devaluation was combined with a draconian austerity plan. The immediate outcome was social upheaval but the longer term outcome is a revived economy:

- Exports and manufacturing activity are growing by over 20% per annum
- Real wages, after declining by over 13% are now growing at over 2% per annum
- Unemployment, which peaked at 9.3% has now fallen to 7.5%
- Interest rates are now at 5.5% vs. The 18% reached in 2008

The contrast with Ireland is interesting. The Government's only option has been to accept the EU/IMF bailout package and to put in place a massive austerity programme. Unfortunately, the Irish Government cannot devalue their currency to make them more competitive, therefore their economy WILL shrink. They simply do not have the economic tools to make the necessary adjustments. The sizes of Ireland and Iceland's economic problems are comparable and the key question is will Ireland have to suffer 60% price and wage deflation due to its inability to devalue its currency? Massive austerity measures without currency devaluation are effectively economic suicide. Will the Irish population be willing to suffer this level of pain to stay in the Euro? Only time will tell.

Remember also that Greece, Portugal and Spain are in similar circumstances. Continued bailouts funded by other European governments will inevitably raise the spectre of German citizens rebelling against the continued funding of their European 'partners'.

Most, if not all of the finance ministers in the 2nd division of European economies are wishing for interest rate cuts and a round of quantitative easing by the European Central Bank. This seems somewhat unlikely however, as the keys to the money printing machine are securely held by the 1st division members of Europe!

So, will the Euro collapse? We think an outright collapse is very unlikely. However, we think that the Euro will not exist in its current form in two - three years time. Perhaps we will have a two tier monetary system or a 'soft' and 'hard' currency system. The clear message, however, is that a two tier economic system cannot operate in a one tier monetary policy environment. We are sticking with our zero weighting to Europe for the foreseeable future.

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