



No instant solutions for Europe

After months of meetings, we appear to be no closer to a clear solution for Europe's debt problems. The hard reality is that there isn't one. In this Point of View, AXA's Chief Investment Officer Mark Dutton dials down the noise to look at some of the potential implications for investors as the world goes through painful adjustments.

It's a case of two steps forward, one step back

Many investors seem to believe that if European leaders get their act together, the world's economic problems can be solved quickly.

It is clear that a solid plan is needed, otherwise conditions will deteriorate further. Therefore it is right for markets to be concerned that political leaders seem unable to agree on a plan. But it is not realistic to expect that any such plan will provide an instant solution. There is unlikely to be a specific point at which we can say the problems are 'fixed'.

Climbing out of the slump was always going to be a very difficult and lengthy process. Progress has been made on a number of fronts, but investors need to adjust to the prospect that the process will include some failures as well as successes.

The priorities over recent months were never about the permanent fix. The key focus has been on containment: measures that will stabilise the system, ring fence the problems in Greece, and avoid an uncontrolled spread to other vulnerable economies.

Markets initially experienced a relief rally in October as new measures were agreed. Over the space of a few days, the global sharemarket rose by 14 per cent, the US market 17 per cent and the Australian market by 12 per cent. In the case of the US, these were the strongest October gains since the early 1960s.

Gains of this magnitude can easily occur any time that steps forward are made, partly because the starting point is relatively cheap valuations.

Even the Australian share market is about 30 per cent cheap relative to long term valuations.

Sharemarkets around the world have very low growth expectations already built into current valuations, providing a big cushion for risk.

Conversely, backwards steps trigger strong sell downs. But setbacks should be expected. Most 'decisions' on European policy initiatives cannot be

agreed at a single forum. They require agreement and ratification in a number of other forums, by member states, and the markets.

Political instability is slowing this process, which is why a range of workable solutions involves a frustrating process of two steps forward and one step back.

Dialling down the noise

It is important for investors to be able to turn down the noise on the blow by blow commentaries and focus on the key issues at stake.

Commentators often talk about a 'financial crisis' and 'economic crisis' as interchangeable terms. They are really two separate groups of legitimate concerns, even though each can impact the other.

Financial crisis concerns

Financial crisis concerns relate to the risks to the global financial and banking system.

To help avoid a repeat of collapses in Europe, the European Financial Stability Facility (EFSF) was set up in 2010 specifically to provide stability for Euro member states.

Recent steps forward have included agreements to widen its scope and increase funding from €750 million to around €1 trillion by extending the guarantees from member states.

This fund is designed to support the borrowing requirements of troubled countries and help the process of recapitalising European Banks.

This type of fund wasn't in place in 2008.

Over the past month, the European Central Bank has also effectively intervened as a buyer in Italian and Spanish bond markets.

Economic concerns

Economic concerns relate to risks to global economic growth.

The western world faces a long period of adjustment from high levels of debt, much of which is now in the form of government debt.





Europe is focussed on government debt reduction through what's being referred to as 'austerity' measures – effectively tightening the belt by reducing government spending and increasing taxes.

The markets are concerned that these measures will also drag the global economy back into recession.

But not all economies are equally vulnerable.

One way of looking at the potential impact to the stronger growing region of the world is through its trade relations with the Euro area.

Figure 1 shows that developing countries with large export markets such as the Czech Republic, Poland and Hungary are likely to feel the brunt of the slowdown in the Euro area. Over 50 per cent of these countries' exports go to the Euro area.

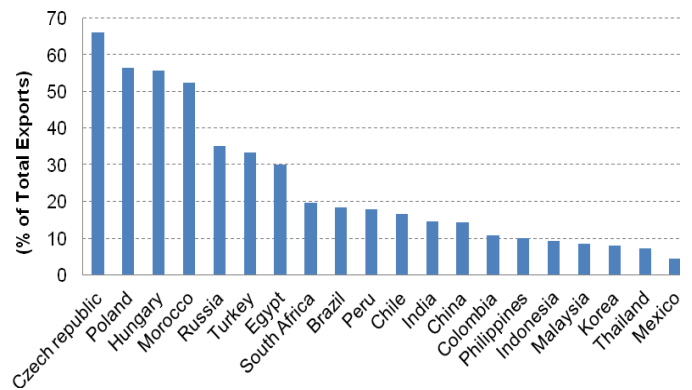
The faster growing Asian economies, including China and India have a lower exposure to a further slowdown in the Euro area, but are likely to still feel a negative impact.

For example, China's export market is around 30 per cent of its economy (GDP), with around half of its exports going to the Euro area.

In contrast India has a small export market. It is less than 20 per cent of its economy (GDP), with approximately 15 per cent of its exports going to the Euro area.

These trade dynamics may provide a buffer for the Australian economy. We sit within the developed world but are also directly linked into developing economic growth of the faster growing Asian region (as shown by our terms of trade) that is likely to hold up relatively well even if Europe slows further.

Figure 1: Developing countries exports to the Euro area



Source: IMF, National Account, Haver Analytics, and AllianceBernstein. Data as of June 2011

Some investors may need to recalibrate their expectations of an all encompassing solution to Europe's debt problems.

Heightened volatility, periods of both 'good' and 'bad' news and even occasional defaults will all be features of the resolution of current concerns. Market valuations already reflect a high level of anxiety towards these issues.

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