

Economic Views for Investors

by Roger Nightingale

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The ECB has turned economics misanalysis into an art form.

For much of the last twelve months, the ECB dismissed claims that the economy of the EuroZone was vulnerable to secular retrenchment. Governor Trichet, full of hubris, was consistently upbeat in his assessments of the outlook. The region had not been exposed to excessive liquidity in the period prior to 2007, he explained. It had not developed imbalances, and had little need therefore to make corrections. Other countries, he implied, were less well placed. Some, the US and UK for instance, might struggle to keep their heads above water. Not so the EZ; it would power serenely ahead.

Its assessments of the outlook are beautifully crafted...

The published data were never consistent with the spoken words, but, for quite a while, financial markets accepted the proposition at face value, lifting the euro in relation to the dollar and sterling. Europe's emergency financial aid would shortly come to an end, it was presumed. Interest rates thereafter would be returned to "normal" levels. The euro would rise by another 10 to 20%!

...but invariably wrong.

That's no longer the view of the consensus. It's accepted instead that the global recovery is faltering, and that that of the EZ is particularly fragile. Recent numbers for retail sales have been shockingly weak and those for industrial production modestly so. Additionally, exports have begun to falter. It's only public expenditure that continues to rise and, even there, probably not for much longer. If the ECB should have its way, state spending will fall and taxes rise.

The EZ is not on the verge of recovery, but on the brink of systemic collapse.

Confirming the picture of EZ debility, the German authorities indicated that the Federal Republic's GDP had stagnated in the fourth quarter of 2009. The modest growth in the second and third periods was a reflection, not of final demand resilience, but of inventory stabilisation. The future was bleak: unemployment was set to rise and sales to retreat; a double dip was on the cards!

Germany is troubled, and a number of smaller countries headed for disaster.

And Germany was the most competitive of the EZ's members. If it were sneezing, others would be succumbing to pneumonia. Indeed, they seemed to be: Greece and Portugal in the lead, Spain and Ireland not far behind. Belatedly, the ratings agencies had woken up to the problem. They were busily intensifying the problem by marking down the creditworthiness of the countries concerned.

Nobody will willingly hold a Greek bond, especially one denominated in euros.

Understandably, the bond markets were in a frenzy. Devaluation aside, international equilibrium in these countries (an acceptably small current account deficit) could be achieved only by years of enervating recession. But that would exacerbate domestic disequilibrium (making the fiscal deficit unacceptably large). It was Catch 22: what ameliorated one problem worsened another!

There is a preference for any other currency—yen, dollar or sterling.

By comparison, the US looked much better: its industry was growing; its retail sales advancing; and its employment stabilising. Unsurprisingly, the dollar has stopped falling and seemed to be about to rise. Once again, Americans had proved themselves better able to handle a crisis than Europeans (or Japanese).

Will the European authorities interpret the signals correctly?

How will Trichet and Barroso interpret these observations? Will they accept that the financial straitjacket they've applied to the European economy prejudices not merely the people's democratic rights but also their material well-being? Will they consequently abandon monetary union and abolish the commission? Probably not.

Very unlikely. But a euro devaluation is coming anyway.

But it is possible that they'll encourage (or not discourage) a euro devaluation. A return to parity with the dollar would be a sensible target. It would make Germany competitive in world markets and it would extend a lifeline to Greece and Portugal.

Equities, meanwhile, will continue their advance.

In any event, the near term monetary outlook is going to be very easy (no foreseeable reversal of QE). Accordingly, asset prices will continue to rise. It's not until the liquidity starts to be abused (late 2010 at the earliest) that we have to worry about valuations. In the meantime, equities will lead the charge. Another 25% is a realistic expectation.

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