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"He who can have patience can have what he will." BenjaminFranklin

A European Germany or a German Europe?

Economies are under pressure and there is a pattern of steady decline in growth prospects and expectations, all of which impacts market sentiment. Greece has voted for the second time and the outcome is interpreted as a vote for austerity and for staying within the Euro. Of course, politicians can move quickly in another direction so we cannot read too much into these particular elections as the possibility of further elections cannot be ruled out.

This seems to leave three options regarding Greece:

1. Greece leaves the Euro and is an isolated case
2. Greece leaves the Euro and currency union collapses across the board.
3. Greece remains a member of the Euro.

The preferred political option for the time being is number three, staying in the Euro, in large part because the impact of an exit is unpredictable in the same way that the Lehman Bros. collapse unleashed a host of unintended consequences. If Greece falls away from the Euro there is no simple outcome that can be calculated: what will happen to other peripheral members of the Euro, how will the European sovereign bond market react, who will suffer the most under the exit scenario (most likely the European Central Bank (ECB) itself as it holds vast amounts of bonds of the weaker members of the unified currency) and so on?

The question on everyone's lips is what form will Europe take as it steps forward from this crisis? Will we see a European Germany or a German Europe? It is true to say that Germany is becoming increasingly isolated having been lobbied publicly by President Obama, David Cameron the UK Prime Minister, as well as the head of the International Monetary Fund, Christine Lagarde, in the last week. The IMF chief urged Euro members to issue debt jointly rather than individually, to shore up the banks and to relax the austerity measures imposed as part of previously agreed aid packages. She said:

"We are clearly seeing additional tension and acute stress applying to both banks and sovereigns in the euro area."

Thus far, all calls for Germany to change course and act as a *"good European"* have fallen on deaf ears as Mrs Merkel, the German Chancellor, has continued to call for reform and responsibility. The cries of *"discipline"* are heard loud and clear and there is the feeling that nothing will cause her to change tack.

Looking at it from Germany's point-of-view it is understandable that the strongest nation at the core of Europe, both economically and geographically, is unwilling to hand over untold sums of money to countries that have acted imprudently. The German people are clearly unimpressed with the approach to life, work and taxes demonstrated in several European countries, especially as Germany is already footing the bill for lavish pension packages and wages in these places! Frau Merkel is taking away the punchbowl and is unpopular as a result but the action is well-intended and necessary.

Of course, the current crisis was born at the very beginning of the Euro project when countries like Ireland joined the party. Ireland, like the UK, had always experienced a higher rate of interest than was usual in Germany. On joining the Euro in 2002 and with interest rates set by the ECB, the property boom ignited and the house building sector became a large part of the economy. As Ireland could not influence interest rate policy set by the ECB, the government could have introduced fiscal measures to contain the boom. However, they did not. It is worth remembering that the ECB could have raised interest rates to temper the boom in Ireland, Spain and elsewhere but chose instead to base its rate policy on the weak economy in Germany. Germany was in difficulty and would have suffered had rates been increased and so rates stayed too low for most member states other than those at the core. Therefore, Germany benefitted at the expense of the long-term stability of those considered to be on the periphery and it is convenient to forget this today. Indeed, the peripheral countries look as though they will always have to play second fiddle to the Nordic bloc and may end-up being controlled by them.

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The former British Prime Minister Tony Blair was interviewed on the Andrew Marr show on the BBC on 24th June and he gave a perfect summary of the situation as of now:

"The only thing that will save the single currency now is a sort of grand plan in which Germany is prepared to commit its economy fully to the single currency. That means treating the debts of one as the debts of all, which is very hard for Germany to do. It means the other countries in the Eurozone need to reform — need credible programmes of reform so that Europe can regain its competitiveness. Otherwise it is quite unfair to ask Germany to pay."

Mr Blair made the point that the current position seems to be all-or-nothing. Either it is all growth and stimulus or it is all austerity. In practice he said that reforms are needed to make progress and austerity measures should be relaxed so there is a healthy mix of growth and reform as European nations move closer together. As with so much in life it is not a question of black-or-white but rather a case of many shades of grey – let us see if this is going to be recognised by politicians.

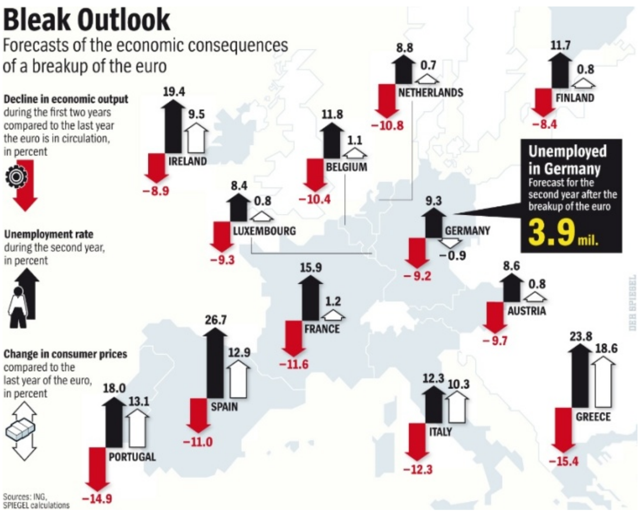
There is a powerful lesson from history regarding debt forgiveness which comes in the form of the Treaty of Versailles, a peace treaty signed on the 28th June 1919 in the aftermath of the First World War and in the shadow of the Russian Revolution. Germany, Austria and Hungary had to accept blame for the Great War and were forced to compensate the Entente powers financially. France pressed for heavy reparations, which were deemed by economists like John Maynard Keynes to be excessive and ultimately unpayable. Nevertheless they were imposed and hyper-inflation ensued in Germany (repaying the debt in full but in currency that was worthless) all of which laid the foundations for the rise of Hitler and eventually the Second World War. Surely the politicians of today cannot be blind to the lessons of the last century? As Christine Lagarde of the IMF said when asked about her suggestions for Europe:

"We hope wisdom will prevail."

What would Europe look like in the event of a break-up of the Euro?

An article in the German magazine Der Spiegel gave a clear view on this question:

1. Economic output collapses across all countries
2. Unemployment shoots higher
3. Consumer prices rocket skywards.



Source: Der Spiegel

Although the pain is not the same for all countries no-one would be spared, not even Germany at the core. If this is the expected outcome of a collapse it seems that politicians have every reason to find an effective solution. Watch this space…

Deflation or inflation?

This is a discussion that continues to rage and also one that offers investors considerable hope in today's markets. We must remember that the biggest gains for equity investors come at the turning point from one condition to the other. Bedlam Asset Management pointed this out in one of their recent bulletins and used the example of the Asian Crisis of 1998 when you could acquire a 5% stake in Astra International, an Indonesian car company, for some US$6m. This stake is now worth US$1.5bn! The message is that there are good quality companies out there that have cash on their books and will come through the current turbulence stronger than before. Indeed, the SUNARES fund saw a big recovery from the 2008 crisis by concentrating on quality, something that we continue to do.

Although the Federal Reserve have not yet pushed the QE3 button they have left the door open for them to do so. In early June Janet Yellen the Vice Chair of the Fed said that it is crucial to stay ahead of the curve of actual events to prevent problems from developing. She said:

"It may well be appropriate to insure against adverse shocks that could push the economy into territory where a self-reinforcing downward spiral of economic weakness would be difficult to arrest."

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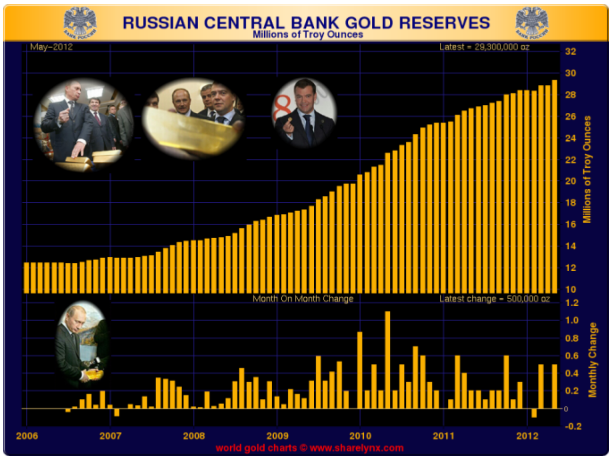
In fact the Fed chose to extend their *"Operation Twist"* by US$267bn. This policy sees the Fed reduce its holdings of short-term debt and then purchasing long-term treasury debt and thereby keeping down longer-term interest rates (another example of state intervention in our free market and capitalist system!).

Chairman Bernanke did say: *"he was prepared to take further action as appropriate to promote a stronger economic recovery and sustain improvement in labour market conditions".*

We should also remember that monetary policy is already highly accommodative with rates set to stay low for years to come…

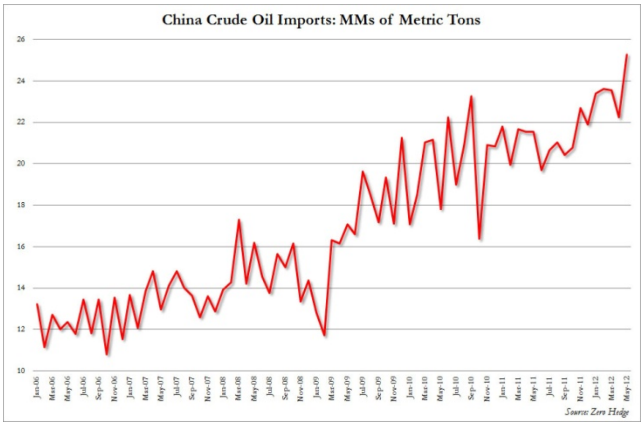
What are the Big Players doing?

Amidst the political confusion what is really going on? One thing we can say with certainty is that Russia continues to accumulate gold and we know this because they update their holdings every month. The following chart shows the latest picture:



Source: Casey Research

It is a similar picture for China as confirmed in the record gold imports from Hong Kong in April. However, China is also pressing ahead with purchases of oil and bought nearly 6m barrels of oil per day in May, an increase of 10% over April's level. They paid expensively compared to the current market price with an average cost of US$120 per barrel, but possession of the commodity is worth more to China than a profitable paper holding. This confirms that China and others continue to reduce their holdings of US dollars in favour of useable alternatives.



UK Banks and Undeclared Losses

A recent study of the top 5 banks was conducted by a group called PIRC – a shareholder advisory group. The purpose was to look at the losses that the large banks expect to realise but have yet to recognise on their profit and loss account. The results are staggering. Royal Bank of Scotland (82% government owned) estimates losses at £18bn, or around one third of the capital buffer and which could force the bank to go back to the shareholders (taxpayers) for further money. Not all is well over at RBS.

Overall the top 5 banks have some £40bn of undeclared losses. The losses are not provisioned for as they would have been under prudent banking rules that existed up until new international accounting standards that were introduced in 2005. These rules do not allow provisioning for losses. This means that reported profits are over-stated, as are bonus payments to workers and dividends paid to shareholders. Under this system there is no incentive to recognise and clear losses and this means that balance sheets stagnate.

The financial sector is still one to avoid.

Index-linked bonds in the UK

For bond investors who have sought protection from future inflation, index-linked bonds have been the instrument of choice for many. However, there are changes under consideration that would change the way in which inflation is measured for these bonds.

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Currently there are two measures of inflation that are officially recognised and of course the plan is to try to move towards the lower of the two measures. The investment house M&G have been particularly vocal about the proposed measures:

"Holders of some UK index-linked gilts could see more than 40 per cent wiped off the value of their bonds, according to M&G Investments, as a result of technical changes to the way the retail price index, which underpins these "linkers", is calculated.

The mooted changes are designed to eliminate "unjustified" causes of the persistent gap between inflation as measured by the RPI and the normally lower consumer price index, narrowing the "wedge" between the two measures by altering the way the RPI is calculated. Some industry figures believe the gap between the two measures could be eliminated entirely."

"To eradicate the wedge altogether would be tantamount to an event of default," said Ben Lord, portfolio manager at M&G.

Gold Stocks

It has been strange to witness the performance of the gold stocks against the back-drop of the banking and sovereign debt crisis as we have been right in thinking that financial stocks are a dangerous place to be invested.

Euro Stoxx 600 Banking Index
Source: Bloomberg

Greek banks have seen huge withdrawals of cash deposits thus draining the banks of much-needed capital and liquidity. This forced Greece to go cap-in-hand to the ECB to receive billions to prevent the banking system from failure. Spain is now in the same situation with Bankia needing to be bailed-out despite claims that all was well. Spanish depositors have been quick to catch the Greek mood as they too have taken money out en masse. Fernando Jiménez Latorre the secretary of state for the economy tried to calm the situation by saying:

"It is not true that there has been an exit of deposits at this time from Bankia… there is no concern about a possible flight of deposits, as there is no reason for it."

Of course, within the space of a few days the bank received Euro19bn to prevent outright failure. It reminds us of Sherlock Holmes in *"A Game of Shadows"*:

"Has all my instruction been for naught? You still read the official statement and believe it. It's a game, dear man, a shadowy game. We're playing cat and mouse; cloak and dagger."

The official line certainly has to be taken with a very large pinch of salt these days and very often the words of support given are exposed in quick time as being entirely false.

None of this has come as a surprise but it certainly has been disappointing to see the precious metals and their respective mining companies perform poorly against this back-drop. Nevertheless, it is our view that this will come to pass and gold and silver mining companies along with the metals will be seen as a haven of value for investors. There are the first signs of this coming in the wake of the Facebook IPO since when gold and silver shares have moved up, with the gold bugs HUI index ahead by 16% since then. If we go back to the 2008 crisis, precious metal stocks were the first to recover whilst the rest of the equity markets only moved higher 5 months later in March 2009. By then gold stocks had already moved up 50%.

Source: Bloomberg (HUI index – black, MSCI world – orange)

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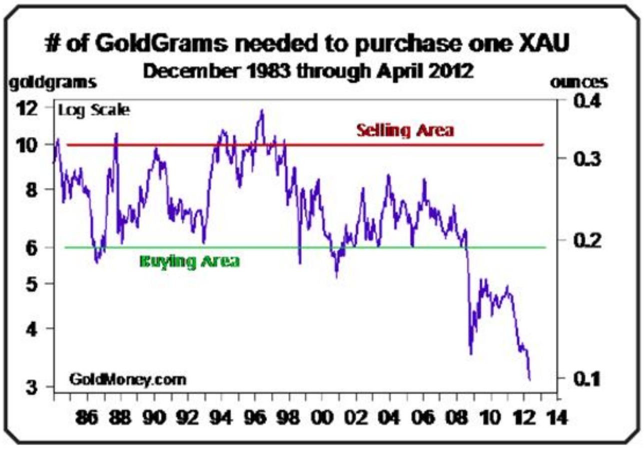
It is also worth remembering that gold shares are valued at incredibly low levels when measured against the price of gold:



SOURCE: JAMES TURK

The financial sector is in turmoil as expected by us and it is a matter of time before we see further easing of monetary policy, printing of money (QE) and so on. It is, therefore, in our opinion also a matter of time before the precious metal sector enjoys renewed strength.

"Patience is bitter, but its fruit is sweet." Aristotle

With best regards from your SUNARES team,

Colin Moor