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BEYOND THE EURO CRISIS
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Financial markets have always had a fixation with short-term news flow. Indeed, the endless stream of headlines about the eurozone crisis in recent weeks has been deafening, leading markets to gyrate between panic and euphoria, often in the same day. Each month seems to bring the same question – are we nearing a "grand solution" that will finally stem the rot?

There can be no doubt that the current crisis represents a transformational event in economic history. Undue concentration on daily developments, however, can leave investors blind to the longer-term opportunities and threats. The legacy of this crisis will be felt for decades, irrespective of upcoming policy responses. Policymakers can influence the depth and duration of the pain that will be inflicted, as well as dictate how the burden will be shared by different groups. They cannot, however, make the pain go away. Investors must realise that the rules have changed, and that they have changed for good. Some key take-aways include:

1. Growth will be slow for a very long time. Many developed economies are simply not competitive and structural impediments will preclude a rapid recovery;
2. Weaker economies need to leave the euro or accept a lower standard of living. The poor will get poorer;
3. Slow growth and high leverage will lead to periodic recession fears. The accompanying volatility will present a need for more pro-active asset allocation;
4. The European Central Bank will ultimately need to adopt reflationary tactics; these periods may be good for risky assets even as growth remains subdued. Currency is one of the few remaining policy tools and currency volatility will continue on its upward march;
5. Short-term interest rates are going nowhere fast, and so the search for income will strengthen;
6. Negative real interest rates do not equate to low risk – there are no risk-free assets remaining.

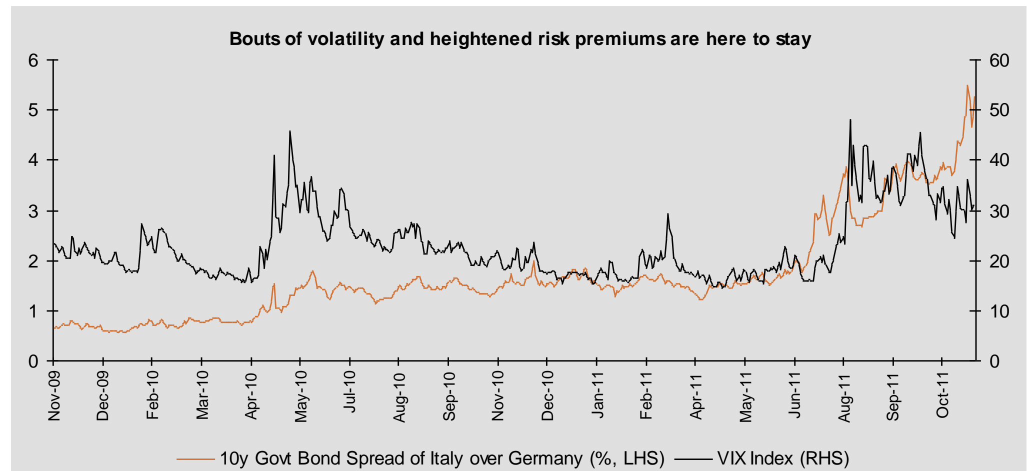
What are the longer-term implications of the crisis? Even if the immediate threats of disorderly default and financial system contagion are averted, deeply entrenched problems will ensure a below-trend recovery. Much of the eurozone is structurally uncompetitive. In fact, the current crisis is merely a symptom of the toxic combination of too much debt and a lack of competitiveness. There are no solutions on the table that adequately address either of these root causes. This competitive disadvantage is a key impediment to the wider recovery in Europe and, in the absence of currency flexibility, can only be addressed via an adjustment to a lower standard of living as real incomes fall and a greater proportion of income is directed to paying off debt.

Higher political risk premiums

Such an adjustment will take time, it will be unpleasant and, as we have already seen, it has the capacity to cause significant social unrest and political instability. One important legacy will be persistently higher political risk premiums attached to over-levered markets.

One way of levelling the competitive playing field within Europe would be for weaker economies to exit the euro. This had never been mentioned as a possibility until late October, but the Greek government's suggestion of a referendum on the subject has broken the taboo. Even though the referendum plan has subsequently been withdrawn, the treaties that frame euro membership are no longer sacrosanct. This

opens a wide range of possible outcomes over the long term. Markets hate uncertainty, but they are going to have to learn to live with it.



Source: Datastream, Bloomberg

With or without Greece, eurozone policy must change. The European Central Bank will ultimately be forced to alter its DNA and become more like its US and UK counterparts. We are already into the second wave of quantitative easing in the UK; the US has completed two phases and may well embark on a third. The ECB is genetically opposed to such reflationary tactics but the reality is that the whole of the developed world needs inflationary policies to offset the deflationary effects of deleveraging. The alternative is nothing short of a break-up of the eurozone.

Currency volatility here to stay

The new ECB chairman has already cut interest rates back to 1% and is likely to follow up with more cuts. As far as investment strategy is concerned, the growing global acceptance of printing money as a policy tool has seen currency moves and currency volatility gain importance as sources of alpha. This trend is likely to persist over the medium term.

Meanwhile, as deleveraging works through the system, growth will remain low and economies will periodically flirt with recession. Low growth, high leverage and sporadic fears of recession will create a recipe for volatility. The coming years will see strategic investors generate more of their return from asset allocation, both within and between asset classes. Coupled with timely changes to the regulatory background, persistent market volatility is likely to herald a golden age for flexible multi-asset investing, for both absolute and relative returns.

Search for income continues

In a world of low growth, short-term interest rates will remain close to zero. Indeed, developed governments cannot afford to raise interest rates with debt levels so high. In this low growth, low interest rate environment, the search for high income with low risk will be a defining theme of the next decade.

The beneficiaries of this theme will depend on investors' definitions of risk. To date, the risk aversion trade has lent support to core government bonds. However, with yields well below the rate of inflation in the US, UK and Germany, these bonds can hardly be seen as a source of attractive real income. Indeed, what many investors have identified as "low risk" investments may actually turn out to merely be an efficient way of locking in negative real total returns. Investors who classify core government bonds as low risk investments in this environment are guilty of mistaking low volatility for low risk.

The likelihood of government bonds producing negative returns will be magnified if QE works and inflation takes hold. The notion of inflating away a country's debt is attractive to some, but it can be difficult to pull off in practice. Inflation can quickly become a problem – especially in an era when the risk of policy error is high – and inflation scares may become a regular feature as the cycle matures in the coming years.

Bond market pariahs

Should inflationary fears escalate, it will be an easy leap to higher yields, rising default risk and a buyers' strike. We have already accepted that it is no longer safe to assume there will always be demand for some countries' bonds; the next decade is likely to see the list of bond market pariahs lengthen unless policymakers step up their game.

Which asset classes will investors turn to as they search for income without exposing themselves to excess risk? High yield and emerging market bonds arguably offer greater transparency and a better risk/reward trade-off than government bonds, and both are therefore likely to continue to be well supported. Shares in large-cap, high-yielding companies with strong balance sheets, robust cash flow generation and proven capital allocation strategies are also likely to be in demand. Emerging companies are cash rich and increasingly appreciate the need to return this cash to shareholders. Mirroring the multi-asset approach for total returns, investors will look for flexible products combining all of these sources of income.

In summary, short-term developments are unusually difficult to predict at present. Some aspects of the longer-term picture are also highly uncertain, but there are other aspects of the world after the eurozone crisis that we can start to map out. It is a world of serious challenges, but one that will be rich in opportunity for flexible investors.

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