

Play it safe in challenging Europe

By **Stirling Larkin**

EUROPE is different and Australian ultra high net worth investors know why.

These investors are acutely aware of the difference between growth and thus inflation between the “real economy” and asset prices and have learnt, through experience, not to confuse the two.

This experience was gained while investing in the “Japanese Miracle” between the 1970s and 90s.

Through these journeys, it became abundantly clear that inflated asset prices, over time, distorted investments and all forms of annuities and thus - detrimentally eroded both real and absolute returns.

Australian Ultra High Net Worth (UHNW) investors recognise that Europe is different from other global markets in 2014 and therefore do not want to be caught in the same beartrap again.

This is because even though eurozone equity, debt and credit markets appear buoyant, they are incommensurable with the likes of the US, Britain or even Japan, where the underlying real economies are not only on the mend but on the rise.

The announcement last week by the European Central Bank of their own unconventional monetary stimulus program — known as “quantitative and qualitative easing” or “QQE” with the sobriquet of “Draghinomics” — albeit a positive step forward, is being viewed by many astute global UHNW investors as simply window dressing and wasted gunpowder.

This is because it is thought that such stimulus — unlike that seen in the US or Japan — will have limited or no effects on the real eurozone economy and therefore add little to investment returns in the years to come.

QQE is designed to provide more credit for the private sector. However, unlike the US or Japan, banks, rather than bond markets, dominate the provision of credit in the eurozone and therefore its efficacy in this regard is questionable.

“Quantitative easing” or “QE” had some success in the US because it aided the American economy by lowering the corporate borrowing costs — seen as a positive for employment, productivity, economic growth and business confidence.

This was accomplished by the US Federal Reserve buying Treasuries and thereby “crowding” that market. This crowding naturally pushed down Treasury yields and thus drove investors to corporate bonds where, not surprisingly, bond prices went up, meaning that those yields dropped too.

This experiment would be different with QQE in the eurozone and would have far less effect on corporate borrowing costs there.

As discussed previously in this column, Australian UHNW investors also diligently seek out excellent advice and this advice would alert them to what happened when Europe last experimented with unconventional policies during the early 30s.

During the depths of the Great Depression, when countries including Australia abandoned the gold standard and rigid monetary mechanisms, they immediately achieved competitive devaluations and found rapid recoveries in their real economies.

The sooner countries left the gold standard, the sooner industrial production bounced back.

But, of crucial importance, what was learnt during this experiment was that those countries that adopted unconventional mechanisms the earliest — in this case abandoning the gold standard — were the countries that reaped the most gains from such actions in the years to come.

Each subsequent country that followed enjoyed a discounted benefit and reduced yield.

Stepping back into 2014, what this means is that “Draghinomics” is very late to the party and may be successful in inflating eurozone asset prices in 2015 but will have limited benefit, if any, to the real economy in Europe, which is, without question, in serious trouble. This continued and deep trouble has large implications for Australian investors as well.

As we've been discussing since the "Grexit" crisis of 2012, investors need to remember that China needs Europe, the US needs China and Europe, and ultimately, Australia needs everybody.

Without a solvent eurozone, China and the US become hamstrung, which would inevitably mean that they would have to stimulate their economies further, which would include continuing to keep their currencies artificially low. This has been referred to as the "currency wars".

These overseas currency wars are the major contributing factor in the currently resiliently high Australian dollar and any long-term continuation of such forces can only be bad for our currency and economy within the global mix.

Australian investors who would like to participate in the expected inflating eurozone asset prices but not necessarily be stung by the asset-economic real value gap may like to look at eurozone-core investment-grade corporate credit investments over multinationals such as BAE Systems, Daimler or Koninklijke.

Eurozone-core in this context refers to Germany, The Netherlands, Belgium, Finland and Luxembourg.

For those who can weather a bit more volatility and are willing to sit higher on the "risk hyperbola", equity market trades that are heavily concentrated on eurozone output-driven economies, such as Germany, may be worth exploring and examples include Roche (ROG.VX), Wienerberger (WBSV.VI), the world's largest producer of bricks, and Fraport (FRAG.DE), which is Frankfurt Airport's global logistics service.

And for those who wish to combine venture capital with higher-yielding exposures, they may even wish to explore investments linked to the "EuroStoxx Global 3D Printing Tradable Index" (STG3DPP) or alternatively, the "VDAX-NEW 1M EUR", representing the Deutsche Börse's volatility index.

It is important to acknowledge that Britain is an anomaly at the moment, with the Scottish independence question yet to be answered.

Even though this author has the most Celtic name in existence he takes no pleasure in the thought of Scotland seceding and possibly then causing even more uncertainty around the European experiment.

The lessons learnt by Australian UHNW investors should be heeded by all. When considering eurozone investments within our global asset allocations,

remember first and foremost that high and rising asset prices today, over time, don't necessarily guarantee attractive real and absolute returns tomorrow.

As the eurozone and European Central Bank remain stuck on the horns of a dilemma, ensure before anything else that our investments may be sitting on that bull but aren't the actual matador.

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