GERMANY'S GOT IT COVERED

David McWilliams, 9 May 2014

"Don't worry about the tab, Germany has got it covered, have another for the road, why don't you?"

European bond and equity markets are booming.

Bond yields are pricing in little or no risk in countries that can neither balance their books nor pay their way and whose living standards continue to be rented not earned. Despite rising public debts, falling consumer prices, historically high rates of unemployment, dodgy banking systems and zero bound growth rates, investors are rushing to lend at ridiculously low rates to countries that have no viable way of paying this money back.

These countries are locked into an exchange rate brace where their industry simply can't compete with German levels of productivity and capital investment. German dominance of European industry is structural now – a function of decades of current account surpluses.

In the rest of Europe, due to highly efficient trade union movements and large public sectors, when economies slump, wages don't fall – as you might expect. What actually happens is that the insiders (those with permanent jobs and a stake in the society) protect themselves and the people who pay are the outsiders (those in the fragile private sector, on part-time contracts or on the dole).

This split between insiders and outsiders is precisely what we are seeing in Europe. Interestingly, it is an unstable status quo that the two big interchangeable political blocs in Europe – the "Statist Left" in power in France and "Corporatist Right" in power in Italy and Spain – are happy to preserve. Such an outcome leads to economic sclerosis.

As unemployment rises, those in work get worried about the future and they stop spending. Retail sales fall back and the savings ratio rises.

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Given that even in an open economy, most of us are employed in the domestic sector, your spending is actually my income and my spending is your income. My income is also the root of my savings. But as Keynes observed in the paradox of thrift, if we all save at the same time, who is spending? And if no one replaces our spending, then demand and income will fall and fall.

European retailers react to falling demand by cutting prices to coax the people to spend. But the very fall in prices convinces people that prices will fall further and the bargain will come next month or next year. The very act of reducing prices repels demand rather than stimulates it. So the laws of economics are turned on their heads. When prices fall, demand doesn't go up, it goes down. This is why we are now seeing deflationary pressures in the big three – Spain, Italy and France.

In a high debt environment such as pertains in Europe, the dynamic of falling prices and heavy debts causes the debt to income rate to rise not fall (even in countries which are trying to pay back debts) because income is falling faster than the rate at which debt can be repaid. These almost counter-intuitive forces are exactly what Irving Fischer outlined in his seminal 1936 thesis of debt deflation. This is being evidenced in the fact that despite five years of austerity, debt to income ratios all across Europe are rising not falling.

This insidious process, in turn, leads to a liquidity trap where the private sector has too much existing debt so companies and punters don't want to borrow and the banks have too much outstanding bad debt so they don't want to lend. We are seeing this development in the constant collapse of bank lending across the continent.

Politically, these developments will play out in a large protest vote in the European parliament elections in a few weeks' time. All sorts of fringe parties of varying nationalist hues are likely to make significant gains.

So if the economies are so fragile, why are markets – both equity markets and bond markets – so strong?

The reason that yields are falling and valuations are surging is that that there has been an Italian coup d'état at the top of the ECB. Mario Draghi is trying, if needs be, to allow the Euro to turn into the Lira behind the backs of the German people. The Euro would already be much weaker if it weren't for the fact that the US has been printing even more than Europe.

In his new Euro venture, Draghi has the full backing of Mrs Merkel and the German industrial establishment. Even the German constitutional court has thrown in the towel.

Ever since Draghi's commitment to do "whatever it takes", markets have assumed that this expression means European debt financing through the back door. If you believe this, then you are assuming that in the end, Germany will pick up the tab and money will be printed hand over fist. A recent historical points of reference should be a version of Bernanke's QE which, if deflation continues in Europe, will morph into a bureaucratic form of Japan's Abeonomics.

The European QE programme will inject more money into the economic system and, in so doing, will drive a wedge between the actual performance of the European economy – which is weak and risky at best – and the observed performance of the continent's financial markets, which are behaving as if the Eurozone economy is strong, risk is minimal and everything is rosy.

The prospect is helping to push European asset prices – both bonds and equities – way above what is justified by the faltering performance of the underlying economies.

It would be a mistake to think that all this must come to an immediate end and bet the house against the European asset boom. Remember Keynes' observation that *""markets can remain irrational a lot longer than you and I can remain solvent".*

Something will give and when it does we will have a Minsky cycle that would make Kindleberger blush, but that might not be tomorrow or the day after.

For now just remember, Draghi is embarking on a voyage that could last years not months and in the end, for everything to hold together, Germany will have to pick up the tab.

What are the risks?

– The value of the fund and any income from it may go down as well as up, so you may get back less than you invested

- Past performance cannot be relied upon as a guide to future performance
- The ongoing charges figure is charged to capital, so the income of the fund may be higher but capital growth may be restricted or capital may be eroded
- The fund may invest in other transferable securities, money market instruments, warrants, collective investment schemes and deposits – some of these security types could increase the fund's volatility and increase the level of indirect charges to which the fund is exposed
- The fund may invest in overseas securities and be exposed to currencies other than pound sterling – as a result, exchange rate movements may cause the sterling value of investments to decrease or increase
- The fund may invest in unquoted securities, which may be less liquid and more difficult to value, because they are generally not publicly traded – the lack of an open market may also make it more difficult to establish fair value

Important information

Before investing, you should read the Key Investor Information Document (KIID) for the fund, and the Prospectus which, along with our terms and conditions, can be obtained from the downloads page or from our registered office. If you have a financial adviser, you should seek their advice before investing. Woodford Investment Management Ltd is not authorised to provide investment advice.

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