May 2012 Alvine Capital Newsletter

May Newsletter—all eyes on Germany to decide the future of the euro

There are longer any 'taboos' Angela Merkel (source The Times 1/6/12)

Key issues—once again the simmering euro crisis has blown out into the open. France's new president has put his weight behind the cry to temper Europe's austerity path.

Key recommendation---investors should follow closely the unfolding politics within Germany so as to better understand the fate of the euro, and indeed the world economic cycle. Appetite for 'liquidation' is unlikely to prevail with some sort of serious softening of the current tough fiscal stance. Further mass monetisation of debt is inevitable.

'All treatises between great states cease to be binding when they come in conflict with the struggle for existence' - Otto von Bismarck (source Brainyquote.com.)

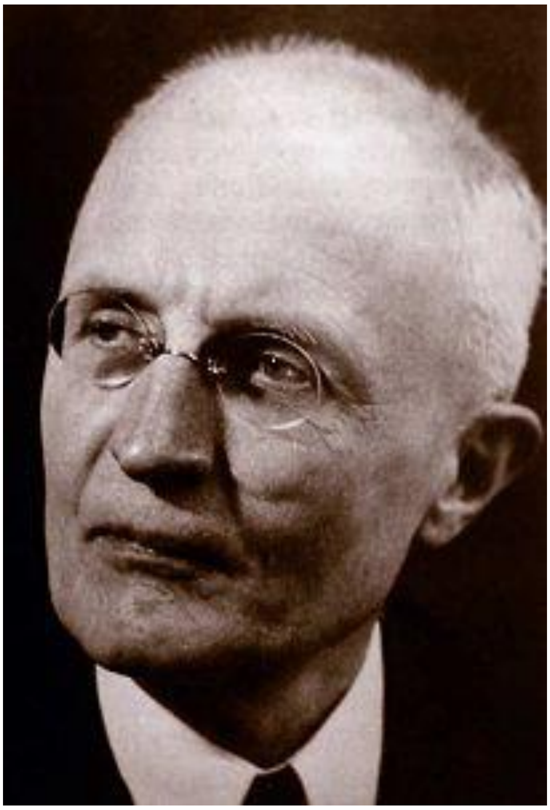
For citizens of the modern western world it is still difficult to imagine the sort of *armed conflict* that the great German statesman was alluding to. However, in our era it is no longer hard to visualise serious economic hardship and indeed western government defaults. Current events in Greece should act as a clear warning to our leaders as to how out of control developments can get.

The election of Francois Hollande decisively altered the balance in Europe, banishing 'Mercozy' along with austerity as the only policy. All eyes now rest on the German response. Drawing on its social market history, and understanding of just how deeply embedded all the participants of the euro zone are, policy is likely to stand back from the brink. **Europe needs further central bank support.**

German history—the powerhouse emerges

When the industrial revolution emerged in the 19th century, Germany was still a rather backward place of city states dominated by artisans and craft guilds. As the country unified over the following years, particular strands of public policy forged a clear path to form the modern economic state.

Walter Eucken and the Freiburg school



‘The intellectual architect of West Germany’s post-war economic miracle’ (source Acton Institut)

Much of Germany’s success as a modern economy was forged in classic capitalist ideology. The Christian Democrat party that dominated the immediate post-war years, needed to make the case against the very obvious example next door of the DDR, against the state direction of the economy.

So the obvious hallmarks of private property - free market openness, the rule of contract law - were to be adopted by the government at Bonn. This Germany envisaged for the state to play a stronger role. Adoption of anti-monopolistic rules could be coupled with a strong minimum wage or an incomes policy should the need allow. This was part of the German tradition of *Staatswissenschaften.*

Driven by Eucken’s strong Christian beliefs, there was acceptance that free markets could give expression to man’s desires but they were best channelled by rules and regulations.

‘In the competitive order Eucken conceived, the state plays a substantially stronger role than in Hayek’- Dr Harald Hagemann (source University of Hohenheim website.)

Monetary nightmare—hyperinflation still haunts

'Stable money is a precious public good. It protects savers and income earners from the erosion of wealth while promoting growth and employment' Bundesbank (source Bundesbank website.)

Any analysis of German attitudes cannot be complete without reference to the horrors of the 1920's.

'It's a bedrock principle, based on history' - Jeffrey Fear Professor of business administration the University of Redlands (source Bloomberg.com 6/12/11.)

The builders of modern West Germany forged the monetary policy with these memories still very fresh in their minds. It is also true that the country's investment- led success was buttressed by this very sound money.

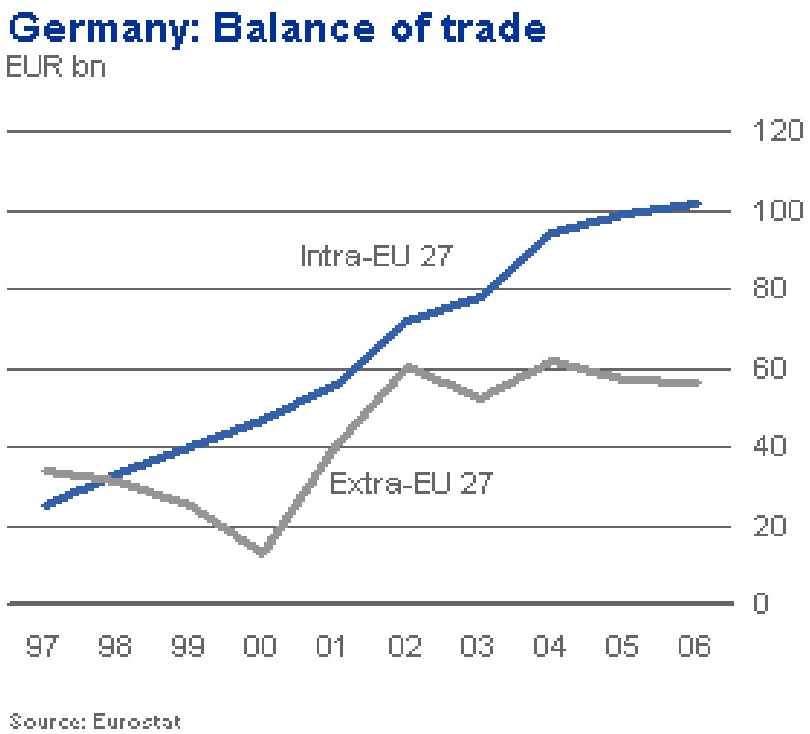
The creation of the Bundesbank as an independent body, ruled by a statute to promote sound money was the result.

The EU and Germany—political rehabilitation and markets

'the solution to the German question' CIVITAS (source www.civitas.com .) After the horrors of two world wars, the main objective in the aftermath was to find a way of binding Germany into the democratic and peaceful fold of nations. As a founder member of the European Coal and Steel community, and then the various European political institutions, Germany's difficult history has largely been redeemed. As a model member of the community, Germany has been allowed to re-enter the company of civilised nations.

As memories of the war faded, and the requirement to neuter Germany was passed, the realities of the EU as an economic unit have become more important. The advent of the single currency was sold to Germany as a way of counteracting the ever strengthening deutschemark, and hence further facilitate inter-European trade. After a break caused by the pressures of re-unification, the German economic powerhouse has roared ahead into the 21st century.

'Being the anchor economy for a currency zone has been a boon for Germany over the last dozen years. Not just political goodwill, but cold hearted economic calculations' - Adam Posen (source Peterson Institute for International Economics.)



Euro benefits----and liabilities

Trying to point out the export successes to today's German populace as a benefit from monetary union is likely to be a tough sell. Thilo Sarrazin, a former senior civil servant and director of the Bundesbank, has recently published a bestseller **'Europa braucht den euro nicht'** (Europe doesn't need the euro). Germany's very export success has been matched by increasingly indebtedness of the southern periphery.

The painful, but ultimately successful, Schroeder labour reforms of the early 2000's gave the already dynamic export machine the extra competitiveness to forge forward within the eurozone. Financed by burgeoning debts, the countries of Spain, Greece etc bought Mercedes, BMWs and other high quality goods. During the global credit boom this was financeable, but as the crash ended the era of cheap debt and ever rising levels of consumption, the question is whether Germany will now have to pick up the bill?

Collision with reality—Germany can't go it alone

Whatever nostalgia for the deutsche mark, tapped into by the likes of Sarrazin, Germany is in very deep.

Reading Deutsche Bank's latest report, it is filled with comprehensive information about how the business is doing, with its 100,000 workers and multi-faceting banking model

https://annualreport.deutsche-bank.com/2011/ar/servicepages/downloads/files/dbfy2011_net_interest_income.xls

But the fact that most astonishes is the size of the balance sheet; at **e2.164trn** Euros surprisingly growing again during the 4th quarter 2011. Given that total shareholders' equity is only a wafer thin 57bn, then it would not take much for these assets to tip the Bank into serious difficulties.

If these assets were spread across Germany, perhaps lent out as corporate loans to the *Mittelstand*, then concern could be tempered by exposure to the country's industrial heartland. However, Deutsche has expanded vastly over the last twenty years, consequently filling its balance sheet with a cornucopia of assets. The German bellwether is hardly alone, as JP Morgan's recent travails show.

The fact is that most European commercial banks are stuffed with European loans, to other banks, corporate and to sovereigns. Greece was able to play politics with her lenders precisely because European banks, with Germany in the vanguard, were so heavily indebted.

The euro crisis is as much about banks' exposure, and balance sheet risk, as it is about sovereign risk.

Even the much vaunted economic strength has begun to evaporate as trading partners across Europe, and the world fall back into recession. While growth is still forecast to come in at just under 1% for 2012, the country can no longer relax.

Conclusion—Germany has already made its choice to stay in the game

'Germany stands at a crossroads where it is about whether we will preserve what makes this country strong-a social market economy-in times of globalisation' - Angela Merkel (source Civitas.com.)

While on the campaign trail, Francois Hollande stated ' **we are not any ordinary country, we are France'** (source Tristan AJE.tw 6/5/12.) Perhaps throwing the gauntlet down to Merkel that the European Union cannot be run by Germany. While the idea of Teutonic fiscal and monetary discipline is attractive, most countries in Europe will not be able to stand it.

During earlier stages of the crisis many figures from the German establishment at times came out strongly against serious ECB support, and demanded that their European partners followed the lead from Germany. Axel Weber, as the German representative on the ECB council, went as far as to resign, while his replacement, Jens Weidmen, got into the habit of writing secret letters to the ECB chair and then leaking them to the press. It seemed with Merkel at the helm that Germany would always say '***nein.***'

With markets falling, the Greeks still fighting even the plan agreed a few weeks ago, Germany's leadership seems to have accepted the inevitable.

Wolfgang Schauble, finance minister, has conceded the battle. As he conceded, price rises **'in a corridor between 2 and 3 per cent'** would be '**tolerable'** in Germany (source FT.com 14/5/12.) While the Bundesbank 'has signalled it would accept higher inflation in Germany as part of an economic rebalancing in the eurozone' - Ralph Atkins (FT.com 10/5/12.)

With tricky election results already seen for the ruling CDU in North Rhine-Westphalia, German ministers were keen to support big pay increases for the IG Metal unions –' **euro zone row gets fat pay rise for German workers'** (source Reuters, cnbc.com 25/5/12.)

Markets—salvation at hand

Stoxx 50 Multiple crises—next ongoing (source Bloomberg)

The story had never fully gone away, as the second quarter data disappointed in America and Europe slid back into recession. Markets fell back from their post-LTRO euphoria.

While the nexus of the crisis is in Europe, pain is now spreading globally. The policy responses are also flowing fast from Brazil to India where interest rates are being cut aggressively.

When the IMF call into London, and criticises the UK authorities it **provides the perfect political cover to re-open the monetary floodgates.** Expect further expansion of the BOE's balance sheet. If the US economy cannot quickly bounce back from its current torpor then expect QE3 to be back on the table.

The options for Germany are now **binary**, accept the internationally accepted path towards greater easing or risk an explosive result. Germany's history and culture suggest that a path will towards engagement and appeasing the rest of Europe will be taken. Accordingly although recession can no longer be avoided in Europe, the euro will be supported by all means and survive. The seeds of recovery will be laid by the vast monetary printing machine.

Model Portfolio

With our forecast for industrial quantities of monetary expansion, and greater fiscal retrenchment delayed, we will adhere to our overweight equity exposure.