Investment update

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Eurozone - the real tests are still to come

Resolution of the eurozone crisis may be a step closer, but real tests lie ahead: huge G6 indebtedness and negative real yields

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Investors have largely accepted the eurozone resolution announced on 27 October at face value. One day when we look back we may see it as a tipping point, but in reality we are engaged in an ongoing process.

Ultimately, the USD520 billion Greek public debt is something the eurozone can afford. The USD1 trillion apparently being offered (the sum still needs to be raised) to back the currency is not excessive relative to the amounts held in reserve by other large trading states. The real test is not Greece but Italy, with its USD2.3 trillion public debt and a government at the margin of dysfunction.

It will continue to be difficult to convince the German electorate of the need to pay, but the reward will be German dominance of the Continental economy, with an exchange rate effectively tilted in Germany's favour. The politics are difficult, but the outcome is almost certain. The eurozone will remain intact in something very close to its present form. Ultimately, what Europe is learning here is how to move at a speed that satisfies the markets and the situation. Europe's traditional approach of ponderous contemplation isn't appropriate for markets that operate 24 hours a day with the sound of a ticking clock in the background.

While investors need to manage the volatility that the successive eurozone crises have thrown up, it is vital to be looking to the far more powerful, even seismic factors which remain unresolved and which are likely to shape bond markets for the next half-generation and possibly for longer still.

Globalisation led to a prolonged 'Goldilocks economy' of high growth and low inflation. Incomes were high, taxes flowed to the central exchequer and were spent on socially justifiable causes and, whilst growth was stable, credit grew unchecked for over a decade. At the same time inflation and credit default risks fell in a long bull run in the government and corporate bond markets, with yields falling from the mid-teens to low single digits.

That economy is now in reverse. Growth is low, inflation is high and credit is tight. With the partial exception of Germany – which derives a trade surplus from the favourable exchange rate provided by the euro – the G6 countries are in debt to tens of trillions of dollars.

Governments have embraced deficit reduction programmes, in thought if not always in deed, to save the day. We see the intractability of the issue in the eurozone and the social unrest it has caused. The US was reduced to gridlock earlier this year and, with an election in 2012, will not start to confront decision points at least into 2013 or 2014. The US bond and currency markets look vulnerable on this basis. In the UK, after 18 months of what we are told is a stringent fiscal policy, our public debt continues to rise at over two million dollars an hour. We will go the same way as the US if the markets ever turn their attention to us.

As things stand, the G5 governments plan to sustain their levels of debt – at least into the medium term – whilst continuing to offer investors a significant annual loss in real terms. A loan to the UK government gives you an income of 2% and, through inflation, a capital depreciation of 5%. Each year, for your risk, you lose 3%. The US offers similar terms.

If credit is tight – so that there is intense competition for borrowing – will it really be possible for governments (whose credit ratings are already falling and whose debts are huge) to continue to attract money by offering their creditors a significant annual loss? It seems unreasonable to expect investors to tolerate this situation unless they are merely regarding the government bond markets as a paper-based safety deposit box to place their money in whilst there is so little faith in a banking system that could evaporate in a puff of logic at any moment.

The decisions taken in the eurozone at the end of October are a step forward. The extension of the European Financial Stability Fund (EFSF), the 50% haircut on Greek debt and recapitalisation of European banks should allow equity markets to realise their inherent value, the euro to recover against the US dollar and corporate bonds to rally.

Resolution should also allow government bond yields to rise. This is important because the great unspoken or forgotten issue for those with or living on savings in the future is that their biggest liability is inflation. In a world where the basic stuff of life can be bought from underneath us by an emerging population that has ample money in their banks accounts, the era of a low cost of living in the West has just passed at the moment when the 7 billionth person is set to enter the world. Greece is relatively unimportant. Now for the real issues.

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