

## Portfolio Strategy

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# Strategy Update: European Debt Crisis

It was another volatile session across offshore markets overnight as the European debt crisis continues to weigh heavily on sentiment and equity prices. With a high degree of uncertainty around how this crisis will unfold, our advice continues to be to retain a cautious positioning, centred around a carefully balanced asset allocation and, within equities, a strong focus on stocks with attractive dividend yields and the potential for sustainable income growth.

## European crisis continues

In Europe, focus has turned from Greece, a relatively small economy, to Italy, the 3<sup>rd</sup> largest economy in Europe, and the 8<sup>th</sup> largest in the world. Italy is 'too big too fail', but also possibly 'too big to bail out'. Italian Government debt sits at 120% of GDP and most concern is focused on whether Italy has the ability to control and service this debt burden in light of a sharp increase in interest rates. Last night, the yield on 10-year Italian Government Bonds rose to 7.45%, before ending at 7.25%. Market's fear that Italy will be unable to service its debt if interest rates stay above 7%.

Italy's dire situation is bringing into question the sustainability of the Euro Zone in its current form. European leadership will be put to the test yet again in coming days and weeks.

While risks remain high, a potentially 'acceptable' solution to this crisis could be found if a new political leadership in Italy is willing to implement fiscal reform. Such a step may restore some calm to markets and see a fall in Italian bond yields. The outcome would be a long period of consolidation and low economic growth, and would likely see a modest equity market rally from the existing unchallenging valuation multiples.

The alternative scenario, where no solution is agreed, could see liquidity dry up, and income yields on the bonds continue upward. This is likely to require a large scale action to rescue the Euro Zone and could result in a number of outcomes. There could be a scaling up of the current purchasing of Italian Government Bonds by the European Central Bank supported by the IMF and other monetary authorities, together with ECB guarantees of sovereign debt. This is effectively a large scale monetary easing programme, which brings into frame the potential for longer term inflation.

Alternatively, we could also see China, Germany or other nations with large foreign currency reserves, step in at some point to assist in the restoration of liquidity and longer term funding for indebted European nations. This seems a preferable course of action for the markets, but the timing and likelihood of such outcomes remain uncertain.

## Other factors to consider

- Europe will need to provide a long term political solution that is sustainable. This is recognised by all parties and is a clear focus for all. It is positive that this process is perhaps already underway, with the resignation of political leaders in Greece and Italy.
- Another modestly positive issue is that unlike the failure of investment bank Lehman Brothers in 2008 which was a complete shock to markets, there is no such 'surprise'

factor in Europe. Markets are well aware of the extent of Europe's debt woes. The issues that appear to be driving the high level of volatility in markets are the political uncertainties.

- In our view, the overriding concern facing investors is the acknowledgement that Europe's debt problems are not unique to Europe. Many of the world's leading economies have unsustainable debt levels and budget deficits. This raises the real prospect of a 'Japan-like' outcome for the global economy. Since peaking in 1989, the Japanese economy has faltered under excessive debt. Deflation and very low economic growth have been features of Japan's economy over the past 22 years. On balance, while we do see a real possibility of a period of below-average economic growth for the global economy, we believe there are two key features that differentiate Europe and North America from Japan. First, market valuations across most markets are reasonable, unlike in Japan where share valuations remained unrealistic for many years. Secondly, there appears to be a greater political willingness, albeit at times hesitant, to take required policy action, than we have seen in Japan over two decades.

### Our Portfolio Strategy View

Over 2011 we have recommended reducing exposures to European equities and financial stocks. We continue to recommend a 'barbell' approach to portfolios, biasing weightings to equities and cash, and having an underweight position in fixed interest. The key elements of this strategy are:

- We clearly face a difficult investing environment. However, we can mitigate this by taking a dual approach to managing portfolios; a 'top-down approach' to ensure that the asset allocation is prudent, and a 'bottom-up approach' that focuses on ensuring the stocks in our portfolios are high quality, defensive, are generating a good income stream, and have the ability, or at least the potential, to grow earnings in a challenging economic environment.
- We recommend clients maintain a balanced portfolio and review asset allocations to ensure it remains aligned with your tolerance for risk, and income requirements.
- While risks remain elevated we believe a cautious balanced approach is more prudent than an excessively conservative 'cash only' approach. A balanced approach will provide more inflation protection, more protection against the possibility of falling interest rates, and most importantly, a higher overall portfolio yield given equities are providing some of the most attractive income yields of any asset class at present.
- We continue to recommend two-thirds of equity portfolios be invested in our local markets (New Zealand and Australia). Our markets offer many stocks with dividend yields well above bond yields, defensive businesses and balance sheets and solid growth prospects. Many are also largely immune to events in Europe.
- Global equity exposures should be anchored in high quality global leaders and a mix of income-growth and absolute-return focussed investment trusts. Global equity portfolios should remain unhedged as the NZ Dollar tends to fall during periods of higher risk, providing New Zealand investors with some cushion against equity market volatility.
- Fixed interest yields remain low and we remain concerned that they could move up if inflation pressures mount. However, we recommend clients maintain a

laddered portfolio to provide a degree of certainty of income and to mitigate interest rate risk. Take advantage of deposit rates which remain higher than corresponding wholesale rates and add selected highly-rated longer term bonds.

### **In Summary**

Markets are being dominated by short-term news flow at present. It is clear that it will take long-term solutions to bring the current crisis under control, and market volatility is likely to continue until more meaningful solutions become apparent.

As always, our advice to clients that are uncomfortable with the current situation is to review your asset allocation with your adviser, and act to lower your exposure to growth assets if necessary. However, with valuations at reasonable levels, and some progress, albeit slow, being made in Europe, we are comfortable maintaining exposure to equities for the longer term. We continue to monitor developments closely.

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