Roger Nightingale 23rd July 2010

Pointon York SIPPsolutions

Fate punishes those displaying contempt for authority; it does so by making an authority of them as well.

Albert Einstein: it happened to him, to Galileo and Newton; it might happen also to Hungary's Prime Minister.

The little boy who cried "wolf" when there was no danger . . .

Those who are economical with the truth often gain a short-term advantage, but usually sustain a longer-term disadvantage. Their credibility is easily destroyed, but not easily rebuilt. The Blairs, Mandelsons and Campbells demonstrate the phenomenon. These days, even if they were to be honest, they'd not be believed.

. . . wasn't believed when there was.

The European Commission has a similar problem. For years, it disdained public opinion, bullying elected Governments and rigging referendums. It won all of the skirmishes it fought, but, in doing so, may have set itself up to lose the war. Suddenly, it needs credibility.

The EU has much the same problem.

It's about to release the results of the "stress tests" conducted on member banks. It worries that, if Europe's economy isn't to slip back into recession, investors and depositors must have confidence in the financial system. To that end, it's important that the people trust the Commission to have conducted the tests honestly and rigorously. Hmph!

It wants people to trust it now . . .

It's a *lose-lose* situation. If too many banks "fail" the test, it'll be thought that Europe is doomed, and confidence will evaporate. If too many "pass," it'll be claimed that the tests lacked rigour, and confidence will evaporate. Catch 22!

. . . despite its having previously abused their trust.

Characteristically, the Commission has been secretive about the details of the tests. It hasn't told analysts the rationale on which they're based. But it's likely that the emphasis will have been on balance sheet considerations. That's not unimportant. Economics growth, however, is more important still.

The "stress test" may be ill-conceived: economics vitality being more important than balance sheet rectitude.

The irony is that the regulators might, by demanding banking "prudence" that undermines growth, weaken the system rather than strengthen it. It may be no coincidence that, when the crisis struck, activity in Europe suffered more than that elsewhere in the world. The fact that its consumers had not over-borrowed was no consequence; the fact that its corporations were boringly well-financed was also irrelevant. The recession was steeper and the recovery shallower.

The Commission and ECB have an unimpressive track record.

Initially, the European authorities, full of *Schadenfreude*, claimed that their banks were safer than those overseas. Not so, apparently. Today, global anxieties centre on the EZ. And not just the usual suspects; Germany too is under the microscope. Its Landesbanken are said to be more at risk than most!

Who dares say so? Who'll risk *auto-da-fé*? Only Hungary!!!

Not many politicians, let alone central bankers, have been prepared to question the wisdom of the monetary authorities. In Europe, free thinking is frowned on, and heresy punished severely. Thus far, only a few brave souls have dared offer any defiance, most notably those in Hungary. They point out that the Emperor is naked, intellectually as well as sartorially! He has been for a long time. What he says doesn't make any sense. It'll be interesting to see how the country fares in the next few years. Probably rather well.

Thankfully, security valuations are rising again.

The markets meanwhile are recovering fairly strongly. They softened when it was first appreciated that economics activity might be slowing. But the down draught didn't last. Investors gradually recovered their nerve. They recognised a positive side to the story: it implied that liquidity would be kept plentiful and interest rates low.

Profits improving despite economics fragility.

Meanwhile, corporate profits have continued to rise fairly strongly. Although sales are sluggish, margins are strengthening. How come? Because the downwards pressure on wages is greater than that on prices (the bargaining position of the employee falling relative to that of the employer). It's been most noticeable hitherto in the private sector, but it's likely to be replicated soon, possibly in seismic proportions, in the public sector.

Fear and greed; hope and despair.

The bottom line, in any event, is low inflation and strengthening dividends: a combination that investors find actuarially attractive. Though paranoid about safety, they're desperate for income. As a result, they switch back and forth between equities and government bonds as they reassess the relative impact of the two factors. Currently, they're more impressed with profits than scared by banks.

They alternate. Currently, bulls are winning.

The optimism won't last forever, but it may see the indices back to their year highs. The danger period for the economy (and for the banks therefore) is not the immediate future, but 2012. That's when activity will be in trouble and finances most stretched. It's also when politicians can be expected to be at their most dangerous. In the interim, not to worry; valuations are more likely to rise than fall.

Contact us . . . For further information about Pointon York's SIPP products and services, call Natalie Oliver on 01858 419 371 or visit the corporate website at www.sippsolutions.com. Alternatively, contact Roger Nightingale, by telephone, on 01858 419 300; by e-mail at rnightingale@sippsolutions.com, or browse his web site at www.rogernightingale.com.