

## SPECIAL REPORT EUROPE

# Credit 'heart attack' in intensive care

Markets remain in a poor state of health because of two major symptoms: irresponsible lending and excessive leverage. Argonaut's Oliver Russ dishes out the doctor's orders

**By Oliver Russ, partner in Argonaut Capital**

Everything seems stacked against investors at the moment: the US teeters on the edge of recession, if it has not already fallen in. Commodity prices everywhere are rising sharply,

squeezing both consumers and margins. Spillover effects are seen in rising general inflation, while equity prices slump globally. In fact, 2008 is already shaping up to be an 'annus horribilis' for almost all markets – be they property, fixed income or equities.

The whole current crisis has been caused by two things: irresponsible lending and excessive leverage. While the former can stop pretty much immediately, the latter will take some time to unwind. This is why financial asset prices are declining worldwide as the air deflates from the credit bubble.

There is one man on the side of investors, however, namely Fed chairman Ben Bernanke, who having been handed a poisoned chalice by his illustrious predecessor, is doing his best to add a little sugar to disguise the taste. Remember that interest rate cuts began last September. They normally take at least six months before the effects begin to be felt – and we are now rapidly approaching that date. The Fed, along with the European Central Bank (and in stark contrast to the Bank of England), have acted with great alacrity in this crisis. The ECB has not yet felt able to cut rates, but it has widened the types of collateral it will accept as security for lending. The Fed has announced a similar initiative recently, which has fired up the markets, at least temporarily.

## Critical conditions

The credit 'heart attack' began in the debt markets, and its resolution will lie in those same markets, which makes central bank-watching a more necessary exercise than normal for equity investors. Currently euro-based financial debt implies a five-year cumulative default rate of 17%. That seems to be somewhat on the high side given the previous worst realised default rate of all corporate debt – even in recessions – has been just 2.4% since 1970, and financial debt lower than that. General euro corporate debt is incidentally implying a 15% default rate, which is slightly better than sterling at 19%.

Nor is bond market disarray confined to corporates – recently the spread on 10-year Italian and Government bonds has widened to

## KEYPOINTS

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- Headline PE is comparable to that paid for trailing earnings in the early 1990s, when the West was in the grip of a vicious recession.
- With 70% of European companies now having reported, 56% of results were better than expected, while 43% were worse than expected. Just 1% of companies were in line with estimates.

60 basis points – a considerable spread since all euro sovereign debt is in theory guaranteed by the ECB. It is a symptom of how badly shaken debt markets are that these anomalies appear. The forced and panicked selling in the debt markets has now impinged on the functioning of equity markets, which, if looked at in isolation, appear to have sound fundamentals. After all, dividend yield levels in financials are at levels last seen in 2003, while the headline PE (12.7x) is comparable to that paid for trailing earnings in the early 1990s, when the West was in the grip of a vicious recession. Both occasions, it should be noted, were a fortuitous time to buy equities.

## Corporate prospects

To look in more detail at corporate Europe, things at the moment (ex-financials) look relatively good. Year-end results were in general fairly tame, albeit backward-looking. According to Goldman Sachs, with 70% of European companies now having reported, 56% of results were better than expected, while 43% were worse than expected. Just 1% of companies were in line with estimates, perhaps a reminder not to place too much faith in analysts' forecasting ability. As a matter of fact, the numbers do not change at all if banks are excluded.

Companies such as Volvo (the truck-maker, with the car unit sold off to Ford years ago) report that demand in Western Europe and emerging economies remains robust. US demand is steady, but at a low base where it has in fact been for a couple of years. Moreover, what is very different about this slowdown versus the last recession is that European corporates enter the slower phase with very robust balance sheets – this is very different to 2001 when a debt orgy for over-investment led areas such as telcos perilously close to the edge.

There are for sure areas of concern within Europe – the UK, Ireland and Spain – as suffering from similar problems to a greater or lesser degree, but do not forget that many areas of Europe are on a different cycle. Norway, for example, is a petrodollar economy, and with oil comfortably (or uncomfortably, depending on which side of the trade you are on) over \$100, recession is simply not on the cards.

## Things to consider

In general though, investors should consider sector exposures and bottom-up fundamen-

tals. For example, in Spain, Indra Sistemas is not usually known as a high-yield stock, but it has been de-rated sufficiently to be included in income portfolios. A very high-quality business, largely responsible for the systems that drive Spanish multi-nationals such as Telefonica and Santander, it is also designing the next generation of air traffic control systems for the UK and other parts of Europe. (Curiously enough, air traffic control technology in Europe is effectively split between the French and the Spanish, not necessarily the first nations one considers in relation to smooth airways operations).

Amidst all the bond market chaos, one area that might be expected to suffer disproportionately is property. It certainly suffered last year. However, as the large UK property funds have now closed to redemptions, there have been encouraging signs of stability emerging in European property shares, which last year were aggressively sold to raise cash as the distressed funds' most liquid asset. Investors would be wise to maintain some exposure to Nordic property: rents are continuing to rise and vacancy rates are falling, and some insurance companies are having to revalue their holdings upwards – in stark contrast to the UK.

## Stable conditions

Another area of focus has been the telecom arena. This has produced very decent relative performance over the last six months or so, as the more stable, cash-flow generative and recession-proof nature of their businesses become highly-prized assets in the current environment. Yields are exceptionally good, with stocks such as Elisa of Finland continuing to show capital discipline with repeated special dividends. The old empire-building mindset of growth by acquisition is definitely on the wane in Europe, with strong dividend or buy-back policies now much more favoured.

Calling the market turn will be next door to impossible, so the preferred strategy should be to invest in high-quality names with substantial dividend yields that look sustainable in the long term. At least this way the investor is being paid to wait for the market recovery, and the yield support should ensure downside is relatively limited – although debt investors are currently finding out the truth of Keynes's old maxim that 'markets can remain irrational longer than you can remain solvent'.

