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Italy is “the elephant in the room”



Q: Greece is such a mess. George Papandreou has said that he will step down. A new unity government will be formed. Will this stabilize things and bring confidence back to the markets?

To a certain extent. But let's see very clear. The only thing we are trying to avoid here is a disorderly default. It doesn't change the fact that there's going to be severe fiscal contraction. There will be private sector write-downs and Europe is going to go into recession. But if it's a disorderly default then it's going to affect all other neighbors as well.

Q: So, do you think this is going to be more contained under the new unity government? Because I'm just wondering what is the difference between Papandreou and the new Prime Minister?

Nothing, to be honest. The big elephant in the room is actually Italy. Greece they can bailout, they can contain. But Italy cannot be financed, and it has \$300 billion of debt to be re-financed next year. The real question is that if they are not able to do that, then you will have a severe global financial crisis.

Q: Silvio Berlusconi survived a confidence vote in parliament, but just. And his prime-minister ship is on shaky ground. Tell about the situation to Italy and how fragile it is?

Italy doesn't have a really good track record of undertaking fiscal contraction. This time they have made promises and I think the fact that there is a lot of intervention in Italy to make sure that they stick to the promises is the key. If Italy is not able to do that, then we will have a problem of all its neighbors - with Spain, France, and Greece, so I think that's going to be the real big elephant in 2012.

Q: Tell us about this contagion effect that is really threatening US and the Euro zone.

Well, it's funny. Europe, of course, is going into recession. But the numbers out of the US are actually looking pretty good. The economic boom that happened in Q3 is carrying on into Q4. The only negative in the US is unemployment. But the Fed said over and over again, that they stand by to support growth, even if it means keeping rates low to 2014 and 2015. Corporate earnings in the US are very strong. So, there is going to be a negative impact as Europe is a big trading partner, both for Asia and for the US, but US corporates are very flexible. They will reorganize or restructure and keep corporate earnings strong. Actually, it's the good time to go back to buy US equities.

Q: What happens to US, if and when Europe goes into recession?

There will be a contractionary impact obviously. But the fact that the Fed is much more proactive on growth is a big help. The big question for the US is what will happen with the fiscal contraction that will happen towards the end of the year. Does it go into a sequester, or are they going to have \$1.5 trillion of cuts? And that will be contractionary. The fact that they have an election next year doesn't help. Whether they do it before the election or take severe cuts after the election, there will be a drawdown on the economy. But if they balance that out with a loose monetary policy, then they can stabilize the US economy. Europe is beginning to go to that slide.

Q: Markets here in Asia are opening, and all down at the moment. How do you think they will react to the news coming out of Greece?

Not good. There is nothing good about the news coming out of Europe. It's momentary positive news if anything, but soon the realization will come that is negative for a very long time to come. The couple of bright spots in Asia are India and China. They are at the top of the interest rate cycle. Just like the US, China has said that it stands by to support growth. And growth is relatively strong in China. I think the concerns about banks in China are over-blown. They will not undergo a hard landing and are proactive enough to support the economy. India is the same. There are interest rate hikes to curb inflation and inflationary pressures are almost at the top. So, all economies which have the ability to stimulate growth now, in the global recession environment will come up positive.

Q: There was concern that China will face a hard landing but not so at the moment. Things seem to have eased.

It doesn't look like it. The fact that inflation has eased and all the pressures of inflation have eased will mean that the Chinese Central Bank can cut rates which means they can stimulate growth whenever it is required if global recession actually comes about.