The Lessons for the eurozone from Argentina

- **Christine Lagarde's leadership of the ECB conditioned by her 'Argentina experience' at the IMF could be good news for the eurozone**
- **The ECB could shift to a more left leaning institution**
- **Falling government bond yields are worrying equities**
- **US equities at a key support**
- **Gold price rise not complete**
- **Currency wars the next chapter in the gold price rise**

The eurozone to gain from the lessons of Argentina

Christine Lagarde's chastening 'Argentine experience' at the IMF could be good news for the eurozone. Many may be concerned that Argentina failed under the watch of soon-to-be ECB President, current IMF Chair Christine Lagarde. However, we believe the Argentina bailout and subsequent recent demise give insight into how Christine Lagarde will approach her role at the ECB.

The IMF under Christine Lagarde's leadership provided the largest ever single bailout of a country when it offered a $56bn bailout fund. We are not here to criticise Ms Lagarde in the context of the current bailout, we are more looking for clues as to how she may lead the ECB through what is increasingly looking like recession-like conditions in the eurozone.

Protecting society
The IMF placed considerable emphasis on "protecting society's most vulnerable" when framing its austerity programme for Argentina. As the FT pointed out the IMF allowed the country to exceed its fiscal deficit target if the additional spending is to was used by the government for social assistance.

Forgiving
In July 2010, before Ms Lagarde took up her position at the IMF, she alluded to the fact that the IMF had committed to supporting the eurozone through the Greek crisis. While in office from 2012 she is understood to have privately supported Greece and its efforts to receive debt forgiveness.

Not a trained finance geek
It's worth reminding readers that Christine Lagarde is neither a trained banker nor economist. She will also be the first woman to lead the ECB. You must believe that there will be at the very least a different tone to the ECB in the future.

We would take comfort from these seeming traits in her make-up (pardon the pun). Policymakers are going to have to have to be flexible and sympathetic and, dare we say it, human in the next down cycle. Dogmatic austerity is not going to win through. Argentina will be an essential lesson to Christine Lagarde, even with a modicum of sympathy the IMFs programme for Argentina have not carried the day with the electorate. Central bank policy in the future will have to have one eye on politics. Driving the government of the day into a corner may only bring more significant problems for the central bank in the future.

Lessons learnt may pay dividends in the eurozone

The tone of the ECB may, with Christine Lagarde's leadership, be shifting to a more accommodating institution. To be fair, Mario Draghi was not in the Bundesbank camp, but Lagarde's left-leaning inclination on policymaking may encourage the ECB to be more supportive of countries that are trying to ignite growth through expansive fiscal policy.

The eurozone is sliding ever more quickly into its 'Japanification' with many of its government bond markets returning negative yields. Eurozone equities would surely be a winner were the ECB to be more emphatic on policymaking (more action and less prevarication), and more flexible, by allowing governments to be more supportive of their economies.

Falling Bond Yields spook the equity market

It seems global equity markets are starting to worry more profoundly about the fall in bond yields. Last week the US 10-year government bond yield fell a further 19 basis points and is down 46 basis points month-to-date. The global MSCI equity index has fallen by 3.6%.

There have been times when the equity market has taken falling bond yields as a positive. Initially, equity investors think that the fall in bond yields would improve the valuation of the equity market. However, this only holds when forecasts for global growth hold up. In essence, your expected growth of corporate profits is discounted by a lower number raising the price of the equity. Current times are much more challenging. The markets now see that the fall in bond yields is an indicator of the elevated risk of a global recession. The inversion of the bond curve, with the 10-year bond yield, briefly trading below the 2-year leading to an initial 3% sell-off of US equities.

We are concerned about the almost free-fall in long-dated bond yields. Should bond yields trade lower, the equity market could fall through a critical support. The US equity market (S&P500 2847) is trading within spitting distance of its 200 days moving average (2796).

In the very near-term policymakers are providing some help to markets. Even President Trump backed off a little by delaying the implementation of tariffs on some Chinese products for fear they would increase inflation in the back-to-school shopping season. However, it feels like we are trading on somewhat of a knife-edge.

Gold price rise is not complete.

The recent consistent rally in gold to above the $1500 level may encourage some investors to take profits in the hope of buying at lower levels. We would advise against such a dangerous game. With the global economy showing signs of a late-cycle slowdown, debt levels showing no bounds and events like the recent setback in Argentinian financial markets, the scene is set for more gains in the gold market. According to the World Gold Council, investors put $2.6 billion into gold bullion-backed ETFs in July, raising their aggregate holdings to 2,600 tons, the highest level since March 2013.

While there is certainly room for the gold price to take a breather, we believe there is more upside**. The possibility of a move to $2000 per troy ounce should not be dismissed.**

A new factor that is providing support for the yellow metal is the fear of a currency war. The US Treasury decision to call out the Chinese as currency manipulators and tweets from the US President suggesting a potential intention to devalue the dollar is being taken seriously by the markets. Analysts are also interpreting the Swiss National Banks recent intervention in the currency market to weaken the Swiss franc as a further sign of these potential 'currency wars'. The Swiss National Bank made its most significant intervention in the currency market since March 2017.

As is often said, gold is not a consistent hedge of dollar weakness. However, we believe that investors will see gold as a better store of value if many of the major currencies in the world are actively seeking to devalue their currencies.

Gary Dugan

Johan Jooste

Bill O'Neill (Consultant)