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No Bazooka

The word "bazooka" refers to a portable anti-tank weapon first used widely in World War II. Back then, a soldier had little hope of destroying a tank, let alone damaging it, without the use of this weapon. As such, the phrase "bring out the bazooka" became synonymous with throwing everything you have at an enemy or, in peaceful times, at a problem. Thus, with problems in Europe getting worse with each passing week, investors expected the European Central Bank (ECB) to bring out its bazooka to overpower the debt contagion once and for all. Recall that 12 days ago, markets were electrified by the news that central banks around the world joined forces to provide liquidity to the global financial system. This inspired us to write the article published last week (see *Central Banks to the Rescue,* 5 December 2011). This coordinated central bank action increased investor expectations that a bazooka from the ECB in the form of aggressive bond purchases of troubled nations was not far behind. Unfortunately, the ECB is still using a musket instead of a bazooka.

Unmet Expectations Led to a Sell-Off

With stock markets riding higher on this hope of all-out support from the ECB, it was no surprise then that when ECB President Mario Draghi dampened expectations on sovereign bond purchases last Thursday by saying such purchases will be limited, the market rally started to ebb. While this statement, as well as the outcome of the EU summit, were not as bad as markets had feared, these were not as good as they hoped for either. The fear that the horse will be long dead before any help arrives remained. That was last Thursday.

Step in the Right Direction Heralded a Rally

On the other hand, German Chancellor Angela Merkel, who is clearly intent on having her fiscal compact one way or the other, argued that the solution the European crisis should be in the form of a long term overhaul of the treaty that governs the Euro region's integration and not a series of short term bailouts. Merkel reiterated her strict policy decision, saying that "it's interesting to note that 20 years later, we have succeeded in creating a more stable foundation for that economic and monetary union, and in doing so, we've advanced political union and have attended to weaknesses that were included in the system. " It can be argued that this may not be enough to persuade the bulls to overpower the bears. However, European governments' hammered out an agreement to raise up to US$270 billion in aid for indebted countries. In addition, they advanced the date when the European rescue fund would come into operation, causing stock markets to reverse their losses that day and end sharply higher.

Common Policy, not Common Bonds

Both Merkel and French President Nicolas Sarkozy have cautioned against plans that do not involve a common fiscal policy among member countries. In order to ensure that all members comply with these, they also included automatic sanctions if conditions, such as maximum deficit-to-GDP ratio, are breached. It would make no sense to throw good money after bad if the profligate countries do not curb spending in order to avoid an otherwise inevitable sovereign bankruptcy. With this in mind, they effectively killed any proposal on common Eurobonds.

Reality Check

During the 2008 financial crisis, traders have become accustomed to quick fixes in the form of QEs to push the market up and solve the problems at hand. However, the sobering reality is that structural problems in Europe are so complex that a band-aid solution will have little or no impact without any long term changes to the Euro region's treaty. Although these treaty changes will be approved by March at the latest, it will take time before their full effect is felt. So, while these actions are necessary, they are not yet sufficient to bring a quick resolution to the crisis.

No Smooth Sailing, But No Shipwreck Yet

In previous months, it seemed like the European leaders did not know the way out of their own crisis. As a result, the stock market did not know where to go either. It simply moved based on whether the news flow from Europe was positive or negative. This uncertainty over the resolution of the European crisis created a great amount of volatility. In addition, S&P declared that a possible downgrade of 15 Eurozone countries could occur early next year, making the spectre of a sovereign default ever more real. This would probably push the European leaders to act more decisively and expeditiously to solve the problem and quell any uncertainty over their resolve once and for all. Thus, we can expect that as the full extent of the crisis and the roadmap out of it becomes clearer, market volatility should begin to drop. However, Europe is a long way from pulling itself out of this quagmire, so while a shipwreck is not imminent, expect the seas to be choppy.

Philippine Stock Market Outperforms With Less Volatility

In a previous article, we showed that the Philippine stock market significantly outperformed both developed and emerging stock markets by a wide margin (see *Gold Medal for the Philippine stock market*, 28 November 2011). In addition, it did so with much less volatility than its Western counterparts which had historically lower volatility than emerging market indices. Last week, the PSEi showed its resilience once again. Our market hardly budged when the US, Europe and other Asian indices were plummeting. We believe that in spite of the European crisis, the Philippines will continue to outperform. However, not all stocks will participate in this outperformance. As such, we advise investors to choose stocks with the right business model, limited exposure to the European region and solid fundamentals. These are what we call "sleep at night" stocks. In addition, investors must hold stocks that he has a strong conviction in. This will help him withstand the volatile market conditions. While global stock markets are being buffeted by macroeconomic headwinds, we believe that with the proper stock-picking, one's portfolio can weather the storm.

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