SIS LIMITED

Synaptic Investment Services Limited

ISSUE 4

Elisabeth Kubler-Ross

5 stages of grief

A DOSE OF BEHAVIOURAL FINANCE

The field of finance and economics has been a continuously evolving one with continuous research leading to new theories which challenge long anchored ones. For some reason, most phenomena that do not agree with classic Gene Fama's efficient market theory, which advocates that participants behave rationally, are included under the umbrella of behavioral finance and economics.

Whilst Fama may have been awarded Nobel prizes for his research, there are numerous studies which challenge his findings by other eminent Nobel laureates such as Schiller, Stiglitz or Kahnman.

Psychology and its application to Finance and Economics

One of the branches of behavioral science is the application of psychology to various economic or financial scenarios. Major global investment banks or economic publications like the Financial Times or the Wall Street journal use these in their analyses.

Elizabeth Kubler Ross's grief cycle model was initially devised to assist terminally ill patients but has since been adapted to various sciences including finance and economics.

Elisabeth Kubler-Ross and the five stages of grief

Anger - The facts and the reality of a particular situation are consciously or unconsciously not accepted. This is a perfectly natural defense mechanism.

Denial - People dealing with emotional upset become angry with themselves or with others.

Bargaining - People facing death can involve attempting to bargain with whatever God the person believes in. People facing less serious trauma can bargain or seek to negotiate a compromise. For example 'Can we still be friends?'

Depression - Regret, fear and uncertainty characterize this process when the person gets prepared to accept reality.

Acceptance - During this stage, the person comes to terms with his inevitable future.

The key to understanding the stages is not to feel like one must go through every one of them, in precise order.

Instead, it's more helpful to look at them as guides in the process.

The stages cause volatility in markets which require careful interpretation in conjunction with other factors.

TAKING THE EUROZONE CRISIS AS A PRACTICAL SCENARIO

A seemingly never ending crisis gripped the Eurozone financial markets in 2011 and threatened to derail global economic growth. The scale of the event was significant as the continent had not experienced something similar for decades.

Countries had excessive debt which they could not continue to rollover as well as budget deficits which could not be funded. A default was the only alternative.

TO DEFAULT THROUGH THE KUBLER ROSS STAGES

In January 2010, Monetary Affairs Commissioner Joaquin Almunia is in denial of a default.

"No Greece will not default. Please! In the euro area the default does not exist."

In March 2010, Luxembourg Prime Minister and Euro group head Jean-Claude Juncker shows anger.

"We have to strengthen the primacy of politics. We have to be able to stop financial markets. We have instruments of torture in the basement. We will display them if it becomes necessary."

In June 2010, European Commission President Jose Manuel Barroso starts to bargain.

"We believe that the private sector could play a role in helping Greece, provided that it doesn't result in a credit event or default. Of course, it should be done in agreement with the European Central Bank".

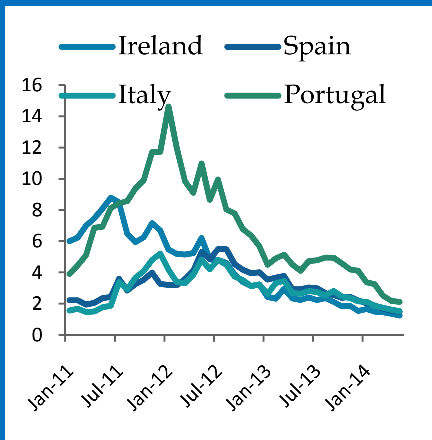
In March 2011, European Commissioner for the Economy Olli Rehn comments look depressed.

"Times are difficult, the reform fatigue is visible in the streets of Athens, Madrid and elsewhere, and so is the support fatigue in some of our member states".

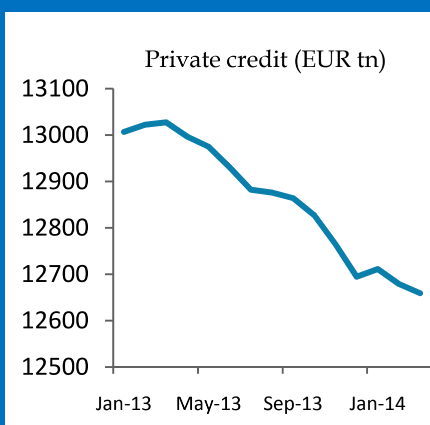
In June 2011, German Central Bank President Axel Weber comes to terms with the situation.

"There are, unfortunately, only very limited options. Either a default or partial haircuts or a guarantee for the outstanding amount of Greek debt...At some point you've got to cut your losses and restart the system."

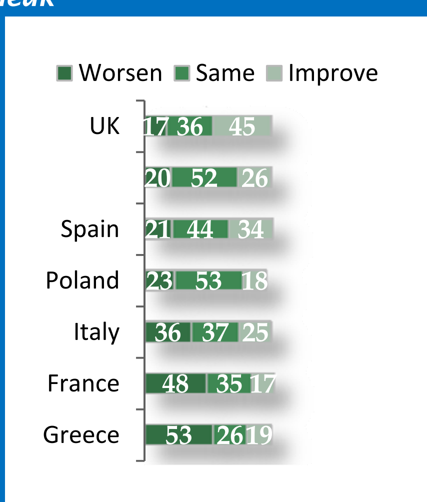
10 year bond spreads against Bund have been compressing….



…while credit to the private sector encounters gravity..



…and growth expectations look bleak



Sources: Synaptic computations, ECB, PEW

UNINTENDED CONSEQUENCES

The ECB was successful in easing financial stress in the euro area and to some extent the vigorous efforts to re-structure ailing economies bore fruit. In parallel, there was some breakthrough on negotiations for a banking union which helped confidence levels. And therein lies the problem as it seems complacency is creeping in again.

The major issue of the Eurozone has been the current account imbalances between the core and the periphery. One could compare this to the China/Japan vs United States trade relationship financed by the former buying treasuries of the latter. Until these balances are not addressed decisively, any progress can only be of a temporary nature.

The incentives of the LTRO operations are misaligned with growth imperatives as there is a banking and sovereign feedback loop. The easing of liquidity by the Federal Reserve Bank of the US has also reduced bond yields to a level of economic convergence with core economies which may not be consistent with reality. The Bank of America Merrill Lynch survey of global fund managers reveals that euro zone peripheral bonds are the most crowded trade.

In these circumstances, the ECB will have no choice but to act. The pre-requisite for the central bank to pull the trigger is a falling inflation rate and decelerating growth.

Whilst this has been visible in a number of countries on the periphery, the most important player, Germany has only recently begun to witness meaningful deceleration.

Earlier in the year, Mr. Draghi showed ‘Anger’ at the IMF when its head, Mrs. Lagarde pressured the ECB to ease. Since then the ECB chief has moved to the ‘Acceptance’ phase of the Kubler-Ross stages of grief by indicating at its last meeting that they are inclined to provide liquidity sooner rather than later. In what form is anybody’s guess.

Synaptic Investment Services Ltd is an investment management company based in the indian island of Mauritius. If you would like to know more on this report or about us, visit our website www.synaptic-mauritius.com or email a.gujadhur@synaptic-mauritius.com

Synaptic Investment Services Ltd, 1st Floor, Block B, Nautica Commercial Centre, Black River,
Republic of Mauritius. Telephone (MRU): +230 483 1212 Fax (MRU): +230 483 1313
www.synaptic-mauritius.com