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The single biggest issue stalking global equity markets at present is the Euro crisis. The threat of a liquidity breakdown and recession in Europe is restraining equities at a time when Asia is booming and many corporates around the world are sitting on healthy balance sheets.

Investors are worried about the disruption that would follow from a break up of the euro and that if any one of the vulnerable countries - Portugal, Italy, Ireland, Greece and Spain - were to default then the others would follow.

My own view is that a partial break up of the Euro is inevitable, with Greece the most likely to default and leave the single currency this year. Whether that would lead to a domino effect remains to be seen, but a clash of political and economic factors means Greece will ultimately have no choice in the matter.

An inevitable test

The Euro was always going to be tested in an economic downturn, for the same reasons the European Currency Unit was tested in the early 1990s. How can the same fiscal policy decisions work for tier one countries such as Germany versus tier two countries such as Greece? The debts were always going to be too much for Greece to pay.

Earlier this month (January), Greek Prime Minister Lucas Papademos appealed to defiant union leaders to accept further income losses for fear that the international rescue loans will dry up and force a disorderly default in March. International debt inspectors are due to visit Greece on January 15 to determine if the country can retain its Euro membership or revert to the drachma.

But Greece’s biggest union, the GSEE, has ruled out any further income losses, saying two years of austerity measures are enough for Greeks to take.

Also, having had foreign governments tell them how much they can write off in terms of haircuts for holders of its sovereign debt, it may well have occurred to the Greek government that if it defaults on 50% then it might as well default on all of it. Its credit rating will still be poor either way. If anything, Greeks will be able to issue a lot more debt and be more successful if they defaulted and cleared all of their debt rather than half of it. There is no logic for Greece to stay in the single currency or aim to repay any of the debt.

The problems in Spain, Portugal and Ireland are also extensive and well documented. We shall see at least one exit from the Euro this year and it could potentially be any of the vulnerable nations. But the most likely departure will be Greece.

The Euro won’t need to break up completely: the benefits for tier one countries sharing currency is by no means at an end, although too many countries have completely different economic cycles for a single currency to suit all of them.

A major correction on financial markets is highly likely at some stage this year. It is going to take a long time for markets to recover because more economies around the world have been impacted by this crisis than ever before and it will take longer for a real recovery to establish itself. Consequently, equity and bond investors have yet more uncertainty to look forward to.

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