
September 2011: Eurozone Complexity Brings Risk Aversion

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Given numerous major news events — the debt limit debate, the S&P downgrade on U.S. debt, Chairman Bernanke’s pledge to keep short-term rates pegged at zero for two years, the slow-motion collapse of Bank of America and the stock market selloff (and bond market rally) — the collective analyzability of all the developments becomes difficult. But those are just the developments in the United States – when we look at the factors affecting Europe, the level of complexity increases dramatically.

As eurozone drama dominates the headlines, we thought it would be helpful to provide some background and perspective on the current crisis. While no one knows how it will ultimately resolve, the European debt situation continues to weigh upon investor psychology and risk appetite, and has heightened the risk of a slowdown in global economic growth.

Within the financial system, fear has become the most important factor in pricing southern Europe’s sovereign government bonds (bonds issued by Italy, Portugal, Spain and Greece), and the debt and shares of the banks that hold them *because the impact of large-scale sovereign defaults is unknowable*. Moreover, the political fallout of taking the necessary steps to bailout insolvent governments is even more difficult to handicap, which could mean that the euro is in the early stages of a struggle for survival where bank solvency, liquidity and politics shackle themselves together in a downward spiral.

Televised displays of violent Greek protests have impaired global investors' willingness to take on investments perceived to have exposure to European banks (and even to U.S. banks because of their connections through derivatives), but investors are also reluctant to take on exposure to companies that have disproportionate sales in the eurozone for fear of a sliding European economy. This dynamic creates a self-perpetuating negative feedback loop.

European politicians and central bankers don’t help the problem with short-term fix after short-term fix. “Official” information and communiqués have also proven themselves to be of dubious value in many cases. For example, last autumn the European Bank Authority, after conducting stress tests on 91 large banks, declared them all strong. Within weeks, five of these banks collapsed as Ireland encountered its debt crisis, delivering a blow to the European Bank Authority’s credibility and

further weakening investor sentiment. The aura of make-believe and denial protracts the problem and arguably makes it worse.

The problem, in our view, is that the euro is the first tradable currency *not* to be backed by any government, fiscal authority, tax authority, army or navy. Furthermore, like the constitution of France on which it is modeled, the euro pact has only rules for entrance, not for exit.

The European Central Bank is compelled by its rules to lend to its members' banks, accepting all sovereign eurobonds as collateral. Analogous to this would be to force the Fed to lend against all manner of mortgage-backed securities under the assumption that "housing can never go down." Since the ECB has only €10 billion in equity, its financial condition risks devolving into that of the ailing Greek banks that are now on the verge of collapse.

The International Monetary Fund became the eurozone's primary savior under the leadership of Dominique Strauss-Kahn. After his scandal in the spring, he was succeeded by another Frenchman, lawyer Christine Lagarde. It is now up to her and Jean-Claude Trichet to coax and cajole eurozone members into continuing to support the ailing countries by committing themselves to what will likely be a never-ending series of aid, support packages and bailouts. At the moment, German Chancellor Angela Merkel and French President Nicolas Sarkozy are putting on a brave face and giving the appearance of unanimity in defending the status quo, but they are also spending a lot of political capital in doing so.

The Germans are less and less happy with the situation and are doubtless uncomfortable with France's control over the institutions that provide aid. The former head of the Bundesbank, Karl Otto-Pohl, recently told *Spiegel* that the euro is in trouble because the eurozone has become a transfer zone, with members sending aid to each other in complete violation of the founding principles. Moreover, the European Central Bank is violating its own constitution by making outright loans to member nations (taking their bonds onto its balance sheet). Finally, he noted that Greece should never have been admitted into the euro.

It seems that if you have a currency with no backing other than a theory and a set of rules, you have a serious problem when you violate those rules on a regular basis. The euro has lost its status as an elegant, eternal mechanism of financial stability and is becoming another dubious European experiment. It will exist until something gives way in the political sphere and/or the Germans balk or push for a new agreement.

A note on Germany

In recent discussions with colleagues at a CFA Institute conference in Chicago, the following hypothesis emerged: When the Berlin Wall fell, Helmut Kohl made a strategic error insofar as he agreed to swap good West German Deutschmarks even up for rancid East German ostmarks. The result was that the reconstituted Deutschland had a powerful, competitive West and a weak,

hopelessly uncompetitive East. Under this exchange regime, wage and benefit levels in East Germany were far too high relative to worker productivity to attract capital investment; as such, the East was hindered from participating in West German-style prosperity.

West Germans collectively sucked it up and for a decade resisted wage increases and improvements in their own social programs, while pouring roughly \$100 billion into the socialist East.¹ During that "lost German decade," Germany got virtually no financial help from its allies and fellow EU members, yet it continued in its role as paymaster for the euroelites and their spending schemes.

Then the new millennium dawned, and all the euro members were locked into sharing the same currency. No longer could weaker economies rely on their ability to ease their competitive problems through devaluations. As Germany's trade surpluses with its fellow eurozone members increased, German banks invested their depositors' savings in bonds issued by the other nations, particularly the weakest of the weak where a premium over German bund yield was available. So Germany lent (on easy terms) the money to its partners that essentially helped them to bankrupt themselves.

Germany's current domination within the eurozone would not have happened had West Germany not sacrificed for a decade to bail out its Eastern brethren. During those long years of sacrifice, the rest of Europe was enjoying the prosperity of the post-Cold War era and the technology boom. Wages rose faster than inflation, France cut the work week from 40 hours to 35, governments grew and civil servants' pay and benefits grew even faster...times were good! And those dull, dour Germans were still writing the checks that kept the EU afloat.

None of the other countries' leaders seemed to notice that German wages weren't growing, but German competitiveness *was* growing. It didn't occur to them that being locked into a common currency with a competitive and frugal economic powerhouse was a high-risk political game where one sovereign nation was subsidizing and lending to the rest.

Now, the bailout rules prescribed by the so-called 'Troika' (the European Commission, the ECB and IMF) force the financially weakest economies within the free trade zone to accept austerity programs that shrink their GDPs. The debt/GDP ratio keeps deteriorating even as the restraints increase, which has led to feelings of resentment in both Germany *and* the rest of the eurozone. The remedies prescribed by the Troika have failed to improve the creditworthiness of the weak members, so all those crisis meetings in which the Germans are asked to pony up more money to prevent some underachieving socialist economy from collapse are now about as effective in restoring sound eurozone growth as waterproof teabags.

Investors must face the reality that the weeks in which there is no European crisis to unsettle global stock markets will be succeeded by weeks of collective nail-biting. There will be no return to the

¹ Western progressives had their analysis of East Germany wrong. J.K. Galbraith and other leading economists pronounced East Germany a successful economy and society, right up to the fall of the Wall, but it was far from it.

kind of self-congratulation of the 2000 Lisbon Summit that was supposed to launch the eurozone on a drive to becoming "the most competitive knowledge-based economy in the world." No one imagined that within a decade of this declaration, we would find that Portugal would be bankrupt.

The euro is no longer just an elegant theory concocted by French intellectuals over glasses of burgundy (from vineyards subsidized through the 41% of the EU budget that went for agriculture), but it is now also the mechanism for political discord and the vehicle that exacerbates economic imbalances. Because socialist ideals backed the theory for the monetary union, the idea that the biggest member would achieve sustained growth in industrial competitiveness within a single-currency environment was as unworthy of reflection as recognizing that the Cold War had been won, not because of a sudden surge of Russian benevolence, but because of the strategic and military leadership provided by the U.S. and Great Britain.

Going forward

Those who participated in the creation of the euro will muster all the mechanisms possible to keep it afloat. But recent elections in Germany and Finland demonstrate that voters have become increasingly disillusioned as they watch Greek rioters and more concerned as they watch the contagion spreading to Spain and Italy.

The most ominous development has been the run-up in yields on Italian bonds, but at the moment there is some noise that the Chinese will buy them to keep their prices elevated. We doubt this. Italy boasts (if that is the correct term) the dubious distinction of being the fourth largest government debt market in the Western world.

We have emphasized in past commentaries that the connectedness of the global economy shines a spotlight on disparities in competitiveness between countries; the eurocrisis itself typifies this dynamic. Long-term changes in relative currency values also highlight these competitive differences. Similar to Germany but on a larger scale, China and other Asian and Latin American lenders provide easy lending terms to U.S. borrowers, enabling them to live beyond their means while they simultaneously lose global competitiveness. Nowhere in the political discussion has this idea been communicated along with the specific steps needed for the U.S. to compete more effectively worldwide *and the importance of learning to spend less than we earn*. The political discussion still mostly centers on how to spur consumption, how to get businesses to hire and how to continue funding outsized entitlement programs without upsetting the Treasury market (as we know, the Federal Reserve will buy Treasury bonds if it has to).

There are many *known* unknowns in the global economy, but among the *unknown unknowns* are 1) the future political direction; 2) policy responses (often designed to lessen near-term economic pain) and their consequences; and 3) when and how the inevitable reckoning of obvious imbalances will occur. The threat of the eurozone unraveling is currently preventing rational, value-based investing,

and the byzantine political relationships in the eurozone ensure that expelling the insolvent southern European countries will be a slow process. In our view, a new agreement will need to be crafted to set up a smaller eurozone because northern European taxpayers picking up the tab for the profligate southern Europe is a situation that cannot go on indefinitely.

As to investment strategy, a prudent step is to avoid European financial institutions and to try to limit over-exposure to Europe at large. As a general rule, we prefer companies that don't over-rely on banks for funding and that sell goods into countries where there is either greater economic health or where their businesses benefit from declining real income.

The global power structure is in the process of shifting from West to East, as are improvements in the terms of trade, but that has yet to be acknowledged from U.S. political podiums. As a result of the power shift, oil and other extractive industries are making a lot of money, but investors, absent some clarity on the way forward, currently are reticent to embrace risk – especially risk that is tied to healthier economic growth.

As the recent announcement from the Swiss National Bank indicates, no one wants a strong currency (it set a minimum exchange rate of 1.20 'swissies' per euro, effectively setting a peg). This is another form of pricing intervention in the free markets by central banks or political institutions, which has its own distortive effects. Space doesn't allow us to fully treat this here, but we continue to believe that certain paper currencies will lose value, and that we want to own assets that are likely to increase or hold their value in the face of this effect.

While recent headlines lack much good news, it is important to remember that the problems are well known by market participants and that psychology and attitudes toward risk-taking can change on a dime. Risk-taking could return with the acknowledgment of the problems by politicians and the gravitation toward sensible reforms. With the Fed's zero-rate policy, clearly *some* sort of risk needs to be embraced, but the environment of make-believe and defending of the status quo keeps markets on edge. We continue to believe that a balanced approach to investing makes the most sense and that our clients are best served by owning high-quality, liquid assets that should help maintain their standard of living in an era of competitive currency devaluations. This will lead to downside portfolio volatility from time-to-time, but tolerating these periods will be key to realizing successful long-term outcomes.

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