CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

January 22, 2012

The ECB Buys Time for Europe

The massive loan program by the ECB has lowered the risk of an banking crisis in Europe by providing an enormous amount of funding to hundreds of European banks. This gives policy makers in Europe time to better the sovereign debt crisis.

Unfortunately, the German approach--extreme fiscal austerity in the heavily indebted countries--chokes the economies of those countries. Austerity is unlikely to solve the debt problems and it may well cause very serious social and political unrest.

By

Jack Mayberry

The World Bank published its forecasts for the world's economies this past week. Because of the Euro-zone crisis, the World Bank now estimates lower growth for the world in 2012 than its previous estimates, and predicts recession in Europe. It warns of the risk of financial system chaos and economic crisis from the Euro problems, and urges developing countries to prepare for such a crisis, by 'assessing their vulnerabilities and preparing for contingencies.' This is good advice from the World Bank--for all countries and for all investors.

As discussed in our last letter, the December action by the European Central Bank (ECB) to provide nearly one half trillion Euros in low-interest, three-year loans to about 500 European banks (the Long-Term Refinancing Operation or LTRO) significantly lessens the risk of an imminent banking crisis. A second round of the LTRO will commence in several weeks, perhaps even of greater scale. This massive infusion of liquidity into the banking system is a clear indication that the new ECB head, Mario Draghi, is using the facilities of the ECB to ameliorate the awful situation arising from the sovereign debt crisis in Europe. (This provides a very sharp contrast to actions of his predecessor, Jean-Claude Trichet, whose crabbed, Scrooge-like interpretations of the ECB's mandate exacerbated the crisis.) The relative calm that has prevailed in markets and at recent auctions of bonds for France, Spain, and Italy, is almost surely a result of the LTRO.

The World Bank is probably correct in predicting recession for Europe in 2012. Germany's economy itself appears to have contracted in the fourth quarter of 2011, as the effects of the austerity regime promulgated from Berlin to the ailing 'peripheral' countries, have cut German exports to its southern neighbors and restrained economic activity. Relentless rounds of tax increases and spending cuts in Greece, Italy, Spain, Portugal, Ireland and (even) France will almost certainly continue to depress those economies, while doing little in a constructive way to decrease the government debt burdens.

The present calm in markets and guarded optimism about the Eurozone crisis may not persist, despite the ECB's actions and related efforts by the IMF. There are fraught negotiations involving private holders of Greek debt to compel the 'voluntary' acceptance of substantial losses in their holdings of Greek bonds. Many private holders of Greek government bonds will have purchased insurance against their default. To expect these holders to forego the insurance coverage they have paid for while accepting losses of 50% to 70% of the face value of the bonds is odd, particularly when some public debt holders, including the ECB, are not being required to recognize losses. Risk of a 'disorderly' default of Greek debt, with unpredictable and disruptive consequences, is still high, despite published assurances that a deal is at hand. Additionally, the huge calendar of upcoming debt auctions by Spain and Italy presents real risks of chaos in coming weeks. And, although the present focus is on Greece and its debt, the unresolved similar problems with Portugal and Ireland are pregnant with possibilities for chaos as the year proceeds.

Mr. Monti's lament--and warning. The new and highly respected Prime Minister of Italy, Mario Monti, has been speaking widely in recent days, in a politic but pointed way, noting that Italian citizens (and, presumably, Spaniards, Greeks, and others) cannot be expected to go along with ever more stringent fiscal conditions imposed by Germany in the crisis, unless they see the long-term benefits for themselves in the grim regime of higher taxes, reduced pensions, increased retirement ages, diminished social services and shrinking economies. While pointedly avoiding criticism of Germany and the German-inspired austerity regime, he notes the political and social impossibility of such strictures, and points out that it is in Germany's interest that European economies grow. Mr. Monti speaks of growing "impatience-cum-hostility to the EU, to the ECB and to Germany." Let us hope that 2012 will not be remembered for widening social unrest in Europe.

Quantifying the probabilities. The World Bank warns of the risk to the world's economies from the Euro-zone crisis and urges developing countries to prepare to meet the crisis. It studiously avoids assessing the probability that things will morph into another systemic crisis. For investors, the key question is precisely that: what is the likelihood of a Lehman-like event? In the autumn, I assessed the risk as uncomfortably high and eliminated investments that I judged would suffer in such an event. In the last several weeks, various actions, notably the ECB's LTRO, has lowered the risk of calamity. Based on this assessment, Core has moved from its extreme risk-averse portfolio positions and made a few investments that will benefit in an explosion-free world.

One new investment is intriguing: last autumn, EU members demanded that European banks increase their capital and raise their ratios of risk-free (or less risky) assets to total assets. Given that raising new, fairly-priced equity capital in public markets is a near impossibility in present conditions, most banks are selling off assets as a means of meeting the new capital targets. As a result, very valuable books of high-credit, fully-performing loans are being offered for sale by banks at exceptional discounts, sometimes at 60 cents on the dollar. We have invested in a fund that trades on the New York Stock Exchange with billions in cash for such investments, KKR Financial Holdings. The fund is run by KKR, the big private equity firm; it has a handsome yield now (about 8%), and has said that it seeks to make such purchases from European banks. We expect, in a modest way, to be beneficiaries of the crisis in Europe's banks.

Given the environment of modest to fairly robust economic growth around the world, except in Europe, but with the risk of a Lehman-like crisis erupting within Europe, we have structured the portfolios Core manages hold two sets of investments. The first include the Japanese yen, long-term US treasury bonds, gold and the US dollar; these will likely appreciate in a calamity. The second set are comprised of more risk-oriented assets, including our infrastructure fund, other equities, and corporate bonds. These are likely to grow well in our slow-growth world if there is no calamity. Core's aim is to find the right balance between these two types of assets, so as to avoid disaster and to participate in growth.

CORE Comments

CORE ASSET MANAGEMENT
PO Box 1629
108 Caledonia Street
Sausalito, California 94966
(415) 332-2000 • (800) 451-2240
fax (415) 332-2151
www.coreasset.com
info@coreasset.com