CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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Mario Draghi Ups the Ante

Eurozone problems grind on in their cyclical pattern with periods of calm and hope lasting days or weeks, succeeded by periods of anxiety and despair. June's summit meeting initiated a hopeful period, with the understanding that the €100 billion for Spanish banks would be loaned directly to the banks, without becoming an additional obligation of Spain. More recently, however, Germany declared that the lending would have to be Spain's obligation and the downward cycle of anxiety began again. Anxiety increased markedly and yields on quite short-term Spanish government notes reached impossibly high levels, suggesting that Spain could not raise money from private lenders even on a short-term basis. Into the breach last Thursday stepped Mario Draghi, the president of the European Central Bank. He told an audience in London that "[w]ithin our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

This was a very bold statement and it looks forward to central bank meetings later this week and to Mr. Draghi's meeting with Jens Weidmann, the president of Germany's Bundesbank. The Bundesbank staunchly opposes outright purchases of government bonds by the ECB as forbidden direct financing of national governments. On Friday, the Bundesbank asserted that there "had been no changes" in its position on this question. The Bundesbank also opposes an alternative means of financing Spain and Greece and the others, namely by the application of the (forthcoming) European Stability Mechanism (ESM) for a banking license, so that it may leverage its €500 billion fund to lend onwards to governments and banks. Over the weekend, German Chancellor Angela Merkel and Finance Minister Wolfgang Schäuble gave support to Mr. Draghi's mooted actions, but without being specific as to actions.

One recalls the tonic--but short-term--effect of the ECB's dramatic and enormous lending program, the LTRO, in December and February, by which it loaned a total of €1 trillion to hundreds of European banks. Like the second bailout for Greece and the announcement in June of the rescue package for Spanish banks, this action lifted moods and markets and engendered optimism about the Euro. Note, however, that the none of these actions has 'solved' the problem; none has given more than temporary respite from the worsening of the crisis. Moreover, there cannot be another LTRO of the same scope. The ECB loaned its €1 trillion against security offered by the many banks. It is widely acknowledged that these banks have very little in the way of adequate collateral to offer in exchange for further dollops of ECB cash. The cupboard of ECB tricks may be somewhat bare.

By

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The markets responded very dramatically and positively to Mr. Draghi's Thursday announcement. In two days global stock markets rose by more than three percent and Spain's borrowing costs fell by a full percentage point. Expectations are sky high for a large round of buying of Spanish and other peripheral country governments bonds, or for even more radical actions, despite the fierce opposition of the Bundesbank. If Mr. Draghi can bring the Bundesbank round his way of thinking this week, the ECB will have shown itself again as an effective (short-term) manager in the crisis. If the Bundesbank does not budge, the ECB will have failed and will have damaged its credibility in a meaningful way. Markets will respond swiftly and negatively. This will be a dramatic week; August vacation plans for European bureaucrats, central bankers, finance ministers, and heads of government may be upset.

The bigger problem is that the European situation is unsustainable, no matter what the ECB's action or inaction this week. The ECB's decision will have a powerful impact on financial markets this week, but still the outcome must be collapse of the Euro system as it has existed and the continued and worsening recession in the 'peripheral' Eurozone countries. Greece and Spain and Portugal are doomed to shrinking economies. It is hard to imagine that social unrest (so far limited to occasional violent protests in Athens and Madrid) will not become endemic with overall unemployment levels exceeding 20 percent and with unemployment for young people exceeding 50 percent. The regime of ever more sovereign borrowing from the ECB, the IMF and European Union entities, largely in order to roll over existing debt owed to these same entities, while economies are squeezed by austerity measures that serve only to shrink economic activity will almost certainly lead to the collapse of the whole edifice of borrowings. As time passes, the borrowings become ever more onerous; consider that the €1 trillion in loans by the ECB to hundreds of European banks all come due between December 2014 and March 2015. Consider that Spain needs to borrow more than €300 billion over the next year and Italy a greater amount. The short-term solutions that the ECB and others consider simply amount to piling on more debt, but pushing off the repayment crisis for a time. An enormous house of cards has been erected; it becomes less stable as its height increases.

Core's investments. We reduced our hedging positions modestly in the last weeks, but still hold meaningful hedges. Our several large high-yielding investments have been very strong in recent weeks, including high yield bonds (symbol HYG), emerging market debt (EMD), global infrastructure (BIP), mortgage REIT (STWD) and speciality finance (KFN). In the context of the European turmoil and the upcoming tension within the US government over taxes and budgets (referred to in the press as the 'fiscal cliff'), these high yielding investments provide solid dividend income, even though their share prices are sensitive to chaos in the markets. Our holdings of somewhat lower yielding bonds (LQD and DBLTX) are much less volatile in price and have produced solid total returns.

We will continue to invest cautiously in this troubled period. The principal characteristic of these years of ongoing financial crisis is the degree to which policy makers and public institutions impinge upon private economic activity. The decision making process in Europe is complicated by the existence of seventeen sovereign nations within the Eurozone (and several more in the European Union), each with its own fiscal and monetary authorities. The partisan gridlock in the US creates its own obstacles to simple, direct action. Policy makers have differing interests, some quite in opposition to good sense.

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