CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

June 25, 2012

Europe

The situation in Europe is too complex to attempt to summarize in these occasional letters to summarize the situation. At best, we can offer suggestions about what may lie ahead. First, however, a reminder of the bigger picture: Since the Second World War, western European countries have engaged in the project that has become the European Union and its common currency zone, in part to put an end to the cycle of war that had plagued Europe in previous generations. To date the European enterprise has achieved that goal, and, in the process, peacefully integrated the Soviet-bloc central European countries--notably including East Germany--into the European Union.

Economies in Spain, Italy, Greece and Portugal are contracting at rates of 2% to 5% per year. Unemployment is rising, having exceeded 20% in Spain and Greece already. It is notable that at the level of 20% unemployment in Germany in the 1930s, the National Socialist party (unfondly remembered as the Nazis of the Third Reich) began to take seats in the Reichstag from liberal democratic parties. In dire economic environments, people attend to the voices of angry totalitarians. There are lessons for Germans here--and for Americans.

These titanic accomplishments are now at risk from stresses of the Eurozone crisis, including anti-democratic decision making processes and extreme political passions unleashed in the straitened economic conditions. I had lunch on Saturday with a Dutch friend, a sophisticated and astute man in his mid fifties, who tells me that, for the first time in his life, he can now envisage war in Europe. In many countries, including his own rich, formerly staunchly liberal Holland, as well as in the economically depressed countries along the Mediterranean, extreme right- and left-wing political parties gather strength. These parties nurture crazily incendiary passions against Germany, against political 'elites' in Brussels, against immigrants, against putatively feckless Greeks… the list could be lengthened. Thus, apart from purely economic travails, apart from the possibility of vast banking crises and financial market chaos is the risk of the unraveling of the social and political fabric in Europe with consequences uncomfortably frightening to consider. (See comments in the adjacent side bar.)

As written in these letters in recent months, there exist approaches to put an end, virtually at a single stroke, to the cycle of ever-weakening governments and their ever-weakening banks. These involve Europe-wide deposit insurance for banks, Eurozone-wide mutualization of at least a portion of the debts of individual countries, and/or a program by the European Central Bank of buying unlimited amounts of government debt of the weak countries. (As to this last point, recall that the Federal Reserve, the Bank of England, the Bank of Japan and the Swiss National Bank all stand unreservedly behind the debt issued by their countries. There is no risk of default of debt of these countries.)

By

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Germany has staunchly rejected all of these measures until a framework of treaties, constitutional changes, and national laws transfers away from the individual countries to real European institutions the power to regulate banks and control taxing and spending decisions in individual countries. Germany's position is reasonable on every point. Except one: As Angela Merkel points out, Germany's resources are not infinite; if Germany lends directly to Spanish banks, it has no control over the activities of those banks; Germany's constitution forbids certain measures it is asked to take; et cetera, et cetera. One point tells against Germany's utterly reasonable strictures, namely that time has run out. The collapse of the Eurozone, a staggering banking crisis, and political upheaval across Europe are in plain view. Prompt decisive action is needed to prevent this outcome.

Unfortunately, 'bailouts' by the EU are not always what they seem. JP Morgan Securities estimates that of the €410 billion of total 'rescue packages' for Greece in the last two years, only €15 billion--not a misprint, just fifteen billion euros--has entered the 'real economy' in Greece. The rest has been to bail out and protect creditors, including a very substantial sum for German and French banks. (Might we have called these improvident lenders? These were big buyers of US subprime debt, as well.)

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Two statistics about Europe's role in the world's economy. 36% of global software sales are in Europe. 15% of S&P 500 revenues come from Europe. Taken as a whole, Europe's economy is larger than America's, and far larger than China's.

The situation with Spanish banks and Spain's debt is dire. Directly behind Spain and its banks lurk similar problems with Italy and France, problems that will almost surely arise unless a scheme to handle Spain is effected in short order. The ill-defined agreement of two weeks ago to lend €100 billion to Spain to recapitalize its banks only increases Spain's debt to such a degree as to render virtually meaningless Spain's deposit guarantees and to worsen its ability to service its debt. The slow-moving bank runs in Spain, Italy and elsewhere are ruinous. Belated half measures from the endless string of summits of heads of governments and finance ministers have, as is said, 'bought time'. Unfortunately, the time purchased has been spent unwisely; problems that were eminently soluble at relatively low cost eighteen months ago have now gotten very costly indeed.

Core's investments. In recent weeks while market conditions have proved reasonably favorable, Core has built meaningful hedging positions in the 'volatility' instrument of which we have written. In our judgment, there is nontrivial risk that either inaction or policy misjudgments will lead to sharp declines in stock markets and related financial markets. Our hedges offer protection from this eventuality. (Note that some of our large bond investments, like emerging market debt and US high-yield corporate bonds, have a fairly high correlation with equities, so we seek to hedge our exposure to these, as well.) Because possible losses in equities (and related bond investments) will be offset by gains in the hedging positions, we are able to maintain these investments we favor. This is all to the good, but a note of caution is in order: although it appears that we have built our hedging position at reasonably favorable prices, the ultimate benefit to be realized from these hedges will only come about if we manage the whole process effectively. The level of uncertainty in markets is exceptionally high, because so much depends upon the judgments and actions of many officials in many countries, in central banks, and in international agencies like the IMF. Decision-making authority is dispersed among officials and governments with interests that are inconsistent with each other and, in some cases, contrary to the greater good.

The global economy. Apart from the political, banking, and financial market stresses discussed above, we have the state of the world's economy to consider. Of course, it is intimately tied up with Europe's problems: A very substantial part of the business of American and Chinese companies is European. (See side note.) The long deleveraging process, begun when the housing bubble burst in the last decade, will inform--and constrain--economic activity for some time to come. Whether or not an aggressive Keynesian approach could have restored a higher level of economic activity is now a moot point. The developed world is stuck in a the realm of slow growth, always threatening to tip back into recession. One can invest productively in a such an environment, but the world's economies remain constrained by the policy uncertainties in Europe and the US. News today from Europe is a little more hopeful. We observe and we take action that should redound to the benefit of the portfolios we supervise.

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