CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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Contraction in Europe…
...Modest Growth in the US

The ongoing crisis in Europe is keeping most countries there mired in recession or growing very slowly. This contrasts with the situation in America, in which the economy continues to grow, even if rather slowly.

In our view, the poor situation in Europe is not likely to lead to another systemic crisis, at least in the foreseeable future. We hold 'normal' levels of equities in our portfolios, with a small hedging position

By

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The Eurozone crisis still presents the biggest risks for global economies, despite the massive bank lending program (LTRO) of the European Central Bank (the ECB), commenced in December and concluded in February. Indeed, the effects of the LTRO, which pulled the banking system and financial markets back from calamity that threatened in autumn, are wearing off and stark problems remain unresolved. The essential issue is that the European fiscal pact requires that member nations of the Eurozone (with some exceptions) cut government deficits to three percent of GDP in 2013. With economies of the heavily indebted countries, including Spain and Italy, already weak, with individuals and businesses cutting their own indebtedness, sharp cuts by governments to attain these goals only constrict economies more tightly. As governments cut spending in an environment marked by private sector deleveraging, economic activity necessarily slows. Slowing economic activity reduces governments' tax revenues, thus <u>increasing</u> the deficit, which is, after all, nothing other than the difference between a government's revenues and its spending.

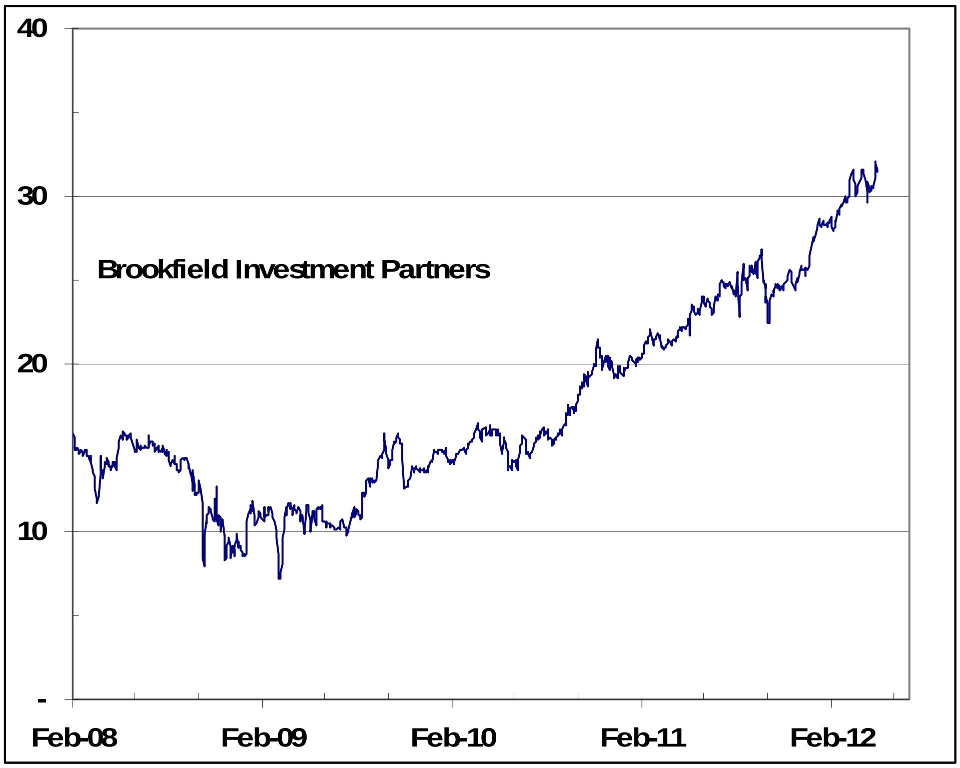
Economic activity slows throughout Europe, tipping some countries back into recessions, precisely at the time when economic growth is needed to supply the tax revenues to pay back government debt. Recently came the report that the United Kingdom has slipped back into recession, having suffered economic contraction in the last two quarters. For Britain, with its own currency, a very supportive central bank and an open economy, to fall into recession again is likely a result of the government's austerity policies It is a sad spectacle, watching all these governments, led by Germany but supported widely throughout the continent, insist that self-constricting fiscal austerity will somehow enable the indebted peripheral countries to restore their finances. Meanwhile, unemployment rises and hope for a good future within a wider Europe vanishes, replaced, one fears, by despair, suffering, and civil disturbance.

Government borrowing rates in Spain and Italy declined after the LTRO loans enabled banks to buy more of their governments' bonds. But in recent weeks, borrowing rates have risen again toward the unsustainable levels that preceded the ECB's announcement. The new conservative Spanish government, firmly in the austerity camp, has pleaded with European Union officials to relent a little on the unachievable deficit target given its terribly high unemployment-- 24%-- and recession, but the compromise agreed to scarcely gives Spain breathing room. The draconian austerity imposed on Spain is self-defeating and unattainable without impossible sacrifice by Spaniards.

The graph below shows the total return of an investment we hold in most accounts. Brookfield is develops, operates, and owns power generation facilities and other utilities in various countries around the world. It is a good way to invest in infrastructure in developing countries. We made the investment a year ago; its prospects look very good.

Ten days ago came the news that the government of the Netherlands has fallen, as the far-right politician Geert Wilders pulled out of the governing coalition as it prepared to imposed new cuts in government services. This is richly ironic, given that Holland, one of only four AAA-rated countries in the Eurozone, has been an ardent supporter of austerity and harshly critical of the profligate southern European debtor countries. It should also be a clear warning to the benighted 'austerians' that their strictures worsen the crisis.

Crisis, solutions? Does this situation lead to collapse of financial systems and markets? I think not. The ECB showed the world in December--when banks teetered on collapse and the financial system was poised again at the edge of that abyss--that it would take radical action to prevent things from spinning out of control. Proposed solutions are fully discussed in countless journals and newspapers. Political leaders, including Angela Merkel, have made clear their awareness of the gravity of the situation in Europe and their duty to find its resolution. For now at least, it appears that Europe's economic weakness is unlikely to cause another Lehman-like collapse of markets and banking systems.



Investments and Hedges. As a result, our portfolios are positioned for the modest economic growth that we now experience and foresee continuing in the US. Our investments, in bonds, currencies, and stocks, are heavily weighted to American investments.

We have also been building a hedging position in many accounts we manage. Despite our view that things are reasonably healthy in America and that we will not be pushed into the abyss by inaction in Europe, we fully expect anxieties to rise again. A list of what might go wrong in Europe and elsewhere is a good indication that market anxiety lies ahead: Spain and Portugal may well need bailouts; France is likely to have a new Socialist president who may be in the vanguard of opposition to austerity; unrest and riots will likely emerge in various cities and countries in Europe; more countries may tip back into recession; political opponents in the US will become more boisterous as the election approaches.

For our hedge, we use an exchange traded note that correlates highly with a widely-used measure of market volatility, the so-called VIX or volatility index.. Volatility is inversely related to stock prices, that is, it increases as stock indices fall. When anxiety rises and stocks fall, volatility increases and our hedging instrument, symbol VXX, will rise in price.

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