

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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The Latest “Comprehensive Solution”

With considerable fanfare and some self-congratulation, European leaders announced a complex set of agreements (and hoped-for agreements) last week. In anticipation and at the announcement, stock markets rallied very strongly.

As further negotiations and more sober examinations of proposed arrangements unfold, we will realize that the Grand Bargain does not resolve matters. Instead, the slow process of widening Eurozone problems will continue, threatening government bond markets and banks.

Another pair of European summits on the October 22nd weekend and on Wednesday of last week has reached another complex deal, characterized by the leaders as a “comprehensive set of additional measures...to overcome the present difficulties.” This is the third such “comprehensive solution” this year. Like its predecessors, this one may buy some time, but it will be tested by reality in coming weeks. It will be found wanting.

At best, the agreements leave for another day (and later summit meetings) agreement upon key details. The ‘Grand Bargain,’ as it has been called, has three components: The first is a negotiated restructuring of Greek debt, by which banks and other private holders of Greek debt agree to exchange their Greek holdings for new (still undefined) securities with half the face value of the Greek bonds to be retired. Second is recapitalization of the weakened banks, the capital of which is impaired by the declines in values of Greek and other government debt. The third is an increase in the capital of the EFSF (European Financial Stability Facility) to enable it to provide a backstop of sorts to prevent Greece’s default from imperiling other heavily indebted but still solvent debtors, including Italy and Spain.

In the three weeks since the markets were in their greatest turmoil, there has been a growing sense that the key parties to the European dilemma were acting with serious concentration to craft solutions to these issues. Markets have rallied strongly in these weeks and celebrated last week’s announcements with robust rallies. But, as negotiations to implement the agreements unfold, their shortcomings will be revealed. The mood is likely to sour once again; Italian, Spanish and perhaps French government bond yields will rise further, and the banks’ capital and funding problems will reassert themselves.

The bank recapitalization agreement has modest targets for increasing banks’ core capital. The assumptions about capital required do not take into account the ever-growing likelihood of a slowdown in European economies, perhaps a recession. Moreover, banks have until the middle of 2012 to meet the new capital requirements. As the Grand Bargain announcements were being made, one bank after another declared that it would not raise new private capital nor accept capital infusions from governments in order to meet the new capital requirements. Thus, banks have determined to shrink their assets, including their loan books: Europe’s economy will be deprived of bank credit precisely when growth is needed to restore the finances of governments, banks, and people.

By

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EFSF. The schemes to increase the capital of the EFSE involve its insuring the first 20 percent of losses on government debt and raising capital from Japan, China, Brazil, the IMF and others. Without offering an explanation, allow me to assert that the losses from insuring the first 20 percent of losses are likely to exceed what would be lost if the EFSF purchased Italian and Spanish debt directly. And, unfortunately for the plan to raise money from other countries, Germany's Bundestag (like the parliaments of its creditor northern neighbors, the Netherlands, Austria and Finland) voted on the day before the Wednesday summit to put no more German money into the EFSF. On what terms will China and Japan wish to risk their capital when the Germans will risk no more of theirs?

The write down of Greek debt is the most promising aspect of the three agreements. In a sense, this is merely to recognize what has been painfully obvious for some time, that Greece has no hope of repaying its accumulated debt in full. But this 50% write off does give Greece some hope for a return to growth in the future.

Like the earlier 'comprehensive solutions,' this one is not likely to resolve Europe's sovereign liquidity and solvency crises. None of the previous agreements has calmed markets for long; none has contained the spread of the crisis, which is now near to engulfing Italy. These half-solutions and ill-structured arrangements with their unintended consequences do not even buy time. As previous agreements have demonstrated their failings, the crisis has continued to widen and the costs to resolve it have risen. In my view, this process is continuing.

Meanwhile, in the United States, economic reports over the last month have been more encouraging than feared just a few weeks ago and recently-announced corporate earnings reports have been generally favorable. In speeches by Fed Chairman Ben Bernanke and other Fed officials, there have been strong indications of further Federal Reserve actions to stimulate the economy should they be needed. The combination of better news from Europe with these positive American signs has produced strong rallies in stocks and other assets that had fallen so sharply from July and into the beginning of October. Risks loom in the United States, however: the summertime negotiations in Washington about the federal government's spending and taxing ended only with an agreement to appoint a super committee of Representatives and Senators to seek a deal. That deadline looms in late November. It seems a certainty that the negotiations will continue without resolution until the last possible moment; it is naïve to expect constructive and thoughtful solutions to emerge. Poisonous political posturing seems far more likely.

Core's outlook and investments. Our view is that, in light of the problems discussed above, investment risk remains high. The swings in asset prices from day to day are quite remarkable. We have retained large investments in high-grade US corporate bonds, in US treasury bonds, and in the Japanese yen as havens. As fear has diminished, as Europeans have worked in concerted fashion, and as the Fed has made its plans clear, we have begun to invest again in currencies that rise with a decline in the US dollar. We have added to small positions in high-yield US corporate bonds and in global infrastructure. We seek to invest in assets with high and safe dividends and interest, in the expectation that waves of market volatility will be muted by the stable income streams Core's portfolios produce.

As we all have been realizing this year, the biggest risks to economies and to financial markets comes from policy makers in Europe and America. Good decisions may be made by public officials, but so far poor ones are more in evidence.

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