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

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The European Crisis Worsens

The crisis in Europe has deteriorated further since our last report. It appears that we have reached a crucial stage. Default on its bonds by Greece seems increasingly likely. This will impair the capital of important French and German banks and may have adverse repercussions on the banking system in the US, as well.

This is my fifth draft of a letter attempting to describe and assess convulsions in Europe and their effects on our investments. I have not yet been able to finish a letter before its having been overtaken by new events. I re-read my letter from mid August and see that I was not far off the mark, but not quite pessimistic enough about the speed with which the problems would develop. We are, it appears, peering again into the abyss of a banking crisis.

Euro-zone bonds. Last week, the German constitutional court ruled in litigation brought by opponents to German efforts to aid Greece and other euro-zone 'peripheral' countries. The first news reports made the point that the direct challenge failed: the challenge to Germany's participation in the EFSF ("European Financial Stability Facility") mechanism set up in May 2010 to provide support to the indebted governments. A fuller analysis, which I read yesterday, makes the point that the EFSF facility passes muster because of its temporary nature, but that next steps in a process that might resolve the crisis, namely participation by Germany in the issuance of so-called 'euro-zone' bonds, would offend Germany's constitution.

I have no German; if I did, I would still be unqualified to render a view on German constitutional law. I can only report that Germany is now preparing for a default by Greece on its bonds. German banks have large holdings in these bonds. If Greece defaults, the capital of these banks (and major banks in France) will be gravely impaired. If the German banks are undercapitalized, US banks are at risk. US banks directly hold very little debt of the benighted 'peripheral' countries, but major US banks are connected to the major German and French banks through opaque derivative contracts. We cannot assume that problems in German banks will stay at home.

Euro-zone bonds have seemed a promising way for the creditworthy European companies to assist the uncreditworthy ones and to preserve the decades-long project of European integration. These now seem to be off the table. What remains?

By

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Monetization by the ECB. The euro-zone does not have a joint fiscal authority to issue bonds, collect taxes and the like. It does have a joint monetary authority, the European Central Bank, which has taken an active role in this whole farrago of indecision that has characterized Europe's handling of the crisis. As I described in my last letter, the ECB has been a purchaser of bonds of the countries facing crisis. In the summer, Italy and Spain became flashpoints; the ECB stepped in to purchase their debt, suddenly being shunned by private investors. Like other central banks, the ECB possesses a

Our foreign currency and precious metal hedges have produced positive returns, as have our large investments in bonds.

'printing press.' That is, the ECB may issue euros in what quantities it will; it may use these euros for its purposes, including to buy government debt of the countries in distress. Thus, it may 'monetize' that debt and resolve the immediate crisis. The ECB is utterly unwilling to undertake that. Its outgoing head, Jean-Claude Trichet, has staunchly and recently defended its decision not to take such action. Indeed, last week, Jürgen Stark, the German member of the ECB executive board, resigned without comment, but with the clear implication that even the modest buying of Italian and Spanish debt was too much. Monetization of Greek debt seems out of the question. What remains?

Default by Greece looks like the next step in this misadventure, although a report this afternoon in the *Financial Times* encouraged the hopeful: Italy has called upon China for help. China may (or may not) find advantage in helping here; at the least the news may forestall panic. It may give Germany and others time to prepare the way to re-capitalize their banks for losses likely to be realized soon.

Investing in this. The report on Chinese interest might lead, in the normal course, to speculation about the likelihood of Chinese help. But this makes clear the problem with investing now: how is it possible to know what decisions may be made by various policy makers about these matters? Never in my memory--with the ugly exception of the autumn of 2008--has the environment been one in which investment outcomes will be determined so much by policy makers, by heads of central banks, by finance ministers, by inscrutable leaders of China's sovereign investment fund, by Tea Party rabble-rousers, by the indecisive president of the United States, by hitherto unknown members of executive boards of the ECB, by minority members of Angela Merkel's coalition, by Christine Lagarde, the new IMF president?

In September 2008, when Lehman collapsed, the principal central banks and fiscal authorities of major countries acted in unison, quickly and decisively in response to the existential crisis facing the global financial system. The situation in 2008 appears in retrospect far more grave than that facing us now, but….wait until next week. Now, three years after Lehman's collapse, resources are far more limited and political will for co-ordinated action seems to be on another planet. Late last week was a meeting of G7 finance ministers. The euro-zone crisis was on the boil, but silence reigned. Not reassuring.

Where does this leave private investors? Core has had very small equity positions for the last several months, and we have attempted to use respites from selling as opportunities to reduce exposure to stock markets. Germany's stock market has fallen by an astounding 41% since May, while the more 'robust' US stock market is down by a mere 15% over the same period. Despite major losses in stock markets, Core's accounts in the aggregate show positive returns for the year to date, because of our large investments in bonds, currencies and gold.

The US economy is either growing very slightly or contracting very slightly. Weak economic growth is a perfectly fine backdrop for our bond investments and we may expect bonds to continue to thrive, even if the deliberations in Washington result in further fiscal restraint.

In sum, the very worrisome conditions in Europe and the absence of growth in America argue for even fewer equities and more bonds. The euro-zone crisis may not ultimately manifest itself; the single currency and it weak governments may yet muddle through. In case they don't, we have very cautious investments.

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