



Europe: What Will Happen Next?

A look at the events in Europe and their potential investment implications

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In the past, we've observed that we are living in what the Chinese would describe as "interesting times". Increasingly, however, we are beginning to believe that we are living in a point in time about which much will be written by future historians. The economic events we are experiencing today are global in nature and in scope are simply unprecedented in human history. While there are many contributing factors impacting our interconnected world, none represent the risk or opportunity of Europe. How events play out over the coming weeks, months and years could again freeze the financial world or see the rise of a new global power in a United Europe. Understanding the dynamics of the situation and how they may play out in real time is critical for investors.

In this article, we attempt to cut through the noise and identify the underlying issues which will influence the ultimate outcome of this developing situation.

Past

Before jumping into the current analysis it is often useful to understand how the union came to be in its current form. As the French originally envisioned it, the European Union was to serve two purposes: First, to serve as a French led and dominated counter weight to both the USA and Soviet Union. Second, to tie Germany to France so thoroughly that Germany would never again threaten European domination. Germany would become *of* Europe instead of *in* Europe.

The earliest steps permitted free trade and movement between member states borders and later the use of a common currency, the Euro. The final step was to be the political union of the member states to create what was envisioned as the United States of Europe. This final step did not take place and may have died forever when the very architects of the idea, the French, rejected the treaty meant to accomplish the unification. Upon that event the other member nations simply walked away from the notion leaving what exists today.

Until 2008 all members enjoyed the benefits of being in the Union and other states, notably Turkey, and Eastern Europe were clamoring to get in as fast as possible. The core states such as Germany enjoyed open trading access and a stable currency that was weaker than what they would have had on their own. Peripheral states like Greece were able to borrow at significantly lower rates than they would have been able otherwise.

Over time this created economic imbalances which began to manifest in 2010. Greece was first to achieve a debt level so severe that the bond market began to price a default into the market. A bail out was needed or Greece would have defaulted.

In 2010 the first bailout was funded with assurances of austerity and a plan to return to the bond markets. This model was repeated with Ireland and then Portugal "the PIG's". A great deal of speculation remains regarding Spain and Italy. Both have made significant efforts to effect their own austerity programs without external assistance.

The problem is that austerity isn't working.

Austerity has slowed the economies of the bailee countries, lowered tax revenue (if it is even collected) and generally increased the debt. One estimate is that Greece will need a 90% haircut to get to a level of sustainability¹. The markets have not even begun to digest this number.

Present

Fast forward to 2011 and Greece is in need of another bailout, Ireland wants to renegotiate, Portugal is on path to need more help and both Italy and Spain are being tested by the bond markets. The ECB resumed its open market operations by purchasing Italian and Spanish bonds in an effort to normalize a very spooked bond market.

In July 2011, after much dithering and frantic negotiation, the Germans agreed to the creation of a stability fund, the "EFSF". Greece agreed to enact another round of austerity (at the angry revolt of its citizenry) and Greek bonds will be restructured (an implied 22% haircut²) on a "voluntary" basis. Somehow this implied default will not be called a default (we will see why shortly).

To go into effect this new institution will need to be voted on by all members of the union but in reality the EFSF is not a European institution, it is a German institution. Germany will decide who gets what, when, and under what circumstances.

This is really an amazing moment! It puts Germany in a very interesting position of influence. Imagine, Germany may now be able to accomplish economically what it could not accomplish in two world wars that being the domination of Europe economically and politically. As the other members begin to understand these implications they may become very nervous, if they are not already.

Most analysts agree that the current size of the fund will be insufficient and when the USA was downgraded by the S&P the markets immediately discounted who might be next with focus on France. This led to massive market dislocation as a downgrade of France would jeopardize the stability fund before it ever got started. S&P affirmed its rating of France but as a side note this simply validates the irrelevance of the rating agencies in their current form. No informed analyst can possibly conclude that the French are a better financial risk than the USA.

Future

So what's next? This is an important question but the answer is truly unknowable even to those responsible for the solution! What follows are possible outcomes and educated guesses based on the assumed interests of those in charge.

The choices facing the debtor nations are not pleasant or not possible.

The current approach, austerity, is leading to recession as spending is cut and labor markets are overhauled. Austerity basically amounts to becoming German.

The transition cannot happen fast enough. The smaller resultant economy and additional debt will not help countries like Greece achieve the ability to service the debt. Greece cannot grow enough to service its debt in any foreseeable scenario. Nonetheless this will likely be a price for any additional bailout.

Asset sales won't solve the problem either. There are not enough assets to significantly impact the debt. Assuming assets are sold they could presumably be taxed but it is reasonable to assume that any asset sold would need to be priced at a level from which the purchaser could generate a profit. Would the sale price plus discounted tax flow equal or overcome the long term profit? To assume it does assumes the purchaser is not too bright. Not likely but possible. It is more likely that the asset sales are in effect wealth transfers from the seller. Nonetheless asset sales and taxation are unlikely to make a dent in the debt. This too has been and is likely a price for further bailouts.

Devaluation of the currency, the time honored method for dealing with too much debt and the policy being pursued by every country on earth right now, is not possible for the individual members within the currency union. They could leave the union (or be ejected). This would permit a country like Greece to issue its own currency. This presumably weak currency would likely result in high, perhaps hyper, inflation and probably much higher interest rates. The debt issued in Euro's would, presumably, still need to be repaid in Euro's. This would further erode the standard of living of the country and the actual results are not dissimilar to the austerity being experienced today although the residents would probably not perceive it as such (e.g. I can give you 10 Drachmas for the 10 Euro's you were getting but the bread that cost 2 Euro's now costs 4 Drachma's or I can cut your subsidy to 5 Euro's.) This option is like jumping from a very high board at the swimming pool when you are not sure how deep the water is or rather you can swim. It could happen but there will be no small reluctance to jump.

A debt swap from one currency to another would be a form of default in the experience of the lending nations (since repayment is in a less valuable and presumably weakening currency) but assuming there is no debt swap the possible result could be a worthless currency e.g. German Mark circa the 1930's. These are but possible outcomes. A country like Greece might find fiscal religion and could overhaul the labor market, taxes, the collection of taxes and slash spending. It has happened before, just look at Brazil, but in the case of Greece we think it is unlikely in the near future.

Finally the countries could default. Outright default is not a terribly good outcome for anyone. The ECB and German banks hold a lot of PIG debt. As currently structured the ECB cannot hold debt in default therefore, in this event the ECB would return the bonds being held as collateral to the banks. There is roughly 450 Billion lent to European institutions on PIG debt and the ECB has lent about 80 Billion to the PIG's directly. In an outright default the ECB, and a number of European banks would likely be rendered effectively insolvent. This would almost certainly freeze the markets in a manner only comparable to the 2008 market seizure and probably worse since it could render a complete loss of faith in the very governments and institutions which the populace would normally look to for leadership out of a major market mess. As US institutions hold European securities we too would feel the impact. Given the structure of European banks they would almost certainly receive some kind of bailout the form of which is uncertain.

For the defaulting country, default is the ace card and this option could be attractive to a debtor nation. They would be able to refocus the money being used to service debt into other functions and the economy gets a reset. However it is almost certain that every type of international relationship would suffer including probable ejection from the Union. The defaulting country would be shut out of borrowing in bond markets until a settlement with lenders is reached. There could also be embargos, tariffs and other restrictions and the economy could suffer a spiral downward as a result.

That noted, this is probably the type of restructuring that will ultimately be needed by the PIG's.

Because outright default carries such potentially devastating consequences, the political establishment will move to extremes to prevent it. Instead any "restructure" will be done in such a way as to not be called a default. It will look like a duck, sound like a duck, but it will not be called a duck.

The options faced by solvent economies, mostly Germany, are likewise unattractive. They basically amount to funding a bailout, leaving the union or suffering a default.

On face large bailouts appear to be enormous transfers of wealth. Understandably, one is not entirely pleased when your wastrel neighbor gets to raid your bank account at leisure and without serious consequence but it is a little more complicated than that.

When Germany agrees to fund a bailout what they are effectively doing is giving money to the PIG's so the PIG's can repay the German banks. It would be far more efficient for them to bail out the banks directly.

As potential evidence of this, pause to consider the case of the IKB. We believe it provides incredible insight into the mind of Germans.

Leading up to 2008, some of the largest buyers of toxic CDO's were German banks. Of those, one of the largest purchasers was IKB. When these bonds went bust and the bank was bailed out the German reaction was to prosecute the CEO for fraud! Not only was he sentenced he was requested to repay his salary (that we would see that here!). The moral is Germans believe in following the rules and there is a great deal of German anger over any bailout. Technically none of "the rules" were followed which is why there are in this position of bailing out the rest of Europe.

Consider too the other benefits that Germany has accrued. They get open markets which has fueled growth with a relatively weaker currency. Ignoring for a moment the financial chaos, leaving the Union or letting the Euro fail would almost certainly lead to a slower or recessionary economy. Nothing any politician wants to face.

If they leave the Euro the result would almost certainly be default of the debt held by German banks. If they don't agree to a bailout they also face default. If they permit the default and bail out the banks the governed will almost certainly extract a price on the politicians in office (they probably will in any event). While this final option is probably the best and most cost effective no politician wants to "fall on the sword" for the potential turmoil, bank bailouts, lost markets, recession, leverage et al.

From a political standpoint bailouts look like the best solution. Selling that to the courts, opposition parties and the populace is another matter entirely.

Any bailout is going to have to be sold with at least the promise of austerity. This has been the play's script so far and until longer term solutions can be agreed upon it is most likely the next act.

Assuming the populace doesn't burn the continent down in the meantime.

For now the highest risk and the "trigger" event (the Lehman moment) is a bank(s) run or liquidity freeze as banks no longer lend to one another. Theoretically the ECB can lend Union member banks unlimited sums and we believe this is what is now happening. It will continue to do this as long as it doesn't appear that a default event is imminent or they are stopped by some other force. This will give the Union leadership time to enact a more sustainable solution but until confidence is restored European banks are on a literal life line. A bank failure and bailout is a very high probability and this could happen soon.

The second highest risk is that the EFSF is not approved and/or the courts rule that bailouts are unconstitutional (the German court ruling issued on September 7, 2011 did not rule participation in bailouts unconstitutional, but it also did not allow for the issuance of a blank check either. A negative ruling would have been a trigger for defaults and the possible end of the Euro.)

Conclusion

As noted at the beginning, the ultimate outcome is unknowable and as rumors and details emerge the markets will continue to react violently both up and down. At this moment the bond markets are telling us that the "smart money" is betting on defaults.

Predicated that the elite continue to support the Euro "project" and on the assumption that the governed people of Europe don't force an outright default, we believe that bailouts (or managed defaults) of some kind or another will continue to be the "solution", albeit in negotiated fits and starts, and as sold to the governed.

Like the deal agreed to in July 2011, further bailouts will be managed defaults but will be structured so as not to be called a default or to trigger a massive run on the financial system. The bailouts will be accompanied by promises of austerity which likely brings about a renewed recession in Europe. If this happens, it is likely that banks will employ some method of gradually writing down the debt they hold (some have already begun the process.)

The EFSF fund could be increased to a level sufficient to cover the bailouts and Merkel has effectively asked for the authority to do this without parliament's approval (the recent German court ruling appears to prevent this.) This would give Germany immense leverage over the rest of the Union and is a high probability outcome. In time, the rest of the Union may become rather uncomfortable with this arrangement. The German people likewise may revolt to the idea of funding this institution, however, German leaders will find attraction to the idea that if you are going to buy it you get to own it and control it.

In the end there are really only two choices. The union must ultimately become, at least, a fiscal union and probably a political union to be successful. The alternative is dissolution of the currency union at least in its current form. For the moment the preference appears to be a fiscal union. The debate is how.

The EFSF solution doesn't immediately affect a fiscal union but if Germany gets to call the shots they could in time bring about something very close to a Germany dominated political and or fiscal union. At least for now, this is the how.

¹ Barron's 7/16/11 interview with Egan Jones

² Calculated based on details reported by the Wall Street Journal 7/22/11

Other solutions under discussion include a bifurcated Euro zone and the creation of Euro bonds.

A bifurcated Euro is an interesting idea. It would basically allow the weaker portion of the Union to trade in a depreciated currency. As discussed above this is a form of default and wealth erosion that is not necessarily perceived as such. Pulling this off could be tricky and we believe that it would cause disruption as people rush to the stronger currency. This is likely to be a low probability scenario, but it can't be ruled out longer term, especially if the governed can't be sold on another form of bailout.

The final solution under discussion, mostly it seems in the US, is the idea of a Euro bond. In this scenario Germany and Greece assume a relationship similar to the relationship that exists between Texas and Massachusetts. Common taxes would be levied to pay for bonds backed by the entire Union. The Euro bond idea as proposed, however, does not seem to be an attractive option for Germany, as a Euro bond would probably require Germany to pay a higher rate for their bonds than the market would require otherwise.

Without a political union it is difficult to imagine countries like Greece restraining them-selves from the issuance of unlimited debt. Assuming that some sort of agreement limiting issuance could be worked out, Germany may feel once bitten twice shy given that other promises have already effectively been tossed to the curb. In all likelihood, Germany will want to keep control over whatever is done, making a true political union as envisioned above unlikely to occur in the near future.

If a Euro bond is created expect Germany to wield power over its issuance in a manner similar to the EFSF.

Finally, we are sometimes asked what direction we think the Euro will go. With the ECB pumping cash into banks, a zone on the verge of recession, and a lack of clarity into the future, it is difficult to picture the currency regaining strength. That said, other parts of the world (e.g. Asia) want an alternative to the dollar. This coupled with actions in the USA, where rates are pinned to zero, the strength of the economy is in question, there is political dysfunction and a clear weak dollar policy, a directional call is unclear, particularly in the short term.

The currency markets are going to react to headlines and so far there is no clear trend. They are currently moving up and down in a range. For the time being this is likely to continue. The trend could break either way depending on central bank policies, political events, and economic news.

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