MARKET OBSERVER

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Half Full or Half Empty

The investment year of 2011 can be divided into its two halves. In the first half, investment enthusiasm seized investors and a half full economic cup seemed very promising. In the second half, fear took hold with the European debt crisis and the same economic cup seemed very empty.

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In terms of the underlying economy, 2011 was actually a decent year for most of the world. The financial markets were a different matter. A full fledged financial panic seized the global markets in mid August. The credit markets reacted violently to the Greek debt crisis, which was exacerbated by the complex politics of the euro zone. The decision to give "haircuts" (imposed losses) to private investors on Greek government bonds in the Greek rescue didn't help.

Investors soon came to the stunning realization that "risk free" government bonds were no longer free of risk. This resulted in a "risk on" and "risk off" schizophrenia for the rest of the year as markets hung on euro policy developments. State elections in Germany, Slovakian coalition politics and Greek referendums all struck terror into the dark heart of the investment consensus. The euro zone leaders huddled frantically at times, calling plays for financial market redemption. Any respite from the selling of risk assets proved short lived, as market hopes for a quick resolution inevitably gave way to the fears that nothing could be done by anyone to improve the situation.

Economically Ordinary

Despite this battering about in risk assets, the economy had a reasonable showing. We called for a decent global economy in 2011, excepting the potential for another financial crisis. We got a doozy of a financial crisis but the economy outside of Europe still showed reasonable growth. It was nothing extraordinary, but a definite continuation of the post credit crunch economic rebound. Given the grim commentary of economists and the sorry state of the financial markets, one would have expected an economic rout as well.

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Dire Headline Competition

The financial markets shunned anything risky in the last two quarters of 2011. Stocks and bonds with any implication European and/or financial were particularly sold off, as the investment consensus moved towards a complete disintegration of the euro zone. Since the treaties creating the shared euro currency didn't contemplate countries withdrawing from the currency union, either voluntarily or involuntarily, the bears ran riot. Cataclysmic outcomes dominated the financial headlines. The normal skepticism of journalists seemed to give way to a competition for ever more dire headlines. Hedge fund managers with CDS protection on the bonds of weak members of the euro zone would obviously profit from an unmanaged disintegration of the euro. These short sellers had a huge incentive to emphasize the negatives and turned to a pliant and willing financial press to spread their doom saying.

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The Anglo Saxon "Big Bazooka"

As we have said in prior newsletters, the Anglo Saxon world is habituated to large doses of monetary stimulus against all financial enemies, real or imagined. The "Big Bazooka" of quantitative easing, the purchase of government bonds by a central bank, has been employed by the U.S. Federal Reserve and the Bank of England. Therefore the financial commentators and market strategists of Wall Street and the City of London have been the shrillest in their demands for the European Central Bank to fire its Big Bazooka and aggressively purchase government debt. Why a bank employee, whose employer's stock in trade is charging a little bit on all money that passes through it, would want more money printed is obvious. What are not so obvious are the political and societal strictures against printing money in northern Europe.

Dunderhead or Genius?

So why is the ECB being so dunderheaded by Anglo Saxon monetary standards and refusing to resolve the crisis? Perhaps they're not so stupid after all. Our rather practical opinion is that the northern Europeans and the ECB are using the imperative of this financial crisis to hammer the euro zone financial plumbing into their chosen mold. Anyone from a labour relations or political background is well aware that unpalatable deals are not struck until the pain becomes unbearable for both sides. They also know there is no point to reach a deal early since it makes one or more of the parties to the negotiation seem weak and results in what the Japanese call "loss of face".

We believe that the Germans and their northern European brethren are using this crisis to complete the fiscal concordat that should have been part of the original design of the Maastricht treaties that created the euro zone in 1992. This is being accomplished both inside and outside of formal treaties and negotiations. Take Italy, for example. There was no formal fiscal treaty in place but the ECB balked at buying Italian debt. This led to the political collapse of the irreverent and increasingly irrelevant Berlusconi regime and its replacement by the technocratic interim government of Mario Monti. Italy also agreed to inspections of its budgetary discipline by the International Monetary Fund (IMF). This turn of events is rather amazing, although totally discounted by investors. What would Americans or Canadians think if the IMF moved in to enforce fiscal budget discipline by unwilling governments? Is the ECB wrong to refrain from firing the Big Bazooka? Clearly, Ben Bernanke and the U.S. Federal Reserve love their Big Bazooka but it is no coincidence that U.S. politicians can't get their spending under control. If there's loads of money to go around, why bother rationing it?

Way Out There

So what is an investor to do in all this financial worry which at times approaches sheer terror? We offer the "way out there" opinion that Europe will survive whether the euro sustains or not. Yes, the dislocations of going back to drachmas, punts, liras and escudos would hurt those countries if they were to exit the euro but the unthinkable is not necessarily the end of the European financial world. Europe has survived many centuries despite war, famine, pestilence and financial crisis.

We think the future for Europe is not the end of the euro. As Angela Merkel cautions, this crisis will not be resolved with the grand solution that the

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market impatiently is waiting for. In fits and starts, not fast enough for legions of traders and market strategists whose bonuses depend on a speedy resolution, things are happening. It is a feature of incipient bull markets that they are built on a "wall of worry". And a wall of worry we do have.

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The Perfidious Slovakians

The financial markets are giving little credit to European politicians for the things they have done to improve the situation. Think back a few months to the hysteria over the approval of the European Financial Stability Fund (EFSF). Variously the Dutch, Germans and Finns were said to face political revolt over the bailing out of the spendthrift Greeks and the other good for nothing Latin layabouts. These countries all passed the necessary legislation.

Then the perfidious Slovakians had their turn to wreak havoc to the EFSF. Who cared that commentators who had never heard of this country were now experts on their political machinations? If they did not pass their enabling legislation then, really, really, really, really bad things would happen. The Slovak government fell but the EFSF legislation was passed.

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Papandreou's Really, Really, Really, Really Bad Idea

What about the dread following Greek Prime Minister George Papandreou's really, really, really, really bad idea to hold a referendum on the painstakingly renegotiated terms of the Greek bailout? The markets had another James Bond moment and they "Died Another Day". Risk assets plunged in price, commentators commented as usual on the dire consequences but the world did not end. President Sarkozy of France and Chancellor Angela Merkel of Germany then pointed out that the Greeks could choose to stay in the euro or not, but that the deal they were offered was final and no one else was coming forward with the cash to pay pensions and government salaries. Papandreou was quickly out and the technocratic Lucas Papandemos was sworn in as Prime Minister with the support of all the major parties. The Greeks did not obviously like paying taxes or austerity, but they preferred fewer euros to many drachmas with much lower purchasing power.

The pattern of a seeming resolution to the crisis by euro politicians and then let down markets showing their disappointment continues. One could see this as the inability of politicians to solve the crisis to the satisfaction of the markets. One could also see this as markets learning that, despite their worst fears, financial life continues.

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The Markets Will "Die Another Day"

What's ahead for 2012? Markets are learning to deal with the euro crisis and are recognizing there is life after financial market death. Markets will "Die Another Day" many times before the euro debt crisis has run its course. This means investors are starting to price things with this in mind. The ECB has provided immense liquidity to European banks with its 3 year loan program. Many have chosen to leave this liquidity largesse in safe German government bunds, "euro free" U.K. gilts and on deposit with the ECB itself. The choice of the U.K. as a safe haven from Europe is instructive. It is not so long ago that investors had written off Britannia due to its banking crisis and weak government finances.

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A Bankers' Stampede?

Sooner or later, some European banker will realize that having borrowed at 1% from the ECB for 3 years, she will be able to buy Italian government debt at over 6% and make a 5% profit. After calming herself over the prospects of an actual Italian default, she will do the calculation to see that she will have 15% more money after three years than her competitors who leave their money at the ECB. When other "safe" bankers see their results are suffering by comparison, they will inevitably throw in the towel and do the same. Aha you say, bankers levering themselves up to make money, that's not likely. Well, having been through many credit cycles, we beg to differ. Bankers and traders have "herded" away from risk assets since August and at some point they will reverse course. There's nothing like a little greed to get bankers stampeding over a cliff.

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It's a great time to be buying if you've got the stomach for it. Remember the year end 2010 fearless forecasts of rising stock markets and the no risk equity trade into the endless growth BRIC countries? The BRIC stock markets are all now down 20% to 30%! How about the investment consensus that interest rates could only rise in 2011? U.S. Treasury yields plunged to historic lows and bonds soared, despite the historic downgrade of the United States from AAA by the S&P rating agency.

Buy Euro Banks, Sell Government Bonds??

As contrarians, we think the assets shunned by others at present will prove to be great value going forward. What is truly loved by investors? The government bonds they shunned in early 2011 since inflation and interest rates would certainly rise. What is absolutely hated? Anything "risky", especially anything to do with Europe and banks since everyone knows that both Europe and all banks (other than Canadian) are destined to fail!

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