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Investment Outlook

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Draghi and Merkel Deliver the Goods in Europe

In our previous installment we marveled at European leaders' dedication to taking off for a month of vacation with the region deeply immersed in the throes of a financial crisis. Our concerns proved baseless as the equity markets coasted through August without incident and then launched to new highs for the year when European Central Bank (ECB) president Mario Draghi made good on his promise to fire up the printing presses and engage in a bit of Quantitative Easing (QE) European-Style. We can't help but think US policy-makers could learn from this "Less Talk-More Action" strategy. Alas, summer vacation for Congress only increases the level of blather, especially in an election year. Their return to "work" goes largely unnoticed by the markets for good reason: The ensuing absence of work product.

As we see it, the only one working on the US economy these days is Fed Chairman Ben Bernanke, who this week fired perhaps his last salvo at an economy that is slowing due to the absence of any confidence-inspiring fiscal policy initiatives emanating from Washington. His launch of QE 3.0, both uninspired and unlikely to produce a meaningful result, is tantamount to the guy in a movie throwing his empty gun at the advancing horde that will inevitably overwhelm him. It's a move that is more symbolic than substantive in the absence of reinforcements arriving in time to save the day. In this case, reinforcements would take the form of a fiscal plan, built on compromise, with an actual budget that imparts financial discipline and provides for deficit reduction. Needless to say, we're not optimistic about the prospect of reinforcements arriving any time soon. We'll address that in our next issue that will focus on the election and the much-heralded "fiscal cliff" that is fast-approaching.

A Framework for the Euro-Zone

Back to Europe. Exigent circumstances are dictating an overhaul of the Zone's financial governance structure. The ECB has embraced the Stimulate and Inflate philosophy espoused by the Fed while the creation of the European Stability Mechanism (ESM) has challenged members of the Euro-Zone to confront the question of how to preserve their national sovereignty while acknowledging the need for financial codependence. Soon after Draghi's announcement, the German Constitutional Court approved that country's participation in the ESM which was essential to any stabilization of the European financial system. The approval was conditioned on limiting Germany's current exposure to the amount of its contribution to the fund. In other words, they would not be footing the bill for the transgressions of other Zone members. In addition, any future contributions would require legislative approval with the same conditions attached.

The ECB's immediate task is to preserve the Euro as the common currency. It will address that need through unlimited purchases of debt securities issued by Portugal, Spain, Italy, and any other distressed Euro-Zone members, even Greece. This version of QE is designed to lower borrowing costs for the sovereigns while the ESM makes cash available to bail out institutions, recapitalize banks, and address pressing liquidity issues. In other words, buy time for distressed countries to rebuild their economies. If this sounds familiar, it should. This is similar to what the Fed has done in the past couple of years to stabilize the US financial system and its banks.

There is one notable difference in the European Plan. Any sovereign who accepts a bailout is immediately subjected to oversight and required to adhere to standards of accountability that will result in operational solvency for that country somewhere down the road. In other words, if Spain and Italy take the money, they have to engage a substantive plan to right their respective ships through austerity and stimulus rather than allowing them to tread water indefinitely, a la the

US model, while they wait for the markets to bail them out. In Europe, unlike the US, failure to comply has consequences: No more money; collateralization of their debt; even a polite request to suspend their membership in the zone. No such consequences exist in the US for banks and institutions (Fannie and Freddie Mac) because of their cozy relationship to policy-makers.

Current State of the Euro-Union

Spain is currently dithering over whether it should petition the ESM for a bailout and French president Hollande is encouraging them to do so at the earliest opportunity. We suspect that he's anxious to see the rescue plan for Europe engaged ASAP for good reason: The longer Spain and Italy remain impaired, the more fragile the French economy and its banking system become and the greater likelihood that Hollande comes knocking at the ESM's door some day. He was swept into office on a wave of socialist enthusiasm for maintaining the status quo in France: More taxes for corporations and the rich; increase the rolls of public employees; more benefits for retirees. That's a sure recipe for winning an election as well as one for bankrupting an economy. It's a model that has been embraced in varying degrees by Greece, Portugal, Spain, and Italy among others. Is anyone impressed with how that's worked out?

Germany, Finland, the Netherlands have taken another path in managing their economies. They've heeded lessons from the past and set a course for fiscal solvency that employs discipline and sacrifice. That means making hard choices at the risk of not winning an election. One might think that this would elevate them to the status of a role model in the eyes of fellow Euro-Zone members. Hardly. Instead they've been pilloried for their audacity in requiring that those looking for a hand-out alter their behavior a bit in order to pay their rescuers back and perhaps even avoid a repeat of the crisis they find themselves in today. In our view, presidents Rajoy of Spain and Monti of Italy "get it" and their efforts to work through the rescue plan have been admirable. Hollande, on the other hand has become an advocate for those who want unlimited aid with no strings attached. In his first month as president, he castigated Angela Merkel for her "unreasonable" demands for any conditions attached to the big check Germany was being asked to write to save the Euro-Zone. As they say in Britain: "What Cheek!"

An Example for the US?

Addressing the challenge of Europe's multiple sovereign-single currency model could be instructive for US fiscal policy-makers. We'll dispense with the Fed here since they're out of ammunition (and without a gun) to make any further meaningful impact on the economy and employment without help from Congress and the Administration. The Euro-Zone members are compelled to compromise because the can they've been kicking is at the end of the road, on the edge of a cliff. Without substantive action, the union and its currency will dissolve into history as a great experiment that Milton Friedman said was doomed from the start. What's fascinating at this juncture is the opportunity that has arisen for the Zone to acknowledge the differences among its members and at the same time re-write the rules in a way to preserve a solvent, enduring entity. As they say in golf, this is time for their Mulligan.

Current conditions are forcing compromise on all but the most diehard of ideologues. Rational leaders see the long-term benefits of maintaining the Euro-Union and are willing to sacrifice in the form of concessions or writing a big check. They see unpalatable consequences arising from their failure to act. Others, like Francoise Hollande, will have their 15 minutes of fame but ultimately be rendered irrelevant by economic and market forces. We're betting that he won't be in office when it's France's turn to come hat-in-hand to the ECB and ESM for aid.

One might ask why the US isn't embracing compromise and change in the same way as Europe? It's simple. There are no immediate dire consequences for government's failure to act or adhere to "best practices". The fast-approaching "fiscal cliff" is unlikely to spur meaningful change in the way we manage our economy. The effects of today's inaction will come home to roost, not for us, but with future generations and their elected representatives. Until then, the union of states will remain intact, the currency will endure, and there's plenty of road ahead for the can to be kicked. Those embracing the "Hollande model" of governance will continue to be elected and no hard choices will be made here until we reach the point where Europe finds itself today. Until then, the Stimulate and Inflate strategy should buoy the markets and push prices of inflation-sensitive assets higher. For now, investors are advised to remain over-weighted in US-based global companies until we see the first signs of a healthier Europe and a return of investors' appetite for risk that assigns a greater value to growth from the Emerging Markets.