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Investment Outlook

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Europe: Back to the Drawing Board

We delayed publication of our April Outlook to include the results of the European elections in our analysis and commentary.

The Global View

Eight of the seventeen Euro-zone countries are in recession and none are seeing their economies expand as measured by manufacturing and purchasing surveys. Even Germany's most recent Purchasing Managers Index ("PMI") declined from 48.4 to 46.2 (any number above 50 indicating expansion). The remainder of the Euro-Zone's PMI numbers range from France's 46.9 to Greece's 40.7. By comparison, US PMI surged to a robust 54.8 with China close behind at 53.3. It appears the world's two largest economies are alone in keeping global growth on an upward trajectory. While we're not among those predicting depression for Europe, the breadth and depth of recession there will impact global growth for the next several years. Barring an "event", we see the modest recovery of the US economy continuing with growth in China and the Emerging Markets moderating only slightly.

In our March Outlook we noted that a strong first quarter masked a change in tenor of the markets. We saw a flight to quality prompted by macro-level concerns emanating from Europe and shared our view that a consolidation of the markets recent gains was in the offing. That was borne out by the pullback that began in mid-April that has left the S & P 500 down 8% from its most recent high. Foreign markets have fared even worse and are in correction territory with declines of more than 10%. The difference between this year and last is the decided lack of volatility. We see the current weakness continuing until a decision regarding Greece is made. Regardless of the outcome there, we don't see events in Europe derailing the global recovery and are viewing this as an opportunity to deploy the cash we raised during Q1.

Things Change in Europe

Last Fall, in response to the perceived need to bail out Greece, the world's central banks and the IMF came together to inject both capital and confidence into the global marketplace. Their actions provided certainty where none had existed with regard to the impending default of Greece and any contagion that might affect other Euro-Zone members. It worked. Borrowing costs for those countries were lowered and stock prices moved higher through the end of Q1 2012. Along the way we saw new leadership in Greece, Spain, and Italy and a commitment by those governments to austerity programs defined by the ECB or, as we like to call it, Germany. These were the conditions set forth by Angela Merkel, whose government would be writing the big checks to fund the bailout. At the time, France and president Nicholas Sarkozy stood as a close partner to Merkel in promoting the ECB plan.

Cut to the present. On May 6, Sarkozy lost the presidential election to the Socialist candidate, Francois Hollande. That same day legislative elections in Greece left no party in a position to form a government. That triggers another election next month that will serve as a second referendum on whether they remain in the Euro. The original plan has begun to unravel with regime change.

We've been vocal in our belief that Greece would eventually leave the Union. Their problems are symptomatic of the structural faults that have plagued the Union since its inception. The ECB looked the other way as Greece doctored its books to attain membership and now find they lack the statutory authority to sanction any of its members for non-compliance with the "standards' they established for participation. Greece must devalue and the only way to do that is to print drachmas. Yes, they and other Club Med countries could adopt a cheaper, second-tier Euro but that would require they acknowledge their status as second-class economies and we see no chance of that. What we see ahead is a departure by Greece from the Euro and a major revision of the rescue plan that was crafted last year.

Saving the Euro Version 2.0

France is caught in the middle: Part of the solution under Sarkozy; Now a part of the problem under Hollande. Since the election, France has been exposed as an unwilling partner in Germany's austerity-based rehab plan for the Euros. Today they look more like Greece than Germany and that poses a problem: Can they really "negotiate" for more credit and stimulus from such a position of weakness? This week, president Hollande is in Germany meeting with Merkel to negotiate new terms to the plan hatched in the fall. He's promoting a "growth" strategy that entails raising taxes, rehiring public employees, and preserving their pension benefits at current levels. Using government as a growth engine is a proven recipe for failure. Another recipe for failure is to suddenly shut down government *investment* during a structural collapse a la 1930 in the US. We see the need for balance between the two in addressing the crisis.

Last week's regional elections in Germany, won by the Social Democrats over Merkel's Christian Democrats, sent a message: Employ a balanced approach of both stimulus from the ECB and spending cuts to navigate through the crisis. Hollande's plan to stigmatize the accomplished and wealthy in France with 75% tax rates will prove to be divisive and counterproductive. We think Merkel and the ECB will find middle-ground and soften in their austerity-only stance. That should be well received by the markets. They will still be left with the problem of enforcing compliance of members under a central fiscal authority. Consolidation of members under the ECB authority will likely be the bargaining chip demanded by Germany in exchange for its continued funding of any pro-growth rescue plan.

Will there be a Version 3.0? Very likely. We see a bifurcation of the Euros between those who are or will be competitive economies and those who will not. The question for the markets is whether Spain and Italy will avoid the same fate as Greece. We believe the ECB, IMF, and the other major central banks are committed to stemming any contagion that could adversely affect Spain or Italy. Whether those countries can become competitive and succeed to the point of joining Germany at the head of the table is one question. Whether France remains there is another. It will likely take several years and another iteration of the current plan to sort that out.

Europe's economic woes are likely to be the major topic behind the scenes at this week-end's G-8 meeting at Camp David. Hollande will huddle with president Obama prior to the proceedings. It will be interesting to see where the two differ in their approach to the fiscal crisis since both favor plans long on taxes and short on meaningful spending cuts or investment. We're curious as to whether Merkel finds herself as the sole practitioner among the three that employs economic discipline and political will in crafting a sustainable fiscal policy. We hope not.

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