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Investment Outlook

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Europe: A Good First Step

June ended with a bang as news from Brussels propelled the S & P 500 to its best single day advance of 2012. Seemingly, a long-awaited breakthrough resolution to Europe's credit crisis had been crafted. Much like the last "big announcement" of October 2011, this one held forth the promise of a permanent solution to the structural infirmities of Europe's financial system. And, much like that previous announcement, the devil lay in the details. What was initially hailed as a major concession by Germany in funding the European Stability Mechanism ("ESM") upon further review appears to be only a well-intended first step toward a lasting solution to Europe's credit crisis. The markets quickly sniffed this out in the days following the Brussels announcement and quickly erased the quarter-ending advance.

The ESM is another in the list of acronyms (IMF, ECB, EFSF) that serve to identify the financial entities that have been called upon to rescue the European financial system. All, at one time or another, have stepped up with news of bailing out one or more of the Club Med countries. The markets have routinely rallied on that news, only to see those advances erased as it becomes evident that the problem is simply been kicked further down the road for a changing roster of finance ministers and heads of state to ponder once again. However, it's worth noting that this latest announcement does offer a welcome change from past efforts.

This latest plan to utilize the ESM accomplishes several things: It changes the dynamic between the banks and sovereigns by directly injecting capital into the banks rather than through the sovereigns; It creates a blueprint for the mutualization of debt among the Euros and calls for the formation of a banking supervisory authority; It renders all lenders equal in that bond-holders and private investor interests are not subordinated to ESM loans. Most importantly, it limits Germany's liability to only the percentage of capital they actually contribute to the ESM, approximately 27% of that fund. They've been understandably reluctant to participate in other Long Term Refinancing Operations ("LTRO") where they are exposed to *joint and several liability*, meaning that they would be on the hook for the entire tab if other Euro-members are unable to meet their obligations, which they are likely to be.

While Angela Merkel appeared to cave in Brussels under the pressure applied by Spain, Italy, and France, she returned home with what she's been asking for all along: Agreement to convene a supervisory body that would monitor members' fiscal policy and compliance with Euro-Zone standards. That agreement is the most significant component of any permanent resolution of the crisis. Unfortunately, the execution of that agreement faces a challenge in Merkel's backyard: The German Parliament quickly ratified the agreement announced in Brussels but it must also ratify any funding of the ESM by that country and that may require a constitutional amendment. An injunction seeking to prevent the funding has been sought and will be heard by the Federal Constitutional Court where an opinion isn't expected for roughly three months. That leaves the ESM waiting to be funded while the

ECB makes piecemeal loans to Spain to buy more time until the German Court decides and the supervisory body is formally convened.

The Challenges Ahead

That last hurdle for Germany could prove to be the undoing of any lasting fix for the crisis. It's a safe bet that Merkel's concept of any Euro-Zone oversight body looks little like that envisioned by Rajoy (Spain), Monte (Italy), or Hollande (France). While they and Merkel are finally on the same page regarding the need for a hybrid strategy of both pro-growth stimulus and fiscal discipline, we're curious to see who sits at the head of the table. A reasonable person could assume Germany, having the only checkbook in-hand, will set both the menu and seating arrangement. However, that would entail an acknowledgement by Spain, Italy, and France that they are lesser among equals in the hierarchy of the Zone. This will be a major stumbling block that, if resolved, will likely take months of posturing and negotiation by leaders of those countries to obscure the fact that they have to subordinate their sovereignty to that of not only Germany but other "Haves" in the zone such as Finland and the Netherlands. France may avoid swallowing that bitter pill but Spain and Italy have no choice. This could explain Mario Monti's announcement this week that he'll not be seeking reelection next year.

If the Brussels Agreement is successfully enacted there will still be more to do to. Informal discussions regarding a Pan-European Deposit Insurance facility have taken place and it could come at the behest of the newly formed central fiscal authority in an effort to smooth the significant divergences in balance sheet quality among the Euro-zone banks. There may also come a day when collateral is routinely pledged for credit extended to financially stressed sovereigns. Finland made such a demand this past week of Spain and it's been reported that shares in Spanish banks might be pledged in exchange for their contribution. If made part of the blueprint, this could facilitate future LTROs or investment in Euro-bonds that may be issued as a result of what began in Brussels.

The markets are yearning for a solution in Europe prior to the fall elections in the US. It's unpleasant to entertain the possibility that we could see both Europe and the US weighing on the indexes in the second half of 2012. That would test the resolve of even the hardiest of individual investors. Professional investors are also confessing to "fatigue" over these too frequently recurring conditions of crisis management and heightened uncertainty arising from a void in fiscal-policy leadership. We believe the other steps needed to resolve the Euro-crisis will ultimately follow this first one. The prime variable is time and how the markets react in advance of seeing a number of Euro-zone members sublimate their sovereign pride to a desire for a permanent fiscal union under a common currency.

After that, the focus shifts to the US where we already enjoy a central fiscal authority and a common currency. Unfortunately, we don't have an Angela Merkel who has emerged as the only head of state willing to risk her political career in the pursuit of resolution to the crisis. The recipe for solving the US's fiscal woes is no secret. What's lacking is the resolve to get it done in an election year where rhetoric overshadows action and compromise is viewed as weakness and a losing strategy. Recent history indicates that leaders don't act until they have to and severely stressed markets have usually provided the impetus for meaningful action. We hope the lessons of the past two years have provided enough motivation for policy-makers in the US and Europe to be preemptive and act in advance of another "scolding" from the equities markets.

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