

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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The Eurozone is at the brink of collapse

The sovereign debt crisis in Europe has worsened markedly in recent weeks. The opportunity to resolve matters before real chaos unfolds is narrow. Germany and the European Central Bank can resolve the crisis in the short run, but they continue to refuse to countenance the needed action.

The risk of a European event leading to another financial crisis has become uncomfortably large. We are engaged in a series of trades to remove risk from portfolios.

You will have noticed a large number of buys and sells in your accounts with Core in recent days. Here is the explanation: In the last week, I have concluded that the risk of disorder in Europe has risen markedly. The chances of the collapse of the Euro, of bank failures, of defaults in government debt have reached levels far above the trivial. Any of these events could lead to chaotic market conditions and to sharp declines in many assets, akin to what we experienced after the bankruptcy of Lehman in the autumn of 2008. Officials in Europe, at the IMF, and in the central banks are intent on solving these problems, and they are working mightily to restore calm, liquidity and solvency. It is also clear, however, that the insistence by Angela Merkel, the German chancellor, on narrow remedies raises the alarming possibility that markets and banking conditions will unravel before the German approach can become effective.

After an exceptionally grim period of weeks, the markets relaxed and a rally unfolded in this week just past. Major central banks have entered into a new program to extend lower interest rates on US dollar interbank loans for a longer period; three auctions of government debt (in Belgium, France and Spain) have 'gone well'. (In this case, a 'good' auction means at much higher rates than similar ones a month ago, but with enough demand at the high rates to sell the bonds on offer. In normal times, no one would call these 'good' auctions.)

A new plan is afoot, to be announced on December 9, which might, just might save the Euro. The outlines are being discussed in the press. If one had not been reading similar reports of solutions over the last year and more, one might be inclined to optimism. Recall that, on October 26, and with some fanfare, European leaders announced a "comprehensive solution" in three parts "to overcome the present difficulties". The three legs of this involved a "voluntary" write down of Greek government debt by some private holders, a beefing up of the EFSF (European Financial Stability Facility) to enable it to provide a backstop of sorts to prevent Greece's default from imperiling other heavily indebted but still solvent debtors, including Italy and Spain, and recapitalization of European banks, weakened by ownership of imperiled European government bonds.

Without detailing the weaknesses of each of the three provisions, suffice it to say that within days, the weaknesses were exposed in the markets. Interest rates on government bonds of Italy, Spain, and Belgium rose steadily. More disconcertingly, the yields on the bonds of the strongest countries, those with AAA credit ratings, Finland, the Netherlands, France and Austria also climbed. Note that the Greek and Italian governments fell last month, replaced by so-called technocratic governments. Despite the new and well respected Italian prime minister, Mario Monti, Italy's borrowing costs have reached unsustainable levels, threaten-

By

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ing its solvency. The “firewall” to prevent the Greece’s problems from damaging the solvent countries like Italy and Spain involved bringing lots more capital into the ESFS. Unfortunately, its first auction after October 26, of a mere €4 billion to continue funding an existing activity, failed. Bringing the ESFS to the planned €1 trillion seems like the remotest of possibilities. There is no firewall.

Most ominously, on November 23, a regular auction of ten-year German government bonds--the bund--failed, in that only about 60 percent of the €6 billion issue was sold at auction. The Bundesbank had to take the rest. Thus, the credit-worthiness of Europe’s strongest country, the very core of Europe and the Eurozone, is now in question, as investors contemplate (a) the collapse of the Euro or (b) Germany’s taking on (all unwillingly) the debts of its weaker Eurozone member states.

In this week, the news became positive and the market reaction nothing less than ebullient. Concerted action by the major central banks, a suggestive speech by Mario Draghi, the new head of the European Central Bank (the ECB) about what it *may* do after governments take more concerted fiscal action, and renewed hopes for another plan, have lifted the gloom. For now.

The existential crisis for Europe is at hand. Events have moved with alarming speed in recent weeks. The failure of the Euro, should it happen, would not be a small event; its consequences would not stay in Europe. The slowness of decision making within a large group of different countries certainly heightens risk. Worse than that, however, is the misguided brinkmanship played by Germany. Germany does not wish to pick up the tab for the failures of the last decade, despite its reaping the fruits of the easy borrowing and lending. Nor does it wish to create the ‘moral hazard’ of stepping into the breach to stop the downward spiral. It insists that the problems be handled by austerity at the level of the individual countries.

The failure of the ECB and Germany to act raises, day by day, the risk of real peril. Without something along the lines of an ECB program of unlimited sovereign debt purchases or the issuance of so-called euro-bonds (bonds to raise money for Eurozone governments with the joint and several guarantees of all Eurozone countries), the Euro will fail. The failure would give rise to a serious global recession, widespread bank failures and a financial crisis of a scale greater than that experienced when Lehman failed. From these events would flow serious social unrest; the rioting and falls of governments in Europe so far witnessed offer a prelude. Will Germany and the ECB act? Time will tell.

Core’s actions. It is impossible to know the likelihood that a decisive response by the governments of Europe will be launched before the markets riot and descend into chaos. My assessment is that the risk of chaos has risen markedly in recent weeks; Core has decided to concentrate the portfolios for which we have responsibility in the safest securities, those investments that passed through the post-Lehman crisis without failing. These are few: the US dollar, the Japanese yen, and US government bonds. We have been selling securities, including high-grade US corporate bonds and the government debt of financially strong countries, which, in ‘normal’ markets, would be quite safe, but which would be at risk in a full-on financial panic.

It is our hope that the exceptional actions we now take prove unnecessary. We hope that we will soon reinvest in these normally safe investments with good returns. Given the adverse developments, given the record of European policy makers delivering far less than promised, given the risk of government bond defaults, and given the risk of the failure of the Euro, we feel that we must take these measures to protect your capital.

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