



Family Feud

A 12-year-old coffee mug has a permanent place on the right corner of my office desk. Given to me by an Allianz executive to commemorate PIMCO's marriage in 1999, it reads: "You can always tell a German but you can't tell him much."

It was hilarious then, but less so today given the events of the past several months, which have exposed a rather dysfunctional Euroland family. Still, my mug might now legitimately be joined by others that jointly bear the burden of dysfunctionality.

"Beware of Greeks bearing gifts" could be one; "Luck of the Irish" another; and how about a giant Italian five-letter "Scusi" to sum up the current predicament?

The fact is that Euroland's fingers are pointing in all directions, each member believing they have done more than their fair share to resolve a crisis that appears intractable and never-ending. The world is telling them to come together; they're telling each other the same; but as of now, it appears that you can't tell any of them very much.

The investment message to be taken from this policy foodfight is that sovereign credit is a legitimate risk spread from now until the "twelfth of never."

Standard & Poor's shocked the world in August with its downgrade of the U.S. – one of the world's cleanest dirty shirts – to double A plus. But what was once an emerging market phenomenon has long since infected developed economies as post-Lehman deleveraging and disappointing growth exposed balance sheet excesses of prior decades.

Portugal, Ireland, Iceland and Greece hit the headlines first, but "new normal" growth that was structurally as opposed to cyclically dominated exposed gaping holes in previously sacrosanct sovereign credits.

What has become obvious in the last few years is that debt-driven growth is a flawed business model when financial markets and society no longer have an appetite for it. In addition to initial conditions of debt to gross domestic product and related metrics, the ability of a sovereign to snatch more than its fair share of growth from an anorexic global economy has become the defining condition of creditworthiness – and very few nations are equal to the challenge.

It was in this “growth snatching” that the dysfunctional Euroland family was especially vulnerable. Work ethic and hourly working weeks aside, the Euroland clan has long been confined to the same monetary house. One rate, one policy fits all, whereas serial debt offenders such as the U.S., U.K. and numerous G-20 others have had the ability to print and “grow” their way out of it.

Beggar thy neighbor if necessary was the weapon of choice in the Depression, and it has conveniently kept highly indebted non-Euroland sovereigns with independent central banks afloat during the past few years as well. Depressed growth with more inflation, perhaps, but better than the alternative straitjacket in Euroland. As currently structured, Euroland’s worst offenders now find themselves at the feet of a Germanic European Central Bank that cannot be told to go all-in and to print as much and as quickly as America and its lookalikes.

Proposals from the German/French axis in the last few days have heartened risk markets under the assumption that fiscal union anchored by a smaller number of less debt-laden core countries will finally allow the ECB to cap yields in Italy and Spain and encourage private investors to once again reengage Euroland bond markets. To do so, the ECB would have to affirm its intent via language or stepped up daily purchases of peripheral debt on the order of five billion Euros or

more. The next few days or weeks will shed more light on the possibility, but bondholders have imposed a “no trust zone” on policymaker flyovers recently. Any plan that involves an “all-in” commitment from the ECB will require a strong hand indeed.

On the fiscal side the EU’s solution has been to “clean up your act,” throw out the scoundrels and scofflaws (eight governments have fallen) and balance your budgets. Such a process, however, almost necessarily involves several years of recessionary growth and deflationary wage pressures on labor markets in the offending countries. While the freshly proposed 20-30% insurance scheme of the European Financial Stability Facility (EFSF) offers hope for the refunding of maturing debt, it is the deflationary, growth-stifling, labor/wage destroying aspect of the EU’s original currency construction that threatens a positive outcome over the long term. Without an ability to devalue their currency vs. global competitors or even – “Gott im Himmel” – Germany itself, peripheral countries may have survival to look forward to, but little else. Perhaps the Italians and Spaniards will put up with it, but maybe they won’t. The ultimate vote of the working men and women in these countries will always hang over the markets like a Damocles sword or perhaps a French/German guillotine. If the axe falls, then bond defaults may follow no matter what current policies may promise in the short term.

Investors and investment markets will likely be supported or even heartened by recent days’ policy proposals. The problem of Euroland is twofold however. First of all, they will remain a dysfunctional family no matter what the outcome. You can’t tell a German much, and while they can issue what appear to be constructive orders and solutions to the southern peripherals, there is little doubt that none of them will “like it very much.” Slow/negative growth and historically wide bond yield spreads will therefore likely continue. Globalized markets themselves will remain relatively

dysfunctional, pointing towards high cash balances in presumably safe haven countries such as the United Kingdom, Canada and the United States. The U.S. dollar should stay relatively strong, ultimately affecting its own anemic growth rate in a downward direction.

Secondly, and perhaps more importantly however, investors should recognize that Euroland's problems are global and secular in nature, reflecting worldwide delevering and growth dynamics that began in 2008. It will be years before Euroland, the United States, Japan and developed nations in total can constructively escape from their straitjacket of high debt and low growth. If so, then global growth will remain stunted, interest rates artificially low and the investor class continually disenchanted with returns that fail to match expectations. If you can get long-term returns of 5% from either stocks or bonds, you should consider yourself or your portfolio in the upper echelon of competitors.

To approach those numbers, risk assets in developing as opposed to developed economies should be emphasized. Consider Brazil with its agricultural breadbasket and its oil. Consider Asia with its underdeveloped consumer sector but be mindful of credit bubbles. In bond market space, the favorite strategy will be to locate the cleanest dirty shirts – the United States, Canada, United Kingdom and Australia at the moment – and focus on a consistent, “extended period of time” policy rate that allows two- to ten-year maturities to roll down a near perpetually steep yield curve to produce capital gains and total returns which exceed stingy, financially repressive coupons. A 1% five-year Treasury yield, for instance, produces a 2% return when held for 12 months under such conditions. Bond investors should also consider high as opposed to lower quality corporates as economic growth slows in 2012.

Because of Euroland's family feud, because of too much global debt, because of deflationary policy solutions that are in some cases too little, in some cases ill conceived, and in many cases too late, financial markets will remain low returning and frequently frightening for months/years to come. I can imagine the coffee mugs for 2020 now: “Gesundheit!” from the Germans, “C'est la vie,” from the French and “Stiff Upper Lip,” from the British. In the United States I suppose it'll still say, “Let's go shopping,” although our wallets will be skinnier. You can always tell an American, you know, but you can't tell 'em to stop shopping. Likewise, investors should always be able to tell a delevering, growth constrictive global economy – but perhaps not. Dysfunction is not exclusive to politicians. Families, it seems, feud everywhere.

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