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Moral Hazard and the Euro

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Assante® WEALTH MANAGEMENT

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Chris provides financial planning, investment planning and full implementation services to about 100 families.

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This newsletter doesn't often comment on quarterly investment market results, but the quarter ended September 30th, 2011 seemed a little painful, as the S&P500 fell from within a few points of its high for the year on June 30th to near its low for the year on September 30th, a drop of 14%, just in time for your September statements. A nasty air pocket.

Investors in the US, and I am sure investors in Canada too, responded to the barrage of scary news by moving money away from the equity markets, to the apparent safety of bonds. According to Reuters news agency, US investors' equity holdings at the beginning of October were the second lowest in the last 12 months.

The timing, as readers could guess, in moving from volatile equities and into bonds, was exquisitely incorrect: the S&P 500 rose about 12% in October, making it the best monthly return since 1987 as reported in the Financial Post [November 1st, 2011].

Not So Bad

The total peak to trough decline between June and September was actually 19.4%, if you were so inclined to look for the worst data (S&P 500 per Bloomberg).

Let's put the volatility in perspective. Looking at the 65 calendar years between 1946 and 2010, the average intra-year volatility in each of those 65 years is … 14%, according to Nick Murray, an industry veteran and commentator.[1] In other words, at some point in each year since WWII there has been a decline, on average, of about 14%. So the 19% decline this summer of 2011 was actually not far off the average.

[1] Long term returns from N Murray newsletter, December 2011 'Surprise is the Mother of Panic' p4

The other side of volatility is return. In those same 65 years, the market has gone up in 46 of them, or 71% of the time. I'll leave aside for now the question of why you would want to be out of something that has a 71% chance of going up. Because in those same 65 years the S&P went from 18 to 1257. Heck, in my career, which is only 30 years, it has gone up tenfold.

So you have to ask the catastrophists this: with all the bad news that's out there, is it possible, just possible, that maybe the markets have digested it, weighed the bad news against the excellent prospects for the future, and found, on balance, that things aren't so bad after all?

As we say, is it possible the bad news is already priced in?

Euro Update

The European front is definitely centre stage in the anxiety department. The slow-motion train wreck that seems to be engulfing the Euro does not - yet - seem sufficient to galvanize the European authorities, in particular the German government, into serious action. Ireland, Portugal, Greece and now Italy seem to be going down, taking the Euro with them. Why are the Germans dragging their feet?

It's quite a story.

First, the Euro zone's debt issues are - or should be - easily within Europe's ability to resolve[2]. The exposure of the French (E35billion) and German (E27billion) banks to Greek bonds is a little more than 1% of combined French and German GDP of roughly E5 trillion[3], so the French and German taxpayers can easily absorb any recapitalization of their banks from a full write-down of Greek government bonds. (There is a big 'IF' here, which we will come back to.)

Secondly, it is also widely agreed that with modest adjustments to its economy, Italy's debt load should be easily manageable. Italy has a healthy savings rate, much of its debt is held domestically, its gold reserves of E90billion are the third largest in the world, and its government runs a primary surplus, meaning it runs a surplus except for interest expense. All this to say that the budget adjustments necessary to get Italy to overall fiscal surplus are not terribly difficult (Canada did it in the 1990's).

So why the difficulty?

The first problem is that Europe's debt problems are in the southern countries, and the resources are in the north. So there is an 'us' and 'them' aspect to this, which makes the conversations more difficult.

Credit Scare

The interest rates that Italy must pay on its bonds have gone up sharply because demand for its bonds is weak, reflecting investor concern about Italy's creditworthiness. This rise in rates is a normal market signal that investors are concerned, and the normal response is for the borrower to take action to improve its creditworthiness. While higher rates are not an immediate problem for Italy, if they persist for say a year or more, Italy's debt could accelerate past the point of no return.

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[2] John Cochrane, Professor of Finance, University of Chicago, Financial Times, September 29, 2011, Eric Lascalles, Chief Economist RBC Asset Management, among others.

[3] Bank exposure per Globe and Mail has French banks at about E35billion and German banks at about E27billion; actual amounts vary depending on the source, GDP data per The Economist

Unfortunately, the Italians may not have a year to sort things out. A funny thing about debt is that everything can be tickety-boo, until some little thing changes a lender's mind, and suddenly it's over. A normal rise in rates can morph gradually to a tipping point, where lenders are suddenly spooked, and they all head for the exit at once, just like a run on a bank.

Another thing about lenders is that there doesn't actually have to be a problem. Investors just have to imagine there could be a problem. In fact, speculative investors only have to see someone else heading for the door and the rush to the exits is on.

In situations where creditors rush for the exits, a *lender of last resort* can step in. This lender can assume the debt (at pennies on the dollar), or lend a bank cash to stop a run. When things normalize and the borrower eventually repays the loans, *a lender of last resort* can make a fortune (as JP Morgan did in the 1930's[4]).

So a *lender of last resort* can prevent the problems from happening in the first place: **IF** the lender has real muscle the run can be stopped. And **IF** the borrower will actually remain solvent, the lender can be repaid. Thus the lender of last resort (usually a central bank) provides confidence that a temporary glitch won't spook the herd.

Back to the Euro story:

The Germans are insisting that the European Central Bank (ECB) and the European Financial Stability Fund (EFSF) backed primarily by German and French credit, not be used to support the Italian bond market – for now.

Just so there is no doubt about how the Germans feel about the idea of using German credit to back up Italy, Wolfgang Schauble, the German Finance minister said, "I don't understand how anyone in the European Commission can have such a stupid idea"[5]. In September, Germany's ECB board representative, Jurgen Stark, resigned following a heated and public dispute over the issue[6].

Are you a US Citizen?

Recent US tax initiatives, such as the 2011 Offshore Voluntary Disclosure Initiative (OVDI) and the Foreign Account Tax Compliance Act (FATCA), have sent many US citizens living abroad scrambling to meet their IRS obligations.

The attention has focussed on the various US tax reporting obligations of US taxpayers, including those who have resided in Canada for a number of years, and who are compliant for Canadian tax purposes but who may not be compliant from a US standpoint.

The US assesses personal income tax on its citizens, unlike Canada which assesses personal income tax on its residents.

If you are a US citizen, please let us know so that we can review your accounts. If you have not been filing your Report of Foreign Bank and Financial Accounts form (FBAR) and US tax returns, please contact your accountant or if you need a referral to an accountant, we'd be happy to help.

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[4] JP Morgan stood behind US banks that faced runs, and became the model for the Federal Reserve. The US government's Resolution Trust pretty much broke even on the Savings and Loan crisis in the 1990's.

[5] The Economist, October 8, 2011, p87.

[6] Axel Weber, head of the Bundesbank, resigned in May 2011, citing 'personal reasons', also after debate over German resistance over ECB lending plans.

The Germans are fiercely resisting becoming the lender of last resort because they believe that artificially protecting debtor nations from the pain of rising interest rates will create what is known as 'moral hazard' by reducing the motivation for the debtor nations to take corrective action on their own.

Moral hazard is one of the central concepts of the financial crisis, being equally applicable in both the US-centred crisis in 2008/09 and Europe today. On one hand, rescuing something too soon - before a problem has caused serious pain (or taken someone's head off) - can leave questions about whether the debtors need to reform, or how bad a bank failure might be.

On the other hand, letting Lehman Bros go bankrupt, as the French say '*pour encourager les autres*', detonated the US financial system, taking it literally to the brink of disaster, and sent the economy into a deflationary shock from which it has not yet recovered.

The Germans Have a Point

This summer, as Italian bond yields began to creep up, Silvio Berlusconi, then Italian Prime Minister, presented a package of economic reforms to boost Italy's economy and bring its debt under control. The ECB responded immediately in support by buying Italian bonds, thereby keeping prices firm and interest rates steady.

Berlusconi also responded immediately - he returned to Rome, and began backpedaling on the reforms – just as the Germans feared.

The ECB countered, again immediately, by stopping its Italian bond-buying program. Italian rates quickly spiked to 7%, infuriating (and possibly terrifying) the Italian electorate. Berlusconi was forced to resign, and now an unelected technocrat government is in place in Italy. The ECB (and Germany and the world) awaits news of new Italian reforms.

It Gets Worse

The personalities involved are no help either. Some of the stories are shockingly childish.

For example, Nicholas Sarkozy, the French President, commented after a private dinner with Angela Merkel, the German Chancellor, that 'You never know what to believe with her. She says she's on a diet, and then takes another helping of cheese'.[7]

Tax-Free Savings Accounts (TFSAs)

Did you know that Assante can hold Self-Directed TFSAs?

Our self-directed plans can hold GICs, stocks, bonds or mutual funds. Please contact us if you would like to open a TFSA or transfer your existing TFSA held elsewhere.

[7] Financial Times, Telegraph, October 25, 2011

This is more than just a stupid comment. Sarkozy was arguing at the same time that Germany should contribute a larger portion than France to recapitalize European banks, even though French banks have the larger exposure. This is a bold enough argument, but to insult the German Chancellor makes it a definite 'nein'.

It is no surprise that Germans feel like everyone wants their cash.

Another reason the Germans will go slowly is that voters worldwide are livid at the mess: governments have fallen in Greece, Italy, and Spain, who in late November threw out their Socialists in favor of a more rightist, reform-minded government. Angela Merkel, the German Chancellor, has lost several seats in successive by-elections since the crisis began, and the French take Sarkozy to the ballot box in 2012.

Barack Obama is looking weak and the US crisis wasn't even on his watch – he is the cleanup crew. Taxpayers are on the hook, and they resent the lack of leadership.

This is the knife-edge we sit on today: rescue too soon and the painful reforms won't get done, so the problem grows; delay too long and a speculative rush could dynamite the system anyway.

All these things mean that the Germans will likely hold the Italians' feet deep into the fire. I suspect the Germans will let things go a lot closer to the brink before they act forcefully; at least to the point where German interests are threatened. German taxpayer money will come only with a very painful pound of flesh.

So where does that leave us?

Greece is toast, destined for maybe a 30% decline in living standards as they deal with lenders who are no longer willing to lend them anything. The Greeks are in for a very rough ride, either within the Euro or back to the Drachma. Europe will survive a Greek default. The Greeks not so much.

I suspect that the cries of anguish from the Greeks across the Adriatic will provide sufficient motivation for the Italians to get their fiscal house in order *pronto*. See 'moral hazard' above.

There is, however, little time to lose. The lenders are inching towards the door, threatening to seize up the banking system.

My guess is that the authorities, motivated by the US experience in 2008, will a) enforce strict financial standards and severe penalties on troubled borrowers, and b) then back up Italy and Spain to prevent a run on their bonds and banks.

As Mario Draghi, the new head of the ECB and former head of the Italian central bank said recently 'The sequence is important'[8].

[8] Financial Times, December 3, 2011

Investment Outlook

Markets Less Negative

Four things have happened since the summer that has brought a little optimism into the picture.

First, the Europeans are inching towards maintaining confidence in their currency. The Euro is holding up much better than when Greece's problems first surfaced in 2010.

Second, US corporate earnings for Q3 have come in better than expected, thus indicating that the feared double-dip recession is less likely. John Deere and Caterpillar announced profit increases of 40% and 44% respectively; Boeing announced a sale of 70 787 jets to Emirates Airlines and an even bigger sale to Indonesia's Lion Air. On top of the order for 70-odd 787s from Air China earlier this year, a lot of Americans will be building airliners in the next few years.

These orders are important proof of the benefits of global trade. These emerging countries need to sell a lot of stuffed toys to earn the currency to buy jets. And very few things on the planet have as much engineering and sophisticated materials, or are as difficult to design and build, as a modern jetliner. This is exactly the way progress is supposed to work.

Third, industrial production in the US expanded strongly[9] in October, thereby providing evidence that the US economy will avoid the dreaded double dip recession, and economic growth in Canada picked up as well in Q3.

Fourth, and you won't have read about this in the news media but inflation in China is slowing, while growth there remains strong at 9%[10]. Moderating inflation is good news because it means the Chinese authorities can ease off the brakes.

Thank you all for remaining cool in these tense times. I wish you and your families a wonderful holiday season and all the best for 2012 (yes, health, happiness and wealth).

[9] US Industrial production, up 0.7% in October, reported by Nick Murray, November 27, 2011.
[10] Consensus forecast GDP growth for 2011, The Economist, November 19, 2011. Chinese industrial production growth is forecast at 13% for 2011.