



CUMBERLAND

## MARGARET WAS RIGHT

European Contagion. I think I have already caught it. The symptoms include insomnia, fits of anxiety, outrage and unrepeatable character assassinations of most of the inept politicians. But the most severe symptom is the brain throbbing confusion over the conflicting proposals that are saturated with self interests even from within the same country.

Sometimes it's hard to believe that things can go from bad to worse, but I guess when politicians get involved, anything is possible.

The fact is, if we had listened to Margaret Thatcher, none of this would have been a surprise.

“A unified ‘Europe’ is the result of plans. It is, in fact, a classic utopian project, a monument to the vanity of intellectuals, a programme whose inevitable destiny is failure: only the scale of the final damage done is in doubt.”

On The European Union, “What we should grasp, however, from the lessons of European history is that, first, there is nothing necessarily benevolent about programmes of European integration; second, the desire to achieve grand utopian plans often poses a grave threat to freedom; and third, European unity has been tried before, and the outcome was far from happy.”

“The European single currency is bound to fail, economically, politically and indeed socially, though the timing, occasion and full consequences are all necessarily still unclear.”

“It is highly questionable whether when ‘Europe speaks with one voice’, as we are so often told it is doing, anyone is really listening. Europe’s reputation as a serious player in international affairs is unenviable. It is a feeble giant whose desperate attempts to be taken seriously are largely risible. It has a weak currency and a sluggish inflexible economy, still much reliant on hidden protectionism. It has a shrinking, ageing, population and, with the exception of Britain, rather unimpressive armed forces and, not excepting Britain, muddled diplomacy.”

Don't you wish she'd tell us what she really thinks?

Nonetheless, it's a refreshing, straight from the shoulder, realistic assessment. Too bad we don't have a few leaders like this today.

So, maybe the best place to start is by trying to gain an understanding of the magnitude of the problem and the politics surrounding the solution. However, let me start with my own biases. The problem is that too many countries, especially Greece, already owe too much, so lending them more is not a solution but a deferral. The only real fix will involve defaults and the extinguishment of some of that debt. Second, there can be no real resolution until the private sector gets involved either through absorbing some of the default losses, extending further credit or both. Governments have essentially run out of money and the only remaining capital pool of any significance that remains is with the private sector. And lastly, one has to understand that Sovereign nations and the banking system are merely the pawns in this mess. The ultimate objective here is to save economic growth. In other words, no one cares if Greece defaults as long as the banks are protected and can continue to lend.

Not controlling the contagion between these interconnected relationships risks certain recession, if not worse, and the social unrest that would accompany it.

It's not that no one understands what the problem is. The issue for the market is whether European lenders are simply in denial or incapable of politically arranging a plan. The fear is that we could go over the cliff, while solutions are available, because of political ineptitude and uncompromising regulators.

It's worthwhile trying to get one's head around the politics and all of the various players, the instruments available to them such as the European Financial Stability Facility, EFSF, and the proposed European Stability Mechanism, ESM in order to understand what can realistically be worked out.

Within the European Monetary Union, there are 17 members and changes to their treaty must be ratified by each country's parliament. However, two countries, Germany and France are by far the most dominant and their bilateral agreements essentially established the basis for any collective accord. Unfortunately, they philosophically support different resolutions for the current focus of their discussions – Greece. This comes shortly after a July 21<sup>st</sup> compromise offering Greek bondholders a 21% haircut on the value of their bonds.

Unfortunately, the current complexities and misunderstandings have lead investors to believe that the political leaders are completely inept and that there are simple solutions to the problem such as kicking Greece out of European Monetary Union (EMU).

So, let me see if I can provide some clarity by defining some of the programs and all the acronyms along with some numbers that complicate the possible solutions.

I'll start with the two funds that are routinely mentioned as vehicles for resolving the problems. The first is the European Financial Stability Facility, i.e. EFSF. It originated in 2010 when the Greek financial crisis first broke out. It could only carry out state bailouts and only after European governments approved them, resulting in lengthy debates about bailout conditions with public airings of disagreements. This past July's agreement strengthened the facility and streamlined its process by allowing the fund to engage in bank bailouts. This afforded the fund the flexibility to make pre-emptive loans to countries that were not yet in distress and also to buy bonds in the secondary market to support their price.

How does it operate? Well, each Euro Zone Member State guarantees that it will back a certain volume of debt issuance by the fund. The EFSF then uses the guarantees to raise money in the bond market which it then passes on to the bailout targets. Trouble is that only six of the member states have a AAA credit rating and those ratings become jeopardized the more they guarantee.

The new deal for Greece in July actually put more pressure on Spain and Italy's credit ratings as they had to raise their guarantees.

The fund's ability to function is dependent on it retaining a AAA credit rating which is jeopardized as countries see their ratings cut.

With the recently expanded powers and size, the fund now has 440 billion Euros of which Germany guarantees 211 billion. There is another fund sitting in the wings known as the European Stability Mechanism (i.e. ESM). It was supposed to start in the summer of 2013, but is now being advanced to 2012. It will be a permanent facility with 500 billion Euros. Why do they need another fund? This one is a step towards more fiscal unity where now you only have a monetary union with 17 central banks that can issue Euro-denominated debt without any coordination. Effectively, the European Monetary Union (EMU) is a severe form of fixed currency controls.

The new facility, unlike the current rescue plan (EFSF), permits a Euro member to become insolvent and it can be involved in a restructuring, which would avoid the political assessment that now influences the process; part of the current problem.

Under this facility a "European Monetary Fund" would take control of select fiscal and economic policies in the insolvent state and substitute powers that normally lie with the sovereign government. This would include negotiating new terms with investors for bond repayments and selling state assets.

Essentially, it's giving up certain sovereign powers by the 17 member states to a control authority. However, it still needs approval by all Euro area countries and all 27 European Union countries which need to pass a treaty amendment.

The other two players worth mentioning are the European Central Bank, ECB, and the International Monetary Fund, IMF.

Each of these funds offers a potential solution but they are also under the control of the politicians.

As I said at the outset, there is no real solution unless there are debt defaults and the private sector, including the banks, is involved. The July bailout for Greece at least incorporated these elements as their bonds were restructured and institutions had to take a 21% haircut.

Part of this agreement was the expansion of the EFSF to 440 billion Euros. The trouble is, it didn't go far enough. The cuts weren't deep enough to get Greece out of its mess.

Second, the size of the EFSF seems to be big enough to take care of current problems but not big enough to handle problems in Spain and Italy.

According to the Bank for International Settlements (BIS), aggregate exposure of the French banks to Greek debt, both Sovereign and private sector liabilities, is about 40 billion Euros versus almost 500 billion Euros of bank capital. A 75% write-down would deplete French bank capital by 6%. For German banks a 75% write-down of all Greek exposure would erode capital by just over 3% and for other nation's banks the impact would be even less.

So why does the fund need to be larger and how big does it need to be?

Well, once you let Greece default you've set a precedent for other troubled and indebted nations such as Spain and especially Italy. For perspective, Italy is the third largest sovereign debt market in the World ranking behind only the United States and Japan with 1.9 trillion Euros (\$2.6 trillion) of debt outstanding. This amounts to 120% of the GDP and is three times as much as Greece, Ireland and Portugal combined.

The size of the final write-down of Greek debt is likely going to be viewed as a template for what may ultimately happen in other countries according to J.P. Morgan who provides many of the insights and statistics in this report.

How big could the problem become? According to Bloomberg, Portugal, Ireland, Italy, Greece and Spain (PIIGS) have about 2.9 trillion Euros in government bonds outstanding, and Italy is more than half at 1.59 trillion Euros. About 413 billion Euros of the debt is held by 38 of Europe's largest banks which is about 40% of the banks 1.1 trillion Euros of equity.

French bank exposure to Italian and Spanish Sovereign and bank debt amounts to 38% of bank capital. For Germany, the figure is 49%.

The IMF estimates that marking all Sovereign debt to the market would reduce tangible common equity of the European commercial banks by 200 billion Euros (\$287 billion) or 10% to 20%. German's 10 largest banks need about 127 billion Euros (\$175 billion) of additional capital according to Reuters.

Consequently, the consensus number is that the EFSF needs roughly 2.0 trillion Euros of fire power, not the current 440 billion Euros.

So, how do they expand the EFSF? Essentially, there are three options, increase the government guarantees, turn the facility into a bank that can borrow from the ECB or use the fund to insure private sector investing. Unfortunately, there are problems with all of these.

Let me start with increasing the pro rata guarantees; again, thanks to J.P. Morgan for a lot of these numbers. Currently the guarantees represent a contingent liability for each country that amounts to about 8.5% of their GDP. Doubling and tripling that would increase this liability to 17% and 25% of GDP.

Currently, Germany's debt to GDP ratio is around 83%. With the current EFSF commitment that ratio is pushed to 92%. Doubling the EFSF guarantees would increase it to 100% and a triple to 109%. For France, their current debt to GDP is about 82% so their increases would be similar. To take on further guarantees would probably affect each country's credit rating and interest cost. The problem is compounded as the EFSF has to borrow in the open market and its credit rating is dependent on the underlying country's ratings. Should the EFSF's rating get cut, it may not be able to access the market or costs would escalate, impairing its economics.

There is also the problem that countries receiving aid are excluded from the guarantee. To some extent, this makes the guarantees joint and several. This could be seen to substantially increase a country's exposure. In the case of Germany, the current fund's size amounts to 101% of GDP and 118% and 136% if the fund were doubled or tripled.

The EFSF could also be turned into a bank which would allow it to borrow from the ECB to expand its resources. In practical terms, this would be no different than the ECB lending directly. The ECB has objections to this. Besides its funding again coming from the member states, the Central Bank is concerned that it becomes an instrument of fiscal policy as problem countries would no longer be compelled to make difficult fiscal decisions and could rely on the ECB for their funding.

The last option is to use the money in the EFSF as an insurance policy. It would not require any further parliamentary approvals and would guarantee investors against the first 20% to 40% of loss in buying government debt.

At 20%, it would expand the fund's scale to over 2.0 trillion Euros, except for the funds that have already been extended to Greece, Portugal and Ireland. So, in practical terms, it will only have about 280 billion Euros remaining to leverage.

Second, there is no assurance that investors would take advantage of the facility, leaving its ultimate execution in doubt and requiring a backup which is likely to be the ECB.

So solutions are difficult, but they do exist if tough decisions are made.

What is likely is a three pronged approach:

- Further write-downs of Greek debt.
- Recapitalizing the Banks
- Increasing the EFSF's size

Most everyone agrees on the first point, except the banks. Under the July accord, the banks will take a 21% haircut on their Greek bonds. This provides some, but not enough relief to Greece. Currently, the suggestion is for a 40% to 50% reduction in the value of Greek bonds. It is something Germany is insisting on, and realistically includes the private sector taking some of the hit. France would rather avoid a further write-down because it would have a bigger impact on their banking sector.

Regardless, the reality is that 10 year Greek bonds trade at 40 cents on the dollar in the open market.

Recapitalizing the banks is an absolute necessity to retain private sector confidence in these institutions, and to allow the economy to function properly.

Germany proposes that they should be recapitalized based on marking sovereign debt to the market and requiring 9% tier 1 capital ratios. To do this, they suggest a grace period of six to nine months for the banks to raise capital on their own. After that, each country would inject capital into their own institutions and finally the EFSF would be used to recapitalize those banks that cannot obtain government financing.

This would put less strain on the EFSF. France is not in favour of this option because it could risk their AAA bond rating and that could jeopardize the EFSF's bond rating.

From the banks' perspective, this is an inopportune time to be raising capital, and consequently they will probably try to reduce capital requirements by eliminating loans. That won't be good for the economy.

Lastly, expanding the EFSF. No one is in favour of further guarantees which only leaves open the banking or insurance options. Neither of these would require further parliamentary approvals. France would prefer the bank option which would allow for leveraging through the ECB while Germany would rather not leverage the fund.

Although the politics makes this a very complex problem, I believe we can simplify the issues. Think of the ECB as a provider of liquidity while the EFSF deals with solvency.

Every bank's balance sheet has both assets and liabilities. The assets are loans and in this case, they are loans to sovereign nations such as Greece. Liabilities are deposits and certificates of deposit. Right now these deposits are being taken out of the banks because depositors are worried about the bank going broke. So, the ECB lends the bank money to replace these deposits.

The EFSF is considering investments in these banks to replace the capital that will be lost as the bad sovereign loans are written down. As an analogy, the ECB is like the U.S. Federal Reserve and the EFSF is similar to the U.S. Treasury.

This points out the flaw in the European Union's system. Their treasury, i.e. the EFSF is controlled by 17 separate countries whereas the U.S. Treasury is under the control of only the U.S. government. Consequently, the EFSF is a function of fiscal policy; in other words, each country's ability to borrow. As it currently stands, each country has its own agenda when it comes to funding the EFSF, which makes it difficult to get an agreement.

In the end, the resolution is likely to use the EFSF as an insurance vehicle to expand its leverage as this doesn't require any further commitment on the part of the 17 member nations. The problem is that it may not work and the fund has a limited amount of capital. The ECB on the other hand, does not require member approvals and is the "deep pockets" institution with theatrically almost unlimited resources. France wants to rely on the ECB for that reason, which would be very similar to how the United States used the Federal Reserve to bail out their banks. Germany is opposed to this solution because it may require them to make further contributions to the European Central Bank's Capital.

In my opinion, if Europe is to come up with what is considered a permanent fix, the solution has to have access to the ECB, even if it is a last resort back stop. The bottom line is that we will know which route will be taken by the end of the G20 Heads of State Summit on November 4<sup>th</sup>.

Regardless, these proposals are moving in the right direction by reducing Sovereign debt, including the private sector and hopefully putting to rest concerns over the banking system which will allow Europe and the rest of the world to refocus on economic growth.

To this I'll add one more comment. We have heard very little from the International Monetary Fund, IMF, which includes U.S. resources. I'm sure they're waiting for Europe to resolve their own mess but they could also come to the rescue and currently have about \$630 billion in usable resources.

## North American Economy

In North America we also face a political confrontation over the U.S. budget deficit which led the country to the eleventh hour standoff over raising the budget deficit ceiling. As with the European crises, the psychological damage to business and consumer confidence has been dramatic.

In my last quarterly, I expected the U.S. economy would start recovering in the third quarter after being held back by parts shortages post the Japanese earthquake and a spike in oil prices that dampened consumer spending.

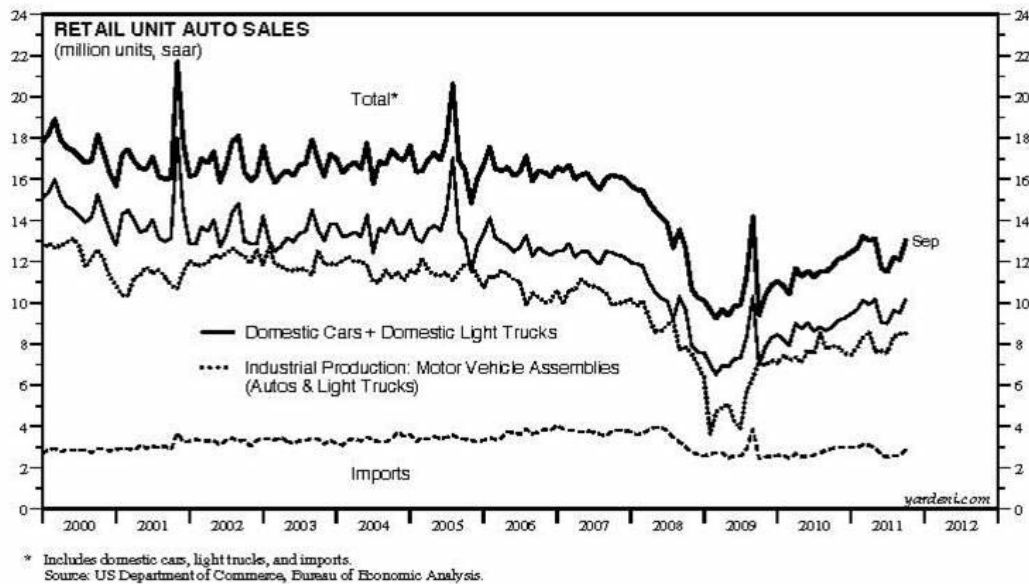
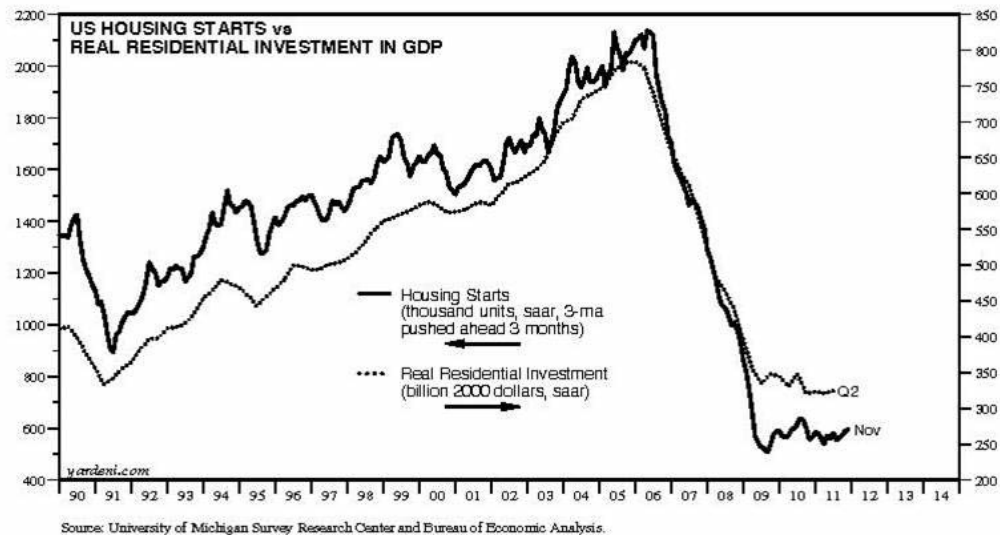
Due to the U.S. debt ceiling debate, a lot of business and consumer spending initiatives were deferred. So through the summer, we saw weaker economic statistics than what we had hoped for.

Although the headlines remained filled with negative news, the U.S. economy is best described as slowing more than expected, but still growing, albeit at a very slow rate. Some recent statistics are actually a bit encouraging. Demand for capital goods rose in August, the most in three months. The Chicago Institute of Supply Management Index rose to 60.4 in September from 56.5 in August, the University of Michigan's consumer sentiment index increased to 59.4 in September from 55.7 the previous month. September auto sales rose 8.3% to a 13.1 million annual rate. Year over year light vehicle sales are up 11.3% and rail shipments are the highest in almost three years.

Even employment is showing slow improvement. Nonfarm payrolls increased 103,000 in September as the private sector hired 137,000 workers. The average work week also improved, which would be equivalent to an additional 318,000 jobs. And finally, same-store chain store sales improved 5.5% year over year in September.

So, not everything is negative, and I would still bet that North Americans can muddle through. If I'm wrong, the consequences don't appear that dire. It's hard to build a case that we would have anything other than a mild recession.

First, business inventories remain well below their 2008 record high. During the credit crisis, this was one of the areas that contributed to the sharp economic decline as inventories had to be liquidated to raise cash.



Second, as seen in these charts, auto sales are still well below 2007 levels and housing has made virtually no recovery. So the downside for these two industries is limited.

And finally, bank loans have already deteriorated and the bank's capital positions are in significantly better shape than they were at the beginning of 2008.

Like Europe, I think a realistic resolution to the U.S.'s problem requires debt write-offs, mostly for home owners, the involvement of the private sector, a strong banking system and a focus on promoting a favourable business climate rather than social welfare policies.

Certainly the United States is much further along in achieving these objectives than is Europe.

The U.S. banks have continued to write down their defaulted mortgage portfolio and the capital ratios and reserves for nonperforming loans are significantly better.

The private sector currently has over \$3.0 trillion in cash on its balance sheets and there are now bills in Congress such as the Homestead Act that will provide down payment assistance for buyers of new homes, allow them to escape transfer and property taxes for five years, future capital gains taxes and pay no taxes on rental income for 10 years.

So, although I now believe that Europe will probably experience negative economic growth, I still think that the U.S. can muddle through.

### **Stock Market**

Recession is an important distinction for the stock market, as I think it is being priced in, which, if true, means we're probably closer to a bottom than most think.

As for a repeat of 2008, I think it is highly unlikely. What we saw then was a liquidity crisis where even healthy organizations couldn't get funding. Today, we have a solvency issue for some of the European Banks and Sovereign Countries. The issues are well known and the ECB is prepared to provide liquidity to whatever extent is necessary. The only liquidity issues will arise from European Banks contracting their balance sheets, not money market funds closing down the short term paper market.

As I see it, investors have four options for their investable assets; go to cash or government bonds, real estate, gold or equities.

For sure, cash is the best bet if we're going into a liquidity crisis. Otherwise, less than 3% yields on 10 year U.S. government bonds when inflation is 3.8% seems like a bad alternative. To demonstrate how expensive the government bond market is, one only need compare today's yields, when the government is running trillion plus dollar deficits to the average yield of 5.48% from 1998 – 2001 when the budget was in surplus and S&P's debt rating was AAA. In fact since 1980, ten year government bonds have averaged 7%.

Real estate is also an option. But measured by "cap rates", which are simply the net rental income divided by the cost of the property, it is historically expensive because interest rates and therefore financing costs are so low. But one has to also recognize that it isn't immune to a credit crisis nor an economic slowdown as occupancy would decline.

Gold is a third option. It can't be properly evaluated, but in theory it is the reciprocal of investors trust in fiat currencies. However, it is perplexing that people are rushing out of the stock market and into cash and gold as they seem to be opposing bets. It's hard to reconcile the demand for gold because of the distrust for currencies, yet the demand for currencies in the form of government bonds.

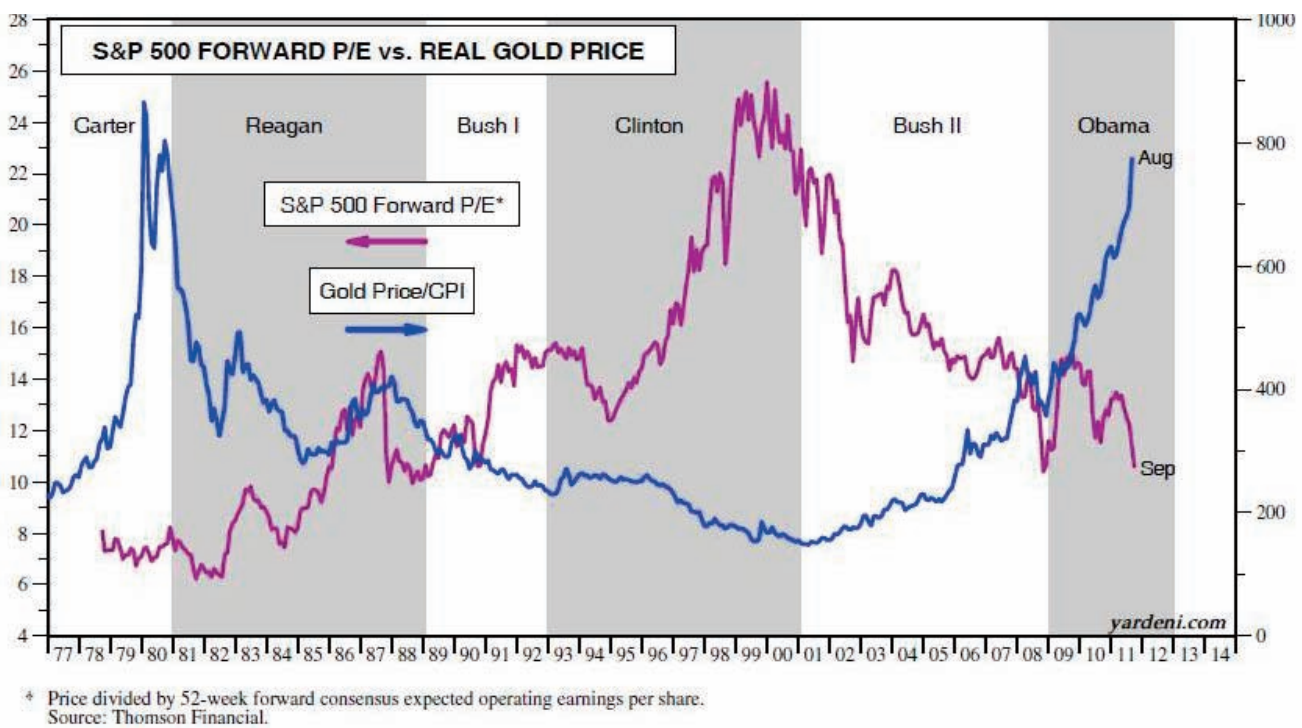
Gold also isn't undiscovered. It bottomed at \$253.25 in July of 1999. If it were a stock, it would have appreciated from \$2.50 to \$18.85 in the last 10 years.

Warren Buffet commented that all the gold in the world would make a 67 foot cube worth \$7.0 trillion at \$1435.50 per oz. That would buy all the farmland in the U.S. plus seven Exxon Mobils, and you'd still have a \$1.0 trillion left over.

Could it go higher? I guess it could, but I do know it isn't cheap.

The fourth alternative is equities, which are out of favour as measured by both investor sentiment and valuation; two good measures of value.

In mid-August, Gallop did a poll that found 34% of Americans identified gold as the best long term investment. That is double the percentage choosing equities. Real Estate was the runner up at 19%.



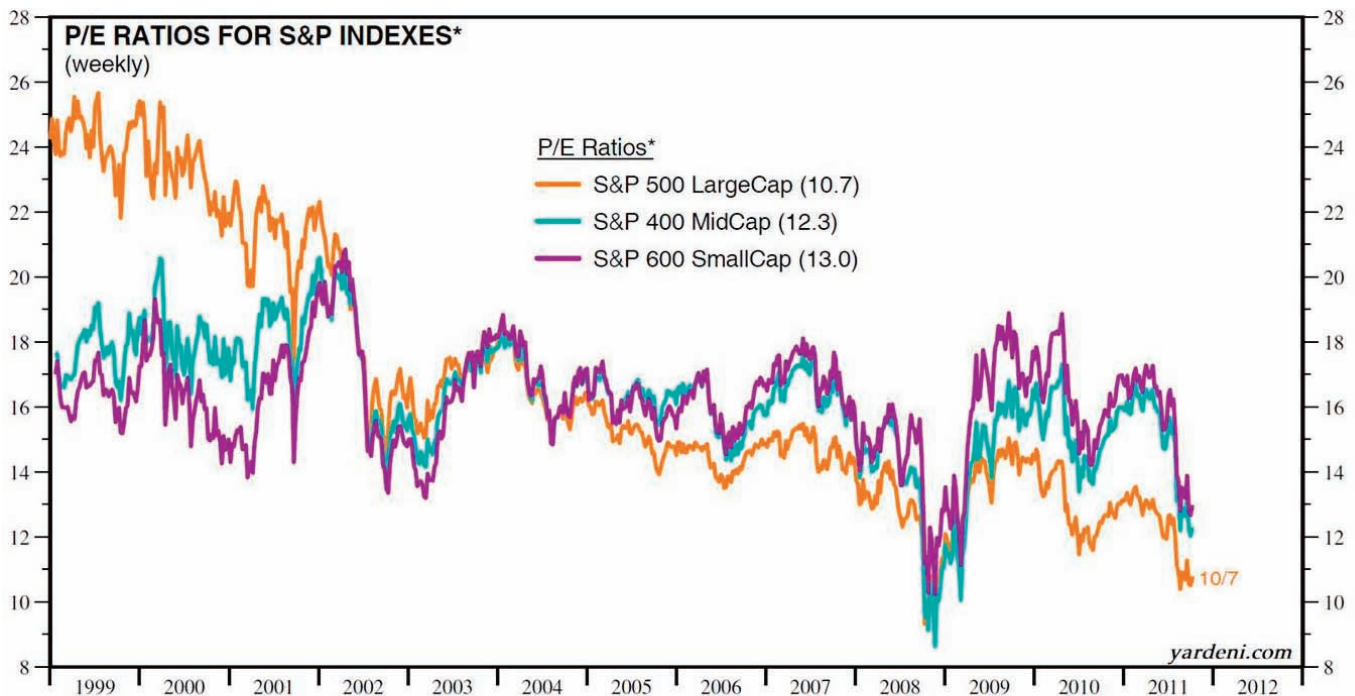
As for valuation, one can see in this chart, which interestingly is plotted against gold, that the forward price earnings ratio of the S&P 500 got down to about 10.5X earnings at the end of August. That's about as low as it got in 2008 and outside of that, the lowest since 1990.

If earnings estimates hold, the market is cheap. But one might question those forward projections if we face a recession.

So we can do a simple calculation to determine how much of an earnings decline this market is pricing in.

In the last nine recessions, the average P.E. ratio of the S&P 500 was 13.7 X at the market bottom. The 2012 earnings estimate for the S&P 500 is currently about \$110.78 and the S&P averages are around 1,150 which means earnings next year would have to drop to \$83.94 or 24% below current estimates and 15% below this year's estimate, suggesting that the economy is setting up for a rather sharp correction, which I don't think is in the cards.

Either way, recession or not, the market by valuation doesn't seem to represent a lot of risk considering that it is discounting a recession, meaning there is a significant upside should it not happen.

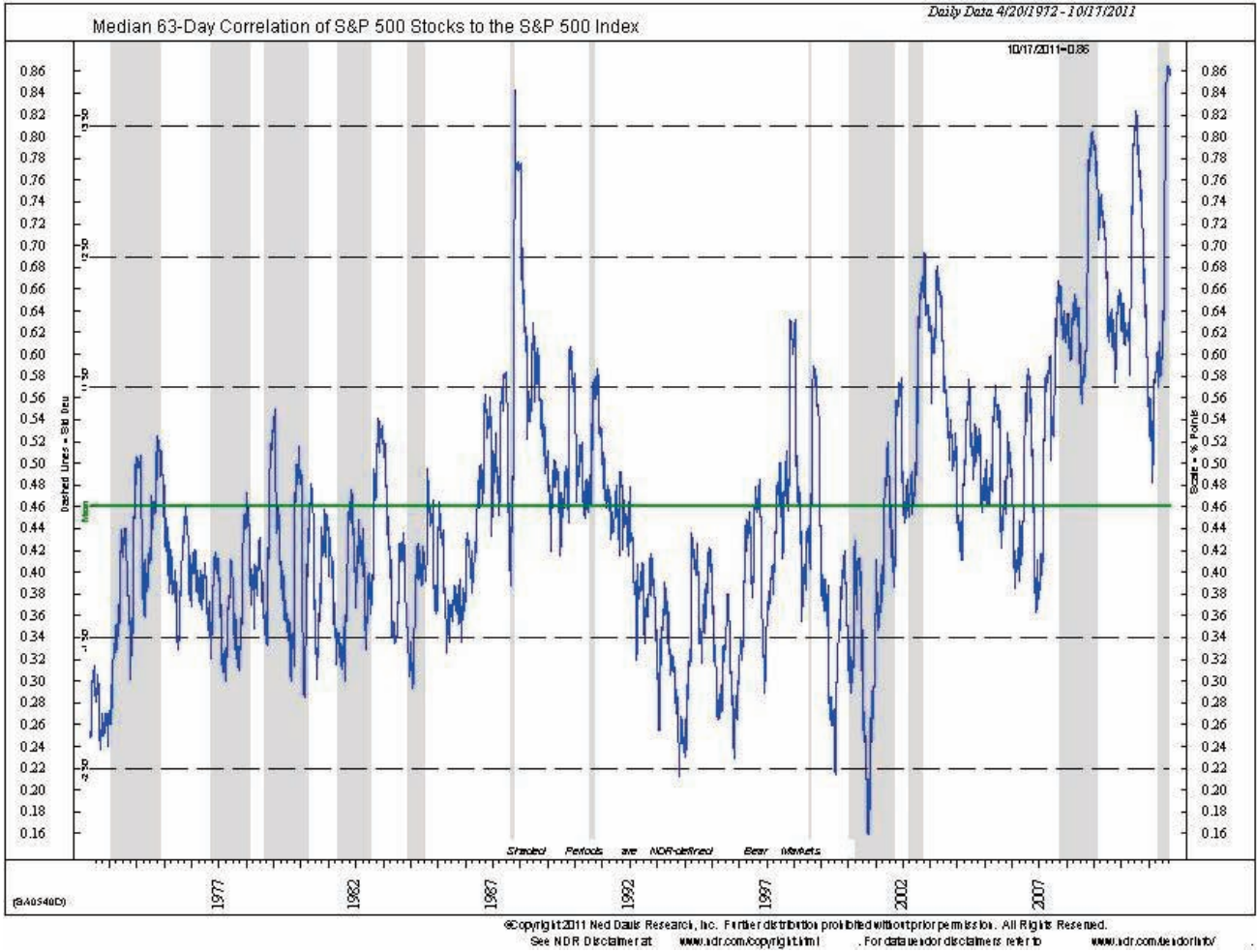


\* Price divided by 52-week forward consensus expected operating earnings per share.  
Source: Thomson Financial.

This second chart on valuation also shows an anomalous pattern. For the first time in decades, the cheapest equities are the biggest and strongest companies, the S&P 500.

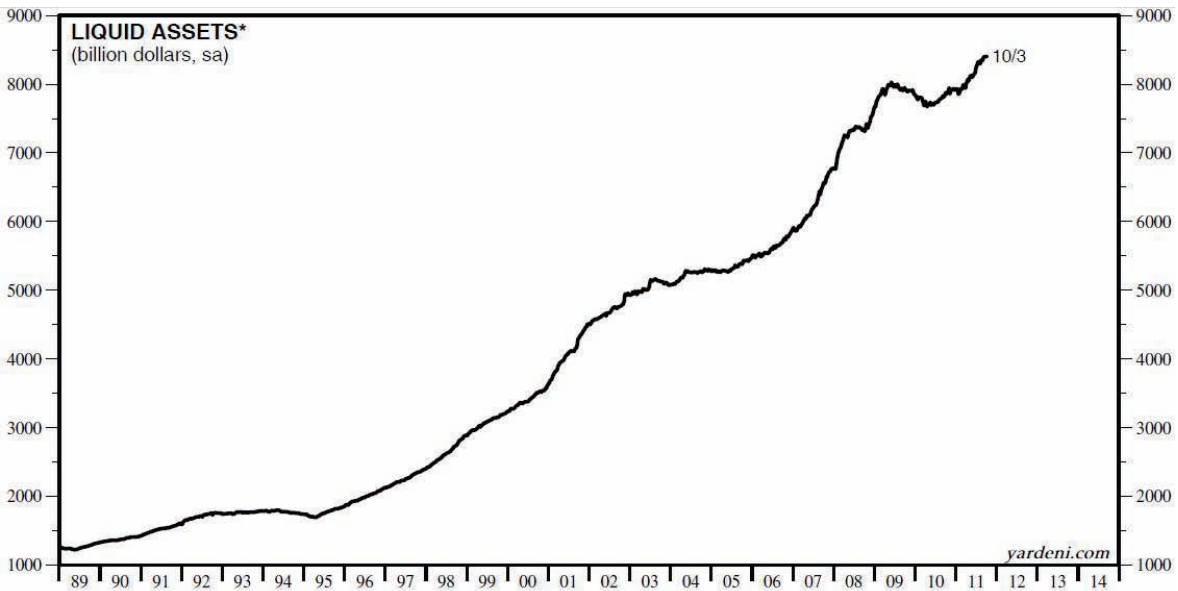
The other indexes include smaller cap companies, those that one would assume would be more severely impacted by a recession. So for the first time in a long time, the biggest, best and highest yielding companies in North America are also the cheapest.

What caused this? I think the index funds and Exchange traded funds (ETF's) are responsible. In today's environment a lot of people have given up on buying specific companies and use ETF's, which own baskets of stocks to make their investment decisions. It's no longer what you buy, it's just whether you want to be in equities or out and we know which way most investors are going currently.



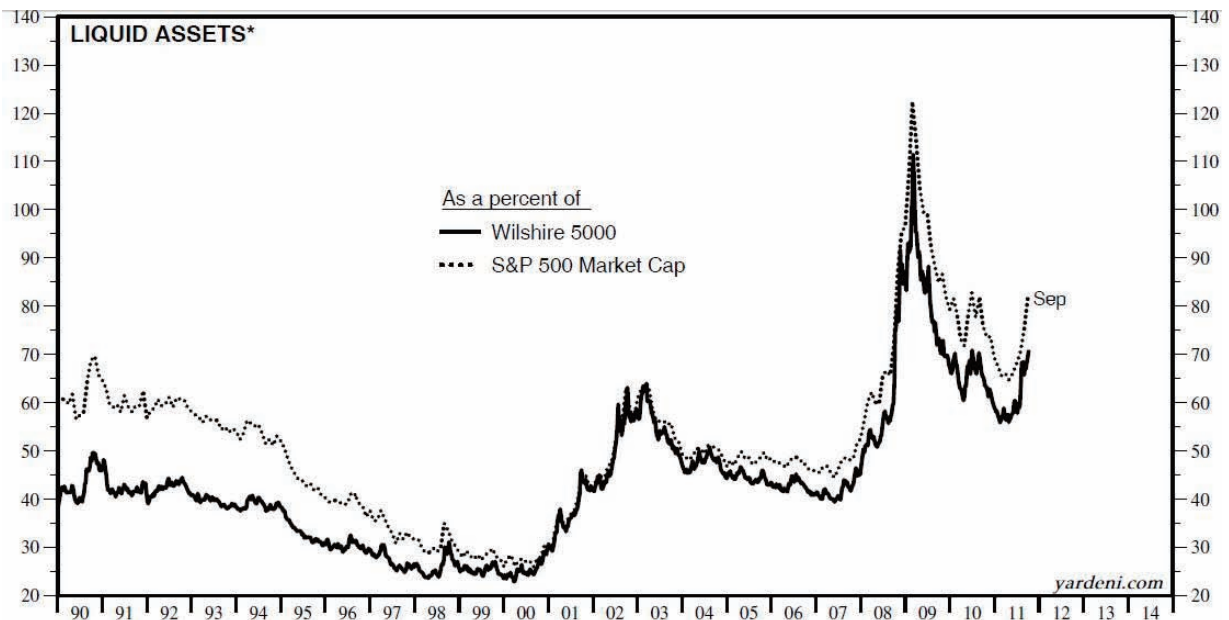
This chart shows the correlation of all S&P 500 companies with the index. Usually, less than half would necessarily move with the market. Today that ratio is 86%, higher than the correlation last seen on black Monday in 1987 and higher than any time since 1972. It means there is no discrimination being made between good companies and bad ones, which is good for stock pickers like us. It also correlates very well with market bottoms.

The reciprocal of this selling is the build-up of liquid assets.



\* Total savings deposits (including money market deposit accounts) plus total money market mutual funds held by individuals & institutions.  
Source: Board of Governors of the Federal Reserve System.

As seen in the above chart, savings type deposits now total almost \$8.5 trillion, a record.



\* Total savings deposits (including money market deposit accounts) plus total money market mutual funds held by individuals & institutions.  
Source: Board of Governors of the Federal Reserve System and Standard & Poor's Corporation.

As a percentage of the market, these liquid assets amount to over 80% of the value of the S&P 500. Not as high as 2008 because the market was lower, but still very high in historic terms.

You can add to this about \$3.8 trillion in cash held by the S&P 500 companies that could go towards stock buybacks, dividend increases or capital spending which would help the economy.

There is also an inclination to buy equities as demonstrated by corporate insiders. Barron's Magazine recently reported that insider purchases were 15% higher than the aggressive volume of purchases at the market bottom in March, 2009.

## Conclusion

There is no doubt that the “macro” environment is uncertain. But the stock market seems to be pricing this into its valuation. Investor sentiment is quite negative and there is an historically high amount of liquidity sitting on the sidelines earning next to nothing.

Unfortunately, valuation is a very poor timing tool, but it does work in the long term as trends regress back to their long term mean. But it does require patience.

What if Europe implodes? I doubt that it would be a totally uncontrolled collapse and in fact might set a bottom.

Maybe the best analogy is 1998, when the stock market rallied 21% in the 4<sup>th</sup> quarter after Russia defaulted, which caused the collapse of the hedge fund, Long Term Capital Management, that sent the S&P 500 down 15% that August.

Bottom line, there are an unusual number of great companies with terrific balance sheets and high dividend yields trading at valuations not seen in decades.

All that is required is a little confidence when none is currently apparent.

GRC/amh  
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