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# Global Crisis: No End In Sight

Another spring, the third in a row, became the theatre of a swift equity plunge colored with economic and political problems. Three springs in a row can be viewed as a pattern. Debt and politics in the U.S. and Europe generated legitimate doubts in the mind of consumers, businesses and investors across the globe. The prospect that Greece might renege on the austerity pledge is causing money to flee Greece, but it is also flowing out of economies on the periphery of the Eurozone. Cash dries up in Spanish banks, while a flight to safety pushed sharply down government bond yields in Germany, Switzerland, Denmark and the United States. On the short-end of the yield curve –- *1 to 2 years* -– investors are actually paying safe-havens to look after their money.

The whole world is looking at Europe, as the outcome of its crisis might very well tilt the global economy into recession. Financial markets get quickly scared at any hint of possible/probable deflationary trends that might develop *(in China? Elsewhere?)*. Is the real economy at risk? No doubt for Europe. Q1 was positive, but with Q2 and Q3 forecast to be recession periods *(according to Moody's)* the whole 2012 might disappoint in a big way *(EU could grow less than 0.5% at best)*. Even Germany saw its economy contract in June: the ZEW indicator of Economic Sentiment plunged by the most in 13 years!

Troubles in the Eurozone and across Europe are raising the "worry" level in other parts of the world, notably in the United States, as growing headwinds in the old continent threaten the fragile state of the American recovery. The U.S. grew solidly in the first quarter, but afterwards muddle-through economics appear to dominate. There is even a more pessimistic view: global financial circles fear that the U.S. economy might be headed off a fiscal cliff, while the presidential election is only four months away. Meanwhile consumer confidence *(University of Michigan consumer sentiment survey)* has fallen over the past two months to a new low for 2012. Consumers' sour moods are the result of the marked slowing in job creation, the uncertainty about looming U.S. policy decisions, and fears of a potential meltdown in Europe that could drag the U.S. economy into a new recession.

Asia did not fare any better. Its dependence on exports makes the region quite vulnerable to weakening global trends. The word "decoupling" is not fashionable anymore! Readers might recall how often I doubted, in the INFERENTIAL FOCUS pages, that China or any other emerging country *(even the BRICs altogether)* could drive the global economy. Now, the absurdity of an Asian decoupling is becoming quite evident to all. China *(annual growth slows to 7.6%)* and India see their economies exposed, not only to global woes, but to domestic weakness as well. In these countries, domestic economic weakness could quickly turn into a social nightmare and political infighting. Are investors ready for it? Latin-America is trying to entertain the myth of Brazilian growth trickling down to the whole region. How could it be? Brazil's economy is desperately trying to survive with extensive fiscal and monetary stimulus. Will it lift domestic demand in coming months?

When so much risk circles the global economy, uncertainty sets in for a prolonged period of time and, inexorably, volatility keeps investors nervous about another global recession appearing on the horizon. The evident preponderance of gloomy developments is such in so many places, that the road from here for equity prices can only point downward until next spring at best!

Central banks still have the power to surprise and shock global financial circles. Recently, the Bank of Korea (BOK) lowered its key interest rate by 25 basis points to 3%, in a totally unanticipated move and for the first time since February 2009. Some weeks ago, however, investors waited anxiously for the policy announcements from the Bank of England (BOE) and the European Central Bank (ECB). Monetary policy easing was expected from both. The Bank of England eventually expanded its asset purchase program by £50 billion to £375 billion.

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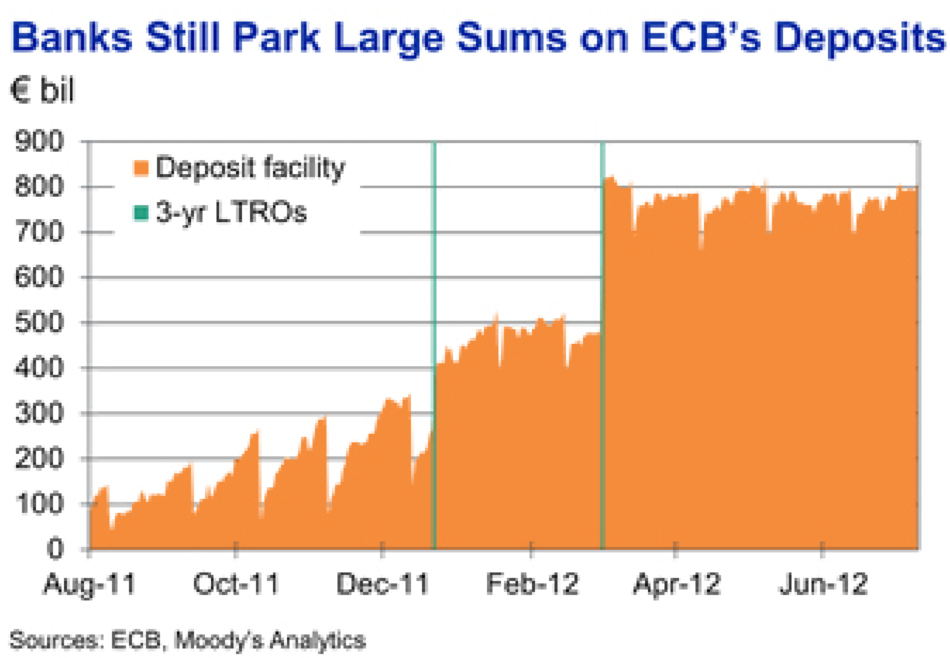
The ECB as well announced policy changes, but the announced cut in interest rates disappointed the market place. The ECB Governing Council cut the refinancing rate only by 25 basis points to 0.75%, the third reduction since Mario Draghi took over as ECB President last November. Equivalent cuts occurred in both the deposit and marginal lending rates to zero and 1.50% respectively. It remains to be seen, however, how much impetus to economic growth a 25 basis points cut can provide, since real borrowing costs are already strongly negative *(June inflation at 2.4% annual rate)*.

Financial markets were disappointed that the ECB did not do more regarding Spain and Italy. Mario Draghi did not even discuss non-standard measures, such as the now moribund *(about to be resuscitated?)* Securities Markets Program *(purchasing Spanish and Italian bonds to help lower these countries' borrowing cost)* and LTROs *(Long-Term Refinancing Operations)*, but continued to put pressure on national governments to solve the debt crisis. Recently, it has become quite a bit harder for the ECB to provide liquidity for the market, despite its non-standard measures. In fact, most banks continue to choose parking funds with the ECB rather than loaning them out -- see above graph.




Graph courtesy of www.economy.com

Meanwhile, the People's Bank of China (PBOC) surprised the financial markets by reducing interest rates *(one-year lending rate cut to 6% from 6.31%; one-year deposit rate lowered by 25 basis points to 3%)* for a second consecutive month. The 7.6% annual increase in growth confirms that the Chinese economy is growing. But, the economy is growing at the slowest pace in three years.

In July, investors waited in vain for clues to new stimulus (QE3) from the U.S. Federal Reserve. According to the latest FOMC *(Federal Open Market Committee)* minutes, the Fed will take action as appropriate without showing any particular inclination toward another round of quantitative easing. The historical graph *(on next page)* is insightful, as it shows how the market reacted to each stimulus provided by the Federal Reserve since the 2008-2009 crises. The histogram on the bottom of the chart is quite revealing of markets' disenchantment with Fed's Operation Twist liquidity interventions.

Lastly, I continue to recommend extreme caution. I believe that the equity road onward will be rocky, with a pronounced downward bias, until next spring at least.

### Another Failer EU Summit

National interests continue to be in conflict with supranational processes at the core of the European Union, land

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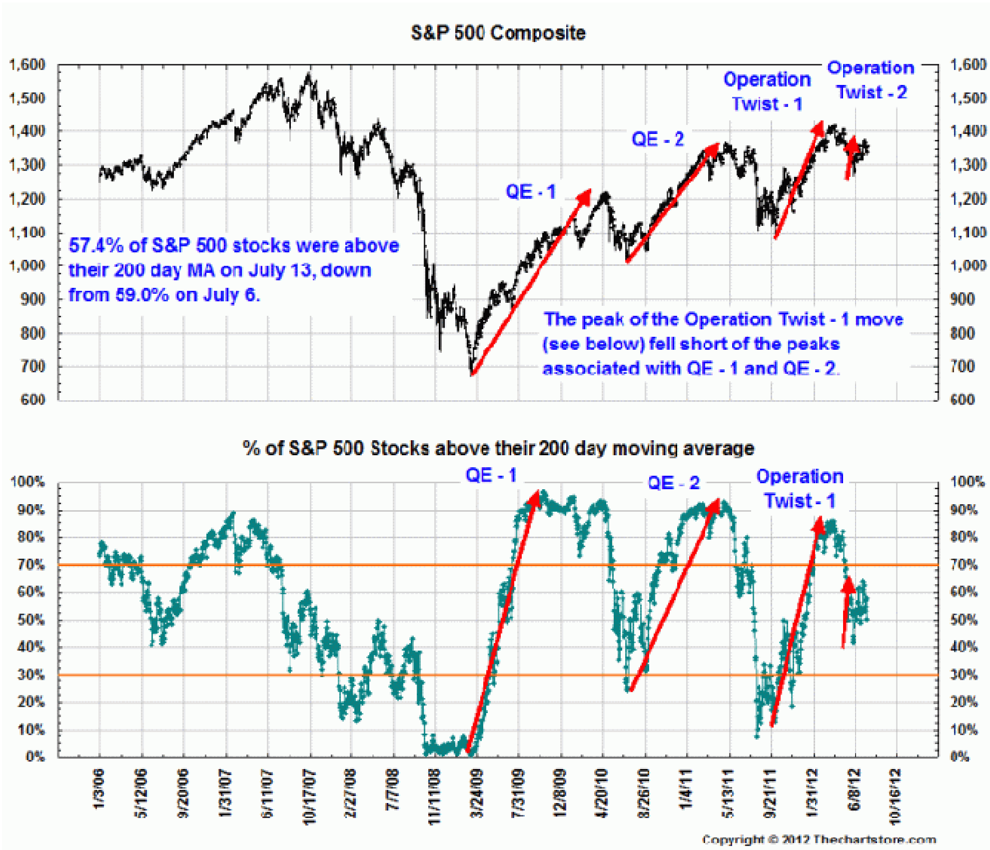
of contradictions which, aggravated by the financial crisis, undermine Europe's attempts to mitigate/solve the crisis. All member states have difficulty forfeiting national sovereignty to supranational institutions. Generally, member states have conceded more of their sovereignty on economic issues, allowing for the elimination of internal tariffs and the creation of a common market. But, on such issues as foreign policy and defense, states have tended to exercise national prerogatives and retain their authority.




Graph courtesy of www.thechartstore.com

This fundamental contradiction was a constant source of tension. Every instance, in which sovereignty was forfeited, was accompanied by lengthy negotiations. In 1965, France even withdrew temporarily from the European Council of Ministers in protest of a proposal to increase the supranational power of the European Commission. In other words, the European project has involved a lot of compromising during its 60 years' construction in order to bring economic prosperity to the Continent. The current crisis, however, has threatened that prosperity along with exacerbating old tensions inherent to the European experiment while introducing new ones.

In December 2011, the 27 members of the European Union failed to reach a consensus on the "Fiscal Compact" treaty, as the United Kingdom and the Czech Republic did not sign the intergovernmental agreement. The treaty provided for some members to integrate faster than others, the preference being given, obviously, to Eurozone members. De-facto, the development of a "two-speed Europe" was being accelerated. For example, in theory the proposed banking union would govern the entire European Union, but it has little chance of taking hold outside the Eurozone.

EU leaders succeeded in one major goal at the end of "yet" another *(the 19th)* «make-or-break» crisis summit in Brussels on June 28 and 29, 2012, as they unanimously claimed having "saved" the Euro Monetary Union. Every single EU leader *(France's President François Hollande, Italy's unelected-PM Mario Monti and Spain's Prime Minister Mariano Rajoy)*, claimed to have scored a victory over Germany's Chancellor Angela Merkel. Supposedly, EU leaders claimed having achieved an important "breakthrough" in Brussels. Behind the curtain, however, the story was totally different. In truth, these countries had their "face-

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saving" day and merely gained some time. At least, this is what financial markets, showing unusual euphoria after the summit, tended to make the whole world believe. Yet, deep down, nothing has changed.

All the proclaimed *("with fanfare")* steps toward an economic and fiscal union were merely empty words, only apt to heighten the afterglow of July's summit, to sell newspapers and to get people glued to the tube. The European Stability Mechanism *(ESM ... due to come into being in July)* was already in place before the summit and, yes, the ESM could already purchase government bonds in the open market *(the previous mechanism EFSF could not)*. It was more important for EU leaders to seriously tackle the size of the ESM fund, but they conveniently ignored the issue. The fund has a lending capacity of only €500 billion, which in case it needs to help one major country *(namely Italy, Spain, France, etc.)* it would be too small a coffer regardless of how much dexterity one employs to twist and turn it in multiple ways. Moreover, the ESM was never granted a banking license. The issue was not even discussed at the last summit. Therefore, the ESM does not have the ability to leverage its lending capacity and will depend exclusively on the "funding" members' willingness and ability to increase the fund coffers' size in case of need.

How can Monti, Hollande and Rajoy claim victory at this summit, when the amount available for bailing out failing countries remained unchanged? For sure, Germany came out of this summit with its overall liabilities unchanged! So, who is the real winner?

So far Germany has laid out the most coherent plan to deal with the ongoing European crisis. Berlin believes that tighter fiscal and political EU integration will beget a financial transfer union, ideal to alleviate in time the effects of trade imbalances, lack of competitiveness and debt overhang in the periphery. The German plan is focused on the Eurozone nations, which are locked into a monetary union with Berlin. Therefore, whatever solution is chosen it must fit the German plan. It would be entirely illusory to think otherwise. For instance, Germany said "no" to Eurozone bonds, no matter how Hollande would like to call them *(project bonds)*. Hence, Chancellor Angela Merkel affirmed that she will never accept the mutualization of EU members debt ***...for as long as she lives***. So much for the "major step" toward an economic union, not to mention that the fiscal union had been agreed upon in earlier summits and that there is no turning back on this issue. Straight down the drain then goes Hollande's pre-election promise to his constituencies in France!

Incidentally, in my early days in finance *(four decades ago)* the so-called "eurobonds" were bonds issued by companies, states or other, from outside their country of legal domicile. The issuance of bonds for instance by General Motors outside the U.S. were considered "Eurobonds", regardless of the currency or country in which the issuance was done. The difference to the buyer of these bonds, was that "Eurobonds" were subordinated to domestically issued bonds and notes. If I let my imagination wander on the subject, then I could easily let myself consider, by extension, the "newly conceived" eurobonds as subordinated to still existing nationally issued bonds. Evidently, the capture here for bondholders would be to count on the entire EU to guarantee these bonds. How could a politically, fiscally and economically "divided Union" offer a solid guarantee to bondholders? The European project was to endorse "unity" in all respects: social, political, economic and strategic *(including security and defense)*. Being "European" would have to translate into sharing a "single fate" and "common burdens".

Was there any progress towards a "political" union? Admittedly, the European Council President Herman Van Rompuy did not aim so high for the likely outcome of this last «make-or-break» summit in Brussels. After all, he had at heart the progress to be made especially in laying out a clear path to economic and monetary union *(a pan-European banking regulator)*. The fiscal union was to be achieved through (a) the issuance of "Eurobonds", and (b) fiscal transfers among member states. As to growth, more specifically a common growth policy was to be penned out by the convening EU leaders.

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The word "federalism" was all over the media and TV journals reporting on the summit. It is no less than tragic for the "man in the street" to witness that his leaders do not even understand the basic meaning of "federalism" *(intended as a "union of states recognizing the sovereignty of a central authority while retaining only certain residual powers of government at the state level")*, let alone how it could be implemented across the European continent. Supposedly, EU leaders agreed during the last crisis summit to establish a "Banking Union" upon which any common bank recapitalization could be done. This was a great step forward on the path to crisis resolution, so global media reported the news. To the contrary, some states *(not the least among EU members: Germany)* rushed to remind the others that no "Banking Union" is possible without a "Political Union"! In truth, the Banking Union deals only with joint supervision, according to Germany's Chancellor Angela Merkel. The trouble is that the ECB's Chairman Mario Draghi might have come to a different understanding, which is a union based on central regulation and supervision, as well as common tools *(restructuring fund and deposit insurance)*. Under such a plan, European Treaties should be redrawn as well as the Constitution of each single member state in the Union. Probabilities to see this happening over the next few years are "very" slim.

Furthermore, the summit failed to address the European Central Bank (ECB) founding principles, which, for instance, prevent the central bank from purchasing sovereign debt directly. In 2010 and lastly in the summer of 2011, the ECB made large purchases of Spanish and Italian bonds in the secondary market. By doing this, the ECB acted illegally! It circumvented its own founding treaties.

This year, following the example of the U.S. FED *(Operation TWIST allowed for the first time the central bank to act in the longer term spectrum of the yield curve maturities)*, the ECB put aside purchasing sovereign debt and switched to "Long Term Financing Operations (LTROs)". It injected €1 trillion into LTROs and actually postponed the EU's solvency crisis by three years. Soon after, it crushed the newly implemented monetary strategy by proclaiming that ECB's bond holdings would have priority claim over any bonds held by other bond holders in the market. Consequently, prices fell and the overall value declined sharply for all bonds. Unquestionably, the ECB acted against its own interest *(and against the interests of the financial system)* although the intention was to preserve the value of its own holdings. I doubt that there could be another LTRO operation coming to the market any time soon! Incidentally, the €100 billion committed, during this last crisis summit, for Spain to recapitalize its banks would no longer be "senior" to other debt!

Europe continues to try surviving its crises with "bail-out and hope" strategies! Meanwhile, as I have repeatedly said a year ago, two years ago, three years ago ...cracks are appearing in the sacrosanct "national sovereignty" of individual member states, even though in a stealth way. When a country must resort to an EU-IMF bailout, it is "de-facto" relinquishing its national sovereignty... Hasn't even "super Mario Monti" experienced the bitter taste of the so-called "troika" *(EU, ECB and IMF)* looking over his shoulders even if Italy is not yet begging for a bailout? In July, Moody's downgraded Italy's credit rating by two notches, fearing contagion from Greece and Spain, higher borrowing costs and a deteriorating economic outlook -- Italy's government bond rating was cut to Baa2 from A3. Moreover, the agency maintained a "negative" outlook on the rating, citing substantial risks to implementing the planned fiscal reforms. Monti had just made a tour to convince U.S. investors to trust Italy with their money. Evidently, despite all the smiles, his "crusade" to convince foreign investors was not successful.

Indeed, the turn of events suggests that July's summit was no more than a fleeting interlude in the ongoing EU crisis. Unquestionably, hard decisions have still to be made regarding Greece, for instance, which was barely mentioned at this last summit.

Even more worrisome is the growing isolationism of the Eurozone, quite a delicate issue for the other ten EU countries *(the United Kingdom, Denmark, Sweden, the Czech Re-*

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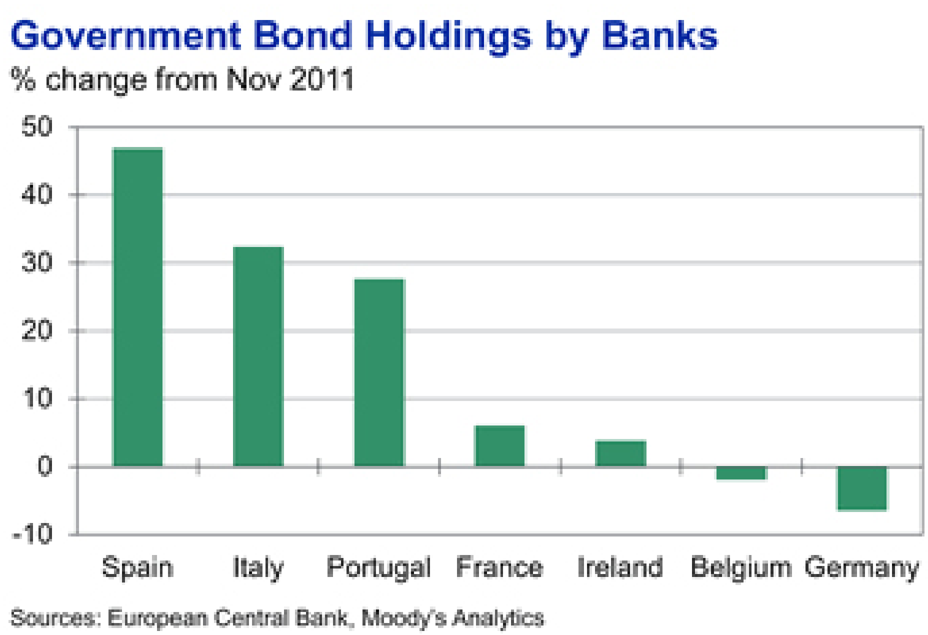
*public, Poland, Lithuania, Latvia, Hungary, Bulgaria and Romania)*. While these countries still control their own currency policy, as a group they have no common policies toward the Eurozone. For example, The United Kingdom, Sweden, Poland and the Czech Republic oppose the creation of a pan-European banking regulator and will resist increased oversight over their banking system. Another example is that the "Fiscal Compact" was only signed by 25 members of the European Union, the U.K. and the Czech Republic having not agreed to the treaty.

As Europe's core turns increasingly inward and remains focused in salvaging the Eurozone common currency, other members of the European Union are facing other issues. Especially Central European states are becoming increasingly financially and politically alienated, not to mention the major security issue even though the EU was never a "security" guarantor for these countries. Their geography places them in a "buffer" strategic position between the EU and Russia. With a resurgent Moscow, several Central European countries felt the security void *(they were increasingly disillusioned with both NATO and the U.S.)* and have been seeking alternatives *(Visegrad Group - V4, or Poland, Hungary, Slovakia and the Czech Republic)*. The growing discontent with the European Union might well result at some point in time in the eventual formation of regional groupings, as the EU-10, regardless of how the Eurozone crisis is resolved, will look outside the Eurozone to pursue their economic and security interests. In other words, the EU-27-nation bloc will become increasingly fragmented.

### Who's to rescue the ESM fund?

A second recession in three years is plaguing the Eurozone's fourth largest economy -- Spain. The blame goes on the newly imposed "austerity" program on the people *(€65 billion tax hikes and spending cuts)*, but Spain's problems were home-grown. Undoubtedly, the global financial crisis aggravated Spain's situation. Deleveraging hit the country at the worst possible moment, when weakening external demand compounded the negative effect of sharply rising unemployment across the country *(24% now, from 8% in 2007)*. The whole age spectrum is hit hard, but youth the hardest as more than 50% of those under 25 are unemployed.




Graph courtesy of www.economy.com

Moreover, public finances are weak and the fragile banking sector took center stage at the latest EU-leaders' summit in Brussels, where they agreed to lend Spanish banks a €100 billion lifeline directly rather than through the government. Thus, the public finances should not be affected and private

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sector lenders were assured that these loans would not be granted "seniority" over theirs. Since Spanish banks made real estate loans for approximately €300 billion, or some 30% of GDP, they are now experiencing the sorrow aspect of being forced into "landlordship" -– according to Moody's, the non-performing share of real-estate loans has climbed above 20% and keeps climbing.

Spanish banks have been hit hard on two accounts. They might have been too naive in believing that the real estate boom would extend into infinity, but they also blindly trusted their own government as they raised their holdings of public debt nearly 50% since last November.

Spanish banks needed a bailout, which involved a concerted action by European Finance Ministers, without conditions! The EU capitulated in front of Spain's financial crisis and readied €100 billion to bailout Spanish banks, out of the €500 billion European Stabilization Mechanism (ESM).

However, the Spanish government alone might need over €300 billion to service its debt through 2014. Considering also Italy's financing requirements -– approximately €700 billion for the same period -– **how could the ESM fund be rescued then?**

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# INFERENTIAL FOCUS

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The idea is there, locked inside.
All you have to do is remove the excess stone.
Michelangelo

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