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Market Commentary
Byron Wien

The Smartest Man in Europe Is Very Cautious
July 2011

Every year I try to spend time with the person I have come to think of as The Smartest Man in Europe. I met him almost thirty years ago when he encouraged me to think about the investment implications of the end of communism in the Soviet Union. He later saw opportunities developing in the emerging markets of Asia. Over the years he has been early to see important changes in trends across the world. He is descended from a mercantile family that has been involved in trade for hundreds of years, going back to the operation of canteens for travelers along the Silk Road. Fluent in many languages, he trained in the United States after World War II, but returned to Europe to take advantage of the recovery taking place there.

Usually we have our discussions in hotels or offices, but this year I spent a weekend with him at his summer home on the Mediterranean in France. There, surrounded by his impressive paintings and sculpture, we talked about the current outlook for global investors. I wrote my first essay about these meetings in 2001 and it was called "The Smartest Man in Europe Is Upbeat." His mood was very different this year.

> "It's very hard to make money in stocks. Earnings growth is the key to equity market performance and with the heavy debt burdens of the developed economies of the United States and Europe, growth is likely to be slow. I know earnings are going to be good this year but profit margins are high and it will be hard for earnings to exceed the nominal growth rate of the economy on a sustained basis. The developed economies don't have the resources to stimulate to grow faster even though that is what their people want. Unemployment is high in the United States and many parts of Europe, and this will dampen consumer spending. Politicians are in a difficult position. They would have to spend more money to create jobs and they need the money to service and draw down the debt in the United States and to deal with the credit crisis in Greece and Portugal in Europe.
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> "Ironically, the big beneficiary of the financial problems in the weaker European countries has been Germany. The credit crisis has kept the euro cheap. I know it doesn't look that way to you Americans because your currency has deteriorated significantly, but to many others around the world German goods are very attractively priced, making their exports strong. That's why it is in Germany's interest to keep the European Union intact. If Greece and Portugal were thrown out because of their poor financial management, the euro would appreciate and the German economy would suffer. The current solution that allows Greece to roll over its maturing debt into new longer-dated, lower-interest obligations avoids default and is very elegant. It doesn't solve any of the long-term problems, but it does get Europe through the current crisis. Greece will have to undergo severe austerity and the people will react badly to that, but they have no other choice. The hope would be that they could grow their way out of the problem, but that's hard to do if your economy is based on tourism and olive oil.
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> "Over the next few years the banks in the stronger countries – Germany, France and the Netherlands – will try to become less exposed to the sovereign debt of the weaker countries. In a few years, if the situation has not improved, the European Union may have to be

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restructured. While the Germans believe that the people in the weaker countries should go through a period of hardship as Germany itself did when the East and West parts of the country were combined, they have come around to the view that they have more to lose than to gain if the euro collapses, and so they are supporting the program to help the weaker countries get through the crisis. Ultimately the Greek banks will have to be nationalized. They have already lost most of their deposits. The government has tried to solve part of the problem by raising taxes, but 30% of the economy is underground and there is no record of income. If Greece defaulted, the whole European banking system would be in trouble.

"The United States is destroying its currency. You cannot keep borrowing from abroad at the rate you are doing it and expect the dollar to maintain its value. America has been living beyond its means for a long time. Most people think that means that consumers have been spending too much and borrowing to do it, but that's not what bothers me. The government has been spending seriously beyond its means. It has 150 military bases around the world and is involved in three wars. How does that make sense when you are running a deficit of $1.5 trillion?

"Right now my portfolio is invested in gold and Swiss francs. Every once in a while a special situation appears that interests me. Last year I made a real estate investment in Baghdad. I remember the look in your face when I told you about it. After I had owned the property for less than a year, the Iraqi government wanted to buy it and I got out with almost a 100% profit. I like to seek opportunity in places everyone else is avoiding.

"The central bankers throughout the world have lost touch with reality. They did not recognize that the liquidity they were creating would produce excesses in the housing industry. This was particularly true in the United States and Spain. Housing is no longer attracting capital, but there is still plenty of liquidity out there. I know you have been expecting interest rates to rise, but all this liquidity looking for a place to rest has to go somewhere. That's why interest rates are so low in the United States, and if I am right and it will be hard to get a satisfactory return in risk assets, U.S. Treasury yields will stay low.

"The biggest bubble in history was the financial crisis of 2008. It was much bigger than the Internet bubble of 2000 or the housing bubble that preceded it. The leverage that built up in financial institutions was enormous and the Federal Reserve did nothing to restrain it. All the problems really started when the dollar was no longer convertible into gold. That happened in August 1971 and eliminated all currency restraints because money became only paper and not backed by anything real. The bankers were all cowards. Basel III closes the barn door after the horses are out. Leverage rose under Basel II.

"The political process is also broken. Money drives politics. The problem is less severe in Europe than in the United States. Europe has four-year terms for elected officials and more campaign financing controls. Big business influences politicians everywhere and the politicians influence the regulators. Look at how much money is spent on lobbying in the United States. This is done much less by corporations in Europe.

"The present level of debt is like a cancer and it is deadly. It makes it hard to know what will happen in the future and how to invest under these circumstances. Perhaps all these problems will be solved ten years from now and the crisis will be over. By then we will have a new form of financial system and you will be able to invest again.

"America will probably figure out a way to raise the debt ceiling this time, but you will have the same problem several years from now and you will have to raise the ceiling again. The politicians are in a tough place. If they cut the budget by too much, they could put the country back in recession with limited options for getting out of it. One solution would be to devalue the dollar by 50%. That would cause exports to surge and bring in a lot of tourists

> and investors. Imports would decline and many jobs would be created. This solution is much better than cutting spending and putting the country once again in a recession. The dollar is being gradually devalued anyway. The difference is if you did something dramatic now, the U.S. economy would be revitalized. Don't worry; devaluation by 50% isn't likely to happen anytime soon. There is no leader or political will to force it through.
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> "The world is in limbo because nothing significant is likely to happen before the U.S. election in 2012. The Republicans have to come up with some fresh ideas that appeal to the American people or they will lose. Devaluing the dollar is one such idea. If that were to happen, the world would have to move to a new reserve currency which would most likely be a basket including the dollar, the renminbi and gold, but this will only happen after the next crisis. There would be a number of collateral effects from currency devaluation. Profits from U.S. operations abroad would be vastly higher. The stock market would be strong. There might be a formation of economic blocs with countries with common interests banding together. Trade barriers might increase and the price of oil would probably go to $200 a barrel, seriously reducing consumption in the United States.
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> "I remain positive on China. It is the new world power. It is on an upturn now and it will have setbacks from time to time, but they are headed toward being an increasingly important part of world gross domestic product over the long term. There is talk about corruption, housing excesses, accounting transparency and bad loans on the books of the banks being major problems, but the authorities will figure out solutions to solve them. In Europe and the United States we are jealous of China. We have learned that everything that appears this good has to have a flaw somewhere, and so we set out on a search to find it. There are flaws, but their system has been effective in dealing with them. We tend to think that what we have is better than what they have, but who is to say that Christianity is better than Confucianism?
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> "I am also positive on India. Everything is going forward there also. They are a low-cost producer with plenty of momentum, but that doesn't mean that the stock market will rise. I think direct investments in private companies may do better. I am also positive on the long-term prospects for Brazil. Many proven investors outside of Europe and the United States are buying in Africa. Mongolia, with three million people, has vast resources in copper and coal. Corruption is part of the way of life there, but remember, until about 1920, corruption was part of the way of life in America."

While there have been times in the past decade when The Smartest Man has sounded gloomy, I thought he seemed especially somber in these discussions. I mentioned that to him and he responded, "It's true that I am somewhat anxious, but you should talk to some of my friends. They think the situation is cataclysmic."

As usual, he gave me plenty to think about until our next meeting. I am much more positive on the near-term outlook than he is and I hope I am not delusional.

Click here to register for the Wednesday, July 13, 2011, 11:00am ET Blackstone Webcast: Byron Wien presents "Stronger Economy and Market in the Second Half".

The webcast presentation will be downloadable from the interface at the time of the event, and webcast replays will be available beginning Monday, July 18, 2011.

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