THE Weekly View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

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Europe… What If?

- **We believe Europe has reached a critical crossroad.** Because of their size, if Italy or Spain suffer the fate of Ireland, Greece, and Portugal and are unable to fund their fiscal deficit in the market, then the negative consequences for the global economy and financial markets are considerable. We want to be clear: this is not our most likely scenario, but we are forced to acknowledge its possibility. We therefore believe that this complex situation warrants a risk management plan.
- **Recent history has shown, and we believe, that 7% interest rates are approximately the 'tipping point'** that makes the deficit situation untenable for nations with the debt levels and growth prospects of Italy, Spain, and even France. Given that Italy's 10-year bonds traded as high as 7.5% on Wednesday, November 9th, this is no longer a matter of conjecture. Following European Central Bank (ECB) buying on Thursday, rates have fallen back below 7%, but the ECB's resolve will continue to be tested, in our view.
- A broad market consensus believes, as do we, that a collapse of confidence in core Europe's sovereign bonds, and thus Europe's banking system, presents systemic risk. **This leads us to the conclusion that the ECB will ultimately overcome its differences and become the buyer of last resort for sovereign debt.** We agree, and further believe that if the ECB joins the Fed and the Bank of England in providing 'quantitative easing' support for financial markets it will ignite a market rally. But what if we are wrong and the ECB sticks to its single mandate to fight inflation, abandoning it only after the market falls substantially lower? There has been a great deal of research on the European issue, but the writers keep coming to the same basic conclusions:
    - The fate of Europe's banks is inextricably linked to the value of the sovereign debt of each of the 17 Eurozone members. Bank regulators encouraged the ownership of sovereign debt over the last 10 years by making it a 'risk free' asset on bank balance sheets, which therefore required no capital offset. This makes European banks' current capital structures highly vulnerable to default.
    - Germany's demand for fiscal austerity – spending cuts and tax increases – by troubled European countries is unlikely to result in significant short-term improvements in budget balances while these economies are falling deeper into recession. The consequent social upheaval (e.g. 40%-plus youth unemployment in Spain) will continue to create political instability.
    - A vicious cycle of a weakening economy leading to increased default risk, to higher interest rates, and thus to worsening deficits as interest rates rise has already forced Ireland, Portugal, and Greece to go on the life support of subsidized funding from the European Financial Stabilization Fund. However this fund is not large enough to offer similar support to Italy or Spain.
    - Thus most commentators, us included, see the ECB as the only entity capable of helping should Italy, Spain, or even France become caught in the vicious cycle. The problem is that the ECB (especially its conservative German members) consistently refutes its responsibility to assume the role of 'lender of last resort' to Eurozone governments in the manner that the Fed and Bank of England have done for the US and UK, respectively.
- **In essence, the ECB, Eurozone governments, and European bond investors are playing a high stakes game of 'chicken.' Investors are being forced to guess who will blink first, and under what circumstances. What seems clear to us is that the longer this lasts, the greater the stakes become.**

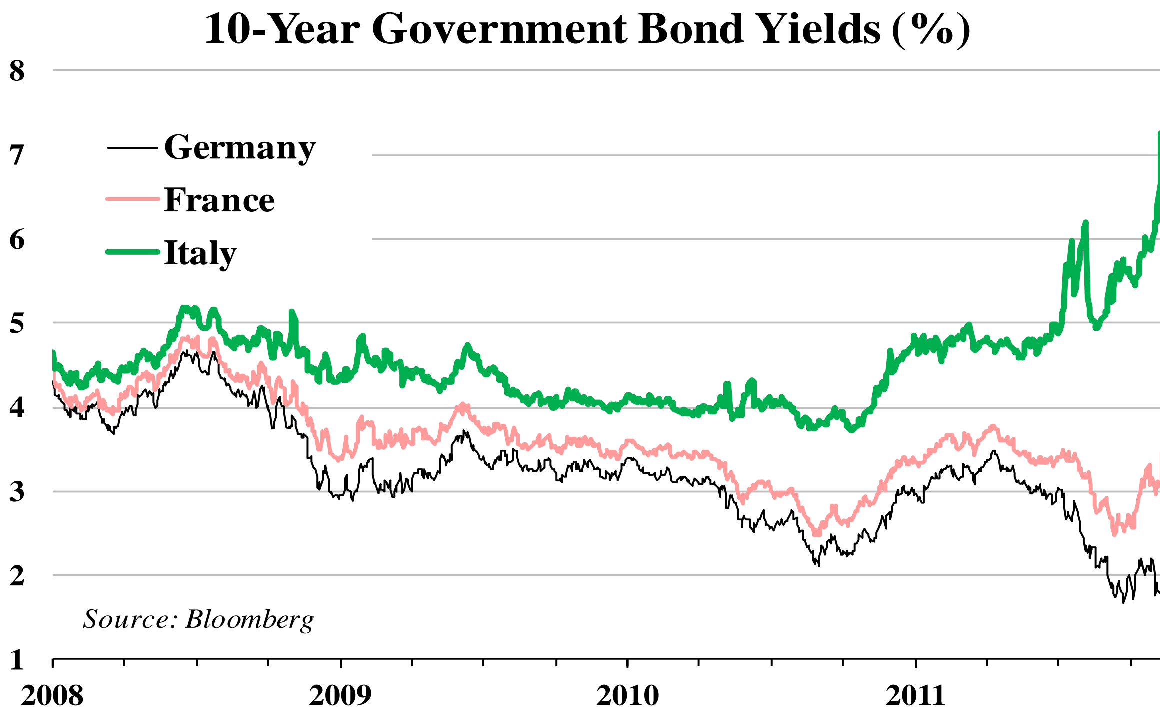
Our risk management plan

We have been more positive about stocks since early October, driven initially by extreme investor bearishness and then by the resolve of European politicians to tackle the issues. However the ECB's unwillingness to commit fully to the process has caused us to develop risk management plans for all of our portfolios. The first step was executed last Friday: a 3% reduction to Europe in our three most conservative portfolios. When we identify a credible risk, our first priority is to reduce exposure in these portfolios, and the rebound on Thursday and Friday gave us that opportunity.

Because we believe that European policymakers recognize the gravity of their situation and (through the ECB) have the tools to prevent a systemic crisis, we believe the issue is 'when' not 'if' the ECB will become fully engaged, and when they do, the euro will likely fall and stock markets rise. Unfortunately, we do not know the circumstances that will cause a policy change.

This is a challenging environment because, in the absence of a crisis, we believe stocks, especially US stocks will continue to rise based on current valuations and driven by solid earnings. Conversely, if consensus expectations are wrong and European policymakers lose control of the situation, then we believe there is sufficient downside risk to warrant an increase in assets that will provide short-term safety.

The Weekly Chart: Italy tests the ECB's resolve



Italian bond yields rose over 7% last week and are again testing that level, which we think is the approximate 'tipping point' that makes the deficit situation untenable for nations with the debt levels and growth prospects of Italy, Spain, and even France. With Greek yields over 28%, Ireland over 8%, and Portugal over 11%, the rise on Italian yields – the third largest government bond market in the world – prompted some risk management in our portfolios. We are also watching the spread between German yields (considered the least risky among European bonds) and French yields, which has widened by 1.2 percentage points since early September, suggesting that investors are requiring higher yields to compensate for growing concerns about France and its top-tier bond rating.

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