

How Things Getting Worse Makes Them Better: The Road to a European Union

Imagine a state, California for example, needing a Federal bailout to avoid defaulting on its municipal bonds. The Federal Government might agree to back the debt of California, but only if the state government is run in such a way that meets Federal guidelines and ensures a road to recovery. After the bailout of California, a doctrine would be introduced that any state that desired Federal assistance would have to submit to the same guidelines.

Advocates of states' rights would be incensed. Who is the Federal Government to dictate the fiscal conduct of the states? Rumors would be started about a national takeover by the Federal Reserve. Some states would threaten to issue their own currency, something not done since the Federal Reserve was enacted. However, at the end of the day, cooler heads would prevail. The merits of a single currency would outweigh the arguments for fiscal independence for those states in need. The episode would serve as a warning for other states to get their fiscal houses in order, lest they, too, run afoul of the new Federal standards.

In a nutshell, the above scenario is currently being played out in Europe. The difference is that, while Europe has a common currency, it has no common authority over the countries that use its currency. The European Central Bank (ECB) issues the currency called the euro. Backing the euro is the financial system of each country. In the case of Greece, this was not considered sufficient by the marketplace, and the Greek euro bonds were dumped. Other euro countries, specifically France and Germany, have brokered a reorganization of Greek debt in exchange for Greeks now having to work longer and the Greek Government committing to collect the taxes for laws already on their books.

From Greece, doubts about European municipal finances have spread to Portugal, Italy, Ireland and Spain. These countries, collectively known as PIIGS in a less than endearing abbreviation, have clamored for the same treatment as Greece. The German government is less interested in crisis management than in a longer term solution to the problem. Their approach is thus more methodical and in the end more demanding.

What Germany wants is the ability to dictate fiscal policy in any European country that requires assistance. The German prescription for austerity, benefits reduction and export growth is an anathema to Europeans who have shouldered some of the highest tax rates in the world in exchange for generous government benefits, especially for health care and retirement.

In the middle of this are the speculators of European debt. By agitating for a change whereby euro debt is issued by a central authority rather than a single country, bondholders are trying to improve the collateral and price of the debt they have acquired. Germany will not agree to such a central authority without the aforementioned control of the country's finances. Thus the sensational stories of European collapse should the euro fail, the potential of going back to individual currencies, etc.

The fact of the matter is that everyone gets too much out of the euro to walk away from it. Germany owes much of its growth to its ability to export to other European countries. The euro is an integral component of that growth, eliminating the currency conversion cost that previously existed. For much the same reason smaller countries need the euro for the commerce it generates, from European tourism to investment by European companies looking to build products in eurozone countries with lower wages.

Germany is the logical leader of the new euro order. It has the largest and most vibrant economy. Germany and France combined account for about 60 percent of eurozone GDP. The loss of domestic fiscal control does not go down well with other countries. However the alternative, a minor currency and exclusion from the eurozone countries, is hardly palatable either.

Thus the end result of this crisis will be a United States of Europe. Bringing the eurozone countries into closer alignment will create a trading block whose economic activity will rival the US. Through NATO, most of the countries already combine their defense capabilities. Such a block will be a formidable market that will emerge as a key trading partner with the rest of the world. While the US will find much to like with a united Europe, the potential for greater diplomatic independence will mean that the aims of the two areas will diverge over time. For example, a united Europe may see Russia in a more conciliatory light than that of the US, driven in part by the potential for trade.

Over time, a successful integration of Europe will lead to a stronger euro to the point that it may compete with the US dollar as a reserve currency. This potential, along with the rise of the Chinese yuan at the same time, means that the US's timeline to address its own deficits is not infinite.

The Economy

The US economy continues to do modestly better. Employment numbers are up, as are retail sales and bank lending.

The traditional beginning of Holiday shopping, dubbed “Black Friday,” got off to an impressive start. This helped to offset anemic retail numbers in October and November as shoppers have become conditioned to wait until Thanksgiving to make major purchases.

One interesting statistic to come out of the retail analysis is that 20 percent of American families make 50 percent of all retail purchases. This helps explain how retail sales have done so well, even when general consumer sentiment has been so anemic.

Interest Rates

At this time there continues to be little compelling evidence to suggest an increase in interest rates in the next twelve months. None of the major sources of loan demand, housing, business or consumer, are posting material year-over-year increases in demand.

The lack of demand in the three areas above explains how the Government continues to garner ever-lower interest rates on an ever-increasing volume of debt. While the \$1.4 trillion deficit for FY 2010-11 was less than the original \$1.7 forecast, it is still a large number. Getting it somewhere below \$1 trillion should be a priority of both parties.

Inflation

Inflation has received several reprieves, from collapsing raw material costs to lower energy prices. Labor is still in too much abundance to be a serious inflation source.

Expect inflation to be a non-issue until labor markets tighten up and the world economy resumes its growth. That would be 2013-14 at the earliest.

The Stock Market

Stocks have been in a downswing since November, as worries about Europe offset the progress being made in the domestic economy.

The sense is that, once the European crisis is resolved, attention will return to a US market that is both statistically cheap and slowly improving. Such an environment will propel stock prices upward between now and the New Year.

Warren M. Barnett, CFA
November 29, 2011

© 2011 Barnett & Company

Barnett & Company is an advisory firm registered with the Securities & Exchange Commission working with the investment needs of retirement plans, organizations and individuals. For a brochure on the company and its services available call (423) 756-0125.