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Between a Rock and a Hard Place – Europe's Crisis

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The history of the European Union dates back to 1950 and the creation of the European Coal and Steel Community. The primary motivation was political – by uniting European countries and overseeing the two key industries required to create weapons of war, leaders could hopefully ensure that an event like World War II could never again occur. Soon enough, policymakers saw that a single European trade market could bring great economic benefits as well. European countries first established a common market, which entailed the elimination of trade barriers, and then pursued the implementation of a common currency.

A common currency offers several attractive economic advantages, chiefly around lower costs (e.g. the elimination of currency exchange costs, price transparency and complex accounting systems) and improved efficiency (e.g. labor mobility and facilitation of easier cross-border trade). A common market combined with a common currency put Europe back on the map as a world power, alongside the U.S., Russia, and Japan (and now China).

But in the rush to capture the benefits of a common currency, European policymakers overlooked the serious dangers that accompanied such a policy. In order to facilitate a common currency, participating regions must submit to a common monetary policy (i.e. central bank) and forfeit their national currencies, and thereby their ability to print money. Yet Europe failed to create a political union – while pan-European political bodies do exist, they are incredibly weak compared with national governments. In short, Europe was trying to have their cake and eat it too – they wanted the benefits of an economic union without paying the costs associated with giving up their political sovereignty.

Europe tried to address this concern by requiring admitted nations to meet supposedly strict economic criteria before entry – subdued rates of inflation, a minimal budget deficit and modest public debt burden, similar levels of interest rates and stable exchange rates. In practice, however, the European authorities grew lax on these measures, admitting states like Greece that should have been refused entry.

Cracks Exposed

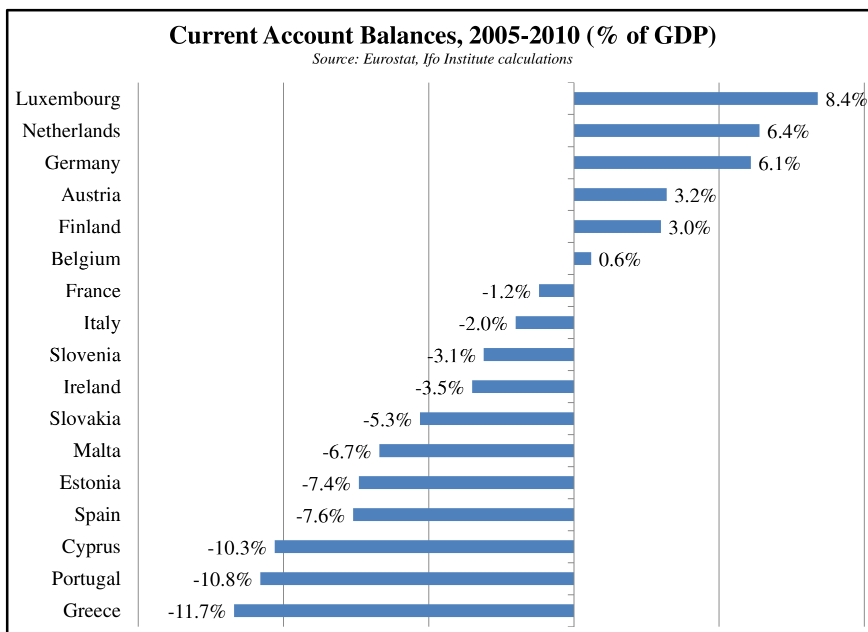
For a time, financial markets bought into the European dream. Borrowing costs for Greece, a poorly run country with a history of defaults, were nearly identical to those for Germany, an industrial powerhouse. Countries such as Greece and Spain took advantage of cheap interest rates to load up on debt and consume goods while Germany, which had a structurally superior economy, took the opportunity to serve as the manufacturer and exporter to these countries. (This part of the story has similarities to Chinese-U.S. relations in recent years.)

Then the bottom fell out – the credit bubbles in peripheral European nations (primarily the PIIGS: Portugal, Ireland, Italy, Greece and Spain) popped, exposing the large debts that had been accumulated. Yet by joining a common currency, the PIIGS had forfeited the key tools they might use to combat such a crisis. Think back to the U.S. credit crisis – the federal government stepped in with massive guarantees and investments, backed by the Federal Reserve, in order to stabilize the system. While controversial, these measures were effective because Federal Reserve officials were able to convince the public and the financial markets that they were more than willing to print dollars in order to stem the crisis. This has given our economy time, manifested by ultra-low interest rates, to sort through our challenges.

Now consider the PIIGS. There are usually three ways countries can deal with a problematic debt burden:

- The easiest and most popular prescription is to use the central bank to act as backstop and show markets it is willing to print money as needed in order to ensure a financial collapse does not occur. Yet the PIIGS have no control over the European Central Bank (ECB) and have no national currency. Further, the ECB has always been German-centric and, because one of the chief reasons for Hitler's rise to power was the German hyperinflation of the 1920's, German bankers are notoriously afraid of money printing (which has historically created inflationary pressures).
- The toughest remedy is to grow your way out of it. But how can the PIIGS grow? Germany is demanding severe fiscal austerity measures in the face of large debt burdens. But this creates a severely negative feedback loop – government cuts reduce economic activity which in turn reduces private sector confidence and begets weaker economic activity, which pressures government revenues and creates the need for additional cuts to balance the budget. Further, the PIIGS have no ability to devalue their currency in order to make their economies more competitive. If Greece could halve the value of their currency relative to Germany or the U.S., their exports and thereby economic activity would increase; but Greece is anchored to industrially superior Germany.
- Finally, countries can choose to default. This has been the path taken by struggling emerging countries in the past, such as Argentina and Russia. This is an alternative only when sovereigns have borrowed in external currencies and thereby cannot print their way out of the hole. Yet it is unclear what chain reaction a Spanish or Italian default could set off [Greece did institute a partial default]. During the U.S. financial crisis, healthy banks were quickly infected by the problems of sick banks.

It is important to note here that Europe has the capacity to solve its problems. Taken as a whole, Europe's debt-to-GDP ratio is similar to that of the U.S. But Europe has not shown the political will or ability to tackle its problems. U.S. policymakers provided a blueprint for how to fight such a crisis – step in with wide ranging, unconditional guarantees to both strong and weak links. The German citizenry is unwilling to go down that road however. Their reaction is understandable – they see the Greeks as irresponsible and naturally think the German prescription, i.e. labor market reforms and fiscal austerity, should work for other European countries as it worked for their own. Yet it is mathematically impossible for all of the European countries to be Germany. Germany, as the creditor nation, exports goods to the debtor nations (the current account, graphed below, measures the flow of goods and services between countries and illustrates Europe's imbalances):



While political pressures push German policymakers toward taking a "hardline" with struggling Eurozone nations, a Euro breakup would be a nightmare for Germany. First, the country has huge claims against their European counterparts that would be incredibly difficult to enforce. Second, Germany's reintroduced Deutschemark would likely rocket in value, putting great pressure on Germany's export-oriented economy. Economically, European nations must come together; politically, this sometimes seems outside the realm of possibility.

The key variable of this saga is time – how much time does Europe have to confront their problems? If the crisis continues in a linear fashion, plodding along, the odds of successful political cohesion, which will move slowly, increase. But if the crisis accelerates and financial markets dismiss Europe's half-hearted programs, the risks rise. Recent actions by the European Union have increasingly been met with skepticism by financial markets.

Investment Implications

We have not sugar-coated the predicament – Europe and its banking system face sizable, though solvable, challenges. Now the important part – what does this mean for investors?

We would first highlight that our direct European exposure is quite limited. This is not so much the result of recent actions that we have taken but instead the fact that we have never maintained a large allocation to international investments. We have always had a core allocation to both developed and emerging international markets as we believe the diversification offered by international investing is an important contributor to portfolio returns and risk reduction. We have kept those allocations large enough that they matter, but no larger. Whereas the typical endowment invests over half of its stock allocation in international stocks (reasoning that international stocks make up over half of the global economy), we prefer the U.S. – we know the companies and believe the U.S. has some of the best institutional attributes in the world (rule of law, standardized accounting, capitalist economy, etc.). Accordingly, we maintain less than 20% of our stock portfolios in international stocks.

Further, our international positions are diversified across many regions – Asia, Latin America, Europe, etc. Europe comprises on average just 1/3rd of our international stock portfolios, and less than half of that consists of countries that are part of the Euro currency (we would argue non-Euro currency countries like the UK and Switzerland carry less risk than members of the Euro currency). Putting all that together, we estimate that our long-term investment portfolios only have approximately 1.7% exposure to members of the Euro; more risk-averse portfolios would have even less.

Why keep that exposure? While the risks to the European economy are sizable, the stock markets are also very cheap and the majority of European exposure is comprised of large German and French companies that sell products all over the world and will likely survive and continue to grow over time. For instance, Siemens is a large, global company headquartered in Germany that competes head-to-head with General Electric. In all likelihood, Siemens will be worth more in 7-10 years than it is today. Due to the cheapness of their stock markets, some investors we respect have been increasing their European allocations. We don't feel comfortable enough with the economic risks to take this action, but we are willing to keep our small, core allocation intact.

The bigger question for our investment portfolios is what chain reaction European difficulties could have on the U.S. economy? We have been constructive on U.S. stocks at current valuations. While we don't believe they are incredibly cheap, we feel that they offer good long-term value in both absolute terms and relative to other asset classes (bonds, real estate, etc.). But in a global economy, developments in Europe and Asia certainly have an effect on the domestic economy.

Our belief is that the U.S. economy, while still growing slowly, is much more robust and resilient than it is often given credit for. Leaving aside our own political inability to deal with the country's long-term fiscal challenges (we hope this will be attacked more constructively after the November elections), we feel the U.S. economy is quite lean (there isn't a lot of excess slack to cut out, i.e. laborers, inventory, etc.), key capital goods markets like housing and automobiles have bottomed out and will contribute to future growth, and the U.S. banking system is much better capitalized than at any time in recent history.

That being said, ever since the financial crisis of 2007-09, markets have been highly skittish. Over the period 1950-2007, stocks moved in excess of 3% in one day 115 times; over the past 3 years, it has happened 85 times! The stock market frequently goes up or down based on news out of Europe. Accordingly, while we believe the U.S. economy and the domestic companies that we own can perform adequately even in a tough European environment, domestic stock prices will likely oscillate widely.

The best way we can put it is this: our expectation is that stocks will continue to exhibit heightened short-term volatility, with potentially large sell-offs and rallies (which are entirely unpredictable); that being said, we feel that the long-term investor is adequately compensated at current prices for such volatility. In other words, stock prices will move around a lot, but we believe that they will be higher in 5+ years. Any investor who has a time horizon less than 5 years or is likely to sell stocks after a price decline should seriously consider their participation in the stock market. Investors who are comfortable with a long-term horizon and can stomach stock market volatility should be aptly reward.

There is no doubt that these are tough markets to navigate. But such markets can offer great value. As we frequently tell our clients, volatility is the friend of the disciplined, long-term investor.