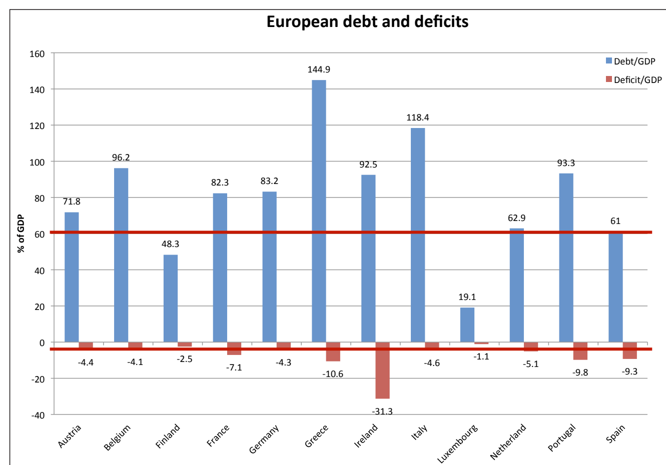
KAPSTREAM CAPITAL

Sometimes the truth can be so unnecessary

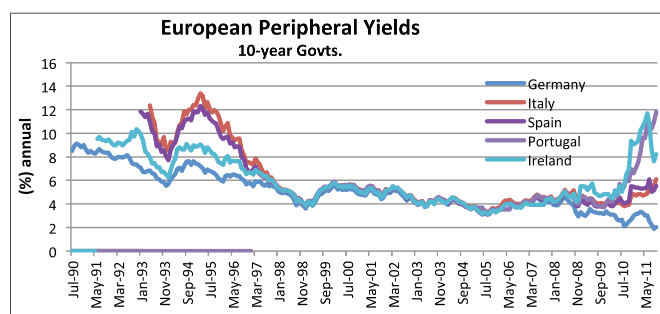
How many investors remember the Maastricht Criteria's two main fiscal tests that were required of countries in order to join the European Monetary Union? Let us remind you. First, all countries that wanted to join the Euro in 1999 needed to limit their outstanding sovereign debt to 60% of GDP. Second, countries needed to also limit any annual budget deficit to 3% of GDP.

Looking back on the 11 years since the formation of the European Monetary Union, we see that Europe didn't do very well in sticking to their fiscal plans. Eurostat, the commission charged with collecting and reporting European economic data, have continually showed European governments failing to meet these criteria. Their latest data, from December 2010, shows that only Luxembourg and Finland currently meet the original Maastricht fiscal criteria. Unfortunately, they account for less than 2% of European GDP.



The remaining original EMU adopters have debt to GDP larger than the original target of 60% and deficits to GDP larger than the original target of 3%[1]. And that was 2010, with continuing stresses in the European market, 2011 will look even worse.

Markets became too complacent in measuring true government credit risk once the Euro was formed. Interest rates fell in most Club-Med countries to the levels of the stronger countries (see chart below). As rates fell, these countries borrowed at German levels, but spent money like a drunken sailor on shore leave. The market finally began to re-access European government default risks, leading to today's crisis.



The biggest question facing markets today is Europe. Will there be fiscal/political union or will there be a breakup of the Euro. Can some members leave, how will they leave, and what are the consequences for the remainder of EMU? Can policymakers put together a plan for fiscal/political union as well as monetary union to save the Euro? Will the ECB monetize (print money) to buy sovereign debt? How will the banks survive, given the levels of sovereign debt remaining on their books, their lack of capital and their inability to tap financial markets? How will a full blown crisis impact the rest of the world?

Policymakers have so far only demonstrated how far behind the curve they remain. Like most conservative investors, we remain concerned over the impact to the

[1] Source: Eurostat

rest of the world, and in particular, worry about the short-term performance of our risk assets as market liquidity decreases.

Will the Euro-zone break up?

The continued escalation of the euro-zone debt crisis, including the borrowing costs of Club Med countries hovering at unsustainable levels, suggests an increasing probability of some form of break-up of the currency union and sovereign defaults. Policymakers are currently debating a plan for some form of policing/control of each other's fiscal situation. However, policymakers' failure to agree on the form of this obvious requirement has cast yet further doubts over their ability to take the action needed to secure the euro-zone's future. And official acknowledgement of the right to leave the euro has shattered any illusion that a euro-zone break up is technically impossible.

Given financial market uncertainty and the future fiscal sacrifices that are in the making, European economies have begun to slow and most face severe recessionary risks. It is becoming increasingly difficult for governments to implement austerity measures – increasing taxes and cutting spending when economic growth is weak. In order for fiscal austerity to work, most countries need economic growth. And weak growth and high unemployment have led to further social unrest and political upheaval across the region. Three prime ministers have already lost their jobs (Italy, Greece and Spain) as they were unable to provide a quick resolution to the crisis. We foresee considerable further social unrest and political upheaval.

Despite these headwinds, structural reforms are necessary both in labour markets and taxation and spending policies in order to promote market credibility. This lack of credibility has led to rising borrowing costs, which has compounded the current problem. Centralized oversight/ control of individual country fiscal policy is now a requirement to salvage market credibility and for further bailouts. But this will take time and pain to implement.

Small steps are beginning, both by a bail-out fund (EFSF) and the ECB's bond purchases, which implicitly transfers risk from the peripheral countries to the core. A sounder, longer-term solution of issuing bonds by a central borrowing authority for the Euro-zone 'a Euro-zone bond' would remove the need for countries to individually fund their debt. Closer economic integration would lead to stronger governance within the region and possibly eventually lead to full political and fiscal union – not impossible – but highly controversial.

All solutions require extensive and very drawn out treaty changes. Unfortunately, European leaders continue to believe they have already contained the crisis. Following last week's latest 'final' summit, German Chancellor Merkel stated, 'the breakthrough to a stability union has been achieved.' ECB President Monti said 'It's a very good outcome for euro-area members and it's going to be the basis for a good fiscal compact and more disciplined economic policy.' And proving the end to the European crisis was near, it was just announced that the 2012 and 54th winner of the prestigious Charlemagne Prize for helping foster European unity was just won by German Finance Minister, Wolfgang Schauble for his work toward stabilising the Euro. The inaugural Kapstream 'Sometimes The Truth Can Be Really Unnecessary' Award is currently accepting nominations! We remain bearish on policymakers' ability to successfully implement necessary policy changes.

What about the rest of the world?

As the European crisis took centre stage, few have focused on the US recovery. While non-farm payroll numbers have been steadily increasing (at about 120k a month), job growth remains below the average level needed to meaningfully reduce the unemployment rate. Given the 8.5 million job losses through 2008-2009, we estimate job growth needs to be in the 250k to 300k/ month to return to pre-crisis employment levels. While not at these levels, at least job growth has returned to consistent positive numbers. More recently, consumer confidence numbers have been much higher than expected and retail sales were larger than expected, post the Thanksgiving holidays. Housing still remains a weak point, as data remains weak due debt levels and