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## **The Sick Man of Europe**

For those of you not obsessed with history, “the sick man of Europe” in the latter 19<sup>th</sup> century was the Ottoman Empire, which duly collapsed after being on the losing side in WWI and was finally replaced by Ataturk, the father of modern Turkey.

Happy to say, Turkey’s doing fine now (despite fading hopes of entering the European Union). And no, this won’t be a political diatribe of how the entire European Union is “sick”. Maybe some other time.

The unquestioned sick man of Europe today is Italy. Its bonds’ yield crossed 7% -- that’s not a “record level” in absolute terms, but the yield spread might be, at least since the fall of Mussolini. Berlusconi’s fall has been way too gradual, so I reject that the market should fear “Italian instability.”

Italy has suffered from way too much “stability” in my view. Since Silvio Berlusconi swept into power in 1994, things have gone steadily downhill. The Italian real annual GDP growth rate in the last ten years has averaged only 1%; terrible by any measure, and it has been getting worse.

Italy has ten times the bonds outstanding as Greece, and a higher percentage owned by foreigners, so the problem is immeasurably larger. Greek banks are not important to the world; French and German banks are. Greece was never an engine helping world prosperity; Germany was, but that is now threatened by Italy and possibly France.

So Italy, a fading power which in my lifetime may end up smaller in population than Nepal, faces “austerity” -- which it has actually been suffering for some time now, with very high unemployment for the young resulting from a kind of country-as-a-wealthy-union model. A new person has great trouble breaking in unless he or she is well-connected to one of the “power blocs” – The Catholic Church, the unions, or the government, plus maybe the Mafia in the South, but I don’t want to over-emphasize that. Italy’s a democratic country with the rule of law. The important thing is that despite having the richest head of state outside Brunei, a multi-billionaire has presided over his country’s significant decline over a long period of time. Success isn’t obscene; failure is.

I believe the market is rational in waffling back and forth on the issue of life-after-Berlusconi. However, I would come down on the side of “How can it be much worse?” That’s all. Nothing profound.

Our bond market, especially our corporate bond market, must eventually get used to the obvious: Germany aside, **most sovereign debt in Europe is riskier than most medium-to-high quality U.S. corporate debt.** For example, the midpoint between U.S. “A” and “BBB”-rated debt is 247 basis points (bps) over Treasuries. I would rather have that good-quality debt at that spread than the combined debt of the following group: France, Belgium, Austria, Ireland, Italy, Spain, Portugal, Cyprus, and Malta. The debt of all those countries can continue to widen dramatically while U.S. corporate debt will be only mildly affected. In total that’s a lot of troubled European debt, and I prefer the U.S. credits because Europe’s debt is all connected by a refinancing problem. That’s not nearly as true for U.S. corporates of decent quality, who can get refinancing at reasonable rates based on their individual merits and strength.

Europe could solve its problems over the long haul if it were one country. It would simply start to issue a lot of European-guaranteed debt, which would hurt Germany but help the rest, using the funds to buy back the old country-specific debt. As long as the ECB vetoes this unifying idea, Europe will continue to wallow and flounder, with each country’s debt getting beat up in a never-ending rotation. At some point the U.S. corporate bond market decouples from the European sovereign debt market, since after a while the risk of recession caused by Europe will be completely discounted

The sick man of Europe is causing problems, just as the breakup of the two terminally-ill empires (Austro-Hungarian and Ottoman) caused problems after WWI. But the transition had to happen, and Italy has to go through this phase. No one seriously thinks the world would be a better place if European empires still existed. So investors shouldn’t obsess about Italian instability. It’s been long overdue, and at least it seems as if it will be a peaceful, if economically rocky transition. Anything’s better than creeping death.

Good luck and good investing,

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