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A Fresh Primer on Europe

- **It's all up to Germany and, to a lesser extent, France**
- **Germany is being remarkably timid, but that's understandable given its roots and mindset**
- **France is a necessary junior partner to help Germany succeed in its proposed reforms and treaties and eventual bailouts and guarantees**
- **The EU is not likely to break up, but the Euro could**
- **Chaos is unlikely, but recession is certain**
- **A deep European recession is unlikely but cannot be ruled out – it all depends on the strength of the German-French response to crisis**

If the never-ending European crisis continues to be the main determinant of U.S. financial markets, it behooves us to take a fresh look at what we know about that too-easily-summarized place and its financial and political system. Indeed, it was the European dream of easy union, permanent peace and endless prosperity which has fueled today's negligence and its consequences.

Rather than demonize the European Union as a bunch of short-sighted, deadlocked idiots (as California was demonized just a couple of years ago), let's examine the European Union, its key players, its likely future, and what it means to us.

First of all let's rule out a few things. Although the bloody Yugoslavian breakup was a rude awakening to the fact that war had not been abolished in Europe, in fact there has been no significant war since then. It's also important to notice that almost all major European wars (on European soil) since WWII have involved Communist or former Communist countries, and have been gradually lessening over the decades to near-zero today as Communism vanished. I would rate the chance of European violence on a large scale (already by far the most peaceful continent) as so low as to be insignificant. Even with its current troubles, Europe today makes South Asia and Southeast Asia (let alone the Horn of Africa and other Middle Eastern hot spots) look like tinderboxes by comparison. A replay of the Thirties is just not in the cards. (Never say never, but for the purposes of medium-term forecasting I **do** say never in this case.)

Next we move to the EU itself – could it break up? Theoretically it could, but as I said in an earlier piece, experts are guardedly confident that the specter of war continues to frighten leaders of this generation enough to stick it out for the foreseeable future.

Finally, we move to the currency union, the obvious weak link of the system today. There is certainly nothing terribly sacred about the Euro, and it clearly isn't serving the peripheral countries very well any more. Not only Greece but Italy would be better off if they could devalue and make their economies more competitive. I'm not saying this will definitely happen, but an investor has to realize the uncertainty – it is neither a certainty of breakup (as some “Euro hawks” would have you believe) nor is it off the table either (as the European leaders, lacking in credibility, would have you believe).

So I haven't told you much so far, but at least you get my view of the basics. A recession is certain; a deep recession is neither likely nor impossible. The Franco-German response will essentially determine the outcome, since no other European countries can come to the aid of the periphery in any significant size (neither will the U.S., although the IMF is gradually taking a larger role).

Indeed, it is a pervasive view of many experts that France itself is relatively so weak compared to Germany that Sarkozy is a kind of figurehead in terms of the role he plays in determining the “reform” package and the “treaty changes”. As former President George Bush and his buddies would say, “All hat and no cattle.”

That is not to say that France is unimportant – indeed no other country is more important after Germany. By a process of elimination, I eliminate Britain – not on the Euro, and Britain is dealing with its own incipient recession. The strong pound insulates Britain against a run on their sovereign debt. Gilts are at record low yields. The market has voted.

A lot of focus will be on “the sick man of Europe” – Italy. Justifiably so, but from my perspective I see a country which has frittered away the chance to control its own destiny, at least for several years. All it can do is try not to be a basket case like Greece, and hope for the best.

Spain hasn't been in any leadership position since the Spanish Armada (1588, if you cast your mind back) and has too many internal problems anyway. The Spanish Civil War enabled regional autonomy as a sop to the fact that Franco had created a fascist dictatorship. Similar to our own Civil War, after the Feds conquered (in Spain the winners were the fascist church-state “insurgents”) and tried some reconstruction, the defeated regions were left to themselves for a long time. So Spain needs to reform its own house before attempting to claim the political spot in Europe which its decent size might allow.

Well that rounds out the main countries of Europe. Oh, Russia is unimportant, since it is mainly just a commodities exporter and not part of the EU. The best we can hope for Russia is they won't punitively stop the flow of gas this winter on some pretext (they always have some pretext, but it's really all about power).

So France deserves some analysis. What do we know? It's the fifth-largest economy in the world after the U.S., China, Japan and Germany. Paris is approximately tied with

London and Chicago in a three-way tie for the position of the 4th-wealthiest metro area in the world (after New York, Tokyo and Los Angeles). The French language and culture are very strong, perhaps the strongest (for the size of the country) in the world, despite all their complaining about American inroads. China, by contrast, is in an incredible state of flux in which none of its storied traditions (either ancient or Communist) are set in stone any more; raw capitalism casts all in doubt. Japan is the fastest-aging country on earth, and less and less likely to be a difference-maker on the world stage. As the former colonial power which taught West and North Africa French, France is well-positioned to benefit from Africa's rise, since that continent will contribute ½ the world's population growth in the next 40 years.

Since France is not some insignificant or navel-gazing country, its future does indeed impact ours, if only to the extent that France can help Europe ameliorate its crisis. I may have overstated the case when I said that France is relatively powerless in its binary relationship with Germany. Germany needs France to give the semblance that it's not all up to Germany and its wealth. In addition, many top European Union officials are French. France also has more top government officials experienced in finance than the current leadership group of Germany has. So there's no doubt that Germany needs France, if not as much as France needs Germany. France is highly limited by the fact that, like Italy, it too is overindebted (the same cannot be said for Germany) and therefore France doesn't know if the reforms about to be undertaken will affect it more as a creditor or a debtor. France has more than its share of dud banks, many of which are large and international (unlike the dearth of such large international institutions in Spain and, to a lesser extent, Italy).

The wealth and treasure of France as well as Germany will be on the line if they try to meaningfully safeguard Italy from another ruinous run on its debt. Unfortunately, Chancellor Merkl's weakest moments are when she summarily rules out European-guaranteed debt. Her argument has a schoolgirlish rigidity which belies her status as the leader of the future reforms, treaties and bailouts. Indeed, a compromise solution might save face and offer a partial guarantee – it won't work at all and may not work at all, but it's probably better than nothing. If Merkl were more like Henry Kissinger, we would all know that the real reason for this is politics – e.g. “I have to say this because you certainly wouldn't want me and my government to be thrown out at a time like this, would you?” Unfortunately we don't know if she truly believes that European-wide bond issuance is really as terrible an idea as she says it is.

Merkl has inexperienced finance and other top economic advisors, although of course the country is loaded with experience and talent, and so is Europe in general. Investors hate to think that a top political leader in crisis would be acting like Herbert Hoover in 1931 (“Stay the course” – “Government should stay out of it and let the market correct the problem” -- “Prosperity is just around the corner”) which is definitely the impression she gives despite vague big-concept ideas which don't help in the short run. To give her credit, at least she hasn't echoed Hoover in saying, “Prosperity is just around the corner.” Teutonic gloom is too ingrained.

If this article sounds gloomy, it is, -- but not “doomy” (an important distinction, at least to me). Germany and France have their work cut out for them. So do Italy, Spain, Britain and all the EU countries, but they are merely supporting characters with their “fifteen minutes of fame” now and then, as in the recent Slovakian vote and the occasional Finnish outburst of protest. When push comes to shove, it’s way too far-fetched to imagine a minor country upsetting the apple cart – even Greece. However, the events taking place today in Germany and France will determine the Euro’s future, and could be inadequate to prevent the breakup of the currency union. It wouldn’t be the first time in history, but it would be ugly. I recommend U.S. corporate bonds in spite of all this, but don’t imagine I can’t see some really rough alternatives to my generally-rosy scenario. I just keep things in perspective that in the long run, with or without a Euro, our corporations will be able to muddle through and probably prosper.

Good luck and good investing,

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