

The EU comes of age (and may be coming apart)

The European Union (EU) of 27 countries was formed as a sort of united states of Europe and, since 1999, 17 of them (the Euro zone) have the Euro as their currency. Euro zone membership ranges from Germany and France to tiny Estonia, Slovakia, Slovenia and Malta. (Six of the smallest Euro zone members collectively generate only about 2% of the Euro zone's total GDP.) Four significant members... Britain, Poland, Sweden and Denmark... did not adopt the Euro currency. And, in keeping with its tradition, Switzerland not only did not adopt the Euro, it isn't an EU member, even though it sits squarely in the middle of EU countries.

Despite good intentions and EU entry-hurdles, such as a member's budget deficits must be no larger than 3% of its GDP, the union clearly has failed to make its rules stick and, so far, failed to address a major crisis. In fact, the Euro zone group is proving to be little more than a geographic supper-club whose members dine from the same set of plates. And, because France and Germany are the only ones with large enough dining tables for the group, the not-so-well-off members expect them to host.

It's all about the banks

A typical bank's capital base is equal to about 1/15th of its total assets, meaning that a significant decline in the collectability of a bank's loans would likely wipe out much, or all of its capital and, if no bail out is quickly at hand, the bank will fail. In the US, small banks have recently been failing at a record pace, as their typically significant real estate developer loans go into default. But, those US bank failures cause no noticeable pain. In the space of one weekend, the FDIC routinely moves in, takes the bank over, absorbs whatever loan losses exceed the bank's capital and then sells the bank to one of its competitors. Works well, as long as the bank is small. During mid-2008 in the US, the Federal Reserve fell short of engineering a desperate plan to prevent the

collapse of Lehman Brothers, a 158-year-old investment bank. This first-order-magnitude event, involving a major, globally interconnected financial entity, triggered a daisy chain. The nature and extent of the trust relationships between financial institutions is so delicate that, because Lehman's unsecured debts to other large, interconnected banks were not quickly bailed, the entire financial system quickly cascaded toward the edge. The size and speed of the flow began to look like that awful footage of the Japanese shoreline, as the tsunami came ashore, destroying and carrying away whatever lay in its path.

World markets await EU dithering

Europe is home to the world's largest banks. Ranked by assets, Germany and France host 14 of the globe's 50 largest, including numbers 2, 3 and 6. The UK is home to numbers 1, 4 and 5, while the US's top ten ranks include only numbers 7 (Citi) and 10 (Bank of America).

In better times, Greece was the seat of Plato and Socrates, but just now the country has become a synonym for governmental excess and mismanagement. Although membership in the EU requires meeting a number of minimum economic ratios, Greece is bankrupt. It all began (as usual) with a lethal combination of profligate borrowing and mythical bookkeeping. It is ending with two 2011 bailout efforts by the EU and a third awaiting completion. Large banks across the EU hold debt paper issued by Greece and other European governments. In a fundamental way, the EU has essentially no other option than a bailout. Perhaps never before have global investment markets been so singularly focused, without definitive action, for such a long period. Over the past several months, daily market volatility kicked up while leaders of France and Germany rather publicly performed a kabuki which amounted to destructive dithering.

The Seventeen Euro-Currency Sisters

The preceding paragraph describes what has happened so far, but it fails to describe the real threat: a daisy chain of European banks holding assets with make-believe values, each of which is deemed too big to fail, but is actually also too big to bail. The would-be resources for bailing.... the healthy (and likely unwilling) members of the EU... are not sufficiently heeled to backstop such an enormous banking capital crisis. That leaves the US, China, Japan and, maybe the Middle East to top off the job. Put it this way: the “solution” to such a financial panic would have to be based upon a binge of collective money printing by all of these resource nations, on a scale that would cause even Ben Bernanke to blush. Such a “cure” would also generate its own new global economic crisis, measured by runaway commodities prices.

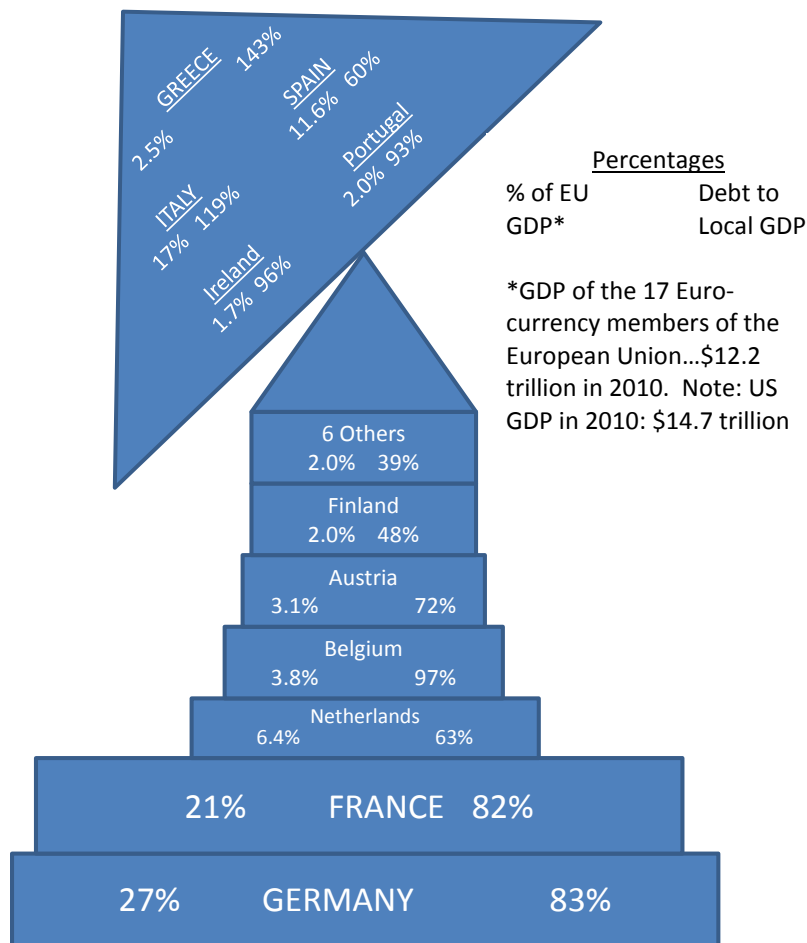
The timing of the Greek-based financial crisis fell on top of a German election season and political upheaval in France, all of which has now turned the US Congress’s disastrous summer into a footnote.

Greece, in this instance, is the classic whipping boy. Spain and Portugal are, and have been in that same leaky Mediterranean boat for some time. A fourth economic basket case, Ireland, has at least adopted major governmental belt tightening. But the really serious fear is not that any, or all four of these stumbling economies will fail, but that a weakened and politically unstable Italy, which houses the numbers 13 and 26 largest global banks, would probably follow them. With so much riding on the situation, what actions have emerged from the EU’s central bank to beat back self-feeding fear and mistrust? As of the end of October, not much.

How rich is too rich?... A global occupation

In the 1970s in the US, it was called a Love-In. In the middle months of 2011, we witnessed the Arab Spring. Now, we have two months of experience with encampment by dozens of folk in centrally located public parks in a number of cities across the world. Many, but certainly not all members of these groups can be described as under-thirty and unemployed. Media interviews have attempted and failed to identify either leadership or objectives; in fact, an interview of the Congresswoman from Oakland asserted that this protest movement may not have leaders or agenda, but it needs none. Instead, she insisted, it “deserves to be heard”.

...The Teetering 5...



...The Foundation 12...

Hearing what? Is this a budding Anti-Tea-Party Party? Please see excerpts at the end of this piece. We remain curious about the eventual impact (on 2012 elections, perhaps?), but across the world the movement has all the trappings of a 21st Century Tower of Babel that seems to resonate with corporate gadfly Michael Moore. The mission among park-gatherings of mostly would-be taxpayers is murky because the membership shares little more than one characteristic: *anger*.

Apparently, the protest target is mostly Fat Cats, but not all overweight felines are included. The real culprits seem to be the millionaires who, driven by

unimaginable greed, hide in towering financial houses, create no jobs and, instead of losing theirs, were bailed by taxpayers, including bonuses. These Cats' pie-slice is growing unfairly. Billionaires, on the other hand, are generally believed by "the 99%" to be enlightened, sympathetic and willing to pay their "fair" (undefined) share of income tax. Hence, they are exempt from scorn among the park dwellers. The standard-bearer, Warren Buffett is indeed a financially interesting cat. His widely known salary from Berkshire Hathaway is \$100,000, which may not be much more than that of his secretary. Moreover, the company pays no dividend and hence, there is no income tax on his shares (which had a recent market value that was a hair over \$48 billion). In August, Buffett wrote a New York Times editorial, brashly titled "Stop Coddling the Super-Rich". However, he has not announced a voluntary contribution toward the federal debt [it's easy: www.pay.gov].

Most park dwellers make it clear that they will stay "as long as it takes"... which seems an easy commitment to make in October's cool, bright weather. So, which actions or signals, made by whom will be sufficient to end the protest? Is this a national, or international movement? A couple of conclusions:

- that the action desired would be governmental... maybe a change in the income tax system, although that goal would not produce the one result the protestors seem to need most: jobs, and
- that perhaps (in the US only) satisfaction must include passage of President Obama's proposed "jobs bill".

A new Fed policy twist

Because the Federal Reserve is running out of options to further manipulate the US economic doldrums and level of unemployment, it has announced a new nine-month initiative called Twist. The Fed will sell \$400 billion in short-term Treasuries in exchange for the same amount of longer-term Treasury bonds, starting in October and ending in June 2012. [For the week ended October 26, we noted that almost \$9 billion of Treasuries maturing in 12 to 15 months were removed from the market,

while a similar amount was added to outstanding issues in the 6 to 10 year maturities and another 2.5 billion was added in the 26 to 30 year range.]

The Fed was quick to point out that the twist policy will feature equal buys and sells of Treasury securities, meaning no new dollars will be printed. Twist is designed to push down interest rates on everything from mortgages to business loans, giving consumers and companies an additional incentive to borrow and spend money. Despite the fact that the Fed is saying they expect short term rates during the Twist to remain at their present (record level) lows, we find reason to think otherwise. Over nine months, the Fed will be selling what will amount to about \$1 of every \$7 held in money market funds. It is a well-known fact that the US money fund industry, the dominant source of worldwide liquidity, is in some trouble, owing to the fact that there is and has been little room for profit, because interest income is near zero; moreover, US money funds were, until recently, heavy buyers of short term debt issued by European banks, in order to gain access to decent yields. But, because of the recent doubts about their financial soundness, especially French banks, those holdings had to be liquidated in a hurry and presumably brought back into short term US securities.

Not so fast, China!

The phenomenal, seemingly endless GDP growth in China is, in fact, just that... a phenomenon. While it has not ended, it has clearly reached a new phase. The inevitable economics of China's serving as the world's manufacturer of choice, because of extremely low wage rates, has not only bottomed out, it is already in reversal. Just when the US (and others) despaired of manufacturing jobs exported to China, those jobs are now beginning to come back home.

China's economy grew at a 9.1% annual pace in the third quarter of this year... down a bit from the 9.5% rate in the second quarter. China's exports have been falling rapidly in recent months, especially sales to Europe which may throw a wrench in China's plans to rebalance its economy (reducing

dependency on exporting, more emphasis on consuming).

Government spending and investment have propped up the economy since 2008, but current levels of expenditure aren't sustainable. And efforts to increase consumer purchasing power will further hamstring exporters facing a darkening global outlook. Of course, if China reduces the pace of its currency appreciation, that action will antagonize the strongest of its large export markets... the US.

So, where are thundering herds headed?

The crisis atmosphere in the Euro zone, despite its age, is still in the bud. And worse, the leadership there has proven that driving a nail by striking its head with a hammer is not their idea of how to do it. This prolonged confusion's most direct market impact shows up in extreme day to day volatility among financial equities which, in turn, will be reflected in many value-style investment portfolios. (For traditional US investors, this period may be a useful occasion to identify value managers who, driven by their value benchmark index, are stuck on a heavy commitment to financials..... it's their 2nd

opportunity in the past three years to avoid financial shares that have been operating as growth companies for more than a decade, spurred by fat bonuses for executives who levered-up earnings.) Do these remarks ignore Warren Buffett's seemingly optimistic \$5B purchase of Bank of America stock in August? No. We view the Buffett investment as a desperation rescue [encouraged by the Fed??] which will dearly cost the bank and likely act as a long term drag on its financial flexibility. That deal involved a new, special-issue of 6% preferred stock which has almost nothing to do with the bank's common shares, other than the possibility that shareholders may eventually suffer dilution, if Buffett decides to exercise his 700,000 warrants to buy the common on the cheap.

As for debt investments, if the Fed's new Twist has the effect of manufacturing more or less equal interest yields from notes and bonds of all maturities, then it will be illogical to buy anything long, while holding onto any existing long bond positions may become unexpectedly profitable (but logically, not for more than a few months).

Excerpts from the Occupation Movement:

Ray Mia (NY) wants "...to bring down the corporations who exploit the planet for profit and poison our slowly dying planet. I am in the Direct Action Working Group here. My goal for the movement is to build alternatives to capitalism while tearing the current system down."

Jonathan Smucker (RI) says he's there in Wall St. "...to stand up to this unfair system, where the richest 1% are still making record high profits, while there's austerity and hardship for the rest of us."

Sandra Nurse (NY): "I am hoping the movement motivates people to become more engaged in the decision making process in their communities in addition to offering alternative institutions to current systems."

Jan, a tai'chi teacher (Frankfurt): "My main reason for being at the camp is my wish for a good future for humanity."

In the UK, where, unlike the US, serious governmental belt tightening is actually underway, an editorial in *The Guardian*: news of a recent survey showing that directors of the UK's FTSE 100 companies increased by almost 50%, has "...furthered the impression of a plutocracy that lives beyond the reach of hard times."

According to Coup Media Group (CMG), Revolutionary Human Media: the movement has no Official Demands...yet, but there are Internet meetings and there will be votes to adopt demands from a (US-based legislative) list which CMG backs, focusing on justice for alleged Wall Street crimes and criminals and reversal of the Supreme Court ruling that grants "personhood" to corporations for purposes of making political contributions.