GUGGENHEIM

Market Perspectives

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July 2011

Europe's Cognitive Dissonance

ORIGINALLY PUBLISHED ON BLOOMBERG VIEW
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In the early 1950s, an American social psychologist named Leon Festinger conducted an experiment that may provide valuable insight into Europe's current troubles.

He encountered a local religious cult that believed UFOs were coming to rescue them from a cataclysmic flood that would destroy the earth. Festinger infiltrated the group in order to research a theory he called "cognitive dissonance," or the psychological tension experienced when an assumption or belief is challenged by contradictory information.

When the prophesied Day of Judgment came and went – without so much as a drop of rain, let alone a flying saucer sighting – Festinger studied how the cult members coped with the conflict between their conviction and reality. Since the group had committed considerable expense in support of its view, altering course was simply too costly. Instead, the leadership addressed the problem by assigning a longer time horizon to their expectation and encouraging followers to escalate their commitment. This helped some members avoid the pain of reversing ideology; but ultimately, reality would prevail.

Festinger concluded, "Though they may try to hide it, even from themselves, the believers still know that the prediction was false and all their preparations were in vain. The dissonance cannot be eliminated completely by denying or rationalizing the disconfirmation."

In many ways, this paradoxical story is analogous to the political psychology of the European debt crisis. At this stage, it should be apparent that liquidity alone is not the answer. Equally evident (at least for me) is that austerity is not the cure. Nevertheless, policymakers remain committed, at considerable cost, to a prescription of bailouts and belt tightening. The recent European Council proposal for Greece offers more of the same – billions in additional liquidity and blind faith in austerity. Conspicuously absent are meaningful structural solutions.

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When Time is Not an Ally

The latest bailout program should be successful in one regard: buying more time. Unfortunately for Europe, time is no longer an ally, and it most certainly is not healing all wounds. Across the European periphery, economic data are degenerating as the calendar marches forward. Year to date, Greece's debt burden, budget deficit, cost of funding, and unemployment rate have increased. Its economic output and tax revenues continue to depress.

Portugal and Ireland are likely to follow in Greece's footsteps in their need for additional support. Spain and Italy face borrowing costs unrivaled since they joined the monetary union, and their anemic economic growth rates and fragile banking systems only complicate matters further. Given current trajectories, recession may engulf the entire European periphery by the fourth quarter, dragging euro-zone GDP to the verge of contraction as well.

In short, the data indicates that without currency devaluation, austerity simply doesn't work. Crisis in Europe has not been averted; it has only been modestly postponed. With their borrowed time, policymakers appear inclined to wait and hope for the best, seemingly oblivious to the pressing need for significant structural reforms.

THE EFFECTS OF AUSTERITY WITHOUT CURRENCY DEVALUATION

Austerity Checklist	2010	2011	Is Anything Getting Better?
Real GDP	-4.5%	-5.5%	
Government Debt-to-GDP	143%	165%	
Government Budget Deficit-to-GDP	-10.5%	-11.2%	
10-Year Government Bond Yield	12.5%	14.7%	
Unemployment Rate	14.8%	15.8%	
Ordinary Government Revenue *(January to June)*	€23.8 Bn	€21.8 Bn	
Ordinary Government Spending *(January to June)*	€30.5 Bn	€33.2 Bn	
Total Borrowing Requirements *(January to June)*	€10.2 Bn	€18.5 Bn	

Source: Greece Ministry of Finance, Bloomberg, Eurostat, Guggenheim Partners. Data is the latest available as of 7/26/2011. 2011 government debt-to-GDP ratio and government budget deficit-to-GDP ratio are annualized based on the first half data for the budget and first quarter GDP. Government revenue is the net revenue after deducting tax refunds.

Policy Reform, My Dear Watson

What action should European leaders pursue? As Sherlock Holmes said, “When all other contingencies fail, whatever remains, however improbable, must be the truth.” The realization hitting European policymakers is that the euro region’s survival will inevitably require a greater degree of fiscal unification. As German Finance Minister Wolfgang Schäuble recently confessed, “The nation state as the sole level of policy-making has exhausted its effectiveness.” He also admitted, “When we founded this monetary union, Germany was in favor of a political union too.”

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European Central Bank President Jean Claude Trichet recently refined the discussion, asking rhetorically in a prominent speech, “Would it be too bold, in the economic field, with a single market, a single currency and a single central bank, to envisage a ministry of finance of the union?” Under Trichet’s proposal, the European Union would have the power to veto the budget measures of countries that go “harmfully astray.” Indirectly, his wish has been partially granted. Sovereign nations such as Greece, Ireland, and Portugal are already subject to governance by the troika of the E.U., the E.C.B., and the International Monetary Fund.

Never Let a Good Crisis go to Waste

The argument remains that Europe is far from possessing the political will for closer fiscal union. Politicians view it as unsalable to nationalist constituents. Ironically, the lack of action by European leaders may do the selling for them as the crisis deepens. As Jean Monnet, the man who built the very foundation for the European Union, once said, “People only accept change in necessity, and see necessity only in crisis.”

Just as crisis forced Greece, Ireland, and Portugal to muster the political will to implement drastic fiscal changes, so it may be with the rest of Europe. The growing financial crisis across the monetary union may ultimately help Germany and France find the political will to lead the euro zone into a new era of economic alignment.

While it may not seem plausible at the present time, a lot of things seemed unthinkable in the United States the week before Lehman Brothers collapsed. This time around, wouldn’t it be better for Europe to end the denial and pursue a structural solution to circumvent a financial catastrophe?

The Truth about Brussels

Peripheral European economies require restructuring to escape a downward spiral. The latest bailout announced out of Brussels may resolve Greece’s immediate liquidity issues, but it turns a blind eye to the nation’s structural problems. For example, Greece has a debt-to-GDP ratio that's currently approaching 160 percent. This is light years beyond sustainable, especially under the economic oppression of austerity and an overvalued currency.

To survive, Greece's debt-to-GDP ratio would need to be closer to 70 percent, implying a debt haircut of approximately 55 percent. Realistically, larger haircuts are necessary, given that Greece is plummeting toward a budget deficit of approximately 11 percent of GDP in 2011. In other words, for Greece to have a fighting chance, it would need bond holders to receive something like 30 to 40 cents on the euro. This is a long way off from the current European Council proposal.

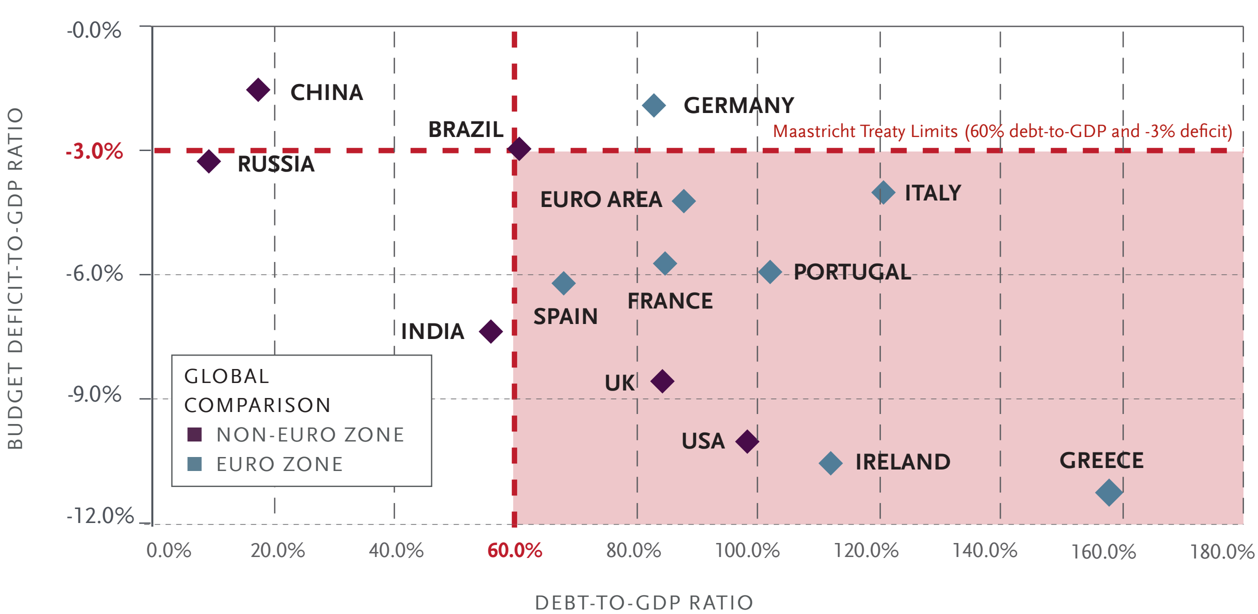
Think of it this way: the Hellenic Republic is caught in the suffocating grip of a giant python. To be effective, any rescue plan must release the country from the constricting coils of its crushing debt burden. Otherwise, asphyxiation *is* inevitable. The current proposals offer temporary relief, but they don't do enough to address the structural problems overwhelming Greece. Without meaningful structural solutions in *all* the peripheral nations, the euro area is likely to return to crisis mode in the next six to 12 months.

Taking a Whack at Structural Problems

How could policymakers begin to enact structural solutions? One vehicle could be via the European Financial Stability Facility (EFSF). European Union leadership has already taken an important step forward by expanding its mandate and flexibility.

GLOBAL COMPARISON: BUDGET DEFICITS AND GOVERNMENT DEBT

The treaty that created the European Union and led to the creation of the euro currency also set fiscal policy guidelines for all euro zone member states. Under the Maastricht Treaty requirements, budget deficits should not exceed 3% of GDP, and debt levels should never surpass 60% of GDP. Here's how leading economies inside and outside the European Monetary Union stack up to the Maastricht guidelines. It's clear that the worst violator is Greece.



Source: European Commission Forecast Spring 2011, Greece Ministry of Finance, Bloomberg, Eurostat, and Guggenheim Partners.

With its ability to purchase bonds in the secondary market, and the authority to recapitalize the banks, the newly revamped EFSF is now reminiscent of the Troubled Asset Relief Program (TARP) utilized during the financial crisis in the United States. This is a good first step.

The next step should be to use the expanded mandate of the EFSF to significantly affect structural changes in peripheral economies. To imagine what this could look like, let's start with Greece as a proxy and work with some round numbers. Conservatively, imagine that the EFSF issues AAA-rated debt yielding 4 percent. The proceeds from the sale of this debt are used to purchase Greek debt out of the market that's yielding an average of, say, 10 percent. As you can see, there is a significant carry-trade arbitrage for Greece (or Portugal, Ireland, Italy, or Spain, for that matter).

Currently, Greek bonds are trading for approximately 60 percent of their nominal value. If the EFSF purchased 100 billion euros of face value bonds at 60 cents on the euro, the European Union could subsequently agree to restructure these obligations with Greece. Hypothetically, the EFSF could slash the Hellenic Republic's interest expense by 7 billion euros per year if it chose to reduce the debt principal from 100 billion to 60 billion and offer a 5 percent interest rate instead of the previous 10 percent rate. A plan like this would not only cut Greece's deficit by more than 3 percentage points of GDP, it would also represent a meaningful stride toward reducing the nation's overall debt burden. As an added benefit, this solution essentially equates to a private restructuring without triggering a default event.

Quid Pro Quo

If the EFSF provided meaningful support to Greece and other peripheral nations, the quid pro quo for the European Union would be a greater level of long-term oversight and control over fiscal reform. Beyond overseeing austerity programs, the mandate could include economic policy coordination via labor market reform, tax reform, etc. Germany – the key dissenter to such a broad use of the EFSF – may not like the idea of a transfer union, but at least this mechanism would help make peripheral economies more competitive, or, some might say, more German.

European Central Bank President Jean-Claude Trichet recently alluded to this concept that I referred to as "quid pro quo." He described the European Union's bailout of Greece as an investment that inherently carried oversight authority, saying, "Europeans are not subsidizing Greece to never see their money again…They are investing in its recovery. Of course, they need to monitor their investment closely."

By taking the reins and overseeing fiscal consolidation and reform in Portugal, Ireland, Italy, Greece, and Spain, the European Union could evolve into stronger, more influential governing body. In time, a coordinated fiscal framework could emerge across the common currency, transforming the monetary union from a failing experiment to a sustainable reality. This is the new dawn for Europe. Unfortunately, dawn may only arrive after Europe

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navigates through its present darkness of denial. As long economic and fiscal reforms remain unaddressed, the darkest hours of the crisis will lie ahead.

Europe's cognitive dissonance is revealed in this paradox of policymaking. Fiscal union is the most resisted resolution, and yet it's likely the only option with long-term viability. Recent policy actions have only delayed the inevitable. The endgame remains clear: Europe will either willingly embrace tighter fiscal union or wait until crisis requires it.

"When the time of reckoning revisits Europe, dollar-denominated investments stand to benefit as capital flows from across the pond in search of safety and relative value in the largest, deepest, most liquid capital markets in the world."

What this Means for Investments

Despite global headlines of "Armageddon" in European and American sovereign debt markets, I'm actually quite optimistic in my outlook for investments. My sense is that the U.S. equity markets want to move back toward their highs. From mid-June to mid-July, the S&P 500 rallied approximately 6 percent (without the support of QE).

Markets are leading indicators, or discounting mechanisms, that can predict the future better than economic models. As an example, consider that the U.S. equity markets bottomed in March of 2009, approximately three months before the end of the recession in the United States.

Currently, I believe the stock market is signaling that the U.S. economy's "soft patch" is coming to an end. The supply chain interruption was just that, an interruption, and equity prices appear to be confident of a strong second half of 2011. I believe the S&P 500 could demonstrate such confidence by reaching 1,475 over the course of the next couple of months. Although there remains a glut of negative headlines in the world, I'm reminded of the old adage that "bull markets climb a wall of worry." There's no shortage of "worry" today, but once we push through some of this choppiness, I believe that U.S. equities will reach for new highs.

Regarding the U.S. Treasury market, I expect yields to rise at the long end of the curve in the near term. After falling from the 3.60 range, rates met resistance down around 2.85. Looking ahead, I expect to see the 10-year note push back up to around 3.30, but I don't believe this is the start of a long bear market, nor do I see it as a fundamental loss of faith in the U.S. government. A back up in long-term interest rates is likely nothing more than the bond market pricing in a pick-up in economic activity, similar to what I described in regard to the equity market.

Further down the road, I believe there's only a remote chance that Europe can make it through the next 12 months without finding itself back in a state of financial crisis. When Europe erupts again, capital is likely to flood toward the only safe haven large enough to absorb it all – the United States.

As a result, I would expect a downdraft in interest rates and appreciation of the dollar against the euro. After weathering the initial turbulence, investment capital bunkered down in Treasuries is likely to grow weary of low rates. Rather than sit and suffer with 2 or 3 percent returns in Treasury securities, investors will probably begin to look elsewhere. When they do, I believe they will look favorably on U.S. equities, where the fundamentals are attractive and so are the prices relative to other investment opportunities.

Fundamentally, the U.S. corporate sector looks like it's in great shape. Balance sheets haven't looked better in 30 years, earnings are strong, and the likelihood of a recession in the U.S. economy is extremely remote (the Leading Economic Indicator Index continued to edge higher in June). Equity earnings yields are currently at historically wide spreads relative to BBB bonds, and price-earnings ratios are compelling. The Federal Reserve model for equity valuation suggests that the price-earnings ratio for U.S. equities should be closer to 25, rather than 15 where it currently stands.

In the foreign exchange markets, a broader crisis in Europe would lead to a weaker euro. Elsewhere, an interruption of economic activity in Europe is likely to drag on emerging market (E.M.) economies. E.M. nations, particularly China, rely on the growth of their export partners to sustain their high growth rates. By contrast, the U.S. economy is likely to experience less turbulence than E.M. nations due to the strength of its domestic market.

In conclusion, I believe the European debt crisis has not been averted, it has merely been postponed. When the time of reckoning revisits Europe, dollar-denominated investments should benefit as capital flows from across the pond in search of safety and relative value in the largest, deepest, most liquid capital markets in the world. □