‘The Opening Act to the Broader Crisis’

‘Tis the season for miracles of all sizes. Microscopic on the grander scale of miracles is the fact that I recently tried to clean my office. While attacking the piles of research that had transformed my desk into a scale model of Midtown Manhattan, I found several reports that actually pre-dated the Great Recession.

Without naming names, one prominent investment firm declared in mid-2007 that the subprime crisis was “well contained and wouldn’t spill out into the broader market.” Another report was directing investors to buy the ABX index – the synthetic version of buying subprime mortgages – because it would be inconceivable for housing prices in America to fall nationwide. Appropriately, the firm that made that particular recommendation is no longer with us today.

Rifling through those old reports reminded me of what a different world it was just three years ago, and how so many investors denied the possibility that the economy sat perched on the precipice of disaster. In early 2006, for example, I gave a talk to a large group of financial advisors about the coming crisis in residential real estate. At the time there were many who vehemently disagreed, siding with the aforementioned founts of conventional wisdom. If I looked foolish describing an imminent real estate crisis of “biblical proportion” in early 2006, imagine how I looked over a year later in June 2007 when housing prices were still pressing all-time highs.

The reason I recount this story is because the current situation in Europe reminds me a lot of the period leading up to the subprime mortgage crisis. In fact, I believe the financial crisis in Europe could make the subprime crisis look like the opening act to the main event.
Much of the shakeout in Europe is likely to occur in the next 12 months, but the chronology and rapidity of how the crisis will fully unfold is less clear. One thing I believe with certainty, however, is that the tenuous situation in Europe will eventually unravel to the extent that the only solution will be quantitative easing and ultimately some form of federalization of Europe.

German Finance Minister Wolfgang Schäuble has already alluded to the possibility of federalization with his recent comments regarding Europe’s need for not only monetary union, but fiscal and political union as well. While Schäuble is but one voice, it’s quite clear that the dialogue around a fiscally united Europe has already begun and is likely to accelerate. Once a full-blown sovereign debt crisis erupts, there will be few solutions of sufficient scale aside from circling the fiscal wagons of the European Union. Between here and there is a long road that will be littered with financial market pain in Europe. Of course, this also means that there will be incredible investment opportunities as well.

‘Imagine You’re Irish’

To help explain why I believe a broader financial crisis is coming to Europe, let me start with a quick story. Imagine for a moment that you’re an Irish citizen. Needless to say, you have many concerns about your country’s economic situation. The unemployment rate is 13.7 percent and climbing, your economy continues to contract, your nation’s debt-to-GDP ratio is 97 percent and rising (up from 44 percent just two years ago), your national deficit has ballooned to a whopping 30 percent of GDP, your government is caught in a debt trap, and its borrowing costs have increased 75 percent year-to-date. If expressed in current market rates, the interest payments on your government’s debt obligations could easily account for 7 percent of GDP, or roughly one third of annual tax revenues. To put this into perspective, the situation facing the Irish government is akin to waking up everyday only to realize that one-third of your salary is gone before you even think about paying for the necessities of life.

Fiscally, everything is heading in the wrong direction in Ireland. However bad it may be, the country’s solvency is a secondary concern. If you’re an Irish citizen, the more pressing issue is what you’re going to do about your banking deposits. Your domestic Irish bank posted a 2.4 billion euro net operating loss in 2009 and is projected to nearly double its losses in 2010. The entire domestic Irish banking system has essentially failed, but the government wants you to believe that everything is fine. After all, the International Monetary Fund, the European Central Bank, and the European Union member countries have cobbled together an 85 billion-euro rescue package of which approximately 35 billion euros is set aside for the banking system.

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In addition to the bailout, the Irish government has assured you that it will guarantee your deposits, therefore, there’s no need to worry.

Then you get a hold of the Central Bank of Ireland’s most recent Credit, Money, and Banking report (publicly available on the internet). You see that total deposits for Ireland’s dwindling base of domestic credit institutions were roughly €496 billion euros as of October 2010. Some quick math tells you that this is more than three times Ireland’s GDP, and 14 times the scope of the current banking system bailout package. You start to wonder, “If I try to get my money from the bank at the same time everyone else does, where is the government going to get the euros to pay everyone?” You can’t think of an answer. Then you start to feel silly. “Why am I even bothering with all this worry?” you ask yourself. “I’ll just go down to the bank and take my money out now before things get worse. I can give it to a multi-national bank and sleep better at night.”

It seems trite, but this little scenario is essentially what’s happening today. The Irish banking system is literally experiencing a run on its banks. According to the most recent banking update from the Central Bank of Ireland, total deposits in Irish banks declined more than 5 percent (28 billion euros) between August and October alone.

**The Banking Woes of the Irish**

Bank deposits at Irish credit institutions steadily declined from a high of €593 billion euros in October 2008 to €496 billion euros in October 2010. In October 2010, total deposits declined at a rate of 10.4 percent per year. Aggregate data for November has not been released by the Central Bank of Ireland, but it will likely show further evidence of a run on the banking system in Ireland.

![Total Deposits in the Irish Domestic Banking Market](chart)

Source: The Central Bank of Ireland. Data includes all banks that operate in the Irish domestic banking market servicing Irish households and non-financial corporates.
WITHDRAWING FROM IRELAND

Since January 2009, deposits of non-Irish residents in Ireland’s banking system have declined by 29 percent. The deposit base from Irish residents declined by 4 percent over the same period.

Year-over-year, deposits declined 10.5 percent, and foreign investors are pulling their money out at an even faster rate of just over 20 percent per year. If the October data was that brutal, I cringe at the thought of what the November and December numbers may reveal. Even more disconcerting, domestic deposits have begun to contract. It’s one thing for foreign depositors to lose confidence, but now even the domestic deposit base is losing faith.

Facing facts like these, each morning when I wake up I have to wonder, “Why is today not a good day for a wholesale run on the Irish banking system?” And if there is a wholesale run on the Irish banking system, then what stops the same scenario from cascading into Portugal, Greece, Italy, and most importantly, Spain?

‘Where’s My Printing Press?’

Someone recently asked me, why doesn’t Ireland drop out of the EU and do what the United States has done with quantitative easing (i.e., run the printing press)? The problem in Ireland, Spain, Portugal, etc. is that they can’t print money – they surrendered the sovereignty of their printing press to the European Central Bank (ECB) long ago.
The next logical question is, why doesn’t the ECB just run the printing press for them? Can’t the ECB create a flood of euros to alleviate any concerns over illiquidity in the banking system and the toxicity of certain sovereign debt obligations? Technically they can, but practically they won’t. The psychology behind this is something that I hope to address in a future commentary. But for now, suffice it to say that dropping out of the EU is not a viable option for Ireland or any of the other debt-plagued peripheral countries. Benefiting from aggressive monetary policy is equally unlikely, at least to the extent necessary to stave off further crisis.

If Ireland and the peripherals can’t drop out of the euro, and the ECB won’t paper their way out, then what is the alternative? The answer most likely lies with the Germans. Since Germany is not willing to let the troubled economies secede from the euro, and they're not interested in outright bail outs, the only option left is for the nations of the European Union to somehow share the burden. This would require greater fiscal union and ultimately translate into European federalization. Federalization may not seem very palatable at the moment, but the debate is certainly gaining steam. Once the crisis comes to a head, I could see the German people looking much more favorably upon playing a historic role in organizing the fiscal union of the sovereign states of Europe.

In simple terms, federalization means that the EU would issue pan-European bonds and begin the process of expanding the role of its central governing body over time (the EU already has a governing body with a formal president, currently Herman van Rompuy). This is what the United States did when it ratified the Constitution and established the U.S. Treasury, which in turn consolidated and absorbed the various debts incurred by colonies during the Revolutionary War.

I believe the federalization of Europe is the most viable solution and will be the ultimate outcome. As German Finance Minister Wolfgang Schäuble said recently, “Sometimes it takes a crisis so that Europe moves forward. In this crisis, Europe will find steps toward further unification.” As Schäuble subtly foreshadows, to get from here to there, the crisis will need to intensify. As sovereign credit downgrades continue to flow in and deposits in Europe’s weakened banking system flow out, a broader crisis in Europe appears to be imminent in 2011.

‘What Does This Mean for Investments?’

If we are on the brink of crisis in Europe, which I believe we are, then there are several expectations we can draw about the investment landscape. First and foremost, the dollar will strengthen rapidly against the euro; U.S. Treasuries will rally; equity prices in Europe will fall; and credit spreads will widen, at least temporarily. In general, risk assets will experience choppier waters, especially as the crisis intensifies.
Now, I’m sure that someone will say, “But Scott, you just told Barron’s that you’re bullish on risk assets, that equities are undervalued and that high-yield bonds are a great place to be.” Let me be clear, I am not changing my mind on any of these investment theses, but a crisis in Europe will likely interrupt, but not derail, certain bullish trends at some point in 2011.

To understand what this might look like, I use the analogy of the stock market in 1987. During the stock market crash of October 1987, the Dow Jones Industrial Average plunged 31 percent. For six trading days, it appeared that everything in the world blew up. Despite its crash that October, the Dow still ended 1987 up 2.26 percent for the year. Annual returns were 12.6 percent during the 1980s, and they surged even higher (15.1 percent) in the decade following 1987. From a historical perspective it doesn’t look like there was much of a crisis in 1987 after all. In 2011, I think the markets will face something similar with the pending crisis in Europe. At least for the U.S. market, at some point in the next year there will be a dramatic disruption that will adversely affect prices. In spite of this, I still believe equity returns will average 7 to 9 percent for the next decade.

Aside from my general view of equities, I believe the crisis in Europe is a one-way bet against the euro. Eventually, there is no way out except to debase the currency. In fact, I believe that one day the markets may look back at this sovereign debt crisis and see that it was actually a bigger opportunity than the one that George Soros saw in 1992 when he broke the Bank of England.

With the great debaser, Dr. Bernanke, leading the way, the European Central Bank will eventually have to join the charge and print money in order to save the European financial system. As Hyman Minsky once postulated, central banks ostensibly say that their job is to maintain stable prices and sound monetary policy, but at the end of the day, the role of any central bank is to save the financial system at all costs. This includes the cost of the value of the currency and price stability. There’s nothing that cannot be sacrificed if the entire financial system is at risk. Practically, I believe this means that the euro will head to parity with the dollar and then ultimately below parity.

In terms of credit spreads, at the pinnacle of the crisis I anticipate that they will widen, but I don’t think corporate bond defaults are a major concern. The main theatre where the events in Europe play out will be in the foreign exchange (FX) market, where the primary opportunity is to short the euro. Outside of FX, I believe there are opportunities to buy gold and invest in U.S. Treasuries (but not just yet), as both will benefit from their safe-haven status once crisis erupts. In addition, there is opportunity to go long credit protection in the CDS of the countries that haven’t blown up yet, namely Italy, Germany, and France.
‘A Final Word for the Year on Interest Rates’

In December 2009, the yield on the 10-year Treasury increased 64 basis points to close out the year, primarily on the back of robust expectations for economic recovery (fourth quarter 2009 GDP eventually registered 5 percent annualized growth). Following the rise in rates in late 2009, the first quarter of 2010 saw rates go sideways. Then, after pushing upward to 4 percent in early April 2010, the yield on the 10-year proceeded to fall precipitously by 160 basis points over the next six months. Most recently, yields have mimicked 2009 year-end by climbing 80 plus basis points off the lows as positive economic expectations are taking root once again.

Although it would appear I'm describing significant fluctuation in rates over the past 12 months, at no point in this story did rates break out of the long-term down trend established over the past 30 years. In fact, even at the nadir of 2.21 percent on December 31, 2008, the yield on the 10-year note remained completely within trend. Even as we end the year with yields rising to what seem to be a relative high, the 10-year Treasury remains completely within the trend channel of declining long-term interest rates.

I’ve already gone on the record saying that the bull market in bonds is long in the tooth, but it’s also important to note that bull markets don’t just roll over and die – they either break trend and continue into a parabolic blow off, or they break the trend and move sideways for long periods of time. To me, the most important point is that the recent rise in interest rates has yet to break out of the downward secular trend in bonds. This event would be the first indicator to watch for before anyone should be concerned about rates rising in a meaningful way, and it has yet to materialize. I suspect that in the near term we'll see continued upward pressure on rates, but I would be surprised if they reached much higher than 3.80 on the 10-year note before declining again. The moral of the story is that as we near year-end, the 10-year note remains approximately 45 basis points below where it started the year. After a tumultuous 2010 filled with rising-rate speculation, the case for an extended period of low interest rates remains faithfully intact.

‘Closing Thoughts for the Year’

In the United States, the data continue to validate that the economic recovery is stronger than most think. As we end the year, there are numerous healthy signs for the economy, and many economists are starting to mark up their GDP estimates for 2011. I believe 2011 GDP will approach 4 percent, but of course the U.S. economy needs even faster growth than that to make a meaningful dent in the unemployment rate. As for the potential ramifications of the events in Europe on the U.S. economic recovery, I look forward to discussing that further in the coming weeks.

“One day the markets may look back at this crisis and see that it was actually a bigger opportunity than the one that George Soros saw in 1992 when he broke the Bank of England.”
In the meantime, to conclude this final note of the year, I would like to thank the team of professionals with whom I have the privilege to work alongside at Guggenheim Partners. I’ve often said that I receive far too much credit for the work they produce year round. As our Executive Chairman Alan Schwartz recently commented at our annual portfolio manager summit, Guggenheim has “pound-for-pound the best team of investment professionals that I’ve ever seen.” High praise from a man whom we all respect, and I must say that I heartily agree.

As the year draws to a close, I was recently informed that Guggenheim Partners was ranked in the top five among 152 investment firms for core plus fixed income performance in 2010*. It’s the hard work and dedication of our team, and the commitment, loyalty, and trust of our clients that affords the opportunity and privilege to achieve such performance.

To the entire Guggenheim team, and to all our friends, family members, and clients, on behalf of the firm and its shareholders, I would like to extend the warmest and best wishes in this holiday season. To all a Merry Christmas and bright hopes for a prosperous New Year.

*Core plus fixed income performance ranking based on eVestment Alliance data through September 30, 2010.