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VIEWPOINTS

APRIL 1, 2017 • NEWPORT, RI

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History has shown that one of the few dependable features of the investment business is the pendulum-like nature of investor attitudes, oscillating between the extremes of euphoria and fear; optimism and pessimism; and risk tolerance versus risk aversion. The timing and severity of these swings, as we can see in the attached illustration of the more significant market moving events of the past 120 years, are far from predictable. One thing is for sure: despite the frequent onset of shocks from both outside and within the financial system, human resiliency has triumphed over fear in the long run. This long-term optimism is the foundation of our investment approach.

In this edition of *Viewpoints* we examine the ongoing debt crisis in the Eurozone, a risk to markets that is not widely understood or appreciated. We'll discuss the history of the Euro as a common currency, the factors that led to the debt crisis in 2010, and the challenges facing the European Union today. You may ask yourselves why, as US-focused investors serving predominantly US-based clients, we'd focus an entire discussion on Europe? Don't we have enough problems of our own? The short answer is that the European economy is equivalent in size to the US economy, but burdened with a more opaque and unstable leadership structure. Given the globalized nature of the world we live in, one cannot be a prudent investor without considering the economic climate in Europe. At a time when the market

seems to be celebrating positive developments in the US (infrastructure spending, tax reform, deregulation, etc.) more than fixating on negatives, we must remind ourselves that the next panic could come at any time, and in many forms.

To grasp the somewhat fragile state of today's European Union it is important to first understand its history. Motivated by a newfound confidence in global capitalism following the

collapse of Soviet communism, the Maastricht Treaty of 1992 established the concept of a common currency and a union to promote the free movement of goods, services, capital, and people across the continent. In 1999, the member states began to fix their currencies to the euro, and by New Years Day 2002 the euro came into use as a physical currency.

The first few years of the Eurozone experiment went smoothly, with moderate growth and an inflation rate of about 2%, in line with the European Central Bank's target rate. These numbers obscured the fact that the ECB maintained low interest rates during this time in order to keep the value of the euro low, allowing Germany's export-oriented economy, the powerhouse of the EU, to flourish. Meanwhile, Europe's peripheral states became effectively endowed with Germany's credit rating under the assumption that the ECB would back all sovereign debt, now that it was all in the same new currency. The yield on the Greek 10-year bond, as an example, fell from above 20% (pre-euro) to 4% in 2005. As Greece and the other "PIIGS" (Portugal, Ireland, Italy, Greece, Spain) were able to borrow more cheaply, consumption surged. At the same time, competitiveness in these states decreased sharply as domestic labor costs became relatively more expensive and trade barriers fell. As a result, exports fell and imports rose in dramatic fashion with the newly available cash.

Exacerbating the situation were European banks, which began swapping en masse low yielding Northern European bonds in favor of slightly higher yielding PIIGS bonds, and turbocharging these positions with operating leverage as high as 40 to 1. When the 2008 crisis hit, the banks were levered up well-beyond their US counterparts, with asset footprints that were multiples of their sovereign's GDPs. Naturally, the money greasing the wheels in the PIIGS abruptly stopped, leaving the countries choked off from the liquidity needed to pay back their debt. In essence, the peripheral states had the

relationship to European banks that subprime mortgage borrowers had to American banks. In the case of the PIIGS, however, default would not be permitted.

Typically when a financial crisis arises in a developed country, a central bank can devalue its currency (to stimulate export demand) or provide lender-of-last-resort services to banks. In the Eurozone, no such shock absorbers exist; countries no longer have their own printing presses and the ECB is constitutionally unable to purchase distressed bank assets – two important mechanisms that both the Fed and Bank of England enjoy. Alas, the weaknesses of the EU structure were exposed.

In 2010, the leaders of the EU (the IMF and ECB), with few options at their disposal, provided a 110-billion-euro bailout loan to Greece in exchange for fiscal austerity measures designed to reduce Greece's indebtedness (cuts to public spending, higher taxes) and sustain the health of Greece's too-big-to-fail lenders. Seven years and several bailouts later, it is clear this strategy has failed. Greece's debt levels have increased to above pre-2008 levels, GDP has contracted by over 25%, and 90% of bailout funds have been used to pay down legacy debt. Additionally, given the free mobility of labor in the EU, the majority of Greece's talented working-age population has migrated to northern industrial centers. The stories are similar, albeit less severe, in Europe's other peripheral states.

In our view, the integrity of the EU has become a stale topic among investors, who perhaps have too much confidence in European leadership's ability to kick the can down the road indefinitely. If one looks more closely, it becomes evident that the common currency has paradoxically resulted in a more fractured Europe, divided between the northern creditors and southern debtors. The low growth, high unemployment, and refugee crises in the debtor states are leading to greater unrest

and nationalist fervor, and the potential for angry voters to send a strong message to EU leaders, as in the case of Brexit, is mounting.

Prominent economists have put forth a number of suggestions that would theoretically lead to a stronger EU - deposit guarantees, a unified banking system, fiscal stimulus, and others – all of which require a greater sharing of debt burdens than core EU members are currently willing to provide. Time will tell the extent to which the various political and economic factions in Europe will cooperate in order to keep the EU experiment alive.

As we've said many times, our formula for long-term wealth creation is not to strive for outperformance in the good years, but to lose less than others in the bad years. To do this we focus on minimizing our exposure to downside risks, with the understanding that the arrival of unpredictable catalysts, both positive and negative, is one of the few reliable characteristics of the market. As the enclosed chart displays clearly, economic and political events create considerable noise that can sway investor sentiment, but the long-term trend-line from lower left to upper right is indisputable, and we fully expect this will continue.

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