INVESTMENT UPDATE NEWSLETTER

ALLEN TRUST COMPANY

MAY 11, 2010

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Europe and the Fattest Tail – Now, Demand Higher Risk Premiums

The proposed bailout of Europe's sovereign profligates (Portugal, Italy, Ireland, Greece and Spain, or PIIGS) resembles US efforts to stanch financial crisis in late 2008-early 2009 which succeeded in restoring the prices of risk assets, if not underlying economic vitality too.

With it, the European Central Bank pushes a lot of chips onto the table at a time of acute political uncertainty in the West – witness UK's hung parliament and first coalition government since the middle of last century, or the wobbling of Angela Merkel's grip in Germany following last weekend's election, or a mid-term US election season shaping up to be internecine in words if not deeds.

If EU membership – a disparate group speaking some two dozen different languages and harboring enmities which stretch back centuries – balks at supporting the stabilization package, or if the eurozone nations required to fund it balk at paying up, or if the beneficiary nations reject the austerity required of them (Greece seems close to reprising its millennia-old knack for self-immolation, and it's not unthinkable that the other Mediterranean debtor nations might choose default over indentured servitude to their northern creditors), or if Americans get riled up that dollars are flowing via the IMF and renewed Fed liquidity swap lines to Europe… well, it suffices to say that the "ifs" pile up fast. Massive economic stabilization programs can be socially and politically destabilizing even if they succeed; once launched, if they fail, look out.

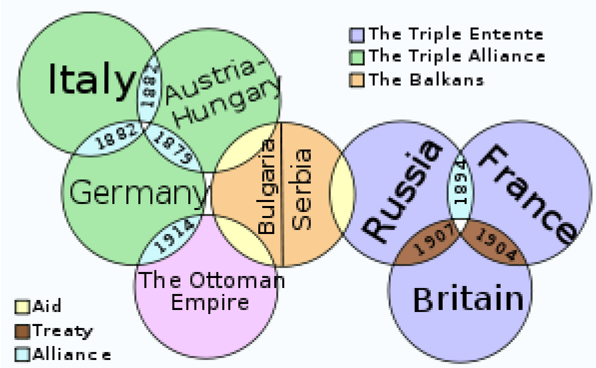
Whether the "Euro TARP" proves successful or not, like its American prototype it broadens the range of possible outcomes we have to consider, good and bad alike. It will have an outsized effect by 1) compounding systemic leverage, which magnifies the intensity of effect, and 2) ramifying the paths the future may take. While an act of grand intention, its consequences will include many that are unintended, and the complexity of the enterprise makes it all the more difficult to identify in advance what their contours might be.

None of which means bad things are sure to happen. Rather, the investment issue is that the probability distribution has widened, and its left, downside tail has fattened. In plain English: more, different stuff can happen now, and more of it than usual can be worse than usual.

The simple solution would be to restructure PIIGS debt, but this would entail near-term pain by banks in particular, and if you follow the American model that's an unlikely choice. No, for now Europe chooses the complex attempt at a solution, which includes not just a grand gesture by a grand alliance but also bilateral loan agreements and interlocking obligations even between the PIIGS themselves (!!!) with fiscal basket cases Spain and Italy helping bail out Greece.

Complexity isn't always the answer. Consider:

Web of alliances



Graphic Source: Xiaphias, Wikipedia

Recognize this? It depicts an intricate balance of power whose interconnections were meant to keep peace in Europe, which worked okay up until an Austro-Hungarian royal and his wife were shot in Bosnia and everything flew apart into World War I.

So far, Greek debt problems haven't been quarantined to the Aegean any more than Archduke Ferdinand's assassination was kept a local matter in the Balkans. My point isn't that the economic equivalent of the Great War is on us, it's rather that stability achieved through complex, transnational structures can become very quickly unstable.

The future has always been and will always be inscrutable. Add to inscrutability an environment of heightened instability, and we have to admit as much as ever the insufficiency of our tools to map what lies ahead. In other words, in contemplating investments today, demand higher risk premiums. As much as ever, margin of safety matters.