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Europe's Rodent Problem

For the better part of two years now, the eurozone's efforts to hold itself together have resembled nothing so much as Whack-a-Mole on an epic scale.

Do you know the game? Whack-a-Mole can be found at any seaside arcade. It features a cabinet top pocked with a dozen holes through which plastic moles pop up and duck down at random, and your job is to bop them with a rubber mallet as quick as you can. Problem is, the moles don't stay whacked – just as you dispatch another of the buck-toothed critters, three more you already clobbered are up and chittering again. Until your tokens run out, you keep pounding.

As you might guess, Whack-a-Mole is not a strategy game but a reaction game. Similarly, eurozone decrees seem increasingly *ad hoc*. Greek government deficits are coming in worse than forecast? Make Athens tighten its belt another notch even if it cuts off circulation below the waist – whack! But wait, that hasn't fixed things, and Greece doesn't have assets or market access sufficient to pay off or roll its maturing debt? Extend them a new credit facility (“Here, have some more cash so our German and French banks don't fail”) – whack!

The mallet work gets more frantic, yet the moles keep popping up. Part of the problem is the EU negotiating financial challenges as if they were political ones. We'll soon learn the difference. Papandreou's and Berlusconi's departures won't dispel Greece's debt/GDP ratio of over 160%, or Italy's of over 120%. The math is unforgiving.

Another shortcoming is the Zone's reliance on complex and internally contradictory solutions. Of late, hopes cling tightly to the European Financial Stability Facility (EFSF), which I'm

sure I won't be the first to call a Rube Goldberg contraption.

The EFSF suffers some major flaws in addition to complexity, namely 1) an unlevered scale that's scant compared to the solvency issues (lending capacity of €440 billion total vs. debt about four times that much in Italy alone), and 2) a reliance on guarantee commitments from countries whose creditworthiness is at issue. To wit, Italy is committed to funding 19.2% of the facility, and Spain 12.8% – in other words, the two countries biggest among the line of tottering sovereign dominoes are responsible for nearly a third of the funds meant to prop them up.

Applause from the relevant markets (bond and credit derivative) has been less than resounding, though the stock market, most hypersensitive in keying off news from Europe, has been happier of late. Still, fresh headlines whipsaw market action up or down with extraordinary speed, and since no headline is the final word on anything, the market impact can be counted on to last only until “new” news comes across the wire. It strikes us as a profound irony that in a market whose volatility is driven by headlines, the headlines fade to irrelevance for anyone whose time horizon can be measured in more than days.

As stewards of long-term money, our job is to see through the headlines, to filter out noise and identify persistent signals. What we've locked in on, unfortunately, is not yet reassuring.

No matter the stock market's erratic jags, the credit markets are sending a steady signal that Europe's in trouble. Italian bond yields are nearing the levels that precipitated Greece's downward acceleration, and across the continent, yields and credit default swap spreads over the German benchmarks have neared euro-era highs. A rubber mallet can't knock these peaks down; only strategic thinking, consistency, and a willingness to face hard choices can do that. With Europe's leaders lost in a frenzy of mole-pounding, those qualities are in short supply, and absent ECB money-printing, tokens will be, too.