Bull and Bear Bulletin

Will the EU Strategy Prevent A Collapse of the Euro?

Last week's announced €100 billion bailout of the Spanish banking sector provided a reminder that the Eurozone crisis continues to escalate. So far, the Eurozone members have been reluctant to provide any thorough long-term solutions to alleviate the growing sovereign debt crisis. Unfortunately, the constant reactive policy making has only eroded the markets and populous confidence in the Eurozone, pushing the crisis closer to an end game moment. In this month's article, we will attempt to detail why the policy making decisions have failed to reinforce investor confidence or to resolve the growing debt crisis.

The greatest flaw of the European Union (EU) is the lack of a centralized banking system that reflects the collective free trade premise for developing the Euro. Without a centralized banking authority, each nation is responsible for its respective financial solvency and banking system. Tragically, this flaw prevents the collective union from acting as a united front in addressing the current financial crisis. With each member nation reluctant to relinquish its fiscal sovereignty, which would force them to take budgetary and fiscal directives from a single EU authority, currently established banking authorities and governments are unable to establish a sufficient strategy to solve the debt crisis.

As the strong EU members, namely Germany, attempt to craft adequate lifelines for struggling nations, they have requested austerity measures in return for the bailouts. These budget cuts are designed to increase the odds of repayment, when in fact they are only likely to make the debt crisis worse for the weak nations. Spain's economy is currently contracting at a rate of 0.4% a year and is likely to get worse, while the nation's unemployment rate hovers around 23% (Chart 1). With government spending representing approximately 15% of the nation's annual GDP, any significant budget cuts are likely to slow the economy further, increase unemployment and reduce the tax revenue needed to make debt payments.

Unfortunately, the markets are well aware of the conundrum and are warning the EU authorities that any short-term and short-sighted strategy will not work and is likely to further erode market confidence. Market confidence is pivotal in a debt crisis. Without sufficient buyers, debt issuing nations are unable to refinance maturing debt or to issue new debt to cover a growing deficit. There is rarely a single moment when buyers avoid a nation's debt. Typically, it is a gradual process that is reinforced by economic deterioration or poor fiscal policy decisions. Over the past three months, many of the troubled EU member nations' debt yields have increased toward record highs as investors have become increasingly concerned about the future of the EU. The rising yields have placed further fiscal strains on the member nations' ability to meet the growing interest costs. Currently, the Spanish and Italian governments are paying approximately 4.5% for bonds that have a maturity of 2 years, compared to a 30-year U.S. Treasury yield of just 2.75% (Chart 2). With €427 billion in Italian debt and €200 billion in Spanish debt maturing in the next two years, it is imperative that yields remain at reasonable levels.

With the bond markets forcing a constructive policy response and the debt crisis growing, the EU will need to move past its recent liquidity strategies and to focus on the actual structure of the European Union. The liquidity strategies, such as the recent bank bailout, will only ensure that adequate Euros remain available for financial transactions and will prevent bank runs. Liquidity has little impact on indebtedness. As the populous continues to grow tired of austerity budget concessions and elects more socialistic governments, Germany may soon lose its ability to mandate specific concessions from faltering members. Germany may be forced into a decision to either leave the EU or to concede its own power and allow the creation of a centralized fiscal and banking authority.

If a central authority body is created, the sovereign debt risk could be spread across the union and the EU will be able to buy a significant amount of time to deal with the existing crisis. While each government would be responsible for contributing tax revenue to the collective union and would be forced to follow directives from a greater fiscal authority, each nation would effectively co-sign on any new loan issued by an EU nation. With the default risk spread across the entire EU, investor confidence would likely be restored and the collective financing costs for the EU would likely decline. The lower interest costs should help promote economic growth initiatives and should allow for gradual budget cuts versus the significant cuts currently forced upon the weak EU nations.

Whether the EU members are willing to relinquish their fiscal autonomy for the greater good of the European Union is anyone's guess. The one sure thing is that time is running short and the market is going to force a decision that will ultimately reshape the EU as we currently know it.

As U.S. investors, we need to keep a close eye on how the crisis plays out but not over react to the news. Investors need to recognize that corporate profitability and solvency remain near record levels and, as long as credit markets remain functional, U.S. companies and the economy should be relatively insulated from a standard EU recession. The greatest risk to the U.S. economy and to investors is a disorderly breakup of the

Volume 3, Issue 4
June 2012

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EU. This breakup would surely impact the banking sector and credit markets and create significant ramifications throughout the world.

While we continue to assess the risks from Europe and how the crisis may develop, we have yet to see a significant change in the economic trends domestically or in corporate profitability. If we begin to see additional signs of economic distress and we conclude that the trends have been altered, we will adjust our strategy and attempt to avoid any significant fallout from the European crisis. As always, we will attempt to share our outlook and analysis with our clients to help create additional clarity on our investment philosophy and strategy.

Chart 1

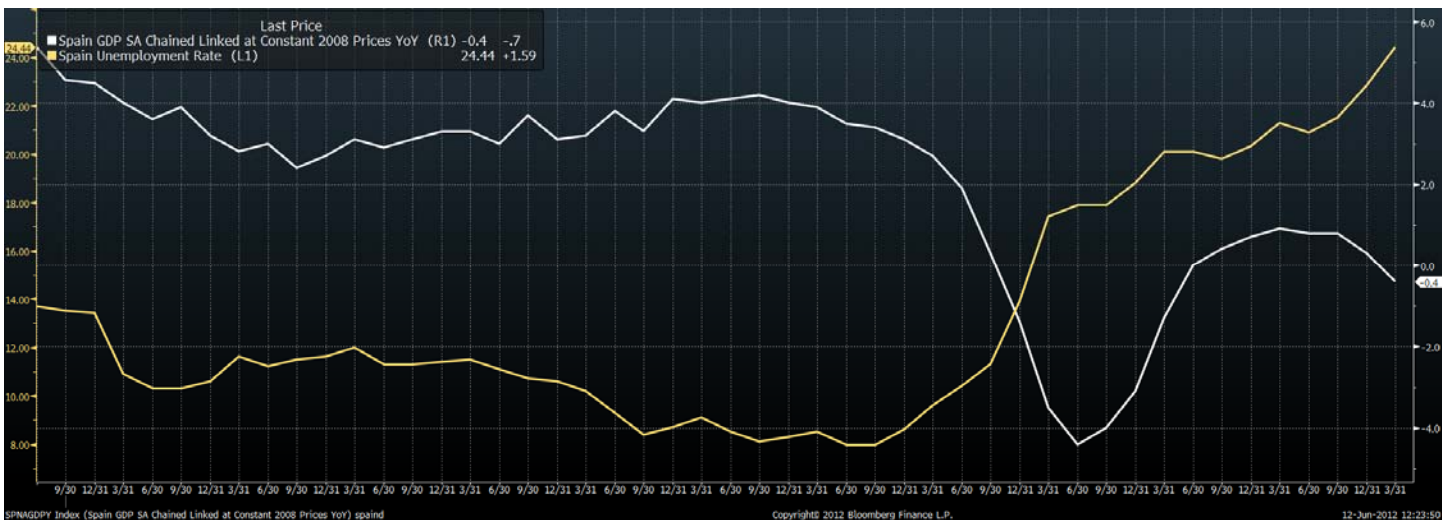

Chart 2

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Valicenti Advisory Services, Inc.), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Valicenti Advisory Services, Inc. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Valicenti Advisory Services, Inc. is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the Valicenti Advisory Services, Inc.'s current written disclosure statement discussing our advisory services and fees is available for review upon request.