You Probably Forgot About Europe Until This Week....

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March 18, 2013

With all the media attention focused on the fiscal cliff, sequesters and the U.S. debt ceiling, the Eurozone's debt crisis had faded into the background--which was no doubt a welcome respite for many investors. However, we are reminded today that Europe's fiscal problems haven't gone away while our attention was elsewhere, and some economists think they may have quietly gotten worse over the past 12 months.

Cyprus is the latest headline. With a banking system 8x the country's annual GDP, no senior debt supporting the country's banks and loan books that were overextended, the whole world knew that this would not end well. Over the weekend, the entire banking system of the country was going to collapse so the EU threw it a lifeline which included taxing the banking system depositors. The mechanics of the tax are still being worked out, but hopefully the government will realize that some minimum value of deposit insurance must be kept in place. Otherwise why would anyone keep assets in a Cypriot bank? Or as the market is jumping to conclude, a Greek Bank, a Spanish Bank, an Italian Bank? Bottom line: $24 billion in GDP means the country of Cyprus is as productive as the entire state of Vermont or the whole city of Jackson, Mississippi. The financial impact of Cyprus to the world is equal to a mosquito on an elephant. But the world is watching the EU for signs that this is their road map to future financial stress scenarios.

So let's catch up with Greece, which is "celebrating" its fifth straight year of recession. Greece's unemployment rate now stands at a record 26%, and the diminished economy is generating ever-fewer tax receipts, making it ever-harder to pay the 340 billion euros that the Greek Treasury owes to investors. That comes to 180% of the country's economic output, and many economists are saying that the only way Greece can avoid a default (and expulsion from the euro) is to have those creditors forgive at least 50% of its debt. Even then, current austerity measures are estimated to take unemployment up to 30% later this year.

Meanwhile, the United Kingdom has seen its credit rating downgraded by the Moody's rating agency (from AAA to AA1), which follows a similar downgrade of France last year. And now, the recent Italian elections have reignited fears that the austerity measures that Germany demanded for keeping bonds afloat are about to be cast aside. The new Five Star protest party in Italy, which has been calling for Italy to exit the euro, received the highest number of votes and will become the single biggest party in Italy's lower house. Meanwhile, ex-premier Silvio Berlusconi appears to have the most seats in Italy's Senate. Berlusconi campaigned on a promise to rip up the European Union's austerity plans and cut taxes--which would make it less likely that the government would have the resources to service its bond debt. The European Union's hand-picked Italian prime minister, Mario Monti, who had pledged to continue reforming the economy and stay the course with painful budget cuts, finished a dismal fourth in the elections--making it clear that the steps needed to put the euro on firmer ground may be too politically unpopular to implement in today's European politics.

After the Italian election results became public, investors panicked. Rates jumped for both Italian and Spanish government bonds, on the theory that if Italy refuses to impose fiscal pain on its citizens, Spain, with its own 25% unemployment rate and ample pain due to fiscal tightening, may follow the same course. This, in turn, calls into question whether the European Central Bank will continue to stand behind the debt of countries who have abandoned its austerity reform measures.

Meanwhile, other problems are beginning to surface. Since the end of July, the value of the euro has risen from $1.21 to $1.36, making Europe's manufactured products more costly in the global marketplace, further reducing export business for already-uncompetitive southern European manufacturers and raising the costs for tourists who visit the Roman Coliseum and the Greek Parthenon. Ironically, the very policies that seemed to stabilize Europe's debt crisis restarted the flow of capital into the eurozone, raising the euro's value and potentially causing the long recession in southern Europe to deepen, even causing a reduction in German exports.

Nobody seems to have a solution that would cause European voters to accept more years of incremental diminishment of their living standards, and at the same time make the weaker European economies more competitive, and at the same time convince holders of Greek bonds that they should give back 50% of the face amount on the bonds they purchased before the mess got started. Look for the euro debt crisis to start reemerging in headlines and in discussions from analysts who recommend where to put your money.

No doubt, the headlines will demand that you panic, but you can decline the invitation, and remember that pundits have predicted a breakup of the eurozone for each of the past five years. The crisis is far from resolved, even if it was not highly visible for the past few months, but it helps to remember that the fiscal mess and the value of individual stocks are very different things. Through February, an index of European Union stocks is up about .8% in dollar terms, and over the past year, it has returned 4.15%. That's not the highest return in the world, but it suggests that investors are looking past the debt and seeing opportunities where the newspapers and bloggers see only fear.

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