McVEAN TRADING & INVESTMENTS, LLC

Weekly Economic Update

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Volume 55, Number 9 **June 21, 2010**

After traveling for a week in Prague and Paris, we can report that there are few optimists on Europe – either among the Americans we were traveling with or the Europeans that we met. However, the pessimists had a wide variety of reasons for their negative outlook and often the root of their concern was in direct opposition to other equally pessimistic analysts. Many felt that Europe, in general, had too much debt and that deficits had to be reduced across the board, not just in the Mediterranean states. Others worried (apparently like President Obama) that the tightening fiscal policy would derail the recovery away from the Mediterranean, hampering Germany and other wealthy states ability to pay for a bailout. Many worried that inflation was on the way as the pressure increased on the ECB to buy bonds to help finance deficits. Others worried that the locking up of the banking system would lead to a deflation. Most felt that the Euro was destined to decline, though the split between those who thought the currency would fail and those that were sure it would be maintained were roughly equal. Few felt that Greece would be able to pay its debts in the face of rising rates and a crippling tightening of fiscal policy. Still, whether Greece would leave the Euro was an open debate, and whether contagion would spread to Portugal or Spain was even less certain. Ireland appeared to get a pass, but Hungary was the new boy on the block for financial woes. Bottom line, there is simply little consensus on anything in Europe except that no one likes the way things are going now and though everyone has an idea how to resolve it, none of them are the same. Uncertainty is an economic killjoy, so we agree that in the near term the economic and investment outlook for Europe as a whole is quite unappealing.

However, Europe is not a whole – and anytime we find everyone voicing one opinion we start to look for the flaw in the argument. In Prague, we did get relatively positive outlooks for the Czech Republic, Poland, and the Euro zone's next entrant -- tiny Estonia. All three benefitted as members of the former Eastern Bloc in that they had not yet ramped up debt relative to GDP, unlike the far more profligate original Euro members in the Med. Moreover, flexible currencies in Poland and the

Czech Republic allowed them to devalue quickly and preserve their export sectors in small open economies. Interestingly, Estonia is entering the Euro because they feel that after many years with a currency fixed to the Deutschemark (and then Euro), they will benefit from removing the threat of devaluation. Meanwhile, Greece, which can't devalue, faces record high rates because of fear that it will be forced out of the fixed currency. Looks like damned if you do and damned if you don't for the small players.

Meanwhile, a weak euro was leading to booming growth in the German export sector, and strength in Italy (a major capital goods exporter) as well. Though the domestic economy in Germany remains soft, the large size of the export sector combined with the plunge in the euro and the rebound in inventory building has the manufacturing sector firing on all cylinders. Add in a German banking system that is benefitting from very cheap central bank money and a steep yield curve and much of the policy needed to offset a fiscal contraction is already in place. However, the Germans will be hard to convince as devaluation of the currency is their number one fear – having suffered the Weimar inflation of the early 1920s, the demise of the Reich mark after WWII, and a wave of inflation associated with reunification. It has taken twenty years of tough talk from the Bundesbankers to anchor inflation expectations in Germany. Though the ECB talks like strict Freidmanesque monetarists who believe that inflation is a purely monetary phenomenon, in reality Germans believe that it is government policy leaning on the central bank that causes inflation – and they are fearful the non-German Europeans are leaning now.

Fiscal restraint is popping up all over Europe as countries are using this opportunity to rein in their runaway government sector spending. While retirement ages are going up across the Med, France announced a two year delay in retirement (phased in years from now) from 60 to 62. The talk shows in Paris that weren't about the world cup, were denigrating the governments heavy handedness in this move. The timing of the announcement on an all World Cup news day was suspiciously political. Bottom line, given the much larger size of the public sector in Europe, the current assault on formerly runaway pensions, holidays and retirement ages will have a far more meaningful effect than similar moves in the US – both as a fiscal drag in the short run and a significant rebalancing for the longer run.

While many US analysts expect growing protectionism in Europe as a result of their soaring unemployment, that theme was rarely heard. Rather, the focus is on the inflow of investment funds from China and the Gulf as the cheaper Euro makes these big savers buying power rise. China is on a buying spree in Greece, and across Europe as well. The oil rich Gulf countries are both lending and buying, with a focus on banks as a long term alternative to oil revenues. Rather than protectionism, Europe appears happy to just let the Euro plunge to wherever it has to go to allow rich exporters to paper over their past losses in the over-consuming Med. Rising Asia is a bigger end market for the exporters than it is a detriment for the Med states –especially now that the cheaper Euro is making the Med more competitive. China's announcement that the Yuan will "float" again was largely political ahead of the G20 meeting this weekend – but it also reflects that the fact that purchasers of European and US technology who gain from a strong currency are becoming a powerful a force in China as the exporters, who will lose, are diminishing in dominance.

Given the Europeans' consensus fear of both inflation and rising interest rates due to burgeoning deficits, it was not surprising that the Japanese dilemma of high debt and deflation was rarely discussed. Yet, Northern Europe has much in common with Japan, given high savings rates, trade surpluses, a tendency to invest at home, and rapidly aging demographics. In Japan, the collapse of domestic lending led to an even more aggressive export orientation -- primarily by shifting resources into China for even cheaper labor -- and a sustained high savings rate to replace devalued investments. Domestic growth was very slow and deflation dominated. Now, the tide is turning as the aging investors are liquidating their savings to maintain consumption. Japan may finally face the long feared rise in interest rates if the government doesn't cut deficits. The response has been a call for a weaker yen and ever more export orientation. Does Germany and the core Euro savers face a similar scenario? A core Euro (savers only) would surely become the strongest currency in the world and the new carry trade favorite, driving the currency even higher. All investors should look at Japan's financial history more closely for themes that will repeat or rhyme in Europe.

Our take away from this trip is that Europe may now enter another period of malaise like the early 1990s as they formed the original Euro bloc. It took a long period of wrangling to work out the Maastricht criteria, even longer to meet them, and an underperforming Europe in the interim. We will not propose any solutions as there are far too many already – but whatever does come out of Europe, it is unlikely that all of the nations will be marching in step any time soon.

The Rise of Earned Income

One theme we picked up in conversations from a number of angles was the shift in importance of earned versus asset based income. The shift to later retirement ages is only scratching the surface in this shift. Clearly, pension promises to a wide array of workers were far too grandiose, so now many potential retirees will have to work longer than they originally expected to enjoy the leisurely retirement that they had planned. Some may work only a bit longer and reduce their retirement plans. Many will be forced to return to work to just make ends meet.

However, even among the wealthy, the decline in risk free interest rates has put lifestyle, charitable contributions and inheritance plans on the line. The latest collapse in equities has shifted balanced portfolios toward fixed income investments. Yet, near zero percent returns on short term investments have forced them out the curve too long dated Treasuries which now yield 25% less than a few years ago. With fees eating up a larger part of the meager results, more portfolios are opting for lower cost strategies. Bottom line, whether you pay someone or not, it is getting harder to capture returns that significantly exceed a risk free rate of return. With 10 year Treasuries bouncing around 3.5%, one more year of work – and one year less of drawing down the portfolio – can have far more profound impact on retirement than moving out the risk curve.

The problem is that governments are taking a bigger bite out of this rising earned income even as the decline in interest rates forces the shift. The US top marginal tax rate will slide back up to 39.6%

in 2011 and state and local taxes are rising as well. These marginal rates are already higher (and rising) in Europe, where the trend is more pronounced due to an older demographic profile. This means that earning more income to boost the future earning power of an investment portfolio actually makes it harder to earn more, as the earner makes a large contribution to reducing the deficit through taxes at the same time they increase the savings available for funding the rest of the debt. The result is sustained low interest rates – not the long awaited rise based on a surge in government debt.

We see this interaction between low returns on risk free investments (government securities) and high marginal taxes on the earned income needed to replace lost investment earnings as a key feature in how governments will reverse their debt positions. There is a reason they call economics the dismal science – it is always easier to identify the loser (they are screaming the loudest) from a shift in prices or policy. These days, the greatest wailing is coming from everyone who will have to work longer to achieve the same leisure in retirement as those that retired earlier. Given that many of the afflicted are near retirement age – and more likely to vote – the uncertainty about future fiscal policy (whether to spend the new taxes or not) is likely to remain high. We note that in Europe, there are new governments in the UK, the Czech Republic, Poland, and Hungary. There are going to be lots of economic experiments to watch. Investors need to watch a wider array of news these days to determine where the winning strategies are developing.