

# No Timeout from “Turbulent Times”

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As the community of nations lurches from one crisis to the next — the “Arab Spring”, the Japanese tsunami and its aftermath, the U.S. Treasury downgrade and debt ceiling imbroglio, and the recurrent EU sovereign debt quandary — financial markets have experienced disconcerting volatility and weakness. Many individual investors have become discouraged by the stock market’s chaotic moves and the low returns on cash savings and bond investments. And to top it off, government policy seems to have helped the improvident and penalized the prudent. It is this apparent inability of developed-market governments — whether in the U.S., Europe or Japan — to deal with excessive debt, high unemployment and marginal economic growth that has most recently weighed on the markets.

## Skittish Markets

The severity of the third quarter’s stock market decline was disconcerting, although the high correlation of developed market equities with other risk assets (emerging markets, high-yield bonds, commodities, etc.) indicated that the sell-off reflected global economic concerns and broad-based negative sentiment rather than individual stock fundamentals. The subsequent October rally produced a recovery in oversold stocks, particularly those with strong

long-term earnings prospects and steeply discounted valuations. Volatility is now a fact of life in the financial markets, a reflection of skittish market participants’ shortened investment time horizons and evaporation of the liquidity provided in the past by larger Wall Street firms, money center banks, structured investment vehicles and large tax-exempt pools. Increased regulation and a greater focus on risk con-

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tainment have contributed to this new environment. None of it undermines the validity of investment decisions based on sound long-term fundamentals, but it certainly makes for a rougher ride.

## A Predictable Outcome

The European Union is lurching toward an outcome predictable in terms of loss, even if not in terms of timing. The European model of political economy since the 1950s has emphasized a growing public sector and the

containment of private sector growth and risk-taking in favor of public sector stability. But the indebtedness of many of the EU governments can no longer be sustained by their private sectors (the productive elements of an economy) and the debt has to be revalued to recognize this reality. In addition, European banks are far less independent than those in the U.S. Their fates are largely intertwined with those of their own governments. Politicians in Europe are reluctant to make the hard decisions, as these would likely cost them their political offices, thus they produce a series of half-hearted pronouncements that financial markets quickly discount. Substantial cutbacks in public sector employment would be a cure, but would come at too severe a social cost and undercut too large a source of political support to ever be realized — even in the extreme case of Greece.

## The True Cure

The Greek situation, in fact, finally seems to be nearing a conclusion — now predicated on a national referendum during January on whether or not to continue with fiscal austerity measures. The EU situation will continue to weigh on global financial markets, and investors will be wise to focus on preserving capital rather than seeking the highest possible returns. Inevitably, holders of bad debt, whether subprime or sovereign, will have to realize some degree of loss, and along with that recognition will come failures of finan-

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cial institutions. The Dexia restructuring in Belgium, as well as Halloween Day's MF Global bankruptcy in the U.S., are simply the earliest examples. After the losses are realized, the true cure for the EU's problem is encouragement of economic growth, effected through a cultivation of the private rather than the public sector. If the EU is to survive as a viable federation of eco-

nomical interests, it must reinstate financial discipline on member states as initially required by the Maastricht Treaty (i.e., maintaining a debt-to-GDP level under 60%, no more than a 3% annual fiscal deficit, etc.), and reduce Germany's role as the dominant exporter to peripheral EU markets by improving internal trade balances. Nevertheless, we in the U.S. should not readily dismiss the EU's struggles as

simply a "European" problem. Today's fractious Europe may be a microcosm of what we have to look forward to if continued growth in our nation's public sector (and the rampant crony capitalism that comes along with it) thwarts the interests of Main Street and deadens the entrepreneurial possibilities that are the only authentic sources of economic prosperity. ■