Europe is center stage in the current chapter of the global debt crisis and is facing its biggest challenge since World War II. With an agreement to write Greek debt down 50%, and the country taking its sixth installment of a bailout, Prime Minister Papandreou has stepped down. *Shockingly,* now we find that Italy has too much debt and, in order to fix their fiscal problems, their Leader Silvio Berlusconi should step down as well. Truly, there is *nothing* that we have learned today, that we didn't already know yesterday and frankly we didn't know at the beginning of this year related to the European debt crisis. Europe has too much debt. The United States has too much debt. We are living with the consequences of years of global excess consumption that will ultimately require austerity which will lower the standard of living in developed countries. This article attempts to provide a context to develop investment strategies and help navigate these volatile markets.

Democracy and Capitalism

At its most basic level, democracy and capitalism go hand-in-hand. A true democracy allows liberties and freedom for its citizens including freedom of expression and religion. A fundamental principal that supports a democracy is that we have a common set of rules that everyone understands and agrees to live by. By way of a simple example, when we get a speeding ticket in the United States we pay a fine to a municipality because we broke the rule. However, in some countries when you are pulled over by the police, you pay them directly – that is an arbitrary corrupt enforcement of the stated laws which is inconsistent with true democracy.

In a democratic society, capitalism is the engine that drives economic growth. There are two fundamental tenants for capitalism to work - a strong and healthy financial system and a set of rules that everyone understands and agrees to operate by. With a strong financial system and common rules we have the confidence to deposit money with banks, extend credit, and to make investments which further grow the economic base. However, the Financial Crisis of 2008 resulted in severe erosion in the confidence and strength of our financial system and revealed that the opaque set of rules in the capital markets and banking system was not effective in protecting businesses, consumers, savers, and investors.

And, with the deterioration in the credit quality of our banks, and the uncertainty to what regulatory reform for the financial system will look like, the banks have been unwilling to consistently extend credit to small and mid-size companies. This has two important consequences. First, without the expansion of private credit in our economy it will be nearly impossible to experience sustained economic growth. And second, the banking system is no longer an efficient means for the Federal Reserve to implement monetary policy. As a result, the Federal Reserve directly invested $2.5 trillion to purchase mortgage-backed and Treasury securities in the open market.

How did European Countries get into their current debt problems?

While they are democratic societies today, immediately following World War II many European countries, including France, Italy, Czechoslovakia, Belgium, Sweden and Norway were rooted in socialism. The socialistic government put a high priority on a state controlled economy with the government providing for its working class citizens. This included a job with a reasonable wage and health care benefits. After the cold war ended, western European socialists were pressured to reconcile their socialist economic programs with a free-market-based communal European economy. Up to this point the government took care of its citizens; yet, many countries never moved away from this premise as they moved further into a free market economy.

In 1992, European countries entered into the Maastricht Treaty which paved the foundation for a common currency, the euro. In essence, each participating country gave up its currency and pledged to abide by certain rules including limiting a country's government deficit to 3% of its Gross Domestic Product (GDP). The European Union provided only for a common currency, not a common form of debt. Each country issued its own debt. Now, let's fast forward to 2008 and the Financial Crisis. As the global banking crisis spread through Europe, member countries were forced to inject capital into their respective banking system. However, in some cases the size of the banking system, including Ireland and Switzerland, was bigger than the GDP of the entire country. In essence, the capital infusion by each government resulted in the debt burden of the banks being transferred from the individual banks to the tax payers.

While the Greek banking system is relatively small by comparison, their poor fiscal management and excessive pension benefits compounded their growing debt problems. By 2009, the world realized that the disclosures of Greece with respect to its debt and the European Union's oversight of compliance had proven ineffective. Greece simply ran out of money first.

Why can't the European Union effectively resolve its debt crisis which has been going on for over two years?

The Maastricht Treaty was essentially limited to the establishment of a common currency for its member countries. The European Union did not set up a mechanism to effectively deal with the deleveraging and insolvency issues related to its member countries. As a result, each country has had to go back to their respective governments and get approval for the recommendations to deal with the growing problems related to the weakening banking system and the necessary bailout of Greece. The process of recognizing the problem, developing a plan to fix the problem, developing a consensus around the plan, and getting member country approval has taken two years. Unfortunately, the plan to bail out Greece, prop up the European banking system, and build confidence in Europe's capital system is still incomplete and ill-conceived. The painstaking process of developing and implementing a plan for Europe to effectively reduce its debt will take at least another year.

Why is there concern about the solvency of Europe's banks and how does that impact the growing debt crisis in Europe?

Arguably, the different members of the European Union have various forms of democracy and socialism today. But, remember that democracy and capitalism go hand in hand. And, capitalism requires a solid financial system in order to instill confidence. One of the problems for the European Union is that the largest holders of its member's sovereign debt are the European banks. Thus, any impairment in the bonds of Greece, Italy, Ireland or any other Eurozone country is a corresponding hit to the capital of the bank. The consequence of deleveraging is that impairments on loans need to be realized and the result is pressure on capital ratios as bank balance sheets shrink. In order to preserve capital banks will reduce risk taking and credit. And, if European banks stop lending to each other, there is a heightened risk that the financial system could seize up and another credit crunch ensues.

In general, relative to the United States the European banks have always been more leveraged and more lenient from an accounting and regulatory standpoint. Regulators in Europe ordered banks last month to increase core capital to 9 percent of risk-weighted assets by the end of June 2012. The banks, which are now facing a 106 billion-euro shortfall in order to hit the 9 percent capital target, are reluctant to plug the gap by cutting dividends or bonuses and are struggling to sell assets or raise cash in rights offerings.

Given the reduced options that the European banks now have to support capital, the regulators are allowing a practice known as "risk-weighted asset optimization," which allows banks to boost their capital ratios without cutting lending, selling assets or tapping shareholders. Effectively, the banks can increase their capital by changing how they calculate risk-weightings (the probability of default lenders assign to loans, mortgages and derivatives). While the banks are required to submit their models to the regulators once a year, they don't have to disclose them publicly, and risk- weightings for the same assets vary among banks. *The use of these financial gimmicks will erode confidence and prove ineffective in containing the crisis.* As a result, the banks in Europe are undercutting regulators' demands that they boost capital by declaring assets they hold less risky today than they were yesterday.

What will happen to the European Economy and the Euro?

We believe that the real cost of the Eurozone bailout, including both sovereign debt and bank capital, is in excess of 2.5 trillion euro. To achieve this will require a level of austerity within the Eurozone that brings spending down, targets a budget deficit that is closer to the original target of 3 percent, and brings the total debt to GDP below 100 percent over a reasonable time frame without gimmicks. The most likely result of these austerity initiatives will be a severe recession that will impair credit expansion, consumption, investment and business growth. And, while it is conceivable that the collective Eurozone economies could "grow into the problem" and through economic growth generate revenues that would support the demise of the debt burden – we would bet against that ever happening. It is befuddling to us that the most current GDP growth assumptions from the International Monetary Fund only have the economy of Greece contracting in 2012. We believe the IMF's expectations for European economic growth are overstated.

We expect that the euro will survive; however, it will likely exist in a different form five years from now. Clearly, we can see today that Greece would not qualify to be in the European Union. While it is impossible to predict, we expect the European Union will likely be constructed differently over the next decade. The journey through debt reduction and austerity will embolden the Eurozone leadership to expand the governance structure of the Euro which may ultimately include Euro-denominated debt. Consequently, we expect to see another Treaty within the next few years that would address many of these issues.

How will Europe's debt problems affect the United States and our economy?

First, unlike the European banks, the major money center banks in the United States are not large holders of European sovereign debt. Thus, any forced write down in value (such as Greece debt being revalued at 50%) will not have a significant impact in the capital position of U.S. domestic banks. However, since the European banks do not have retail operations here in the United States which allows access to a cheap deposit base, they rely heavily on our commercial paper market to support their funding for US operations. A large portion of domestic money market funds are represented by investments in the commercial paper and certificate of deposits of European banks. According to JP Morgan, Eurozone banks were borrowing $218 billion through money market funds in October of 2011. In addition, the money market funds are also large investors in repurchase agreement with European banks.

Every global financial crisis spreads through the banking system and to the extent the European banking system is undercapitalized, it will affect the U.S. banking system. The counterparty risk that the U.S. banks face is very real. Last week, US and European banks and clearing houses required larger amounts of collateral to support trades with Italian bonds.

How does this relate to the volatility of the U.S. equity markets?

While we believe the equity exchanges function the same way they have over the last two decades, the role of exchange traded funds, hedge funds, derivatives and rapid high frequency Electronic Trading Networks (ETN's) have increased the volatility of the equity markets. The near 500 point decline in the market in October of 1987 was a result of individual investors liquidating their investment portfolios in the face of market turmoil. However, today the recent 400 basis point moves are more a result of hedge funds and trading platforms trying to “push” the market into a direction that results in short term profits for the traders. Today, almost 60 percent of the trading volume on the domestic exchanges is through a high frequency ETN. Since the financial crisis began in 2008, we have experienced 31 days where the DJIA has moved over 4%. We have not experienced that level of market fluctuation since the early 1900’s which predated the formation of the Securities and Exchange Commission and our current body of securities laws.

How does one structure an investment portfolio in this market?

The number one rule of investing is to make sure you are adequately compensated for the risk incurred with each investment decision. Understanding the changes in how capital markets operate today, will give investors a better handle on the inherent risks and expected returns for a particular asset class. We believe the process of reducing the serious debt burden in the developed countries will ultimately result in further dislocations in capital markets which may create opportunities for investment. Still, we believe we need to see three things before we become constructive on financial assets over the long term. These include:

1. A plan for the government to reduce the huge debt burden
2. A plan for the Federal Reserve to withdraw its money from the capital markets
3. Financial regulatory reform that protects investors, consumers and savers.

With the Federal Reserve shifting around its $2.5 trillion investment portfolio, it is artificially lowering the pricing of risk in the bond market. As a consequence, interest rates for US Treasury securities are so low that they do not offer investors a reasonable rate of return. However, with the increased volatility, credit spreads have widened particularly in the bank, finance and insurance sectors. We believe there are very good value in high quality issuers with short maturities and certain callable structures.

While we expect the volatility in the markets to continue, we believe the corporate sector is generally healthy with high cash levels, reasonable growth in revenues and robust margins. The S&P 500 is currently trading at a 12.5 times trailing P/E ratio. If we experienced multiple expansion to the twenty year historic average of 19.8x, at $100 expected earnings per share, we could easily see a 25% return in equities. However, in order to experience any multiple expansion, we need to address the structural problems that exist in the economy and our capital markets. With declining household debt, over $2 trillion in cash held by corporations and another $2 trillion in excess reserves on deposit at the Federal Reserve, we see strong catalysts for economic growth *once we address these structural problems in the economy and capital markets.*

With global deleveraging, we expect slow economic growth and deflationary price pressures over the near term. In addition, we expect an adversarial campaign season which will likely result in little progress toward addressing the structural problems and providing much needed confidence to the capital markets. We believe that buy-and-hold strategies will underperform in this environment especially in light of the current market volatility. Portfolios that are diversified to bonds, stocks, and alternative strategies have a better opportunity to outperform buy-and-hold strategies as long as the active management of the asset classes is consistent and based on changes in relative value and risk.