WINTHROP Capital Management

"Clowns to the left of me, Jokers to the right, here I am, Stuck in the middle with you." – Stealers Wheel

The debt crisis in the Eurozone turned another chapter as Cyprus finally reached the point of requiring a bailout from the European Union. The wisdom of Gerry Rafferty's hit song "Stuck in the Middle with You" which was written in 1973, rings true today as we watch the EU and the European Central Bank navigate the mess in Europe. With each attempt at containment, there appears some plot twist, the proposed Cyprus bank bailout is no exception. While the bailout of Cyprus and its banks is not large in size, only €10 billion, relative to the Cyprus economy, it is significant. The most recent measure of GDP of Cyprus is roughly €18 billion, making the bailout over 60% of the total size of the economy. The fact that the situation was allowed to get to the point where the country actually runs out of money is consistent with the "the path of least resistance" approach the European Union has taken throughout the financial crisis. The EU is faced with trying to maintain a monetary union in a cooperative organization where 35% of the participants can't afford to make the payments required to stay in the Union. The economies across Europe have weakened and more needs to be done than simply lowering the borrowing costs for the sovereign governments so they can borrow more money. The Cyprus bailout provides new insight into the thinking of EU leaders as they continue to feel their way through solving this puzzle. This article discusses the current state of the Eurozone economy and the lessons learned from the Cyprus bailout.

The European economy continues to weaken

The Eurozone's economy shrank in the fourth quarter at the fastest pace since the height of the financial crisis in early 2009. The -2.3% decline in GDP in the fourth quarter reflected an inevitable weakening in France and Germany, which have been two of the more resilient economies during the economic and political turmoil following the financial crisis. *This contraction underscores the central problem that the EU is facing – stable credit markets are not leading to improved economic activity.* The EU is challenged to maintain stability in the face of growing discord among its members as austerity measures severely curtail growth. Sadly, watching the EU and the European Commission work through these issues reminds us of the Mary Kate & Ashley movie *Winning London* in which a group of high school students gather in London to simulate the United Nations and solve political problems. Like in the movie, it is painful to watch the EU continue to dither with difficult decisions in the naïve hope that everything will work out in the end. At least every Mary Kate & Ashley movie has a happy ending.

Can the European economy show sustained economic growth after the financial crisis? The answer is probably yes, but not over our life time. We define sustained growth as an increase in GDP over a measurable period without the assistance of government stimulus or extreme central bank monetary policy programs. In Europe, severe structural problems exist in both the economies and capital markets of member countries. Political systems and cultural differences compound the complex structural problems which are acting to impede business development and the expansion in private credit. The ECB's lending and asset purchase programs are helping to support credit markets as banks continue to replenish their capital positions. Until there is more fluid private credit expansion and the banks are in a position to lend to small and medium sized businesses, it will be difficult for Europe to experience sustained economic growth.

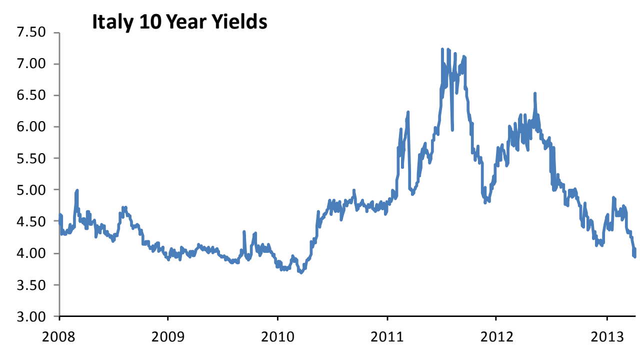
As a result, Europe in its current form will be a slave to monetary and government stimulus in order to keep its economy functioning over the next twenty years. An unintended consequence of the EU's bailout program is that it has created countries that are now permanently poorer and indebted with a lower standard of living than other countries. We expect that it will take the next twenty years for the EU to recognize that the member economies will not be able to grow into the exorbitant debt load they have accumulated and that the wealthier countries will have stopped subsidizing the spending of the poorer countries. Also, during this twenty year period we expect the euro currency will be reconstituted and there will be countries that will leave the EU. In the end, the socialistic agendas will not be compromised and new governments in the poorer countries will form to protect their social welfare programs.

There is a difference between monetary policies that are designed to stimulate growth and policies that are designed to sustain commerce in the face of severe economic distress. Europe is faced with integrated economies of its member countries that are severely impaired and the structural problems are impeding job creation, private credit expansion and business formation. The economic machine is severely broken and barely able to sustain commerce in several member countries. Last year, the ECB provided European banks with €1 trillion in low interest rate loans. This is an example of stimulus that is designed to keep economies and capital markets functioning. There are still some initiatives that the ECB can take to help stimulate growth, and we expect the European Central Bank will likely lower its short term interest rates from the 0.75% level in the near future. However, monetary policies alone will not solve the problem. With its vast cultural differences, Europe must address its structural problems, social welfare expenses, tax policy and labor laws in order to provide a path for sustained economic growth. Ultimately, job growth and private credit expansion are the evidence of healing in the global economy.

The lessons learned from the Cyprus bailout

1. *The EU will not take the initiative to bailout a member country until they are out of money.*

   The process that the EU goes through to resolve member disputes and compliance is both political and cumbersome. One of the primary reasons it has been difficult to contain the debt crisis in Europe is that its members cannot agree on a plan. In the earlier years of the union, member compliance appeared to be more of an honor system based on self-regulation. However, in taking steps towards a centralized bank regulator, there is some evidence of initiative for better governance within the European community.



Source: Barclays Capital

   One of the reasons that the EU appears to be taking its time is that it has a false sense of stability around the low interest rate funding levels of Italy and Spain since 2011. This is allowing countries to fund their deficits at extremely low interest rates. However, as the cumulative deficits turn into debt we believe that within three years we will see another wave of downgrades from the rating agencies, which will further pressure the banking system as qualifying collateral deteriorates.

2. *The EU and the ECB are moving to a bank bailout model where shareholders, bondholders and depositors share in the cost alongside the tax payers.*

   The tools that the EU has at their disposal to address reform measures for a country requiring assistance with fiscal compliance are now severely limited. The EU leadership has been struggling for how to pay for the €10 billion that the Cyprus bailout will cost. *However, this is not an issue of coming up with the money, but rather an issue of fairness regarding whom should be required to pay.* After the EU eliminated all of its options (including the car wash and the bake sale), it decided that the best option was to close the Cyprus banks and go into the depositors' accounts and take the money to help pay for the bailout, while ignoring deposit guarantee insurance. Rational minds eventually prevailed and deposit insurance rules were honored. The Cyprus bank bailout was the first time in Europe the depositors shared in the loss with equity holders. To put this in perspective, private bank accounts in Europe have not been raided since World War II. We agree with the notion that the entire capital structure should share in the cost of the bailout, and that it should not be born exclusively by the taxpayers. However, with respect to its implementation, this sets a terrible precedent for future bank bailouts in Europe. The EU and ECB would help build confidence if they actually had a plan for how future bailouts would be handled.

3. *Eventually a country can run out of money.*

   The government of Cyprus is highly indebted and their banking system is undercapitalized and highly leveraged. Last year, the Cyprus economy was roughly €18 billion and its government debt outstanding totaled approximately €15.4 billion or 86% of GDP according to Eurostat data. At the same time, total bank assets were running over 700% of GDP and estimated near €130 billion. Given the disproportionate size of the banking system relative to the country, there is simply no way the tax payers can support the size of the banking system. This was the same problem Ireland and Iceland faced during their bailouts. Up until the Cyprus bailout, depositors, bondholders and preferred stock holders have largely been made whole. An important precedent from Cyprus is that the EU has been looking for bondholders and depositors to share in the cost of European bank bailouts, and the depositors clearly paid dearly this time.

4. *The forced austerity measures placed on a member country receiving a bailout ultimately results in economic death.*

   The economy of every country that has received a bailout from the EU is in a zombie state. They are the walking dead with high unemployment, no economic growth, declining standards of living. Even some of the countries that haven't received a bailout are stuck in the vicious circle of implementing austerity measures in order to correct fiscal imbalances which only result in higher unemployment and slower economic growth, which in turn require more austerity measures. For the first quarter of 2013, we expect France will post another period of dismal GDP growth. As will Spain and Portugal. *The notion within the EU is that every member economy is structurally equivalent and thus should manage to a budget deficit no greater than 3% of its GDP is terribly flawed.* Until there is fiscal integration and each country's social programs, tax policies and banking system operate under the same set of rules, only then is there a chance that a consistent budget deficit target can be reached.

European Union Bailouts

Country	Cumulative Amount (€ billions)	Year	Deficit/GDP 2012 (%)	Debt/GDP 2012 (%)
Ireland	67.5	2010	-7.6	117.6
Romania	19.6	2013	-2.9	37.8
Greece	245.6	2011	-10.0	156.9
Portugal	78.0	2011	-6.4	123.6
Spain *	41.4	2012	-10.6	84.2
Cyprus	12.5	2012	-6.3	85.8

Source: Eurostat, IMF

** Represents funding from the ECB to recap banking sector*

5. *The stability and integrity of a country's financial system is integral to an economic recovery.*

   An economy cannot experience sustained economic growth without a stable financial system. Until the member countries can stabilize their banks and reduce the structural problems that are impeding job creation and private credit expansion, the weaker economies will continue to languish. While the EU has approved a common bank regulator for Eurozone members, this won't go into effect until July of 2013. As a result, Europe's recovery is still complicated with separate banking systems for each country. Five years after the financial crisis, the fact that Cyprus was still allowed to run a banking system in which its bank assets exceeded the country's GDP by over 700% without coordinated EU oversight illustrates the governance problems that the EU and the European Commission are facing.

6. *The structural problems that exist in the economies of Europe are impeding growth.*

   The contraction in aggregate demand in Europe following the financial crisis has been mirrored in economies around the globe. However, the challenge for the Eurozone economy is that it is vastly more complex with deep structural problems that are impeding growth. These include the structure of the ECB, the complexity of navigating the politics of the EU, the undercurrent of corruption in many of the regions of Southern Europe, particularly Italy and Greece, the uncertainty surrounding regulation, the deleveraging of Europe's banks, the powerful labor unions in many of the countries, the contraction in private credit, and shifting tax policy which has resulted in rising taxes. The friction caused by these issues has the impact of impeding growth.

   Every country, including the United States, has some level of corruption. However, we believe corruption is having a detrimental impact on the economies of southern Europe and Cyprus, one of the countries, along with Bulgaria, Greece and Italy where corruption is prevalent. In a 2010 report published by the European Union, corruption in Cyprus was listed as a national problem. The country is not governed as a meritocracy. Instead, a person needs to have connections in order to obtain employment or advance their career. In addition, public money that is channeled into local government is siphoned off by elected officials to curie favor with elected officials or family members. While it is difficult to measure the size and impact that corruption has on Europe, it suppresses the impact of stimulus and slows the velocity of money. Until the EU and the European Commission get serious on cracking down on corruption, Europe's growth will remain below potential growth.

Investment Strategy for Europe

All the developed countries have too much debt and have adopted aggressive monetary policies to keep their economies functioning with the hope that they can grow their way into their debt burden. Austerity has choked economic growth in southern Europe, and there has been little in the way of reform measures designed to help encourage risk taking and business formation. In its entirety, the price of risk measured in the debt markets of Europe is distorted and, in our opinion, extremely overvalued. Even Italian and Spanish debt appear overvalued given the heightened risk of bailout. As a result, mutual funds and ETFs investing in the debt of Europe are likely not being compensated for the risk taken.

Equity investing in Europe is trickier. As countries look for ways to cover the costs of their outsized budget deficits, they have tried increasing corporate and individual taxes. François Hollande caused a stir last month when he promised to tax incomes over €1m ($1.3m) at 75%. Predictably, the result has been an increased exodus of companies from high tax countries. Until the big picture is resolved in Europe, there will not be stability in the capital markets. Earnings estimates in Europe continue to ratchet lower in the face of a decline in the equity risk premium. However, in order for the equity risk premium to continue lower, we believe that either profitability must improve or there should be a discernible decline in political risk throughout the Eurozone. Profit margins in Europe are below the long-term average. It is similar to the man who stopped pounding his head against the wall only to announce that it felt good when he stopped, at some point, earnings growth will produce a rebound in stock prices. While there are pockets of opportunity, we believe it is still early to add long-only Europe exposure as a focused initiative to an asset allocation.