Since the Financial Crisis began in 2008, the Federal Reserve has provided a steady stream of liquidity to the capital markets which has effectively inflated values of financial assets. With respect to the "Fiscal Cliff" The partisan divide in Congress has resulted in only minor tax reform and virtually no expense cuts or entitlement reform. In our opinion, the most important factor for the long term performance of financial assets is resolving the Global Debt Crisis. Congress will get another run at addressing the budget deficit when it tackles the debt ceiling next month. All the developed countries have too much debt and their economies are not positioned to grow at a rate to support these increased debt levels. Europe is in a process of deleveraging that has included austerity measures for member countries and shrinking the size of its banks. Upon reviewing the progress that European leaders have made over the past year, our assessment remains the same. While progress has been made to stabilize the currency, Europe has slipped into a severe recession and we still expect the euro will ultimately need to be reconstituted. This article discusses the ongoing contraction in the Eurozone economy, the role that the European Central Bank (ECB) has played in helping to stabilize the Eurozone, and the recent capital infusion in the Spanish banks.

Europe Slides Back into Recession

The Eurozone economy continues to weaken as falling tax revenues and rising welfare payments have resulted in increased public borrowing. The Eurozone fell back into a recession last quarter for the first time in three years. There is growing evidence that the European debt crisis is spilling over into Europe's stronger economies as Austria, Italy and the Netherlands contracted sharply last year. We would not be surprised to see Germany's economy, which has been the strongest in the Eurozone, contract in the fourth quarter. At the same time, the debt crisis has gripped the banking sector as European banks shore up capital and shed assets. This, in turn has restricted loan growth, private credit expansion and capital formation. As a result, the unemployment rate in the Eurozone reached 11.7% in October, the highest rate since 1995.

We believe that Europe's strategy to address the obvious weaknesses in its monetary union will continue to be a combination of dithering, denial and compromise which will ultimately make long-term investments in Europe unappealing. Europe is facing severe structural problems in their economy and capital markets that are restricting private investment and impeding economic growth. Beyond the cultural differences that exist throughout Europe, these structural problems include uncertainty over banking reform, regulation, Eurozone budgeting, rules for bailouts and Greece's funding. For example, in the Netherlands, Europe's fifth largest economy, uncertainty over the future of the mortgage interest relief mechanism following their elections, as well as the debt crisis in the periphery countries, have weighed heavily on the Dutch economy as GDP contracted by 1.1% in the third quarter. *As fiscal initiatives have been diluted or fail, the Eurozone has relied heavily on monetary stimulus to sustain economic activity. Does this sound familiar?*

The Role of the European Central Bank

Europe is facing an economic recession, an undercapitalized banking system, a lack of private credit expansion and a continual air of crisis that has helped fuel uncertainty and restricts consumption. We believe that monetary policy alone cannot fix these problems however; central banks of the developed countries have gone a long way to stabilizing markets with aggressive liquidity programs. *For investors to comprehend the potential risks and opportunities in Europe, we believe it is important to understand how the economic machine works in Europe.*

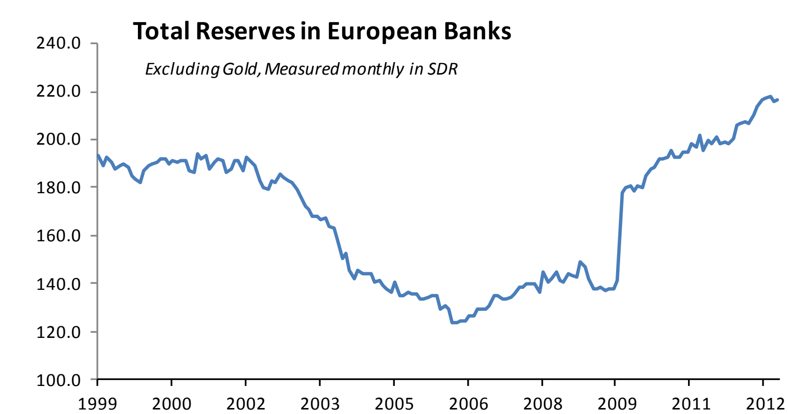
The European Central Bank (ECB) is the central bank for the euro and administers monetary policy for the 17 countries which constitute the Eurozone. The objective of the ECB is to maintain price stability within the Eurozone by keeping inflation below 2% over the medium term. While the ECB has the basic task of defining and implementing monetary policy for the Eurozone, it operates differently than the Federal Reserve since the Eurozone lacks a common Treasury and unified banking system.

There are two important differences in how the ECB functions as a central bank. First, while the ECB is governed by European law, it is structured similar to a corporation with shareholders and stock capital. The owners and shareholders of the ECB are the central banks of the 27 member states of the EU. Unlike the Federal Reserve, the ECB is not a "lender of last resort."The authority of the ECB is limited to the powers that are granted to it through its shareholders. *This past month, the ECB was granted additional powers to police the banking system for the Eurozone. This move toward a common bank regulator is a critical step for the EU in order to ultimately experience sustained economic growth throughout Europe.* The second major difference is how monetary policy is actually implemented. The Federal Reserve controls the banking system by managing reserve requirements - or how much excess capital each bank is required to keep with the Federal Reserve. In the U.S. today, liquidity is furnished to the capital markets and economy primarily through the open market purchase of Treasury bonds by the Federal Reserve System. The Euro-system uses a different method which involves the European banks bidding on short term repurchase agreements through the ECB. This method is less stable since it relies on each country's bank regulator to supervise collateral requirements. The securities that a bank posts as collateral for the repo agreements has been a source of scrutiny over the past several years given the deterioration in quality and the lack of consistent pricing for much of the debt. *Recently, the ECB was given authority through the European Stability Mechanism (ESM) to purchase directly the debt of troubled member countries. This replicates the role the Federal Reserve has through its Quantitative Easing Programs.*

ECB becomes the European banking regulator

After contentious discussions which lasted for most of this year, the European Union has agreed to allow the ECB to become the regulator that would police the European member banks. This is a necessary step in preserving the Euro currency and monetary union. *Remember that leading up to and through the financial crisis, each EU country's respective bank regulator had the discretion and power to price impaired assets.* The result was that Germany, for example, might have a price of 60 for Greek debt while the banks in Greece may have a price of 75 for the same security. *This lack of consistent pricing lead to weakening confidence in the stability of banks in Europe, as well as concerns in interbank lending where sovereign debt is used as collateral for repurchase agreements and counter-party transactions.*

Europe is moving through a painful deleveraging of its economy and capital markets. Austerity measures in the peripheral countries are part of the process of cutting expenses to reduce each country's debt load. At the same time, the European banks shrunk their balance sheets while increasing their capital and reserves. European bank reserves are at their highest levels in over ten years.



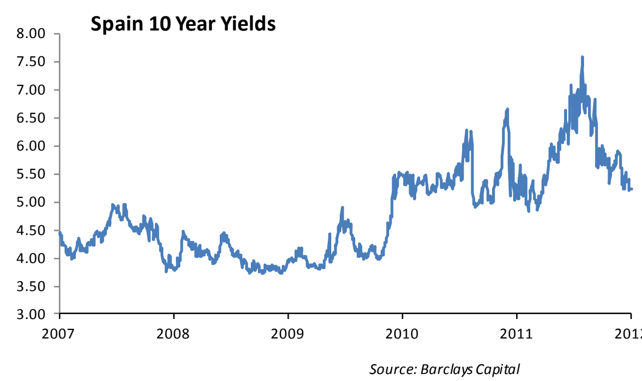
Source: The International Monetary Fund

In addition, the European Central Bank's recent initiative to buy unlimited quantities of government bonds from debtor countries of up to three years in maturity provided relief to the capital markets and helped to stabilize the euro in the currency markets. This initiative represents an important departure from the previous role of the ECB as a central bank for the EU, which did not have the authority to purchase assets like the Federal Reserve's Quantitative Easing programs. *However, these actions to stabilize and preserve the euro could continue growing the seeds of destruction for both the euro currency and perhaps the EU itself.* The EU is a cooperative association of equal member countries and lacks federal integration including a central banking system and integrated fiscal authority with the power to tax. Still, each country surrendered part of the sovereignty for the common good when the monetary union was formed. The euro crisis has effectively divided member countries into two classes — creditors and debtors. The creditors are pretty much in charge, Germany and France foremost among them. Debtor countries have to pay substantial risk premiums for financing their government debt, which has pushed them into recession and puts them at a big competitive disadvantage that threatens to become permanent.

Europe landed in this spot because it implemented a monetary union without the necessary fiscal union, integrated banking system and unified federal oversight. The EU has recognized these deficiencies and has made some progress naming the ECB as the unified bank regulator for the Eurozone. Moving toward fiscal integration with common euro denominated debt and centralized taxing authority will prove nearly impossible given the cultural differences of each country.

Spain's banking system finally receives a capital infusion

While Greece has spiraled into a depression, the epicenter for the Euro debt crisis is now directed toward Spain, which remains in a tango trying to prevent its own bailout from the European Union (EU). For the 10 years following the launch of the Euro, Spain enjoyed a lower borrowing cost which resulted in higher labor costs, as salaries jumped 55% compared to an increase of 22% in Germany over the same period. The increased costs, which supported a large social welfare program and higher standard of living, were funded through government bond sales largely financed through the Spanish banking system. The resulting higher leverage in the Spanish banking system contributed to the weakening of the entire European banking system. *Broadly speaking, an economy cannot show sustained economic growth without private credit expansion, and a system will not experience private credit expansion without a healthy monetary system.*



With unemployment over 12%, increased austerity measures, and a sharp decline in consumption, we expect Spain's economy to contract over 1.5% in 2012. Signs of economic stress are prevalent as the government has deferred paying its bills in a timely manner and relied on its pension fund to help buy its sovereign debt in order to keep its borrowing costs below peak levels of 2011.

After long negotiations, Spain's banks will receive a €37 billion capital infusion directly from the ESM, and subordinate bondholders will incur losses through either haircuts or debt to equity swaps. This infusion avoids a formal bailout from the EU which would have required more severe austerity measures and forced the capital infusion to be pushed through Spain's budget increasing its debt further. In addition, the €37 billion is significantly lower than the €46 billion originally contemplated in the Stress Test results earlier this year.

This acts to stabilize the situation, but doesn't fix the problem. In the absence of real economic growth, we expect the rating agencies will act to downgrade both the sovereign debt and the debt of the major companies in Europe next year. The cost of borrowing will move higher which will be an additional burden for operating margins. At the same time, bankruptcies will increase in the most problematic areas of Europe, including Spain, will experience a decline in population, unwinding the migration from Northern Africa that has occurred over the past ten years. All of this will put more stress on the banking system.

Spain

Annual Revenue and Expense Statement (Financial figures in millions of Euros unless otherwise stated)

	2010	% Total	2011	% Total	2012	%	2013	%
Revenues								
Direct Taxes	198,025	*72.27*	189,727	*69.66*	184,269	59.83	182,500	66.03
Indirect Taxes	40,736	*14.87*	36,142	*13.27*	21,095	6.85	21,250	7.69
Rates, prices and other income	6,169	*2.25*	6,735	*2.47*	8,716	2.83	5,650	2.04
Current transfers	12,020	*4.39*	11,196	*4.11*	68,974	22.39	42,097	15.23
Capital Income	6,727	*2.46*	9,637	*3.54*	8,823	2.86	8,831	3.20
Disposal real investments	335	*0.12*	283	*0.10*	288	0.09	288	0.10
Capital transfers	3,733	*1.36*	2,188	*0.80*	3,254	1.06	3,200	1.16
Financial assets	6,259	*2.28*	16,453	*6.04*	12,574	4.08	12,574	4.55
Total Revenue	274,004	*100.00*	272,361	*100.00*	*307,993*	*100.00*	*276,390*	*100.00*
Total Revenue as a % of GDP	*26.06%*		*25.73%*		*29.53%*		*27.10%*	
Expenses								
Justice	1,819	*0.52*	1,713	*0.54*	1,613	*0.52*	1,613	*0.51*
Defense	7,357	*2.10*	6,868	*2.17*	6,269	*2.01*	6,269	*1.98*
Public safety and Institutions penitence	8,873	*2.53*	8,402	*2.66*	8,355	*2.68*	8,355	*2.63*
Foreign policy	3,548	*1.01*	2,748	*0.87*	1,681	*0.54*	1,681	*0.53*
Social Protection	174,665	*49.81*	175,938	*55.68*	173,283	55.58	178,639	*56.33*
Transfers to other Public	73,599	*20.99*	42,811	*13.55*	49,686	*15.94*	49,686	*15.67*
Interest expense	23,200	6.62	27,400	8.67	28,848	*9.25*	28,848	*9.10*
Total Expenses	350,697	*100.00*	315,989	*100.00*	*311,779.00*	*100.00*	*317,135*	*100.00*
Surplus/Deficit	(76,693)		(43,628)		(3,786)		(40,745)	

	2010	2011	2012	2013
GDP*	1,051,342	1,058,701	1,042,821	1,020,000
% Change in GDP, YoY	*0.34%*	*0.70%*	*-1.50%*	*-2.19%*
Population	45,989,016	46,152,926	47,042,984	46,500,000
Interest expense/population (not in millions)	504	594	613	620
GDP/population (not in millions)	22,861	22,939	22,167	21,935
Total revenue/population (not in millions)	5,958	5,901	6,547	5,944
Social Protection/population (not in millions)	3,798	3,812	3,684	3,842
Net	2,160	2,089	2,864	2,102
Change in Total Reveune	*-9.10%*	*-0.60%*	*13.08%*	*-10.26%*
Change in Total Expenses	*0.14%*	*-9.90%*	*-1.33%*	*1.72%*
Surplus/Deficit as a % of GDP	*-7.29%*	*-4.12%*	*-0.36%*	*-3.99%*
Total Public Debt	644,692	736,468	736,500	725,000
Current Year Public Debt Maturing	84,696	73,218	86,000	81,000
Total Debt as a % of GDP	*61.32%*	*69.56%*	*70.63%*	*71.08%*
Interest expense as a % of Expenses	6.62%	8.67%	9.25%	9.10%
Interest expense as a % of Revenue	8.47%	10.06%	9.37%	10.44%

Source: All revenue and expense figures from meh.es (Spanish ministry of finance), unless otherwise noted.
Population, GDP, and Public Debt figures from Eurostat, unless otherwise noted.
2012 GDP projection from http://www.ey.com/GL/en/Issues/Business-environment/EUROZONE-COUNTRY (*)
2012 Population estimate as of July 2012 from https://www.cia.gov/library/publications/the-world-factbook/geos/sp.html (**)
Current Year Public Debt Maturing from http://appsso.eurostat.ec.europa.eu/nui/submitviewtableaction.do (***)
Total Public Debt from http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics (****)