WINTHROP Capital Management

The Financial Crisis of 2008 represented a turning point for the capital markets, financial regulation and global central bank policies. For the twenty years leading up to the Financial Crisis, accommodative monetary policies of the developed countries resulted in prosperity, higher wages, increased asset prices and an overall higher standard of living. However, this false sense of perpetual prosperity resulted in unbalanced social service and pension benefits that are now more difficult to rationalize in the economic environment following the Financial Crisis. Developed countries, including Spain, Italy, Japan and the United States, simply amassed too much debt. The capital markets are now in a period of deleveraging which is marked by austerity, tight credit, transfer of wealth, debt restructuring, and central bank intervention in the capital markets. And, because of the structural problems with the European Union, Europe is having more difficulty dealing with its deleveraging.

European countries moved to a common currency twenty years ago as a way to promote economic growth and trade. The euro is a cooperative currency that requires member countries to maintain certain fiscal disciplines in order to be a member in good standing. Unfortunately, most of the member countries are not within their required covenants (including the 3% budget deficit to GDP ratio) for membership in the European Union. In contrast, the United States has a complete federal union. Europe lacks a central government that can tax, borrow funds and disperse money through a common Treasury; it really only has a cooperative currency. Unlike the Federal Reserve, Europe does not have a centralized banking system that can be the “lender of last resort” or a Federal Deposit Insurance Commission (FDIC) which can safe guard depositors and wind-down troubled banks.

As a result of the differences in structure, we see distinct differences in the deleveraging of the United States and European capital markets. In the United States, the Federal Reserve has provided adequate liquidity through its *quantitative easing* programs allowing interest rates to remain low. However, domestic private credit expansion has been relatively tight given the constrained capital position and uncertain regulatory environment. Europe is facing more difficulty managing its deleveraging in large part due to the structural problems of the euro, the role of the European Central Bank, and the cumbersome decision making process of the European Union.

What We Know About Europe

Europe is a mess.

Last month, Greece failed to install a new government when the party opposed to austerity won a majority of seats in parliament, and it has set an election for June 17th to vote on whether the country should remain in the euro. Go figure. Greeks say they are in favor of taking the rescue money provided by the European Union and the IMF, but fail to elect politicians prepared to implement the austerity measures that were agreed to as part of taking the money. At the same time, Spain’s government has been bumbling through the process of propping up its banking system after the country nationalized the third largest bank causing a spike in Spanish government bond yields. The result has been increased volatility in global financial markets over concerns of Greece exiting the European Union and the contagion effects of the deterioration of the Spanish banking system.

Source: Barclays Capital

Unfortunately, European leaders are no further along in dealing with their banking and debt problems than they were at this time last year. As investors, we need to recognize the following:

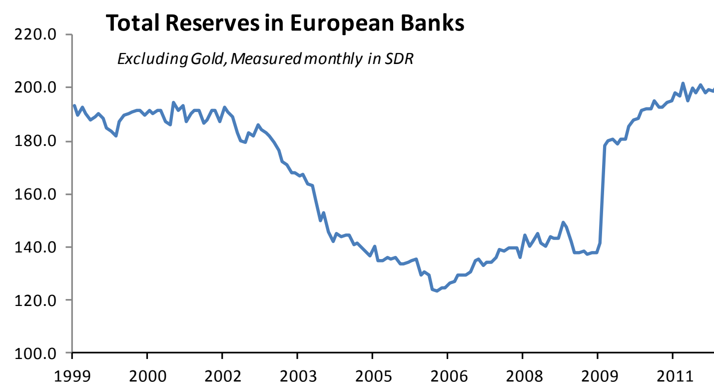
1. European leaders do not have a plan that will install fiscal unity amongst their members
2. European leaders do not have a plan for a member to leave the EU and the euro currency
3. Europe does not have a coordinated plan for spurring economic growth
4. Europe's banking system lacks consistent regulation and governance and does not offer depositors a form of guarantee or deposit insurance
5. The process for making decisions within the EU is cumbersome and will not change over the near term
6. Europe has a very limited supply of Euros for which to fix the banking and sovereign debt problems
7. Ultimately, there must be a transfer of wealth from rich countries to poorer countries in order to address the imbalances in the European Union

Every deleveraging is characterized by slow economic growth, and results in debt restructurings, bankruptcies, and some transfer of wealth. In Europe, we expect that the richer countries which include Germany, the Netherlands and Finland, will ultimately have to subsidize those countries that have incurred larger debt loads including Italy and Spain. While we are not clear how that transfer of wealth will look, it is inevitable for the euro to be a viable currency going forward.

Focus on the European Banks

An economy cannot experience sustained economic growth without a healthy financial system. The European banks are struggling under the weight of troubled loans and weak capital. Strengthening the European banks is critical to stabilizing the European capital markets and economy.

Moody's started its long-awaited process of downgrading the European and global banks last month with the downgrade of 26 Italian banks. The downgrades have been expected and are the result of mounting loan defaults, funding challenges and weak capital positions. This is the beginning of what is expected to be a series of downgrades reflecting the operating challenges throughout a much weaker operating environment in Europe.



The Spanish government, under pressure to take more proactive steps to secure its banking system, initially took a 40% position in Bankia, the country's third largest bank. However, last week the Spanish government increased their stake to €23.5 billion which represents 90% of the equity and effectively nationalizes the bank. The valuations of Spain's real estate market became hyper-inflated leading up to the financial crisis, and now the entire Spanish banking system is polluted with real estate loans that will end up in foreclosure or abandonment. If that sounds familiar, it is because it rhymes with the sub-prime loan problems we experienced here in the United States. *Ultimately, we expect that Spain will need to seek a formal bailout similar to Italy, Greece and Portugal through the European Financial Stability Fund.*

This is a sovereign and banking insolvency problem and not just a liquidity problem. The European banks are caught in a virtual death spiral as the ratings of Sovereign debt, including Italy and Spain, are downgraded which depresses the value of their bonds held by the banks, which in turn causes losses for the banks that have to mark the bonds to market. Furthermore, the deterioration in credit quality requires additional reserves and collateral for securitized transactions such as repurchase agreements. After dropping from 2002 to 2006, total reserves in the European banking system have now increased to levels that are now higher than 1999. One of the structural problems is that there is no clear mechanism to provide a backstop to the banking system as there is here in the United States. The result is that the European banks face both a funding crisis (shoring up depositor confidence) and a capital crisis (shoring up investor confidence).

What is clear is that the European banks have not been consistent or transparent in their write-down of troubled loans. This has created a crisis in confidence for the banks at the same time that Greece's political crisis is heating up. By allowing the banks to borrow €1 trillion through the LTRO program earlier this year, the banks were able to purchase Sovereign debt and keep interest rates low at auction. Yet, this increased the level of net debt – particularly for Spain and Italy which were heavy borrowers in the program. Also, this effectively transferred debt from the bank's bondholders to the ECB since it helped to shore up funding for the next three years.

An economy will not experience sustained economic growth without private credit expansion. As the European banks have been forced to increase their capital in preparation for Basel III, they have been selling off businesses and shrinking loan portfolios. The direct result is an abrupt contraction in the growth in private credit. One of our investment themes for 2012 has been to expect a severe recession in Europe as the banks stop lending and countries implement austerity measures which curtail consumption. And, we believe that we're in the middle of that recession right now.

There are two other related issues worth mentioning. The first is that *since the European banks are the primary lender to emerging market economies such as Brazil and India, we expect those economies will go through contractions as their access to credit is effectively cut off*. The second issue is that we estimate U.S corporations hold over $300 billion on deposit in European banks. In order to repatriate the cash earned overseas back to the United States, companies would have to pay a 35% repatriation tax. Further, U.S. money market funds hold a large portion of the funding base for the European banks. *Thus, the U.S. government has a huge stake in supporting the European banking system. We believe the U.S. government will likely not support repatriation of cash on a tax-free basis from Europe because of the potential negative impact on the European banking system.*

The Future of the European Union

Since the Financial Crisis, European leaders have continually dithered and been unable to take decisive action on issues. We do not expect that to change anytime soon. With that said, EU officials are working on two important issues for the next Summit in June: the pooling of debt and creating a back-stop for the European banking system.

There are two fundamentally different views within the EU on how to address the crisis. Countries such as France believe that Europe must create euro-denominated bonds as a way to attract capital and transfer risk to bondholders. Others, led by Germany, say that further economic integration requires a common fiscal policy which mandates that sovereignty over budgets be transferred over to the EU. Germany has indicated that it is prepared to accept a "grand bargain" that would provide greater support for the entire Eurozone in exchange for more centralized control over budgets and government spending in Europe.

The process of creating fiscal unity, which requires authority over budgets, government spending, taxation, and banking regulation requires that each member country give up its sovereign control over these issues. If history is any indication, nothing will get done before the next EU Summit on June 28th and what will be unveiled at the

Summit will likely address only the less controversial issues, such as creating a banking watchdog and depository insurance.

Conclusion

The European Crisis is not going away any time soon and their structural problems will continue to act as impediments to the vision and initiative that is required to contain the problem and arrest investor confidence. We have always maintained that Greece's departure from the European Union is inevitable. But, dismantling the euro currency is too expensive and disruptive to Europe and the global capital markets.

In order for the euro to work as a common currency, there needs to be fiscal unity among member countries. Until there is fiscal unity, there will not be a consistent method for borrowing and fiscal discipline throughout Europe. It will be difficult to have fiscal unity without integrated taxing authority. While we may see steps toward a more integrated European banking system over the next year, we believe the use of a common euro- denominated form of debt will take more time to implement and work out the difficult governance details. *The complexity is overwhelming and European leadership has an abysmal record of making tough decisions in a timely manner throughout the Financial Crisis. In addition, the cultural differences between the countries and the recent change in leadership in several member countries make the process even more cumbersome.*

The European economy will languish in a severe recession until the structural problems are addressed. The European Central Bank has a more limited tool kit to stimulate the European region the way the Federal Reserve has in the United States. Europe's focus on austerity and budget cutting, combined with the European banks retrenchment from lending, will keep Europe in a severe recession.

Under any normal economic cycle, private capital would flow into an economy where investors can earn rates of return and are compensated for their risk. Europe would clearly benefit from private capital inflows and we are starting to see evidence of that with State Grid Corporation of China's recent acquisition of transmission assets in Brazil from Spain's Actividades de Construccin y Servicios SA. However, we would expect to see more foreign investment in Europe as asset prices deteriorate and government stability programs fail to materialize. While our sense is that it is still too early to jump in, we expect that Europe will offer equity investors wonderful opportunities over the next year as the deleveraging takes shape. It will be interesting to see how much of the cash that is held in European banks is actually used for acquisitions in the region by U.S. corporations.

Ultimately, we expect that the economic and operational problems of Europe will have a negative impact on the United States and our economy will experience a slowing as a result. We believe there is a very real possibility that the U.S. government is forced into a larger role to participate as a back-stop to the European banking system. This will only put additional pressure on the U.S. fiscal position which will result in further downward pressure on the credit rating of the United States.

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