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## How the Eurozone became the mess it is

### German “help” came with a price

Curiously, European stock markets are ignoring the ongoing recession there. Should we ignore it too? The markets are obviously predicting eventual economic progress. Is that reasonable given the euro’s structural problems? Of all the known unknowns, I believe the outcome in Europe is a critical factor in determining an appropriate asset allocation. I’ve been researching the origin of the imbalances within the euro and it provides at least a piece of the framework for predicting the outcome.

Germany is the fox in the henhouse. German government, business and labor came to an agreement in the early 2000s that restrained the wage growth of German workers to improve the health of the German economy. That worked to lower the share of German wages relative to German gross domestic product (GDP) and quickly resulted in a surplus of savings in excess of internal investment requirements. (Don’t think of this savings as the average German household being thrifty. Instead, it was the entire German economy – including government and businesses – producing in excess of what could be consumed and invested.) The simple math of balance of payments dictates that this excess savings is exported, generally through loans. And because of the euro structure, that savings glut was most easily exported to southern European nations. Wherever exported savings goes, it must act either to increase investment or to reduce savings, which – by definition – is consumption in excess of income. With German money pouring in, southern Europe either had to invest more or consume more relative to income. It did both. German money financed real-estate and investment booms/bubbles in the south. Jobs (service-oriented) and higher wages came with the splurge. Southern Europeans felt richer and borrowed to consume. In addition, the surging German manufacturing base took market share, displacing southern workers. Thus the flood of German savings distorted the southern economies and resulted in bad investments, disastrous borrowing and job losses.

The euro structure leaves the southern states with no way to control the flow of German funds or trade goods. Germans, by all accounts, believe their economic model is virtuous but it is no different than the Chinese mercantile model: It preys on the weak. So why is the market so positive? Martin Wolf of the Financial Times recently wrote, “The hope that they (Europe) will grow their way out of their difficulties, via Eurozone demand and internal rebalancing, is a fantasy in the current macroeconomic context.” I agree. That only leaves an external adjustment. Are we supposed to believe the Eurozone will get its competitive house in order, like the Germans, and collectively run surpluses with the rest of the world? External adjustment seems equally fanciful with China slowing, Japan trying to increase exports and the United States fighting low nominal growth. I don’t see how growth revives under the current structure.

I’m very concerned that social unrest due to joblessness will force substantive changes in the Eurozone. History suggests summer is a good time for unrest.

### Stuck with low rates for a while, probably

Treasury rates have ticked up recently and that has the bond bears frothing. Are we finally at the end of the long bull market in bonds? I suspect the U.S. economy is now thoroughly lubricated with very low-cost financing. Every financial transaction involving debt – from real estate to private investment to consumer lending – is now predicated and dependent on very low interest rates. I’m hard-pressed to understand how the economy can grow if rates rise much. I believe we could be stuck with very low rates for years. I’ve written several times that I’m wary of long duration but I’d strongly consider adding some deflation protection in the form of longer-duration fixed income if Treasury rates rise closer to 2.5 percent.

Thank you for taking the time to read this month’s Market Perspective. I do appreciate it.

Total Return Portfolio	
Equities	63%
Gold	2%
Cash	35%
<b>Total</b>	<b>100%</b>

as of May 29, 2013