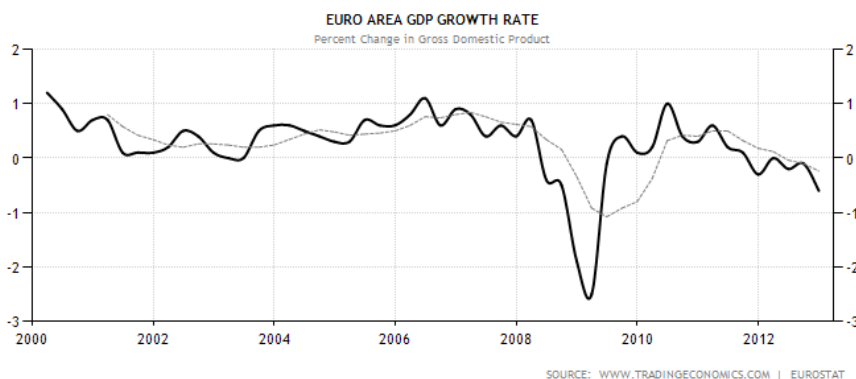


September 8, 2014

Across the Pond

Most who follow the news know that Europe's economy has not been growing well. As a matter of fact, Europe's growth has been so poor that it makes the U.S. economic growth engine look outright stellar. Over the last 12 months the euro zone economy has grown by 0.15%, with the reported 2nd quarter GDP growth rate stagnating at 0.0%. This is not a short-term trend. It's



been 15 years since the euro zone last saw GDP growth above 1% on a sustainable basis. Why is Europe stuck in a slow/no growth environment?

A plethora of reasons surround the economic stagnation in Europe, including:

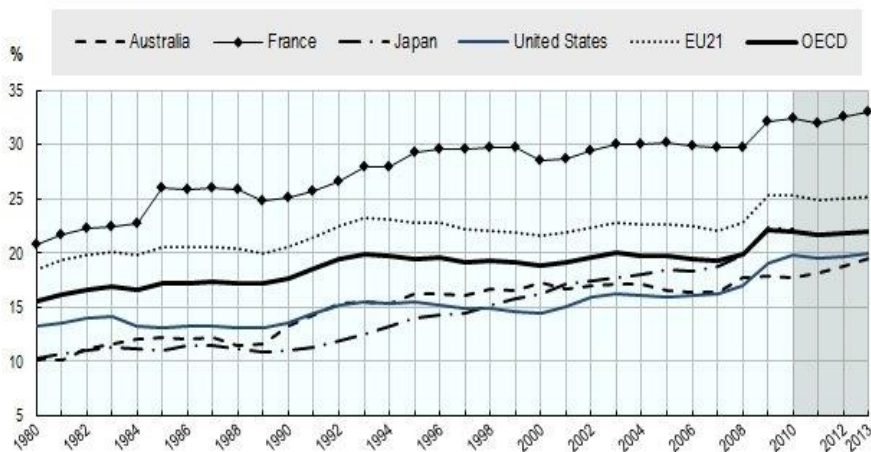
- Inflexible Labor Laws:** Inflexible labor laws have led to a lack of hiring, particularly youth. In a number of European countries, it is very difficult or even impossible for employers to reduce headcount when things get tough. Consequently, employers are hesitant to hire permanent employees when things are getting better. The euro zone unemployment rate is at 11.5%, while the U.S. unemployment rate is at 6.1%, down from 7.2% a year ago.
- Bad demographics:** Currently, 13% of people living in the U.S. are 65 years old or older. In Europe, it is hard to find countries, particularly in Western Europe, where less than 15% of the population is 65 years old and older. Bluntly, retirees are in abundance in Europe, taxing the social-net programs in that part of the world and lowering the overall GDP growth rate. This is not going to get better.
- Decentralized banking/governmental bureaucratic/political system:** Each country in the euro zone is still a sovereign state, holding elections, maintaining different tax rates and different social contracts. This leads to the inability to streamline social contracts and banking systems. Layer upon layer of bureaucratic costs are footed by each country without the ability to share many of these costs. For comparison purposes, roughly 16% of workers in the U.S. work for the government, while 36% of French workers, 31% of

German workers and 30% of Italian workers work for their respective governments.

- **Dysfunctional currency system:** I have written on this issue extensively in the past. The difference in productivity between Germany (highly productive) and Italy (low productivity) leads to monetary policies which necessarily favor one country over another.
- **Over-reliance on the welfare safety net:** The chart below depicts, as a percent of GDP, how much money is being spent to support various countries' welfare states. As you can see, the French government spends about 32% of GDP in support of their welfare system. The average in Europe currently is at about 25%. If one considers the level of welfare expenditure combined with the absolute size of government (about 30% of those employed work for the government in Europe), it is easy to understand why European economies *systemically grow more slowly than others*.

The issues go on from here - but you get the picture. Many of the problems which have led to slow growth in Europe are not cyclical in nature – rather, they are systemic and self-imposed. Economic growth in Europe has been so low for so long that the main focus of many political/economic leaders continues to be worries of deflation pressures rather than a build in inflationary pressures. Low inflation is currently part of the economic landscape on a global scale, but is particularly acute in Europe.

Public social spending based on detailed data for 1960-2009; national aggregates for 2010-2012 and estimates for 2013, in percentage of GDP



Source: www.oecd.org/social/expenditure.htm

Deflation (a period of *falling* prices) is considered by most economists a more serious malady than rising inflation pressures. The inflation rate in the U.S. bottomed last October at an annualized rate of 1.0% and now stands at 2.0%.

Meanwhile, the European inflation rate currently stands at 0.4%. This is the lowest their inflation rate has been in the last 15 years, save during the 2008-2009 recessionary period.

Mario Draghi Announces New Monetary Measures

With this economic backdrop, Mario Draghi, the President of the European Central Bank (the European equivalent of our own Janet Yellen), announced monetary actions which are to start in October. The popular press is calling these actions WIT2 – the second round of “Whatever It Takes”. While not exactly a round of quantitative easing, the actions resemble the U.S. version of Quantitative Easing, where money is “printed” and shoved into the banking system in an attempt to jump-start demand for capital through a number of mechanisms.



One advantage we at Mariner enjoy over many in the investment business is the strong relationships we have established with superior

investment managers on a global scale. One such manager is Louis Gargour, the lead manager at LNG Capital. LNG, based in London, is a well-respected bond hedge manager that specializes solely in the European capital markets. Louis is one of my go-to managers when something is afoot in Europe. He has a firm grip on the European economic and bond markets.

Louis held a conference call this past week to discuss Draghi's decisions and possible economic/banking ramifications of those decisions. My conclusions following Louis' conference call are:

1. The ECB (European Central Bank) will purchase up to \$1.3 trillion (1 trillion euro) in bonds from the market which are backed by loans to the real economy. This will provide fresh capital to the banking system as many banks will be able to restructure their balance sheets by selling their dicey credits to the ECB for cash.
2. The ability of the European banking system to start making more loans will be enhanced. Initially, this will probably have little effect on demand for capital. Loan demand will probably remain fairly lackluster, **with the new, excess banking capital spilling into the public financial markets.**
3. An expansion in the asset-backed market will be necessary in Europe – this is the transmission mechanism that will make the actions become reality. The ECB has announced a partnership formed with Blackstone (a U.S.-based securities manager/underwriter).
4. **This action should be positive for the periphery debt markets and European corporate debt as interest rates continue to come down. The action should lead to a weaker Euro in relation to the U.S. dollar,** with a push to the upside in European exports, particularly in the weaker economies.
5. If successful, the program should eventually push economic activity to the upside and revive inflationary **expectations to a limited degree. The catalyst of the inflation expectation revival would be the expectation that money “printing” to this degree normally does lead to some type of inflationary pressure. This would be considered a positive development since Europe has teetered on the brink of deflation for some time.**

Long Term or Short Term Benefit?

As has been the case in the U.S., when a central bank starts to print money through radical QE type activities, the immediate injection of excess liquidity into an economy initially lifts asset values, as the money has to go somewhere. If the real economy doesn't need or want the liquidity, it tends to flow into the capital markets (both stocks and bonds), raising prices. We have witnessed this in the U.S. on three occasions since 2009 as our own Federal Reserve performs QE activities.

However, as is the case in the U.S., long-term benefits of QE actions are questionable. We don't yet know the final ramifications of the Fed's radical QE activities, but eventually we will witness the results. As Tom Sowell once said, “There are no solutions, only tradeoffs.” At any rate, I don't believe QE activities carry long-term benefits, but act as a shot of adrenaline to an economy, an injection Europe sorely needs.

Update on Vladimir

Another wild card to consider when contemplating the European economy is Vladimir Putin's actions in Ukraine. The economic sanctions imposed on Russia are negatively impacting Europe's economic activity. Currently, there is a stand-down occurring as Russian military advancements appear to have halted. The agreement announced is described as a series of steps which may end the five-month long conflict in Ukraine. The first step, the cease fire, was to

be to be followed by a prisoner exchange. Frankly, there is no other conclusion one can gather from the recent and current events in Ukraine besides a major political win for Putin.

Reacting to Putin's aggression, NATO members have agreed to establish a rapid-response force that can be deployed anywhere there is trouble brewing in Eastern Europe (a.k.a. – along the Russian border). The establishment of this rapid-response force is, at least, an acknowledgement from NATO that Russia is a troublemaker, which needs to be harnessed. This appears to be a step in the right direction for the west.

Nonetheless, Putin has shown his hand that he indeed may not be finished with his aggressive moves within Eastern Europe. In the past, I have stated my opinion as to what Putin is truly up to (*The Consequences of Slow Growth and Leadership Vacuums, March 3, 2014*) and I stand by that view.

I believe Putin considers the scattering of the old Soviet Union a disaster for Russia. He is bound and determined to make up for that dismemberment. While he may not attempt to take physical control of all the old Soviet satellite states, he wishes to have as much political influence on the old guard as possible. I don't believe he is finished with his expansionist plans in Eastern Europe. In Putin's mind, the worst outcome is Ukraine joining NATO. That outcome is untenable.

Summary – Overall Thoughts on Investments in Europe

Bottom line, we expect the European-based capital markets (stocks and bonds) to start performing better than has been the case, particularly in relation to the U.S. capital markets. In many of our recent writings, we have made the strong case that a number of the foreign stock markets are undervalued in relation to U.S. equities. We have been waiting for a catalyst to unlock that undervaluation – perhaps, we now have that catalyst with Draghi's expansionist plans for the ECB.

This isn't to say that we think Europe provides a strong, stable economic/political environment in which investors can park capital and forget about risks. We do believe the risk/reward scenario in Europe is improving for investors to consider additional investments within that part of the world. The new ECB actions will have little impact on the structural problems Europe will continue facing. I still consider the U.S. and other areas of the world more favorable than Europe for long-term capital allocation.

Just for Fun

We Americans like to poke fun at Europe. In the past, they seem at times stuffy, stiff, indifferent or detached. Following are better minds than mine – and their view of the European state of affairs:

Europe was created by history. America was created by philosophy.

Margaret Thatcher

One hundred summers ago, Europe stumbled into the first of two wars, from which it emerged terrified of itself. Having misdiagnosed nationalism as the cause of Europe's sufferings, Europe's leaders undertook the steady attenuation of nationhood. They have thereby eroded the basis of government by consent – the powers of national parliaments.

George Will

And, finally, regarding Putin's naked aggression in Ukraine -

History teaches that war begins when governments believe the price of aggression is cheap.

Ronald Reagan

We will be back next week.



William B. Greiner, CFA
Chief Investment Officer

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