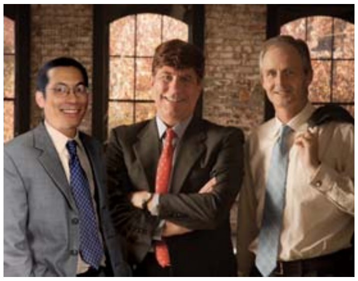
July 2, 2012

THE WEEKLYVIEW

Germany 'blinks' and all eyes turn to the ECB



From right to left:

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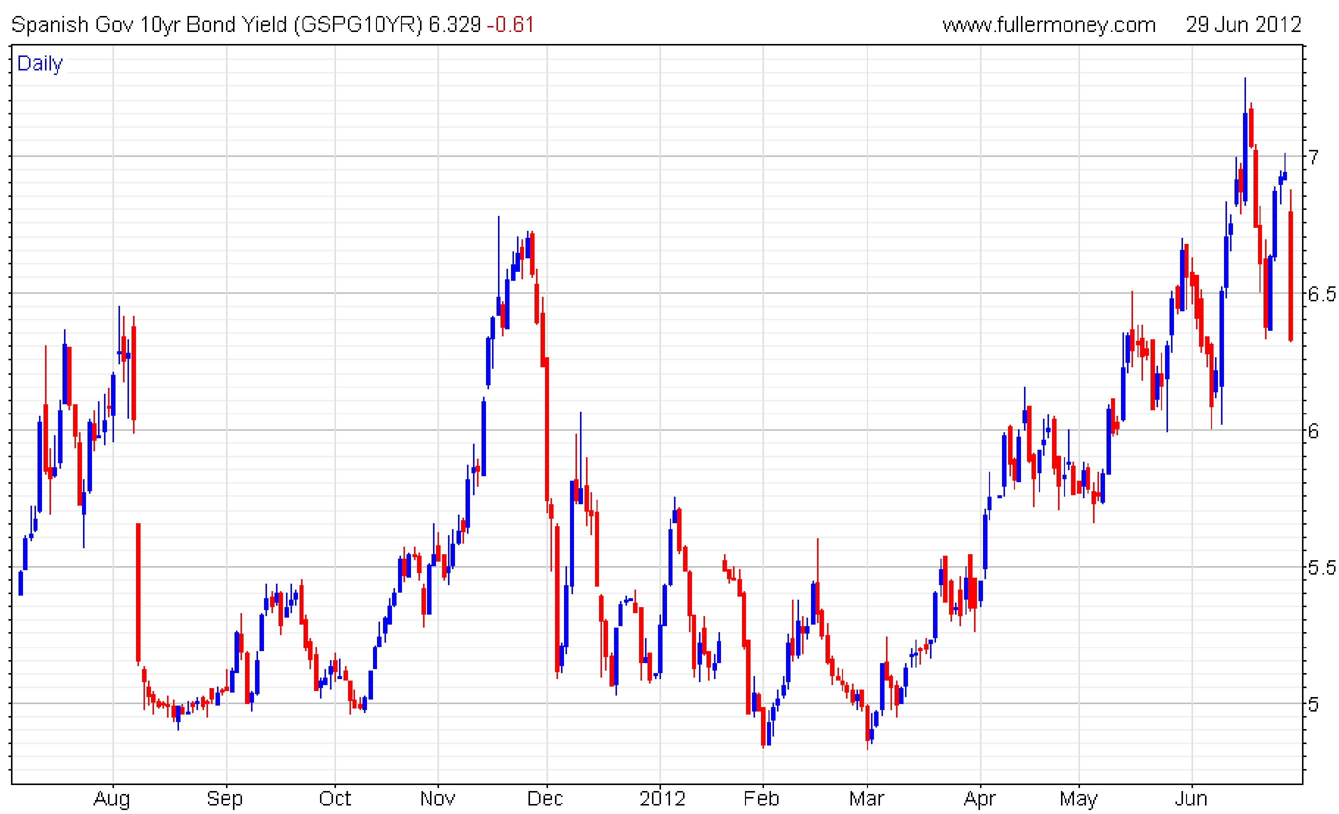
- Two days before the Euro summit, Angela Merkel told lawmakers from her Free Democratic Coalition that she did not "see total debt liability (read eurobonds) in my lifetime". With rhetoric like this, we described a dangerous game of 'chicken' between Germany and the rest of the Eurozone (see June 25th Weekly View), that had (and, with a lower probability, still has) the potential for dire economic consequences and a return to a global recession. Thankfully for investors, Germany capitulated at the eleventh hour by allowing Spain's banks to obtain funds directly from the European Stability Mechanism (ESM), rather than lending the money to Spain's government.
- We have viewed the structure of the Spanish bank bailout as a critical test of Europe's ability to arrive at workable solutions to its debt crises. Had Germany forced the bailout loans to be added to Spain's existing debt burdens, then Spain could have joined Greece, Ireland, and Portugal in losing access to private debt markets and needing a total government bailout. Almost immediately upon announcement of the deal, Spanish 10-year yields fell from 7 to 6.25% and European stocks rallied 4 to 5% in dollar terms. Both are at important technical levels, and follow-through is needed (in our opinion) to confirm that last Friday's rally in risk assets was anything other than traders being caught positioned the wrong way (see Weekly Chart). We are certainly open to that possibility.
- Importantly, the European agreement reassures markets that the key Euro bloc countries remain committed to closer economic integration and are willing to compromise to preserve the euro. Germany allowed a more lenient structure for bank bailouts in exchange for movement toward much closer fiscal integration and central control of budgets. This was the breakthrough that the markets liked, since failure to reach agreement could have seriously endangered the euro. It should also be noted that German banks are significant beneficiaries of this deal. However, talk is cheap; and the hard work of making these agreements a reality now begins in the face of considerable political and structural obstacles.
- **Most important, in our view, as of publication it remains unclear whether the European Central Bank (ECB) has been authorized to use its balance sheet to leverage the size of the ESM funds, which we believe are currently inadequate to the scale of debt rescheduling and restructuring. This will be the next big test of Germany's willingness to compromise.**
- As a tactical manager, we must seek to manage risk as well as return. Last Monday, we judged that the downside from the European summit was considerable. Having opportunistically lowered risk in April, we 'risked up' in early June, only to return to a more cautious stance – especially in our more conservative portfolios – as both the German and ROE (rest of Eurozone) positions hardened into the summit.
- On Friday the markets judged that, while the deal may not be a game changer, it was at least a sentiment changer and, with hedge funds and traders caught wrongly positioned, the rally was violent and reminiscent to us of the short-term rallies that have followed unexpected positive policy developments in the last four years. **In our**

opinion, the sustainability of this rally will critically depend upon the policy follow up (especially leveraging the ESM) **and the ability of global economies to avoid further slowing in the months to come (a Chinese stimulus package is becoming increasingly important).**

Also last week, Supreme Court Chief Justice John Roberts delivered a surprise, ruling in favor of the Affordable Care Act ('Obamacare') by indicating that the individual mandate to purchase health insurance or face a tax penalty should effectively be construed as a tax, and thus constitutional. What had been (a questionable) status quo is now settled and should reduce uncertainty for the 18% of the economy that produces health care goods and services. For the non-healthcare business sector, we expect continued caution on spending and hiring as both the domestic political and global economic environments are so uncertain. Continued efforts for a full repeal will now focus on the elections, and Republicans have been quick to make it a centerpiece of their campaign. Trying to stay objective, we suspect that the rancor over this issue will be a hindrance to post-election negotiations and constructive deal making. Opponents of the bill will likely rally to Romney, and indeed his contributions spiked following the announcement. Additionally, the high likelihood now of the additional 3.8% Obamacare taxes on dividends and capital gains for Americans earning over $250,000 will very likely have some investors with significant gains bringing asset sales forward into 2012 and selling businesses and stocks. We expect Congress at some point to agree to a postponement of the 'fiscal cliff' for a few months to allow time for negotiation, but the outcome of post-election budget negotiations is so unclear that investors/owners are unlikely to wait and hope.

THE WEEKLY CHART: WE THINK SPANISH BOND YIELDS NEED TO FALL BACK TO 5% OR SO



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