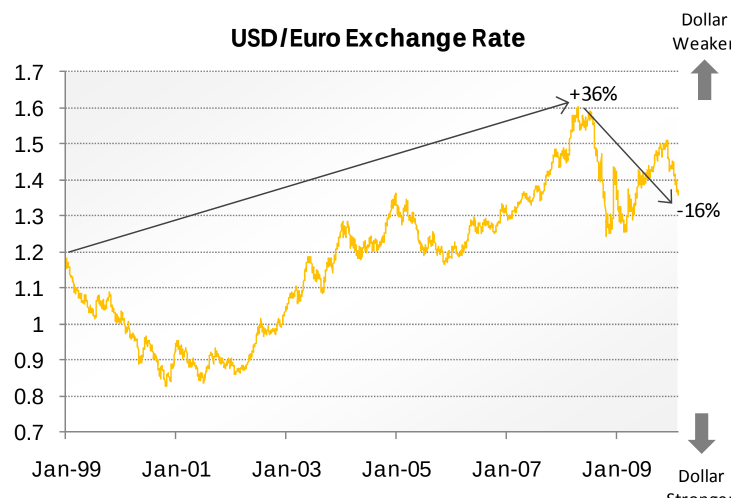
A More Perfect Union

The notion of a unified Europe, and a natural comparison to the United States of America, dates back centuries. George Washington boasted to the Marquis de Lafayette, *"I am a citizen of the greatest Republic of Mankind...We have made a sowing of liberty which will, little by little, spring up across the whole world. One day, on the model of the United States of America, a United States of Europe will come into being."* This idea was reiterated time and again over the years by the likes of Victor Hugo and Winston Churchill, to name a few. Though the groundwork for a coalition of European nations was built in the 1950s, it was not until 1993 that today's European Union was born. The EU has grown to 27 countries, 16 of which trade in a single currency, the euro, launched in 1999.



Source: Federal Reserve Bank, European Central Bank

Until several months ago, it looked like the euro was steadily gaining ground against the U.S. dollar as the world's premier currency. The euro reached its all-time peak against the dollar in April 2008, topping out at 1.6 dollars per euro. The dollar strengthened dramatically on the flight-to-safety trade during the rest of 2008, but as the worst of the crisis waned, concerns about the ability of the U.S. to finance its deficits spurred talk of dollar demise. The euro had been one of the top contenders for new leadership. That idea has died recently, however, as worries over debt defaults expanded to the PIGS countries (Portugal, Ireland, Greece, Spain). This recent fear has sparked a renewed dollar rally, and the euro has now lost almost 16% of its value since April 2008.

Across the globe, admittedly there are few bright spots; but while economic outlooks may range from mediocre to dismal, investing is a relative game. Money needs a home, and it will flow toward the assets that have the most attractive risk/reward profile, on a relative basis. That is the current situation. From a U.S. investor's perspective, bond yields are low, deficits are high, equities have run, and Wall Street is on its knees trying to look repentant. The good news is that things could be worse. In this month's piece, we discuss why we believe that despite dealing with joblessness and deleveraging, the United States still deserves a seat at the head of the investment table, with emerging markets as our guests of honor.

Euro Trash-ed

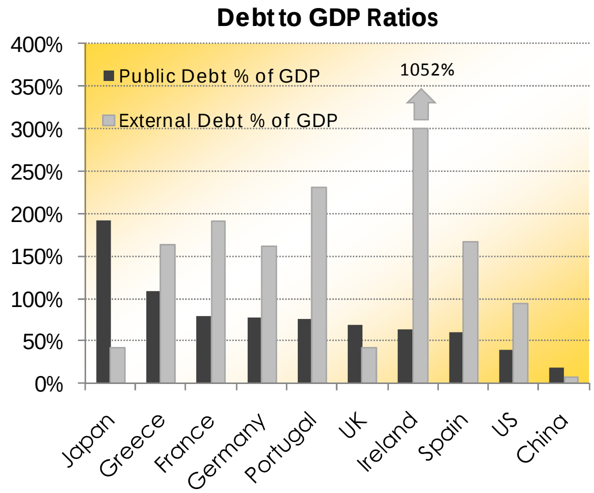
If the bottom fell out in Europe, we would undoubtedly have a global market correction. Although we believe the E.U. has a difficult road ahead, we do not think it will implode. Forget AIG, forget Freddie Mac or Fannie Mae – a member country of the Euro Zone is the definition of "too big to fail". European leaders already have conceded that that some type of rescue will take place.

As European leaders figure out the details of their "determined and coordinated action" to support Greece, we believe that the U.S. stands to benefit from the turmoil. We have had concerns about the health of Europe for some time. About six months ago we made changes in our model portfolios to reduce exposure to Europe in favor of broad emerging markets, while maintaining our U.S. positions. This has proven beneficial for U.S.-based investors as dollar strength against the euro has given a haircut to euro-denominated returns. We expect the U.S. to be able to raise interest rates sooner than Europe, providing further strength for the greenback. In fact, last week's testimony from Chairman Bernanke detailing how (but not when) the Fed will begin removing liquidity from the markets may have been an effort to keep downward pressure on the euro by planting the seed of a higher-yielding dollar. We also saw the diminishing approval ratings of the President and his Administration as a boost to the dollar – a power tug of war with Republicans means that significant health care reform, new spending initiatives, and/or financial regulations are unlikely. Gridlock is good for the dollar in the short term. We have recently taken positions in the Opportunistic portion of our portfolios to benefit from dollar strength.

Team America

Yes, the U.S. has its share of problems. Several U.S. states are in similar predicaments to the PIGS, with mounting budget deficits and worries of being unable to refinance their debts. The major difference, however, is Europe's lack of central government authority. There are many pan-E.U. organizations, but despite a common currency the region lacks a constitution, and even a unified taxation system. The citizens of Europe have, time and again, voted down measures to weaken their status as independent countries. In 2005, France and the Netherlands rejected the latest attempt at a European Constitution, thereby ending the ratification process. However, the Euro Zone does have a centralized monetary authority; the European Central Bank (ECB). But even within the Euro bloc, the members are merely an association of politically independent nations with an overlay of economic unity.

Prior to adoption of the euro, a country is required to meet and maintain a set of economic criteria in an effort to maintain price stability. The so-called Maastricht Criteria include a 3% limit on each country's government deficit to GDP ratio, and a 60% limit on the gross government debt to GDP ratio. Despite much talk about the dismal ratios for the PIGS, even E.U. leaders Germany and France are not within these limits. Germany announced an expected public deficit of 5.5% GDP for 2010, almost twice the E.U. limit, with a prediction that it will decline to 3% in 2013. In France, the deficit is expected to hit 8.2% of GDP in 2010, up from 7.9% in 2009. This is the fourth highest ratio in the Euro Zone, with Greece topping out at 12.7%. In fact, the 3% deficit limit was breached by 20 out of a total 27 member countries as recession-induced stimulus spending and anemic tax receipts necessitated borrowing. In the U.S., the deficit stands around 10% of GDP. The chart at right shows how various countries measure up on the broader debt to GDP ratio, which is limited to 60% in Europe. Public debt, the black bar, is the total of all government borrowings denominated in a country's home currency. External debt, in gray, reflects the foreign currency liabilities of both the private and public sector.



Source: CIA World Factbook, 2009 data and ests.

In our view, the point now is not whose ratio is higher than another's, but what happens next to address the cause of these imbalances. There are vast economic differences between the Euro Zone countries, with varying abilities to finance deficit spending and remain competitive within a single currency structure. Germany was able to keep inflation under control and producitivity high in the face of a strong euro, while countries like Greece and Spain have become even less competitive. These weaker economies are battling uncompetitive situations both outside and inside the Euro Zone. The "one-size-fits-all" economic criteria, meant to keep the "fringe" countries in line with the big boys, are now coming back to haunt them. A shared currency has now forced Germany and France to respond as if their own sovereignty is under attack. Given the lax approach that Germany and France have taken to adhering to the Maastricht criteria, however, it is difficult for them to point fingers.

Brotherly Love

Despite how unpalatable it may be for these countries to provide help to their weaker neighbors, there may be no choice. If Greece were the first to go, we can envision a set of dominos falling as market participants drive up financing costs on a series of weaker European economies. This could threaten the stability of the entire Euro Zone, and the euro itself. Furthermore, the larger European countries have a good deal of exposure to the PIGS. A report from Societe Generale estimates that in total, European banks have an exposure worth US$253 billion to Greece and US$2.1 trillion to the four PIGS. German and French banks alone have exposures of US$119 billion and US$909 billion, respectively.

The initial reaction from some non-euro area countries, including the U.K. and Sweden, was for the countries requiring help to turn to the International Monetary Fund instead of their neighbors. Now, Sweden has said that if the IMF were involved, it would seriously consider joining a rescue package despite the fact that it is not a member of the euro. This announcement has sent shudders down spines in the U.K., who has its own mounting deficit and debt burden to attend. The credit agencies have warned that the U.K. is in danger of losing its AAA credit rating, making fiscal austerity a major issue in the upcoming election.

Going Global

The E.U. has a population of nearly 500,000,000 living on half the land mass of the United States. In 2009 they ranked first in total GDP with the U.S. a close second. To say that the E.U. is an important player in our world economy is an understatement. There is no choice but to make the euro work, but we believe that result will require greater political unity across its members. If the correct measures are taken, a crisis can provide a catalyst for real change.

The last major currency blowup, the Asian crisis in the late 1990s, laid the groundwork for a new economic force. Preconditions for aid from the International Monetary Fund forced many emerging markets to begin improving their fiscal situations. The results of the crisis were lower interest rates, reduced need for public borrowing and lower overall levels of debt. Lower sovereign bond yields also brought down other rates and encouraged corporations to borrow and grow in these countries. In 2002-2003 fiscal deficits as a percentage of GDP were roughly the same in developed and emerging countries. Today, the IMF forecasts that developed country fiscal deficits will be more than double those in emerging markets in 2010.

We believe strongly in the emerging market growth story over the medium to long term. We have discussed in many of our research pieces the argument that the emerging middle class will provide a boost to these countries, and fuel demand for commodities and other world resources. We are also encouraged that China is taking proactive steps to reign in its lending and control economic growth by raising reserve requirements at banks. Though equity markets react negatively in the very short term to news that China may be slowing, it is a positive step toward a more sustainable recovery. Some of these markets experienced dramatic runs in 2009 and were due for a consolidation, but we continue to overweight core emerging market positions and underweight Europe.

As we mentioned earlier, the U.S. must find a way to stimulate labor markets while continuing the process of deleveraging. This recovery is in no way off to the races, but we believe that the U.S. looks favorable relative to other developed markets. The dollar will continue to be the safe haven currency for the foreseeable future, and pro-dollar positions should help offset any equity weakness until the correlation again turns positive.

The low yields on fixed income securities in the U.S. are a challenge for investors. While we believe that there is not much room for yields to go lower, we are not convinced that yields will dramatically increase in the short term. Yields on municipal bonds also remain low, but we think that a carefully selected portfolio of munis is still appropriate for a taxable investor seeking income.

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