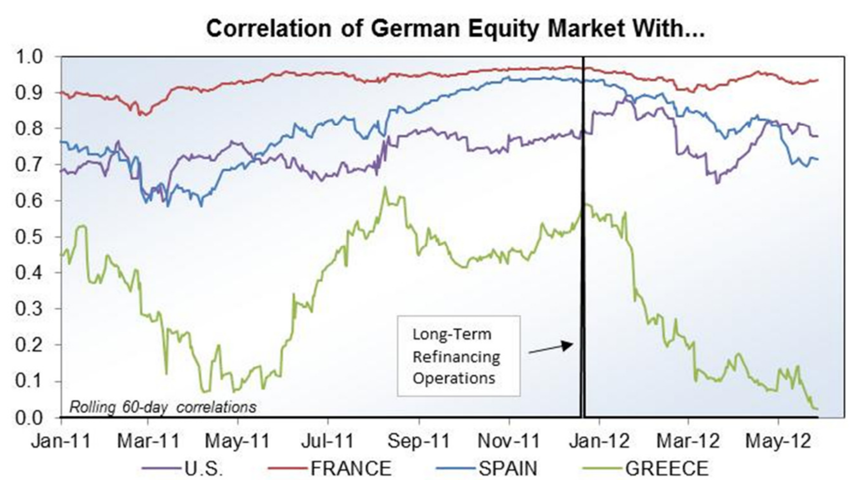
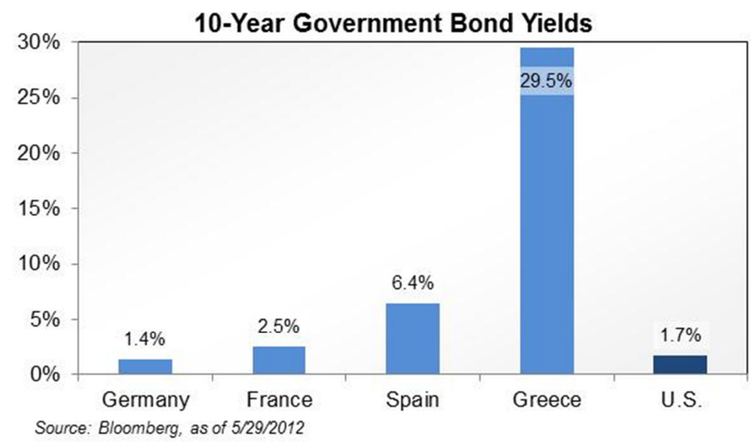
# *Miracle Mile Advisors Research Spotlight: A Tale of Two "Euro-Zones"*

The ongoing fiscal crisis in Europe continues to wreak havoc on financial markets. Since the German stock market peaked in mid-March, most global equities have fallen as the situation in the Eurozone has taken precedence over generally-improving macro data in the U.S. Equities in the U.S. have suffered along with the rest of the world, but to a lesser extent than their European counterparts. The purple line in the chart below shows the relatively-mild decline in the S&P 500 compared with benchmark indexes in Germany, France, Spain and Greece.


It appears that risky assets are being shunned by investors across the Eurozone, but the data tell a somewhat different story. The chart below shows the correlations of German equities with the markets in France, Spain, Greece and the U.S. One might surmise that the path of German stocks would be more closely tied to Greece than the U.S., but year to date this has not been the case. Since the European Central Bank launched its Long-Term Refinancing Operations (LTROs) in late December to backstop the banking system, the movements of Germany's stock market have decoupled from Greece and even Spain to some extent. We believe it is a good sign that investors are making distinctions between the riskiness of core (German and French) and peripheral (Greek and Spanish) European assets, and could be indicative of the markets pricing in some type of exit event for Greece.



Good news for Germany may be bad news for Greece. Investors differentiating between the risk of core countries (less risky) and peripheral countries (more risky) may be beneficial for the core countries, but a lack of pressure on German markets could make the country less likely to take drastic measures to save the alliance. German unemployment is at a 20-year low, and the country's debt has become a European safe haven asset. Investors are lining up to lend the country money for free. Last week Germany sold €4.5 billion of 2-year government bonds with a zero coupon for a record-low yield of 0.07%. Factoring in an annual inflation rate of about 2.5%, investors are willing to accept a significant loss on their investment in "real" terms (in other words, after adjusting for inflation) for the relative safety of German debt. A growing group of European leaders – including those of Italy, France, Spain, Greece and the International Monetary Fund – are lobbying Germany to back the creation of a new Eurozone-wide bond (Eurobond) to help finance the debt of the failing nations. Unsurprisingly, Germany steadfastly has opposed backing a Eurobond. These bonds would significantly raise Germany's cost of debt financing since the risk of the peripheral countries would be imbedded in the new, Eurozone-wide yields. This scenario puts Germany in a precarious situation. If the country refuses to back the peripheral countries with fiscal measures, the risk of Greece leaving the Euro is high and could be followed by a cascade of Spanish, Portuguese and Italian dominoes. If they agree then the Germans give up the economic benefits they have accrued from a strong economy and a weak euro, which has supported Germany's export-led economy.




Perhaps Germany should look to the collapse of Lehman Brothers in October 2008 as a guide. The ensuing banking and liquidity crisis in the U.S. showed that certain institutions really were too big to fail, and it is highly likely that the same is true of a European country. In the wake of Lehman's bankruptcy larger and more solvent U.S. banks bought up their distressed counterparts – either willingly or with the prodding of the U.S. government – and took on their troubled balance sheets. Although the domestic banking sector still has problems to solve, it has rebounded well beyond a point imaginable in October 2008. The Financial Sector SPDR Exchange Traded Fund is up almost 140% since the market low in March 2009 and liquidity concerns largely have disappeared. A critical difference between the U.S. and Europe, however, is that the Eurozone lacks any kind of political or fiscal union to enforce cooperation. The European Central Bank possesses authority only for maintaining price stability (monetary policy), and thus far has been reluctant to overstep its mandate to force the hands of political leaders to implement fiscal solutions as well. It is extremely difficult to predict the ultimate outcome for the European Union.

We believe that short-term tactical moves must be made during times of extreme macro uncertainty. The structural challenges in the Eurozone are significant and we maintain our belief that in the near term potential risks still are to the downside for those equity markets. Accordingly, we recently added the U.S. Dollar Index Bullish ETF (UUP) to our tactical holdings. As the troubles in the Eurozone intensify, the Euro will likely continue to weaken against the U.S. dollar. UUP should benefit from this weakness since well over half of the fund tracks the movements of the U.S. dollar against the Euro. The dollar also tends to benefit from safe haven capital flows when risk-bearing assets in general suffer. We remain committed to our overweight position in U.S. large-cap equities and underweight position in Developed International equities.

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