

Enlightening Irony?

Investors are in a surreal world where the financial markets jump up or down with great magnitude based upon headlines from Europe. Offhand comments by obscure finance ministers across the pond seem to overwhelm any competing domestic corporate, economic or political news. We understand that Europe is important in the world economy, and that if things go badly there, they could go badly here as well. Indulge us, though, in observing three ironies before we point out a key market “battle” for the coming year.

The first irony is that the current problem centers upon Athens and Rome, the cradles of Western Civilization. The Greek city-states provided the intellectual spark, and the Roman Empire provided the organization, to lay the foundation for our modern world, at least in the U.S. and Europe. If you were writing a financial potboiler 20 years ago, in which crises first in Greece and then in Rome brought down the world financial system, editors probably would reject this as too pat a plot element. Now, that is exactly what doomsayers fear. For irony at the beginning of what was supposed to be the “Pacific Century,” this is hard to beat.

Our second irony focuses on what gets debt-issuing nations into trouble. For decades, what we referred to as “third world nations,” then as “less developed countries” and more recently as “emerging markets” repeatedly borrowed money in strong foreign currencies for projects that would pay off, if at all, in weak domestic currencies. If Argentina borrows \$1 billion in dollar-denominated debt and their economy deteriorates, their currency will devalue to adjust and fix things, but the burden of the strong-currency debt grows. It is as if losing your job caused your mortgage to double. The developed nations running the International Monetary Fund would wag their fingers and lecture the emerging economies about the need for austerity, the imperative to get their house in order and the folly of racking up big debts in foreign currencies. The emerging markets persevered and finally strengthened their balance sheets. What did the “advanced” nations of Europe then do? They recreated the exact same problem for themselves.

Europe formed its monetary union permitting Greece, Italy and other weaker economies to issue sovereign debt denominated in the euro. When Greece gets into trouble, it can no longer adjust to fix its economy by devaluing because it no longer has a currency to devalue. The Europeans intentionally imported into their monetary union the very same volatility that used to dwell in the emerging markets. Nobody should begrudge the emerging market nations, now primary creditors to the developed world, the urge to wag their fingers and lecture Europe and us about the need for austerity.

*“Not creating delusions
is enlightenment.”*

-- Bodhidharma

Our final irony involves Europe being the site of the historical period referred to as the “Enlightenment,” one of the precepts of which was the belief in the possibility, loosely speaking, of the perfection of humanity. With the freedom to use our intelligence to institute reason, freedom and democracy, we could make the world and ourselves better. Wonderful things came out of the Enlightenment era, but for our taste the Enlightenment thinkers, like modern-day Baby Boomers, were a little too impressed with themselves. The creation of the euro is a great example of Enlightenment thinking gone wrong, the victim of a concept the classical Greeks would understand well – hubris. How else to explain the fantasy that a region of almost constant conflict, of many of the most destructive wars in history, including two world wars in just the past century, would suddenly be filled with nations voluntarily, honestly, peacefully and even altruistically coordinating their fiscal policy as required to fulfill the requirements for a joint currency? In retrospect, this is delusional, and yet at the euro’s inception, everyone seemed to think it would work.

We prefer systems predicated on assuming continuous conflict and self-centeredness, since that seems more consistent with human nature. It is no accident that the most successful economic system, capitalism, and the most successful political system, ours in the United States, meet this standard. Adam Smith’s invisible hand relies on everyone following selfish endeavors. The checks and balances described in the *Federalist Papers* assume that opposing factions will stop at nothing to get their way, but the structure of our government makes it come out right in the end. Now, we understand that capitalism is under attack after the past few years and public confidence in our form of government getting it right is at low ebb, but in both cases, our response would be “compared to what?”

Our key market battle for 2012 should prove interesting. Usually financial market prices represent an overall compromise between the views of participants, and it is quite rare for two sizable groups to have what appear to be mutually exclusive beliefs. Consider, though, the believers in gold and Treasury Bonds. Gold has been on a tear, rising from below \$260 an ounce in 2001 to above \$1,800 this summer. Investors usually think of gold as a hedge against rapid inflation. Government bonds have also been on a tear, with rates on ten-year Treasuries falling from above 6.5 percent in early 2000 to below 2 percent recently. Treasury yields move inversely with inflation – if inflation is rapid, the value of the dollars you receive when your bond matures is diminished. Gold buyers are betting on rapid monetary expansion, with more dollars chasing the same amount of goods leading to inflation. Treasury buyers are betting on deflation, an economic slowdown that causes prices to fall as fewer purchasers can afford goods. They cannot both be right. Our intellectual interest in this battle is high, but our self-interest in both groups being wrong is even higher. The best outcome for most investors is muddling through – a slowly growing economy while inevitable and badly needed deleveraging continues. Next year promises to be exciting – or perhaps we should say enlightening.