

Investment Update



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No More Cannes. No More Rhodes.

As words tumble onto the page, I am occasionally surprised by obscure vocabulary that springs unbidden from the recesses of my mind. One such set of words, emanating from the economic dialect, I have learned never to say out loud for fear of being mocked. It is "ceteris paribus," which translates roughly from Latin to "holding other things constant." In economic theory, the practice of illustrating, and essentially isolating, the normal relationship between two quantities by assuming that all other factors do not change can be helpful. For example, ceteris paribus, sustained increases in consumer spending result in higher GDP growth.

The problem, of course, is that few things remain constant in the real world, especially today, and other variables inevitably impact or interfere with "normal relationships." Policy makers in Europe and the U.S. have for years "kicked the can down the road" by postponing the need to reckon with rising public debt and unsustainable budget deficits. They have done so through the use of unrealistic assumptions and accounting conventions. As long as rates stayed low and investors played along, unsustainable conditions have been masked, giving the illusion that, rather than crashing down, they can be maintained indefinitely.

But now, as we see the contagion spread from peripheral Europe to the core countries, we are reminded that when investors decide conditions have become intractable (see, there is one of those words!) they will step away from the game, pick up their cans and go home. When investors won't buy a country's debt, yields quickly spike higher, shifting the urgency dial quickly from "future crisis" to "unmanageable" to "nearly impossible to contain." Debt service costs that were once feasible at low market rates quickly become unmanageable. This effect has been seen recently in Italy and Spain, and is moving in that direction for France. Even Germany appears to be seeing signs of reduced demand for its government debt if the poor reception for its bonds in a late November auction was any indication.

Along with a number of other indications of fear, greatly diminished liquidity and economic impact, it seems that, while perhaps not yet unmanageable, the debt crisis has shifted to a more immediate stage. Without more decisive response to the crisis, policy makers could find themselves with no more can and no more road to kick it down.

The Road Not Taken

To date, the European Central Bank and German policy makers have been unwilling to take decisive steps to stem the crisis and have steadfastly resisted growing calls from around the world for increased action. Their reluctance stems from a number of factors. One such factor is an understandable desire not to be left holding the bag as the lender of last resort, thereby paying for the perceived profligacy of other struggling euro countries. Their hard line may also be intended to prod recalcitrant politicians in these countries to initiate economic and political reforms prior to the ECB taking further action. Printing money to facilitate bond purchases would also be a bitter pill for German authorities, given distant but still strong memories of inflation resulting from monetization. Finally, the ECB places extraordinary value on its independence and is loathe to put it at stake.

At this stage, however, the crisis seems too far advanced to expect resolution from further half steps or outlines of plans. Markets have grown weary and leery of political speeches that sound bold but are quickly diminished by internal bickering over direction and magnitude. Only full-fledged commitment in the form of substantial bond buying or outright guarantee of sovereign debt seems likely to save the eurozone.

Ozymandias

I met a traveller from an antique land
Who said: Two vast and trunkless legs of stone
Stand in the desert. Near them, on the sand,
Half sunk, a shattered visage lies, whose frown,
And wrinkled lip, and sneer of cold command,
Tell that its sculptor well those passions read
Which yet survive, stamped on these lifeless things,
The hand that mocked them and the heart that fed;
And on the pedestal these words appear:
“My name is Ozymandias, king of kings:
Look on my works, ye Mighty, and despair!”
Nothing beside remains. Round the decay
Of that colossal wreck, boundless and bare
The lone and level sands stretch far away.

— Percy Bysshe Shelley

Kings of Nothing?

Failure to prevent a disorderly breakup of the eurozone and the resulting global economic chaos while there remain tools at hand is unfathomable. Despite understandable misgivings, it would certainly appear that the costs of further inaction greatly outweigh the costs of a “Shock and Awe” current response. To exert tyrannical independence now risks a European banking system collapse with global repercussions. This would leave the ECB, to quote Percy Bysshe Shelley’s great poem “Ozymandias,” a “shattered visage” ruling over an economic desert where “lone and level sands stretch far away.”

At this writing, it appears possible that market and economic conditions have deteriorated deeply and rapidly enough that global policy makers realize that coordinated response is urgently necessary to prevent an uncontrollable crisis. While damage has been done

that will not immediately be erased, the damage is not yet irreparable. A favorable initial response to coordinated cuts in dollar funding costs to provide liquidity for European banks by a number of central banks including the Federal Reserve, along with a cut in Chinese reserve requirements, suggests the market will applaud further decisive action. It also is a reminder how precariously the balance now hangs. The situation remains quite complex and, based on past experiences, room for disappointment still exists. However, we think markets will be greatly relieved if action takes the place of words. A great many challenges will remain on the road to full recovery, but removing such a clear near-term risk should help confidence immeasurably.

In the U.S., improved economic data also has helped to reduce the gloom somewhat. Those who had a view that a return to recession was upon us or was inevitable may be adjusting their probabilities downward. Although the “super” deficit committee managed to disappoint even meager expectations, its failure didn’t really come as much of a shock. We have maintained that any heavy lifting on deficit progress likely will wait until after the presidential election. The current climate of polarity, perpetual campaigns and incivility preclude the possibility of any significant near-term action.

While our politicians are in no danger of having their likenesses carved and placed on pedestals, we hope they heed the traveler from an antique land. The time to act is when the “sneer of cold command,” so well captured by Shelley, still carries an ability to create or to change. While markets today remain willing to fund our debt at low levels, the lesson of what happens when investors irrevocably lose confidence and trust no longer lies in a distant desert, many years away.



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