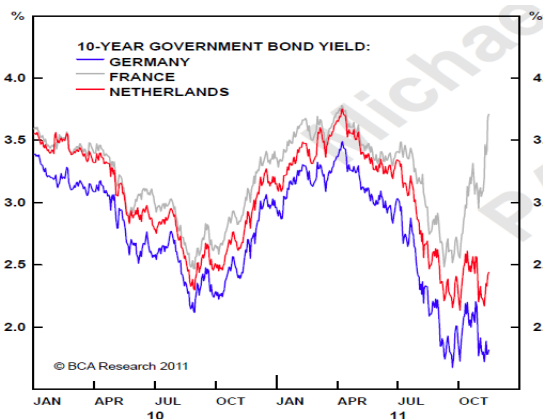


# Tipping Point

## Europe is Reaching a Tipping Point

What once was a peripheral issue in Europe is now reaching the core. France is now squarely in the crosshairs of markets as its 10-year bond yields move higher and widen against German Bonds (chart 1) and wholesale funding sources, which banks depend on for a good deal of capital, are largely frozen.



(CHART 1) Source: BCA Research. [BCAresearch.com](http://BCAresearch.com)

we can not discount the possibility that European powers will make similar mistakes as Henry Paulson and Co. did in 2008 when he fired his “bazooka” to nationalize Fannie Mae and Freddie Mac and let Lehman fail.

### Why is France so important?

Three main reasons. First, France makes up the second pillar of the EFSF fund which depends on the AAA credit rating of both France and Germany to make it viable. As one of the largest contributors to the fund if French yields continue to rise rapidly its fiscal position deteriorates and increases the probability of a credit rating downgrade. A credit downgrade would compromise the EFSF fund and erode confidence that peripheral countries can be supported. This leads to more contagion and fear which begets higher yields and around the merry-go-round we go. Secondly, French banks hold a considerable amount of French sovereign debt and they are already exasperated with stretched capital positions and dependence on short term wholesale funding markets which are now largely closed. Finally, French banks are some of the most leveraged and as demonstrated in 2008, holding leveraged assets of questionable quality in a credit crunch is a recipe for disaster.

### What Can be Done?

It is our view that Germany, who is the task master and controller of the purse, will likely allow the ECB to become the “lender of last resort” and back the banking system. In addition, they will need to allow lending institutions time to recognize losses. —(continued Page 2)

Stealth bank runs are occurring in larger size as depositors in weak countries flee to Germany and Switzerland in fears their Euro denominated deposits could be replaced with less valuable Liras or Drachmas. Like the Black Plague of the fourteenth century, the situation has become a sickness spreading from one country to the next and now threatens France, which is of great importance. However, the difference between the plague and issues currently infecting Europe are correctible and systematic failure can be avoided if the ECB chooses to do so. While we believe there is a good chance the high road will be taken,



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Pushing banks into immediate losses only creates more systematic stress and fear and is counter productive to the ECB becoming the lender of last resort. One only needs to look back upon the Great Depression as a history lesson — Andrew W. Mellon, US Treasury Secretary under President Herbert Hoover, was famous for advising President Hoover “*to liquidate labor, liquidate stocks, liquidate farmers, liquidate real estate...it will purge the rottenness out of the system. High costs of living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up from less competent people.*” The advice was taken and over 1/3 of the banks in the US were liquidated which intensified problems and propagated a greater level of despair than necessary. If Europe wants to avoid these pitfalls it will wisely back the system and adjust the banks on a gradual basis.

### Why Would Germany Promote This?

While we have heard many opine on why Germany will not intervene, we believe Germany will step in sooner rather than later for the following reasons. First off, France is now being threatened, which suggests time is of the essence. The market has forced Germany’s hand and they no longer have the choice to wait as the core is now being impacted. Furthermore, contrary to many who believe politicians are just ignorant, we think the German CDU (Christian Democratic Union) political machine is trying to extract as much gain and leverage as possible. By playing the game of brinkmanship they have effectively bounced Berlusconi and others they viewed as *Untermensch (inferior)* out of office in their respective countries. Replaced by technocrats, Germany can push their will and get these countries to agree to a more prudent “German” way of life. Finally, in the end it will be an easy sell to the German people, especially to the CDU’s *Mittelstand* constituency who Merkel is dependent on for re-election in 2013. By getting the ECB to become more monetarily accommodative and taking the role as lender of last resort Merkel evolves as the hero and the Euro weakens all to the benefit of its industrial exporting constituency. What better way to reach out to these small and mid-sized industrial companies in an election year than by helping their pocketbooks!

### What if We are Wrong?

If we are wrong and the road described above (or one very similar) is not taken then we are of the viewpoint a severe 2008 credit-like scenario could take hold as confidence is destroyed and capital markets come to a halt once again. This would lead world equity markets into a rapid decline, probably not to the levels of 2008 but close. In addition, corporate bonds, Emerging Market bonds, commodities and even gold would face a precipitous drop as deflation fears firmly take hold.

### What To Do?

In either event, the rule of the day is to remain flexible. While it largely depends on your individual positioning (and suggesting a customized portfolio is outside the scope of this write-up), we can discuss our firm’s strategy at an asset allocation level to perhaps help guide you. At the outset of 2011 we took a cautious outlook on the equity markets by purchasing year-long ETF put options and while we remained equal weight to equities versus benchmark, these equity holdings were hedged to limit downside risk. We continue to view this as prudent as well as capable of handling the binary events we think are on the horizon because the strategy deals with both outcomes sufficiently. If the equity markets rebound clients will participate in those gains, as the put options cost only a fraction of the overall portfolio, while if the market declines precipitously they are well protected. — *(continued page 3)*

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*By getting the ECB to become more monetarily accommodative and taking the lender of last resort role, Merkel evolves as the hero and the Euro weakens all to the benefit of its industrial exporting constituency.*

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## Europe is Reaching a Tipping Point

As for other asset classes, we are underweight bonds and short duration versus benchmark as we view the asset class as “long-term” overvalued. With that being said, we have increased our exposure to volatility related strategies which provide enhanced yield and the ability to buy back into equities or fixed income at more attractive levels. *(This is just a broad view of our strategies and if you would like a more detailed look of our portfolio or desire a comprehensive discussion regarding your personal portfolio we encourage you to contact our office. We can set up a time to analyze your holdings, stress test your portfolio and provide individual guidance.)*

### Conclusion

The near term will continue to be racked with high volatility as the tipping point is likely approaching. We will be carefully observing key interest rate levels and credit default swap markets and monitoring ECB balance sheet size to garner clues as to whether the institution will indeed proceed with becoming the lender of last resort. In the mean time, we intend on remaining flexible, dutifully preparing for opportunities that will arise from any market dislocations. We suggest you do the same.



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