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# Core problems in Europe: Options, Solutions & Possible Outcomes

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### 2011 U.S. Outlook

GDP Growth	1.8%
Unemployment	9.0%
Inflation	1.75%
Fed Funds Rate	0.25%

## Summary -- Investors at the Gates

Europe is under fire. One by one, the markets are forcing highly-indebted nations' hands, making the politicians decide what they will do to rescue the structure and future of the Euro monetary union. While this statement sounds exaggerated, we believe the markets are providing a needed shock to the European Union (EU). Economic shocks are seldom pleasant. We in the U.S. went through our shock in 2008 – 2009. In our view, the EU and European Central Bank (ECB) are going through this process.

At the end of the day there are, according to our analysis, five options the leaders and people of Europe can take to solve their dilemma. None of the options we foresee are pleasant. However, like here in the U.S., decisions need to be made regarding an obviously dysfunctional monetary/banking system. These decisions have yet to be made, and in our opinion, the real issue at hand (survivability of the Euro as it now stands) has yet to be questioned.

It is our opinion that the current structure of the Euro as a central currency is at risk. The true core of this disease needs to be addressed, and not simply the symptoms of the disease. This, in our opinion will eventually occur, but while this shock is happening, the overall economic and market environment in Europe may indeed continue to struggle.

## Europe, Dysfunctional Europe

First, here is a quick primer regarding the Euro currency and the ECB. The Euro is the official currency of 17 of the 27 member states of the EU. The EU was started for two primary reasons: first, to create a block of countries which can trade more freely with each other – create a “trading union” that resembles the individual states and the confederation between the states in the U.S. Second, the EU (and the Euro currency) was created so all member countries would have strong ties economically with each other so as to make conflicts potentially very painful.

This is a part of the world which has literally blown itself up on four occasions in just the past 200 years, with a legacy of political, social and economic fragmentation ever since Visigoths and Vandals occupied Rome 16 centuries ago.

Simply counting the military who died during World Wars I and II, just a fraction of the suffering Europe endured in the 20<sup>th</sup> century, we can see (in the table below) why Europeans have largely confined current conflicts to the financial and political realms.

### World War I and II Military Deaths in Millions

Russia	26.7
Germany	10.1
France	2.2
United Kingdom	1.5
Italy	1.0
United States	0.5

Source: Wikipedia

It is easy to understand, when looking at this stark data why leaders in Europe and the people of Europe wish to live together in harmony. At the same time, there is fear of the potential consequences of an iron curtain of debt and the historical specters of rampant inflation, declining living standards, population exodus and social unrest. A question for the second decade of 21<sup>st</sup> Century is: Can Europe draw on the positive experience of its post-Cold War successes to address the current crisis, or will the region become more dysfunctional?

The euro is the second largest reserve currency in the world, and the second most actively traded currency in the world behind the U.S. dollar. In July of 2011, there were 890 billion Euros in circulation. According to the International Monetary Fund, the Euro area represents the second largest economy in the world, behind the U.S. Consequently, what happens in Europe affects not only Europe but the rest of the world, through trade and the world's banking/currency systems.

### Shock, Discovery and Solutions

Economic dislocations are “discovered” and revealed in three stages. We in the United States are still going through this process, due to the core issue of too much debt and living beyond our means. Additionally, we as a people are discovering what we actually expect from government and other organizations in our economic system. The following is what we see as a roadmap regarding the U.S process on this economic journey:

- **Shock to the U.S. system:** This occurred from 2008 to early 2009 as the stock market swooned and the U.S. banking system coming was at the brink of seizure. The markets were telling us, quite loudly, that something was broken.
- **The Discovery phase:** This occurred from spring 2009 to 2010. The U.S. went through a process in an attempt to discover what had happened. First, people focused solely on real estate. Perhaps we built too many houses. No, the problem is broader than that. Next people focused on the financial system – perhaps our financing system was too loose. Indeed, a serious problem which needed to be addressed, as it was part of the mechanism which exacerbated the debt problem. Was this the core problem? We don't believe so. Up to this time, people were focusing on symptoms of the problem – not the problem itself. The focus then shifted to overall debt – a people living beyond their means – and the functions of our institutions, mainly government. What do we expect from government and what are we willing to pay?
- **Solution phase:** This is the phase the U.S. is currently experiencing. This is taking the form of a dialogue between Americans. The dialogue has taken on multiple forms and venues, from Occupy Wall Street to the Tea Party. Perhaps a consensus may emerge that reflects an understanding of the disease and its causes such as too much debt due to too little productivity and too much spending. Then the question will become, what are we going to do about it?

We suggest that Europe is going through the same process; they are simply one step or so behind the U.S. They are currently experiencing the end of the Shock phase and are starting the Discovery phase of their economic journey. In our opinion, leaders and others in Europe are attempting to find out what went wrong with the Euro experiment.

So, what has gone wrong? In our opinion, we believe the actual structure of the Euro, and the powers afforded individual countries has been ill-structured from the start. There are three major macro control levers most governments have to control a nation's banking, currency and economic systems. These three control levers are:

- **Monetary policy.** This is the function of central banks. If an economy is slowing, historically central bankers (Federal Reserve, etc) have the charge of spurring economic activity through “loose” monetary policies. If inflation is rising, monetary policy controls are to be utilized to slow economic activity, thus bringing down final demand pressures and lowering inflation. In Europe, the central banking problem is irritated due to the “single mandate” which that banking system utilizes, focusing solely on price stability, and not economic growth. Are the Europeans, which are driven primarily by the German economists, able to effectively handle all the needs of the continent?
- **Fiscal policy.** These are the taxing/spending policies of sovereign nations. These policies (if you believe the tenants of Keynesian economic thought) are to be utilized to spur economic activity (raising government spending/lowering taxes) or reducing economic activity due to rising inflationary pressures (lowering spending/raising taxes). If a budget isn’t balanced, a country’s Treasury, backed by the central bank, either borrows money or prints currency to make up the spread.
- **Currency policies.** Put another way - devaluation policies. Additionally, if a country wants to increase exports, the central planners can help accommodate this by lowering the value of the local currency, through purchase/sale arrangements. On the other hand, if a country believes their currency is too cheap, and is starting to increase inflationary pressures due to imports costing too much, they can take action to increase the value of their currency.

It is important to understand that the same policy makers need ultimate control over all three control levers for a macro economy to function reasonably well. We have control over all three levers in the U.S., as do most sovereign nations in the world. The member countries of the Euro do not all control all three measures. There are 17 different bodies driving fiscal policies for each of the countries individually. All of these countries are still sovereign states. Due to this the peoples of each country still elect their own public

officials, who make their own budget and tax policies. These policies are supposed to stay within acceptable deficit bands. When they don’t (as has been the case in southern Europe) problems erupt.

The other two policy levers (monetary policy and currency policy) are controlled by one authority (the ECB), but all policies apply to all countries, irrespective of fiscal policy issues. So, each individual country only has one discretionary lever to control economic policies for their peoples. There exists one monetary policy, and one currency policy, being driven by the ECB, for all countries, irrespective of individual monetary or currency needs. Basically, the system appeared broken from the start.

What happens when a member state suffers a slowdown in tax revenue in relation to a budget (economic slowdown causing a reduction in revenue)? Their deficit will be higher than projected. Now, when this occurs, money needs to be infused into this country to balance their budget. Where does this money come from? From the nations who have the capital. In Europe’s case, an example of a needy country is Greece, and a country that has capital is Germany. So, the German people are being asked to move capital into Greece, to finance their deficits. Again, remember these are sovereign countries, with their own constitutions and laws.

The second imbalance in Europe is due to the lack of individual countries having the ability to control their own monetary policies and currency policies. A nation’s monetary policy should be reflective of its competitive position on a world-wide scale. Additionally, such policy can compliment a nation’s fiscal policies of spending and taxation. For all countries operating under the Euro, only one policy is available – that policy is decided by the ECB in Brussels. A “one policy fits all” concept indeed may be reasonable if all countries operated under the same fiscal authority – which of course they don’t.

This second imbalance is exacerbated by the lack of individual countries exercising their own currency policies. A nation’s currency policy should be reflective, and will be reflective in the open trading markets, of that nation’s competitiveness, including trade balance. Operating under the Euro, all 17 countries are harnessed by the value of the Euro in

relation to trading partner's currency values. Many believe the Euro to be overvalued for Greek exporters (at current costs and currency conversion levels, the Greeks indeed may not be competitive) and undervalued for German exporters (arguably German exports and the German economy overall has probably benefited by the value of the Euro, which is lower than if the German Deutsche Mark was still in existence). This creates trade and economic imbalances which, because of the "one size fits all" currency policy of the ECB, is ill suited and creates distortions.

So, there are two fundamental "de-links" in Europe, at least in the Euro countries. In summary, these de-links are:

- A break between those parties which have the "authority" to balance sovereign countries' fiscal budgets and those parties who have the "responsibility" to balance the budgets if the first group fails to do so.
- Sovereign countries only having one control lever to utilize instead of the needed three levers. The one "lever" which countries exercise and have some degree of authority is fiscal activity. Individual countries have no direct authority on their own monetary policies or currency policies.

At the end of the day, we believe the people of Europe and the European leaders, are going through the Discovery stage of their economic crisis. It is our belief they will discover the base, core reason behind their economic woes isn't specifically a debt problem – rather it is an issue where economically, a "one currency" program not linked with direct fiscal authority and responsibility will not last.

### Potential Solutions

If our analysis of the shock and discovery stages of the European dislocation is reasonable, then what are the solutions that may actually solve the problem? Issue more debt? Borrow more money from the Chinese, the U.S. Fed or whomever? We think not. If the problem resides in the actual structure of the Euro system itself, let's look at some possible solutions:

- **People give up national sovereignty.** To tie the fiscal controls (tax and spending) with the centralized monetary and currency controls,

nations may need to give up their national sovereignty. In other words, people in Europe will need to act and believe themselves to be Europeans first, and Germans, French or whatever, second. This is the way the U.S. works. Most people in the U.S. first think of themselves as Americans, not Kansans, Californians or whatever. Are the peoples of Europe ready to make this leap? We don't believe that will happen anytime soon.

- **Wealth transfers.** Due to the non-competitive nature of one country to the other (for example, Germany relative to Greece) one country is being rewarded with a cheap currency while the other is being handicapped because of an expensive currency. To balance this out, some suggest that roughly \$260 billion would need to be moved from more competitive countries (Germany, Netherlands, Finland) to the less competitive PIIGS (Greece, Italy, Spain, Portugal) so as to balance their budgets. It has been suggested that such transfers take place as long as one country is less competitive than others – in other words, over the long run. We don't believe this to be a workable solution. In our view, the peoples of the wealthier nations will not stand for an approach that some might compare to redistribution of wealth in Rome in 410 A.D. or Russia in 1917.
- **A forced massive devaluation of the Euro in relation to other currencies to the tune of 40% to 50%.** This would make the weaker countries more competitive, but the economic fallout would be huge. Savings values would be halved overnight. Living standards would be negatively affected throughout the continent. This solution wouldn't work, as we believe social unrest would accelerate in smaller, less stable countries.
- **Fix the structure of the Euro system.** Combining strong, world-class competitive economies (Germany, France, Netherlands) with those which were inherently less competitive in 1999 was a mixture waiting for a disaster. It appears to us the Euro needs to change its form, with some of the members needing to consider abandoning the experiment. Some suggest that Germany leaving the Euro would be the less-

painful alternative than some of the weaker participants leaving and going their own way.

- **Grow their way out of the mess.** This is probably the preferred solution. Over the long term, many countries may be able to “slog through” this mess, creating balanced budgets, restructuring labor laws and making constitutional changes which would make sovereign countries more competitive, and the economic playing field more level. The real question here – will the financial markets be patient and allow this to occur? We wonder.

None of these alternatives appear attractive – there appears to be no easy way out of this problem. At the end of the day, we expect Europe to grow slowly, if at all during 2012, and perhaps longer. The problems facing the continent’s banking system appear to be systemic in nature, and not cyclical. If this is the case, the overall economic environment in Europe may be weak for some period of time.

### Alternatives

At the end of the day, we at Scout invest in companies, not countries. Within the European markets, many companies which we find attractive are located in the northern tier of the continent – Germany, France, the Netherlands and Scandinavia. Additionally, many of these countries receive a portion of their revenue from within the European borders. These are world-class organizations which are well-financed. Additionally, we continue to view valuation as one of the metrics behind successful investing.

To say the European markets are on sale is an understatement. However, Europe’s historical experience is that turbulent times provide long-term

opportunity for those who can see beyond a crisis and take a more global perspective. For example, some 750 years ago two merchant brothers from Italy faced a severe economic and political contagion originating in Greece (the re-conquest of Constantinople). Their solution in 1261 was to look to Asia for growth. The subsequent pioneering journeys of Niccolo and Maffeo Polo and those of Niccolo’s son, Marco Polo, would initiate a new era of trade with China. Over time, the relationship the Polo family formed with Kublai Khan would provide Western Europe with a new level of access that seeded the economic prosperity that helped catalyze and finance The Renaissance.

Outside of Europe, we are also looking more closely at Asia these days. Look for more thoughts about that in the months to come.



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