

December 8, 2011

Europe: Axis of Debt, Nexus of Recession

William B. Greiner, CFA

President and Chief Investment Officer
Scout Investments
Lead Portfolio Manager of
Scout Global Equity Strategy
william.greiner@scoutinv.com

2012 GDP Outlook

United States	1.80%
Eurozone	-0.50%
Emerging World	5.10%
Total World	2.70%

“Now we are the masters of our fate; that the task which has been set us is not above our strength; that its pangs and toils are not beyond our endurance.”

-Winston Churchill,
Washington, D.C., December 1941

Bankers in Brussels

Seventy years ago, on the day after Christmas, Britain’s Prime Minister addressed a joint session of Congress to express the urgency of saving Europe. This past week, as European leaders met in Belgium to discuss the Continent’s financial challenges, one cannot help but wonder if 21st century politicians can ever, ever avoid giving in to appease constituency groups and defer decision-making.

In Brussels, European leaders are attempting to construct enough governmental fiscal guidelines and controls to satisfy the European Central Bank (ECB). We expect the ECB to print money and buy sovereign bonds aggressively, effectively “kicking the can” down the road. To what “can” are we referring? Well, the market can. The world’s bond investors have become pests to most politicians as interest rates, reflecting higher perceived risks, have risen on the Continent. Things seem tamer over the last few trading days as hopes are high the politicians will not disappoint.

The world’s economy, and specifically Europe’s economy, is at a stage where the politicians have to act. They have little choice. *If the politicians don’t announce a reasonable, workable plan to control and integrate member-country fiscal spending, we fear the markets will show little patience.* Consequently, we believe the European politicians (read Merkel and Sarkozy) will propose a plan that will be viewed as good enough by the markets. We believe both the French and German leaders understand what is at stake – the possible future of the Euro currency from a structural standpoint and a deep economic contraction from a tactical standpoint. Neither is tolerable by the electorate of either country.

More Economic Bad News

Economic activity in Europe is continuing to deteriorate. Timely indicators show that Europe is on the brink of a

serious economic contraction. The composite PMI of the Euro-zone (combining service and manufacturing PMI) has collapsed to below 50, which indicates the business side of the European economy is in contraction. This compares to the U.S. and the U.K. versions of this indicator, with both countries showing readings slightly above 50. The historical correlation between this indicators and Euro-zone GDP growth is very high, indicating that GDP growth in Europe may contract at a 1% annualized rate. Currently, consensus forecasts for the Euro-zone growth are much higher than this indicator suggests.

What if Europe is in recession? Do European recessions look similar to U.S. recessions? What expectation should investors hold towards Europe if indeed we start to see negative GDP data? Let us look at the history books.

Looking at history from strictly a “Euro” environment is difficult, since the Euro currency has only been in existence since 1999. However, the big driver behind economic activity on the Continent of Europe is Germany. At \$3.31 trillion, Germany’s GDP represents the largest economic power on the Continent, followed by France, which is 23% smaller than Germany. So, if Germany falls into recession it is probably a safe bet the entire European economy will be near or in recession. We have significant German historical economic data to analyze. Consequently, let us focus on Germany and their historical standards.

Deutschland, Uber Alles? (Germany Above All?)

This, of course is the title to the German national anthem. History gives us a road map as to how European recessions differ from ours in the U.S. This time may be different (look out when an economist or market strategist says that phrase) as this recession may be balance sheet driven (excessive debt structure, malfunctioning banking system) rather than income statement” driven (excessive inventories, excessive inflationary pressures, etc.). If this statement is correct, this recession may indeed be deeper and more difficult to end than the typical cyclical recession.

That being said, from a historical standpoint, Ned Davis Research has interesting data regarding past German recessions. First, *the average German recession has lasted 27 months, as compared to the American*

experience, which has lasted an average of 11 months. Why do German (and European) recessions last longer than those in the U.S.? Two reasons come to mind:

1. **Labor laws.** Germany and much of Europe have very strict labor hiring/firing laws which are very protective of their labor pool. This allows businesses less flexibility to cut costs when economic growth turns negative. This in turn, increases the likelihood of deeper corporate profit losses which potentially lengthens an economic recession.
2. **Central banking activity.** The U.S. Federal Reserve has two mandates – maximum employment and stable prices. The ECB has one mandate – stable prices. Historically, the *Bundesbank* (German central bank) has been the economically and philosophically leading central bank in Europe. The German people fear inflation more than deflationary pressure, due to Germany’s experience during the 1920s and 1930s. With this in mind, most central banking activity in Europe has historically been centered mainly on price stability, with little attention given to full employment.

A combination of these two factors has led, at least historically, to the experience in Europe of longer recessions than has been the case in the U.S. All of this being said, and assuming a recession has started in Europe (ECB President Mario Draghi has said as much), history suggests Europe and Germany may continue in recession for the next two years.

Potential Stock Market Reaction

Astute readers may ask; don’t equity markets anticipate recession by declining some months prior to the onset of the recession? Our answer to that question is yes. Markets tend to predict the start of recessions (along with much else). The German stock market peaked on May 2 (Frankfurt DAX Index) at 7,527. Recently the DAX was trading at 5,072 (September 12th), down 32.6% from its recent peak. The index is down 37% from its high in 2007, as compared to the S&P 500 which is about 26% from its high in 2007.

Now the other side of this “anticipation” coin is market recovery. From a historical standpoint, the U.S. stock market has tended to anticipate the end of recessions

by four months (data from the end of World War II). In contrast, the German equity market tends to anticipate an end of their recessions by 11 months.

Consequently, given historical data, and assuming a recession has recently started in Germany/Europe, we can draw the following *very rough* potential conclusions:

- The European roadmap would indicate that if in recession, the recession may last until the 2nd half of 2013.
- The European stock markets may indeed start anticipating the end of that recession by the 2nd half of 2012.

Contagion for the U.S.

Europe seems like a long way away from the U.S. Most Americans have historically viewed this to be the case. With more than 3,600 miles between New York and Paris, and a generation or more separating those with first-hand experience of 20th century conflicts with many of those who speak of current domestic imbalances as “economic warfare,” it is easy to understand why some Americans seem isolated from Europe’s problems. However, Europe is a major trading partner. As a matter of fact, when one considers both imports and exports, the Euro-zone represents the largest trading partner for the U.S. (\$559.4 billion in total trade, as compared to Canada at \$525.3 billion).

Looking strictly at exports, Canada remains the U.S. largest trading partner, with exports from the U.S. to Canada at \$248.8 billion, with the Euro-zone close behind at \$239.8 billion of goods going to the EU. Exports to Europe constitute 1.7% of overall economic activity in the U.S. So, some say, let Europe go into recession. That in and of itself is not enough to drag the U.S. into recession. Right? Don’t bank on it.

Europe’s and America’s banking systems are intertwined and interlinked in many ways, and the European banking system is in dire need of recapitalization. Many of the major banks in Europe are currently significantly undercapitalized, and ill-suited to

withstand a deep recessionary environment without strong central-bank support.

European banks have sizeable interests and banking activities within the U.S., and some also have relationships or provide financing for major non-profit organizations here. Activity from these organizations may indeed slow, due to a slowing of economic activity in Europe.

Additionally, the rest of the world is tied to Europe from at least a trading standpoint. China exports more goods to Europe than to the U.S. China traded \$298 billion of goods with the U.S. (as of 2009). That same year, China traded \$441 billion of goods with the EU. Consequently, if Europe is moving into recession, the impact to the Chinese growth engine will be significant. Indeed, many analysts believe China’s economic growth rate in 2012 will slow significantly from 2011 (we concur). As one of the world’s main growth engines is slowing, this indeed will have an impact on U.S. economic growth.

Is the U.S. heading towards recession? It is possible. We are suggesting a 30% probability that the U.S. will be in recession during 2012. This is not our base case economic outlook for the U.S. We haven’t seen enough evidence to support the case that the U.S. will slide into an outright economic contraction during 2012. However, the possibility of this occurring is much higher than normal.



William B. Greiner, CFA

President and Chief Investment Officer
Lead Portfolio Manager of Scout Global Equity Strategy
Scout Investments

DISCLOSURE AND IMPORTANT CONSIDERATIONS

Scout Investments, Inc., headquartered in Kansas City, Mo., offers equity and fixed income investment management strategies for institutions and individual investors through separate accounts and the Scout Funds. Domestic large cap, mid cap, small cap, international, international small/mid-cap, and global equity portfolios are offered through Scout Investments. Fixed income portfolios in core plus, core, intermediate, long duration, low duration, unconstrained and real return (TIPS) are offered through Scout's fixed income division, Reams Asset Management. Scout Investments is a subsidiary of UMB Financial Corporation.

This report is provided for informational purposes only and contains no investment advice or recommendations to buy or sell any specific securities. Statements in this report are based on the opinions of Scout Investments and the information available at the time this report was published.

All opinions represent our judgments as of the date of this report and are subject to change at any time without notice. You should not use this report as a substitute for your own judgment, and you should consult professional advisors before making any tax, legal, financial planning or investment decisions. This report contains no investment recommendations and you should not interpret the statements in this report as investment, tax, legal, or financial planning advice. Scout Investments obtained information used in this report from third party sources it believes to be reliable, but this information is not necessarily comprehensive and Scout Investments does not guarantee that it is accurate.

All investments involve risk, including the possible loss of principal. Past performance is no guarantee of future results. Neither Scout Investments nor its affiliates, directors, officers, employees or agents accepts any liability for any loss or damage arising out of your use of all or any part of this report.

"UMB," "Scout" and the "Scout" design – Reg. U.S. Pat. & Tm. Off. UMB Financial Corporation claims service mark right in "Scout Investments" and "See Further." Copyright © 2011. UMB Financial Corporation. All Rights Reserved.

NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE