

Germany: Trust but Verify

Germany is no island. No other country is in the same degree woven actively or passively into the world's destiny. Everything that happens afar involves the heart of Germany.

-- Oswald Spengler
Early 20th century German philosopher

Sovereign debt (the debt of governments, like Greece and Portugal) issues continue to plague Europe and impact financial markets across the globe, including markets here in the U.S. Will the strain on the European Union ultimately force the departure of one or more of its weaker members? Can the single currency survive? How can the European banks survive a default by one or more of its members since they hold so much of the debt? How far are the stronger countries, particularly the biggest, Germany, willing to go to provide financial guarantees to ensure the survival of the European Union and the Euro? These are the questions torturing investors and politicians alike. And in no place are these issues felt more acutely than in Germany, which would have to contribute the most to a rescue of its neighbors to the south. Michael Lewis, the acclaimed financial author, writes about Germany in the September issue of *Vanity Fair* magazine, and the following paragraphs summarize the main themes.

When the economic and financial history of this period is written in the fullness of time, Germany will likely be mentioned often for its large and important role for all that has and has still yet to occur. It will be a history of great wonder and of contradictions. The German economy and the financial habits of its citizenry provide a model of prudent saving and sound investment. The population is famously cautious and risk-averse. Leading up to the 2008 Financial Crisis, there was no great real estate boom in Germany. The practice of borrowing to fuel consumer spending is just not a part of the culture. Thanks to these good habits the German citizenry is in a position to consider bailing out the weaker EU nations as well as the European banks.

Yet many German financial institutions provided the fuel that drove the lending binge across Europe and the United States. They financed the frenzy in places like Ireland and Iceland and were large buyers of U.S. subprime mortgages. In those places alone it is estimated that German banks have lost over \$180 billion. German bankers were not

financially incented to make big, risky bets like their counterparts at U.S. investment banks were. Their salaries and bonuses were relatively modest. So why did they make big bets that in retrospect look quite reckless?

We can speculate on the impact of typical German mentality and behavior on these bankers as they made these decisions, but suffice it to say that the ability of Wall Street to make packages of risky assets look riskless proved to be remarkably successful in Germany – a place where trustworthiness and rules count for a great deal. If a U.S. investment bank could create a security that earned very high credit ratings and conformed (at least on the surface) to a number of criteria on a checklist, it found the German investment sector to be a great market in which to sell its wares.

Likewise, being trustworthy and rules-oriented allowed Germans to go along with the grand designs that cobbled together the European Union and the Euro. The Achilles' heel of these noble German qualities of trustworthiness and the honoring of rules is that, sadly, others may prove to be less trustworthy. When the Germans agreed to the single currency, they demanded a rule in the charter of the European Central Bank that they would never have to bail out another member country. That rule was violated last year to help Greece, and many Germans have been quite upset since. The Germans demanded that all the member countries that adopted the Euro conform to strict rules regarding budget deficits. Never could they imagine that the Greek government would fabricate its budget statistics. See the current issue of *Vanity Fair* for Lewis' somewhat more thorough and colorful version of Germany's financial story.¹ Be warned: this story is long, somewhat complex, and also disgusting; his analogies and his humor can be more than a little off-putting. But his analysis is certainly cogent. We attempted to deliver a clean and greatly shortened version here, I hope we succeeded.

So what are the scenarios going forward for the Germans? Obviously none of the alternatives is pleasant from the German point of view. Greece and other countries (e.g., Italy and Spain) leaving the EU would damage the German economy; those countries' own currencies would be so weak that their consumers would not be able to afford German goods. It also would be problematic for most of the European banks (including the German ones), which own so much of the weaker countries' debt.

The seemingly less painful way forward is for the Germans to agree to various forms of support of the Union as whole, which could include a greatly enhanced TARP-style rescue fund and the issuance of Euro bonds that are backed by the EU as whole (under the current system, individual members issue their own debt). These new Euro bonds could be used as an exchange mechanism for the banks to swap out their existing single nation bonds. While there has been and will likely continue to be lots of resistance from Germany and the other stronger countries to taking on more of the burden, the markets are likely to continue to push the policy makers down the path towards a closer Union and some form of EU-wide guarantee for the weaker debt. The one possible exception is that Greece, which is such a disaster, may end up being dropped from the Union. The

pressures are mounting, and the coming weeks are likely to bring some level of resolution.

None of the EU member countries is free from blame for the current situation. At this stage it seems the markets will no longer tolerate patchwork solutions but may well demand comprehensive plans to deal with a crisis that has been going on for the last 18 months. Plenty of pain has been factored into European share prices; those stock valuations are down to less than 9 times next year's earnings which, with the exception of the lows in early 2009, are as low as they have been in the last 25 years.²

From an investment perspective, our international value funds in particular should be very well-positioned to capture the potential upside from a meaningful resolution to the debt crisis (which may or may not be forthcoming). Our investment committee is monitoring the developments very closely and will continue to communicate our perspective as warranted.

Sincerely,



John M. Bussel
Principal, Regional Director

References

1. Lewis, Michael (September 2011). It's the Economy, *Dummkopf!* *Vanity Fair*. September Issue, 2011. Retrieved from <http://www.vanityfair.com/business/features/2011/09/europe-201109>
2. State Street Global Advisors (1 September 2011). SPDR EURO STOXX 50 ETF (FEX) Fund Overview. "FY 1 P/E Ratio", Index Characteristics Table. Retrieved from <https://www.spdrs.com/product/fund.seam?ticker=fex>

Hewins Financial Advisors, LLC ("Hewins") is an SEC-registered Investment Advisor.

The content of this posting is informational in nature and is based solely on the author's opinion. *To the extent any reader has questions regarding the applicability of any specific issue discussed in this article to an individual situation, the reader is encouraged to consult with the professionals at Hewins. Moreover, the reader should not assume that this general informational and educational material provided by Hewins serves as the receipt of, or as a substitute for, personalized investment, tax, accounting, and/or legal advice.*

A copy of Hewins' current written disclosure statement discussing advisory services and fees continues to remain available for your review upon request. We remind our current clients to please contact us if there are any changes in your personal/financial situation or investment objectives.