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8065 Leesburg Pike, Ste. 300
Vienna, VA 22182
www.keelpoint.com

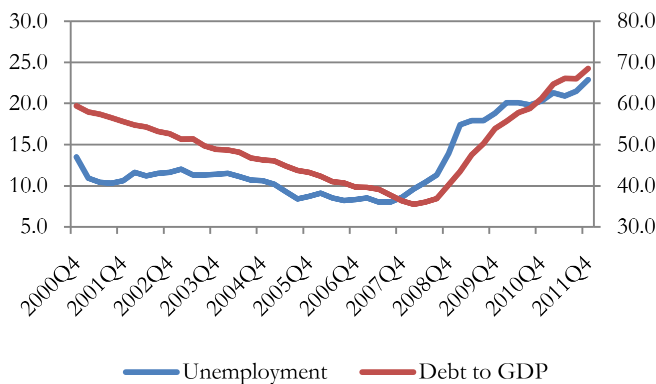
Update on a Volatile European Summer

Now that the European Central Bank's (ECB) €1 trillion worth of cheap loan anesthesia has worn off, Europe is once again mired in an existential crisis. In our January Bulletin, *Expectations for the Year Ahead,* we talked about three outcomes for the European crisis: miraculous resolution, disastrous dissolution, or, most likely, a series of Band-Aids designed to keep the euro zone intact. So the latest Band-Aid has lost its adhesiveness, what does that mean for the continent and concerned investors?

Bailouts & Integration

It is clear that the euro in its current form is not viable. The mechanisms necessary to make a disparate group of countries with different levels of economic competitiveness survive with the same unit of currency do not currently exist. A long term strategy to fix this problem continues to elude consensus, so the European Monetary Union (EMU) has been forced into more reactive, short-term measures. The latest of these is the bailout of the Spanish banking system. Announced in early June, Europe pledged €100 billion in cheap loans to help Spain deal with their crumbling banks.

Figure 1: Spanish Boom and Bust
Unemplyment Rate (%, lhs) & Debt-to-GDP (%, rhs)
Source: Eurostat



Unlike Greece, Spain's troubles do not originate in excessive government borrowing. Rather their debt-to-GDP was comfortably under 40% prior to the credit crisis (see Figure 1). Their problems originate in the housing sector and the banks that were loaning into it. We touched on some of the eye-popping statistics in our April Bulletin. In short, Spain had too many people employed building more homes than there were people to buy them. The bubble burst and Spain's economy has suffered mightily. As of April, the unemployment rate was 24.3%, double that figure for young people.

The banks held many of the housing loans and while they have been slow to recognize impairment, the recent flight of deposits has forced the country to ask for help. It came in the form of a promise to loan up to €100 billion to the Fund for Orderly Bank Restructuring (FROB), a Spanish government entity. As a result, the sovereign is now shouldering the burden for recapitalizing the banks and Spain's debt-to-GDP ratio is inching closer to 90% (not shown on Figure 1 as this number incorporates 2012 debt projections with the assumed FROB liability). At 90%, debt-to-GDP happens to be touching the threshold identified by Carmen Reinhart and Kenneth Rogoff after which countries struggle to grow (Spain's GDP growth was -1.3% annualized last quarter). Public debt has ballooned and has now become the problem.

Despite (or more likely, because of) the bailout, yields on Spanish bonds temporarily jumped above 7.0% for ten year debt. Seemingly each fresh auction of bonds sets a record for highest price paid by the country for financing since the creation of the EMU. Unless the ECB starts buying significant chunks of debt, it is hard to see a relief from the high yields. Of course, the other catalyst for relief for Spain and others is an agreement between euro countries to trade some sovereignty for a set of tools designed to arrest the debt crisis.

Eurobonds would be one such tool. Properly designed, they may solve multiple problems at once: the growth-choking debt of the periphery and the banking system's need for more "safe" assets denominated in euros. Proposals have been floated that would shift each country's debt in excess of 60% of GDP into a joint Eurobond pool that would be paid down over an extended period of time. The idea is that the struggling countries should be able to borrow at reasonable rates for their own debt up to the 60% limit and that the backing of all EMU nations will allow for easier financing of the surplus Eurobonds. After all, the combined debt of the currency zone is on par with that of the United States.

Naturally, there are few hurdles to this arrangement. First, countries would have to earmark revenue to pay down the Eurobonds. Unfortunately, identifying available revenue will be extraordinarily difficult for the peripheral countries that will make heaviest use of this program (Italy for instance). More importantly, Germany, as Europe's largest economy and creditor, has been reluctant to move in this direction. The strength of the German sovereign is critical to lend credibility to joint Eurobonds.

Another necessary tool is some sort of euro-wide deposit guarantee scheme. The Spanish deposit flight was a contributing factor to the request for a bailout. Contagion, one form of which is deposit flight from the weaker countries, is a significant concern. However, the

problems with a deposit backstop are loss of sovereignty and lack of credibility. A euro-wide regulator would need more powers over national banks to make it work and a large chunk of money would be needed to make it viable. Hardest to overcome is the fear of re-denomination: if my deposits are protected, but my country leaves the euro and re-denominates its currency, how do I avoid getting popped with a large devaluation? That said, these are just some of the changes that would be required for the EMU to stay a going concern with its current constituents.

Investing in this Uncertainty

The precarious position of one of the world's largest economic regions and one of the world's main reserve currencies is a huge concern for investors. Stagnant economic growth erodes corporate earning power not only in the EMU but across the globe as companies everywhere face lower potential exports to the region. Further, the euro has stumbled as its future is called into question. The lower euro certainly helps European exporters, and likely earnings, but hurts US based investors.

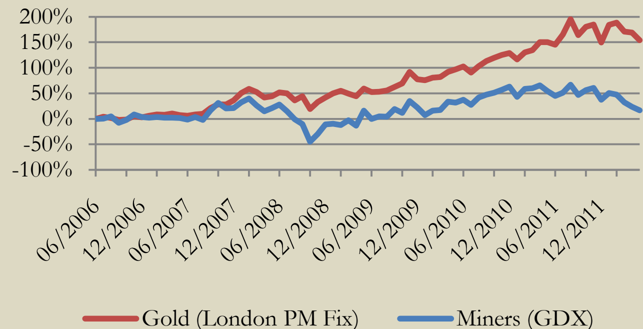
We have maintained lower portfolio allocations to equity wherever suitable in recognition of this huge unresolved issue (as well as other issues in the US). Further, within the non-US equity asset class, we have favored emerging markets equities relative to developed markets. A price to earnings evaluation would show that the cheapest companies to own are the developed non-US, especially European, firms. It may appear this asset class is poised to outperform. Our view is that a proper adjustment for the inherent macro, earnings, and currency risk negates the relative valuation advantage. □

Gold Miners: a Cheap Way to Own Gold?

Europe's woes spell trouble for much of the global economy and likely are a contributing tailwind for the demand, and by extension, price of gold. We see the value of an allocation to the metal in client portfolios but remain wary given its rapid rise. Gold mining companies, however, have not enjoyed the same exuberant rally and thus may serve as a less expensive access vehicle. Such a determination, however, requires a thorough examination of the reasons for the potential mispricing of miners.

Figure 2 shows the decoupling of the price of gold from the companies that mine the metal. We present data going back to the inception of the Market Vectors Gold Miners ETF (GDX) in mid-2006. The correlation between the ETF and the price of gold (represented by the US dollar afternoon fix for a troy ounce of gold at the London Bullion Market Association) has been 0.8 over the time period, but the miners have underperformed by a cumulative 137%. This suggests that shorting miners has been a good hedge for gold positions, but not a beneficial long portfolio position.

Figure 2: Gold Outstrips Miners
Total Return since June 2006
Source: Morningstar



There are a couple possible explanations for this return divergence. ETFs holding gold directly launched in late 2004 and quickly gained popularity. Investors now had a choice for their gold exposure: the ETF or the miners (or jewelry and gold bars). During periods of extreme market stress, the choice has clearly been direct gold exposure. Miners have sold-off in the same fashion as the broader equity markets while the gold slump has not been nearly as severe.

The other explanation is that these two assets are driven by fundamentally different variables. Miner share prices should be driven by projected future earnings and the riskiness of those cash flows. Global gold production has not been brisk and new opportunities are in less politically predictable regions. As such, it may make sense the miner share prices are stagnant. Gold prices, on the other hand, are not driven by cash flows, rather a whole host of variables: central bank reserve diversification, investor demand for uncorrelated assets and a store of value, jewelry demand, etc. Some or all may be underpinning the rise in the price of gold.

While there may be good reasons for the historical divergence, does that mean it is here to stay? We see the factors underpinning gold's rise persisting. Less clear is the catalyst that sparks a rally in gold miners. The two assets will likely stay highly correlated, and therefore share the same directional market movement, but it seems that a re-coupling is not imminent. □

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