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"After a large number of snowflakes accumulate, a snow cap builds on a mountain. At some point, a single additional snowflake creates an avalanche."

-STEPHANE DEO, GLOBAL HEAD OF ASSET ALLOCATION AT UBS, REFERRING TO THE LATEST EUROPEAN BANKING CRISIS

A desirable divorce and a questionable coronation? Charles and Louis Gave are one of the more successful father/son acts in the investment business, with Charles being the septuagenarian dad of the sub-40-year-old Louis. Yet, ironically, it was Louis who lured his pop out of retirement after a lengthy and stellar money management career to start GaveKal Research (along with co-founder Anatole Kaletsky).

They set up shop in Hong Kong shortly after the Asian crisis and thereafter diligently built a reputation for cogent analysis of China's extraordinary economic ascent. Yet, due to the fact that most of its principals were originally from Europe, and still maintain residences therein, they also have produced some of the better forecasts concerning the Continent. This includes their epic call that European interest rates were poised to diverge dramatically six years ago.

At the time, as hard as it is to believe today, government bond yields in Greece were almost the same as in Germany. Suffice it to say that the rate differential is just a bit wider these days. And, as such, their clients have benefited enormously from that inspired call. Additionally, while GaveKal is primarily known for its research, the company also possesses one of the best money management track records in Asia.

As most EVA readers are aware, Evergreen is now officially Evergreen GaveKal, based on the partnership our two firms established early last year. Consequently, my team and I have a ringside seat to the internal sparring, which is often as entertaining and kinetic as a heavyweight title bout. Fortunately, their tussles are waged with words, via email, rather than fists, but there are still some serious blows landed on both sides.

GaveKal, like most investment organizations, is characterized by some cavernous opinion divides. A few of its thinkers are much more favorably inclined to the "print and spend" policies of John Maynard Keynes and his accidental disciple, Ben Bernanke (who, in younger years, didn't seem to be headed for the Keynesian Hall of Fame). Others, such as Louis and Charles, are nearly diametrically opposed. They lean toward the Austrian school of economics, which believes there is no free lunch—least of all the kind central banks are serving up courtesy of their 24/7 printing presses.

In this month's guest EVA, Louis brings up the dreaded "D" word—as in divorce—with regard to Europe. This is an outcome that has been largely relegated to the junk folder since European Central Bank boss Mario Draghi issued his famous Dirty Harry-like challenge to those betting on a breakup of the euro currency union. But, as you will read in Louis' short piece, he believes an amicable dissolution is far less traumatic than the endless crucifixion of southern Europe's economies.

Then Charles, with tongue firmly in cheek, "recants" his Austrian economic beliefs and succumbs to worshipping at the altar of Keynesian policies. Employing a sarcastic tone worthy of his long-departed countryman, Voltaire, Charles outlines the futility of opposing the doctrine of this new global religion. He also discusses a recent papal coronation—only this pope sounds eerily like our very own Fed chairman. (To make it easier on EVA readers, I've added

definitions after a few of his terms.)

As you will see, when it comes to astute observations of economic and financial trends, the apple doesn't fall very far from the Gave family tree.

David_Hay_Signature

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IS DIVORCING AN ABUSIVE SPOUSE EVER TOO EXPENSIVE?

By Louis-Vincent Gave

An old joke asks "why does a divorce cost you half your money?" with the answer being "because it's worth it". After all, there is little worse than being stuck in a loveless, tense, or even downright hostile relationship. Which, of course, is what the eurozone has become, without even the excuse of keeping the show on the road for the kids' benefit. In the eurozone's loveless marriage, no-one dares to move out because the potential costs of that action are so unclear. However, with the news that French unemployment continues to scale record heights, that the Bank of Spain has just downgraded Spain's growth forecasts from -0.5% to -1.5% and that Spanish unemployment will consequently rise for a sixth year in a row to a likely record high of 27%, that European car sales continue to plummet, etc... the question remains open as to how much abuse the various spouses are willing to take?

For now Cyprus clearly wins in the battered wife stakes: daily cash withdrawals from banks are limited to €300, time-deposits (even those below €100,000) are frozen until further notice, etc. And needless to say, like every abusive husband, the Troika offered up the usual contradictory messages of "Cyprus was looking for its beating" and "it will never happen again". And so the question now faced by Europe's other, battered wives (i.e., investors in "fiscally-challenged" countries and other European Monetary Union bank depositors) is whether this abusive husband has seen the light? Or whether the next time the pressure boils, the Troika's punches will again fly, thereby extinguishing any notion of European solidarity, any dream of banking union, and any hopes that eurozone nations will stop sleeping in separate rooms and instead jump in the same bed of a common fiscal union needed to live harmoniously under a common monetary roof?

The "good news" is that Europe's battered wives may not have to wait that long to find out whether the Troika has turned a new leaf. Indeed, recent declarations by the International Monetary Fund (IMF) that Slovenian banks have some €7bn of bad assets to write off, along with the news two days ago that NOVA KBM, Slovenia's second largest bank, was downgraded by Moody's from B3 to Caa2, should, against the backdrop of Cyprus' large bank deposit losses, make it challenging for Slovenian banks to keep deposits. Now, we fully understand that Slovenia is not Cyprus, and that Malta is not Slovenia (just like Portugal was not Greece, and Italy was not Spain, and Spain was not Uganda...). But having said that, Europeans are not that different from one another (after all, wasn't this the premise on which the European Union was built!) and bank depositors in Slovenia or Malta must now be confronting a simple question: believe the Dutch finance minister that the treatment of bank depositors in Cyprus is a new

template to deal with bust banks? Or trust the European Central Bank's (ECB) recent declarations that Cyprus was a "one-time deal"? Needless to say, the risk is that Slovenian, Maltese and others around Europe conclude that, like most abusive husbands caught in the act, the Troika is probably speaking from both sides of its mouth and can no longer be trusted.

If so, a possible jog on the banks in Slovenia (the most likely next victim) will place the Troika in an odd predicament. For if Slovenia turns for help to deal with its challenged banks so soon after Cypriot depositors were left reeling, surely the Troika must apply the same tough love. Yet if Slovenia ends up getting softer treatment than Cyprus, can Nicosia really stick with a marriage where it is so obviously despised and mistreated? And how could Russia not take its dress-down as an extremely hostile act? On the other hand, if Slovenia also gets the full Diesel-bum treatment, the markets' faith in the ECB's ability to keep the show on the road will be properly shattered and a pan-European bank run might ensue. Hence, in Slovenia, the EU may soon face a Pyrrhic choice.

To end on a lighter note, we recall the story of a 95 year old married couple who went to their lawyers' office to file for divorce. The lawyer, a bit surprised, asks "why now?" Both husband and wife answered "we wanted to wait until the kids were dead". When it comes to Europe, let us hope that the divorce, however acrimonious, can happen before more economies die.

RECANTATION

By Charles Gave

Over the years a number of economists and political scientists have seen the error of their ways and come clean with a reasoned recantation. The mid-19th century British thinker John Stuart Mill famously changed his mind on the divisive question of industrial wages. My contribution to political economy hardly matches Mill's, but I have spent my adult life pondering the linkages between economics and markets. However, in recent times I have come to realize that I was wrong in my most basic understanding of these relationships. So for the edification of younger readers, and possibly future generations, I have composed a single document to explain my about-face; to my tormentors I hope this proves that I have left behind impure thoughts and incorrect reasoning!

My recantation will take the form of key lessons learned:

Lesson #1 Government agencies allocate capital better than the private sector

We have moved into a new world where it is no longer necessary to have the market decide short rates, long rates or, for that matter, the currency exchange rate. This happy state of affairs started with euro's adoption in 2000 and intensified in 2002 when US real interest rates were driven negative. Given the massive successes of these policies, the authorities have expanded their horizon to seize control of other troublesome prices such as salaries, either by fixing them (minimum wages and the capping of financial professionals' bonuses), taxing "excessive" remuneration (think anything above the minimum wage, especially in France). Even more creatively, new regulations such as Basel III or Solvency II have compelled savings to be invested in government securities rather than financing private sector capital spending. This properly "guided" financial system means a portfolio invested 50/50 in US and German bonds since 2000 has outperformed pretty much all assets with the exception of gold (we expect a directive banning the use of the "barbarous relic" anytime soon). Such a portfolio of government securities, I am told, will continue to outperform for the foreseeable future, and I, of course,

believe it. Moreover, the next step will be to control the price of disorderly markets that still exist for traded goods and salaries. And the perfectly dreadful free movement of capital will soon be brought to heel through foreign exchange controls. Hence, a portfolio of securities issued by such enlightened authorities will surely outperform for the foreseeable future.

Lesson #2 Central banks should control asset prices and prevent them from falling

The problem with capitalism (a most disruptive and chaotic economic paradigm as anyone with a proper historical understanding knows) is that asset prices can jump around depending on financial market participants' reading of "the expected marginal rate of return on capital". For this reason, central banks will soon act to phase out numerically inexact "expectations" since serious decision makers operate only in an environment of full certainty. This means that asset prices will henceforth only go up, and those market participants who disagree will be dissuaded through a restriction that makes "anti-social" trading activity prohibitively expensive (the Tobin tax on financial transactions). Unhealthy volatility will be removed by banning short sales. Another factor supporting prices is the punitive taxation of capital gains as very few wealthy people will now sell anything. And since such benign interventions must expunge risk from the economic system, it is only fair (and logical) to tax capital at the same rate as labor—France is, of course, leading the world.

Lesson #3 Darwin and Schumpeter were wrong, creationists are right; there is such a thing as a free lunch

I once thought that economic growth emerged from the unplanned process of "creative destruction" identified by a charlatan Austrian-American economist named Schumpeter. This was a misunderstanding since wealth and economic growth are both created *ex nihilo* ("out of nothing") by a benevolent god called "the state," whose role is to stimulate demand by buying goods and services that nobody needs with money that does not exist. This process, of course, leads to an ever rising standard of living. Such truth was revealed by a great prophet named "Keynes" who some years ago endowed a new church and its clergy of "civil servants" who obey the orders of their economist cardinals. Such fellows are beyond criticism as they selflessly strive to improve the lives of lesser mortals. For their service and their abnegation, they are usually very well paid (as the clergy class always is when it supports the dominant political power). They deserve their stipend, or at least this is what they say, and, of course, unnecessary questioning of settled truths can be a bad career move.

Lesson #4 Towards a new *orthopraxy* ("politically correct")

The promise of this religion is that compliance with the clergy's edicts will ensure a happy and prosperous life. How do the new economic clergy measure whether its followers' actions meet divine approval? By using a quantitative measurement called "the GDP"—a central feature of the Keynesian catechism that mixes added values created by the private sector through voluntary transactions and costs incurred by the public sector. These public sector costs are funded from taxes (the ignorant might assume such deductions would reduce incomes, but miraculously they do not) and through borrowings. It is an article of faith that any damage to the national balance sheet from the resulting debt will not be recognized. Hence, I will incant in a lusty fashion "glory to the GDP," even if my recidivist inner-self mutters a little like Galileo, *et pur si muove* ("the sun does move around the earth").

Lesson #5 Wondrous tools used by the clergy to grow GDP

The new clergy uses two tools to guarantee that GDP always gets bigger. It prints "money" which is used to buy government debt and in turn allows the clergy to purchase goods and services on behalf of a needy population. For sure, some citizens may crave worldly vices bought with their own money, but mercifully the good shepherds know best. In order to secure economic control the new clergy needed to capture the central bank(s). Of course, in any reformation there will be apostates; in this case the unreconstructed German central bank which continues to resist the doctrinal shift propagated by Pope Heli I, a brilliant theoretician from the new world who has even promised to dispense money from the skies. Pope Heli I, together with leading cardinals in Europe and Japan, detests the old elite and their quaint belief in monetary orthodoxy. Why this backward-looking ancien regime clings to its old fashioned "market fundamentalism" is beyond me. Looking back, I wonder how I ever supported a group that did not promise happiness on earth for all.

Lesson #6 How to finance infinite needs

This is where the miracle promised by the new faith manifests itself. The elected government issues debt in unlimited amounts to pay for the politicians promises. Hey presto! The old malediction of penury has disappeared as the ability to pay has been unshackled from any worldly constraint. This new debt is bought by the central bank on the most pious orders of Pope Heli I.

Heli I's omnipotence is revealed by his ability to part the sea of market turmoil and set interest rates on the new debt at zero. **Even if the government issues an infinite amount of debt the fact that it pays zero interest means the service cost will remain zero. Truly, water into wine!**

Only a small and increasingly marginalized group of deficit hawks fail to appreciate the beauty of the new construction. The true believers, who proudly proclaim themselves "deficits deniers" have seen the light and promise to lead their flock into a promised land of unlimited borrowing with no downside.

I am puzzled that no one has thought of such an idea before, but then again what need have I for reading history—especially economic history—when, like Heli I, I can rely on my models. After all, these new revelatory tools of science have passed all tests of statistical significance. It does not matter that their forecasts have been consistently faulty—the model is compliant with the Keynesian sacred books.

In summary my new faith can be understood as follows:

1. Government allocates capital better than the private sector, and should use interest rates, exchange rates, price fixing, price controls or whatever artifice it deems fit to ensure that capital goes to where it is properly directed.
2. The alpha and omega of the central bank's proper role is to finance government spending.
3. Money belongs to the government, as we have seen properly demonstrated this week in Cyprus.

4. Property rights, the antediluvian obsession of the market fundamentalists, have been subject to a doctrinal revision "the template" as also shown this week in the eastern Mediterranean.

5. As a result of this new paradigm, asset prices must rise for the foreseeable future so long as Heli I decrees that the money printers keep printing. How can asset prices fall while the US central bank is printing more than \$80bn a month? Even the unreformed Bundesbankers will surely grasp that if the European Central Bank did the same thing, the euro's problems would disappear overnight and prosperity would swiftly return to southern Europe, (Really, Germans should not be allowed into politics until they have had a primer indoctrination at either Cambridge or Princeton.)

6. More money creates more wealth, and more wealth, especially in real estate, creates more jobs—evidence to the contrary in Spain only represents a small setback on this road to happiness. As we all know, a rise in real estate prices leads to a massive increase in productivity, a prerequisite for an increase in the standard of living.

7. Services or goods provided to the population by the government, borrowing money from the central bank to pay the fellows who produce the goods that nobody needs with money that does not exist, will add tremendously to the GDP. This is a sure sign that the right policy is being pursued.

8. These goods and services anyway have a higher moral value than the ones produced in the private sector. One should simply compare the "social usefulness" (a favorite notion of Lenin and Stalin) of a nurse versus a hedge fund manager to be convinced. I rest my case.

So from now on, I will buy what the US, UK, French, Spanish, or for that matter Greek governments and central banks tell me to buy. I cannot afford to offend the new clergy. As a market "intellectual" the risks to my social standing, not to mention career prospects, are too high. One day if I keep my nose clean and my thoughts pure, I may just be admitted to the College of Cardinals.

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