MV Capital Management Thought Leadership

Liquidity, Credit and Solvency

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"You only live once" has become the popular catch phrase among the young crowd this year. YOLO – as the ubiquitous t-shirts proclaim on the Ocean City boardwalk where high school seniors from the DC area flock en masse for the annual rite of passage known as Beach Week. Back at MVCM, our days are more filled with the ongoing Eurozone crisis than with the pleasures of sand and salt air. If we were to come up with a situation-appropriate phrase that could be boiled down to a t-shirt slogan it would more likely be YOLT – you only live twice. As in that catchy theme song from the James Bond movie "Casino Royale", and as in the potential course of events for certain currencies that have already lived one life – the drachma, the peseta and the lira among others. The more the default solution to every perceived crisis flashpoint is to kick the can down the road – yet again – the more likely we think the outcome that we may once again be shelling out wads of lira for our favorite Italian leather goods and counting out the peseta after a satisfying dinner of *paella de Valencia*.

It's getting to the point where reasonable people will surely wonder if there is ever going to be a final act to this play. The pattern is stale and achingly familiar: crisis festers, crisis reaches boiling point, central banks make reassuring supportive noises, risk assets rise, nothing changes, borrowing costs inch back upwards, boiling point approaches again, risk assets sag, central bank platitudes ensue…ad infinitum ad nauseum. Markets go up, they go back down, and every time someone comes up with a "If the ECB says X, the markets will do Y" theory, the markets wind up doing Z instead. Consider the past couple weeks. On Monday June 11, trading opened with the weekend news of a bailout plan for Spanish banks – a modest one, to be sure, but a commitment (and admission to reality by the Spanish government) nonetheless. As the baton was passed from Asian markets to Europe and then North America general sentiment seemed to settle on the idea that this was a nice development – mind you, not because the $150-plus billion package was going to do much to help Spain, but because it increased the likelihood that Fed doves would come fluttering in with a new package of quantitative easing – QE3 – at the forthcoming June 19- 20 Open Market Committee meeting. That was enough to sustain markets for a few days of robust upside. Now that (as of today) the Fed has affirmed there will be no immediate increase of their balance sheet to accommodate a new QE3 program (but they totally, absolutely, positively will be ready to do so, should the need arise) there is another brief pause before the collective consciousness determines that it is time for a resumption of risk on or a return to risk off.

The two things we do know with regard to policy and the markets are (a) the stimulus packages and bailout measures, when they do come, are likely to keep a full-blown liquidity crisis from happening; and (b) solving the liquidity crisis is not solving the Eurozone crisis, because that is primarily a crisis of solvency, the solution to which lies beyond the mere printing and flooding the market with money. It's frankly a waste of time to look at movements in the stock market for clues about solvency risk. But ultimately the fate of Eurozone unity turns on the question of whether these peripheral economies can do anything to arrest the self-reinforcing downward spiral they are currently experiencing. If not, there is more likely than not going to come a point at which the best we can hope for will be an orderly break-up of the single currency zone and a second life for those bygone national currencies.

The problem with focusing exclusively on liquidity, as all the bailouts and other policy measures to date have done, is that they are aimed for the benefit of just one very distinct community – that of the creditors holding exposure to the troubled countries and their banks. "Liquidity" is simply supplying funds to assets where private demand is insufficient. In other words, holders of Spanish sovereign bonds or Spanish financial institutions have a willing buyer for their holdings at 100 cents on the dollar, rather than having to dump them into the market at reduced values from par. That benefits the bondholders, certainly. It also keeps a lid on the potential for widespread banking runs, a specter which hovers over Greece, Spain and

Italy like the proverbial Sword of Damocles. It benefits holders of other risk assets, like global stocks or commodities, because the tight web of global interdependencies means that very little time would elapse between a catastrophic run on Spanish banks and a collapse in the Nikkei 225 or Brent crude futures.

We don't want to understate the importance of this – we much prefer waking up on any given morning not having to contend with another 2008-style market meltdown. And we would be a bit more forgiving of the kick the can approach if it seemed like buying the extra time was helping policymakers get at the real underlying roots of the problems, and figure out what combination of national or regional policies really could put these countries back on a sustainable growth trajectory – at least to the point of seeing unemployment rates falling between the clearly unsustainable levels of 20% or more. But we're in the third summer in a row of the same discontent now – and while much time has passed the discourse has stayed the same. Paeans to the importance of unity and the need for austerity and all the rest. It's a stale discourse, well past the sell-by date. Unquestionably the best of all possible worlds is for the Eurozone to get back on course as a single currency union. The worst of all worlds would be a disorderly, chaotic break-up. In between these two extremes there have to be other alternatives. Starting up the peseta printing presses would not be without risk – but if that is to pass, better that it be from a planned and orderly program rather than from kicking the can one last time…over the cliff.

With warm regards,

Masood Vojdani
President

Katrina Lamb, CFA
Senior Investment Analyst

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MV Capital Management, Inc.
4520 East West Highway, Suite 400
Bethesda, MD 20814
www.mvfgroup.com
(301) 656-6545 tel
(301) 656-2722 fax

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