



OAKWORTH
CAPITAL BANK

COMMON CENTS

There is a book I keep in the, um, reading room. The title is: In War's Dark Shadow: The Russians Before the Great War, and it focuses on the events in Russian politics, industry, military, and society leading up to World War I. Admittedly, this isn't for everyone. In fact, it is for very few people; but, I like historical non-fiction, and have no problem picking it up and putting it down.

All told, I have probably read the thing some 4-5 times, although only once from start to finish.

What has always struck me was just how stupid the Tsarist government was, and how hopelessly, and effortlessly, the country stumbled into the First World War. As we all know, or maybe should, the country, as it existed at the time, didn't come of it alive.

When the end of the Romanov dynasty finally came, no one was really all that surprised. What was surprising was how relatively easy everything came down. Perhaps we have the benefit of hindsight; however, a blind man could have seen it coming, or so it would seem.

This year has started off surprisingly well. Now, I have been a little, shall we say, less than ebullient in my musings recently, but I try to write it like I see it. The US private sector is still deleveraging; credit standards have been thawing, a little, but still pretty tight; there is plenty of excess capacity in real estate and manufacturing, although we have been nibbling away at it; there is plenty of uncertainty regarding the tax code and the future machinations of our central government; corporate America has been posting some pretty stellar profit numbers the last couple of years, but you can't count on that to continue at the same magnitude. All told, when you add it all up, there isn't any reason to jump off a bridge, but I would also stop short of breaking out the champagne. The US should enjoy a mediocre year, in terms of economic growth, and that should be enough to keep profits at reasonable levels, meaning the stock market, at this point, is a decent bet relative to other asset classes.

There; that about sums it up. What has surprised me, and what continues to surprise me, is the situation in Europe, particularly Greece.

I was on a economic panel last week over at Samford University, and made a 'bold' prediction: "The euro, as we know it today, will cease to exist by the end of 2015." That is one of the safest things I can ever predict. Why? All they have to do is add one country or remove another, and the euro will cease to exist as we know it today. The ECB can also fiddle with the formula, and likely will if the current state of things continues. Throw in a 4-year time frame, and, voila, you have a seemingly 'salacious' prediction, which is really nothing more than "it will than likely rain pretty hard when that cold front moves through town."

The professor sitting next to me concurred, and, there you have it: my big prediction and some immediate validation. Even so, what I was really talking about was, and is, Greece. A blind man can see what is going to happen there.

As I have written in the past, I think here, government spending constitutes something like 40% of the Greek Gross Domestic Product (GDP). If they calculate things the way we do, government spending doesn't include simple transfers, which show up in consumer spending. In the US, these

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I am not yet ready to be Tsar. I know nothing of the business of ruling.

Nicholas II

A Random Discourse, *cont.*

would include things like Social Security, pensions, food stamps, etc.

Now, we all know Greece has to get its spending under control, right? I mean, it can't continue to borrow the way it has, because it is largely shut out of the legitimate capital markets. I guess that means the Greeks have to endure some pretty stringent austerity measures, huh? Let's say they cut spending some 10%, what does that do?

Well, if the budgetary cuts are evenly applied, that would mean a 10% reduction in the 40% weight government spending has. Multiply the two, and you come up with -4%. There, that is the starting point for the Greek economy, before it picks the first olive, makes the first bottle of wine, presses its first razor blade, ships its first container of whatever, or makes its first sweater, etc. As such, just to break even in the GDP equation, the remaining 60% of the Greek economy MUST grow roughly 7%.

Is the Greek private sector really that efficient? Particularly IF transfer payments are also reduced 10%? What would that do to the consumer portion of the C+I+G equation? It can't be good, right? As such, any austerity measure Greece undertakes to balance its books will throw the Greek economy into an even greater tailspin, which, ironically enough, will make their budget balancing a more tricky prospect. Compounding the problem is the euro itself: Greece can't intentionally inflate its way out of its debt morass, and it can't export its way to prosperity because it has to compete with other, more export driven economies using the same currency.

As a result, I think it very safe to 'predict' Greece will default on its debt at some point. I can't say for certain when this will happen, as I am even more unsure how much longer Germany and France, essentially, will be willing to finance this 'smallish' economy at the bottom of Europe. Smallish? Well, to put things into perspective: the Greek economy is roughly the same size as, well, Maryland's. Does that put it into a little better perspective?

What would happen to the global economy IF Maryland defaulted on its general obligation debt? Unleash the hounds of hell? Empty Sam's Wholesale Club of its canned goods and rice? Have you loaded up on your shotgun shells? I am obviously being sarcastic, but the point is: in global economic terms, Greece is the mouse who is currently roaring. So, why all the fuss and muss?

The answer is simple: European banks have loaded up on Greek debt in their portfolios. Unfortunately, the European banking system is far more concentrated than ours. This means the problems in Greece have a more immediate impact on the health on the European banking system, than any arising out of Annapolis would have in the US. Would a default in Maryland hurt? Sure, and plenty of people and firms would lose plenty of money, but we could, and would, make our way out of it with only some minor bumps and bruises.

But Europe? What can be done? Well, the truth of the matter is pretty simple: this has been such an amazingly drawn out crisis; it has been so public and so well-known, and we have been talking about this for years and years. We know it's a problem. We know Greece will eventually blow up. We know the Europeans have demographic and fiscal problems (the latter largely because of the former). We have seen it coming, haven't we?

Now, forget finance for a second. Consider your life experience. When a problem is well-known, and the worst case scenario well-discussed, how often does it come to that? If you are standing in the middle of the road, and you see a car heading straight for you, what is the problem? What is the worst case scenario? What is the likely outcome? Exactly.

That might not be the best analogy in the world; however, my experience has been the worst problems are those we DON'T see coming. You know, the ones that catch us unprepared, with the proverbial pants down. Those are the ones that cause the most problems, right?

After all, you would have to be a real dope NOT to take measures to mitigate your losses IF the end outcome is certain. In traditional American culture, you would "get what you deserve," right? In today's day and age, who knows if that still applies. In Europe, maybe that sentiment never existed. I don't know, as I am not a European, unless I am in the, um, reading room. Increasingly, I am of the opinion perhaps it didn't or doesn't. Perhaps you don't get what's coming to you in Europe. How else would you explain this agonizingly slow death scene? As though by a ham actor in a fourth rate play?

With that being said, IF the American banking sector is directly vulnerable to the inevitable default in Greek debt, you

A Random Discourse, *cont.*

know, the banking system was going to fail anyhow, as it was obviously being run by fools. IF our larger, multinational banks are indirectly exposed to the inevitable due to business dealings with European banks which are directly exposed, well, that is to be expected. IF they haven't hedged their bets and mitigated their downside, again, they were going to fail anyhow...being run by dopes as they were.

I guess you could say I am of the opinion if the inevitable Greek default results in a global financial system collapse it was going to happen anyhow because if the world's bankers are too stupid to get out of the way of a slow moving freight train, they are too stupid to being running multi-billion dollar financial services firms in the first place. Seriously.

This takes us back to the proverbial blind man: he sees this all coming. He started seeing it some time ago. So, if he can see it, why can't we? Why can't the Europeans? Why are they so intent on prolonging the inevitable? It baffles me, much as the events in Russia leading up the First World War do/did. How could you NOT see autocracy was dead in the Industrial Age? How could you NOT see the time of tsars was long past? How could you NOT see the inefficiencies in the Russian military and economy, particularly when compared to the German Empire AND go to war against the latter? How could you NOT see the inevitable, and, at the very least, get your wife and children out of the cauldron of the February Revolution AND to Finland, or elsewhere, anywhere? Why?

Well, because Nicholas II was a fool, and he basically got 'what he bargained for.' Are we, and will we? I am currently more hopeful than that.

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