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02/01/2015	Value	YTD %
Dow Jones Industrial Avg	17164.95	-3.7 %
Vanguard 500 Index	184.17	-3.0 %
Vanguard Total Bond Index	11.1	2.3 %

The Saga of the Struggling Euro

Happy Asian New Year! Officially commencing February 19, 2015, this is the lunar year 4713, the Year of the Sheep.

We are sending you the traditional gift of money in a small red envelope for good fortune in the coming year. This year, our gift is a genuine collectable Austrian Notgeld. This is money created by local Austrian communities in 1918-1924 when the Austro-Hungarian Empire vanished and the national currency became useless. Since this money was created by hundreds of towns, cities, and regions, there are thousands of different Notgeld designs and sizes. Yours is likely to have a fascinating story.

Nothing is now left of the Austro-Hungarian Empire. During its time, it was a tenuous multinational cobbling together of ethnic minorities, largely Hungarians and Austrians. The nation of Austria-Hungary was geographically the second-largest country in Europe after the Russian Empire, encompassing 239,977 square miles. It was the third most populous nation in Europe, and it contained the fourth largest economy in the world, after the United States, Germany, and Great Britain.

Ninety-seven years later, how the world has changed! World War II and the rise and fall of the Soviet Union changed the map and the culture of Europe. The creation of a common European currency was a game changer as well. Now we are witnessing giant change yet again.

In 2014, the US central bank, the Federal Reserve, continued its efforts to balloon the global money supply. That resulted in the continuing rise of the US stock markets. Likewise, India, Indonesia and the Philippines also experienced rising markets as finished goods exports grew, all helped by the global money supply surge created by the US Federal Reserve. In essence, the US central bank is now the central bank for the world. GRAPH 1

Graph 1 Performance 2014: World Indexes

However, in 2014, gold, commodity, and oil prices all fell as economic growth meandered. Many countries are dependent upon these materials for exports. When these prices went down, stock markets in the exporting nations declined as well. Brazil's stock market went down 17%. Mexico's market was down 10%. These declines might create bargains for us if they continue. And there's also no doubt that the decline in the price of oil is a tremendous boon to American households. We may be investing when opportunities emerge.

There are two currents in the tide of history which promise to change the world profoundly. The first current is Putin's scramble to re-establish the Soviet Empire before Russian demographics reduce the population base to such low levels that re-expansion becomes demographically impossible. At an average birth rate of 1.7 children per couple, Russia's aging population will crimp Russian capacity for military power at some point in the 21st Century. Also, Russia is profoundly dependent upon oil exports for economic growth.

2014's decline in oil prices has hurt the Russian economy deeply. Since the Russian economy is also a kleptocracy, featuring the enrichment of a cadre of oligarchs which support the de-facto dictator, Vladimir Putin, Putin faces the impossible algorithm of feeding his pet lions while the meat supply declines. To do this, he has launched a thinly-veiled invasion of neighboring Ukraine, which has aligned itself with the West. Thus we find ourselves in a situation similar to the beginning of World War II, when the Soviets and Germany commenced the greatest war in history by invading Poland. At the time, Poland had diplomatic ties to Western Europe which were generically similar to Ukraine's current alliances. Will we see Putin's expansionist agenda thwarted, and thus Western Europe and the US in dominance in Western Europe? Or will we see the West back away from the military threat of Russia's nuclear stockpiles, which will result in a restored Soviet and a Western Europe which is a husk of its former influence? We don't know. Meanwhile, the Russian stock market was down about 49% in 2014.

The second great trend is the struggle to establish the Euro as the common currency of Western Europe. In 2014 we watched as real interest rates in Europe actually went negative, which means that depositors were paying the bank for the privilege of maintaining a savings account. This indicates that the economy is barely growing, if at all. Part of the reason is sheer demography: the European population is aging. This means that population growth in Europe is increasingly due to immigration from third world countries.

The Achilles heel of the Euro is in this demography, but also in the reality that the 25 countries currently using the Euro as their common currency all have separate national budgets and economic plans. Some, such as Greece, Italy, and Spain, are deep in debt with faltering economies, and rely on the support of the Euro to fund their negative balance sheets. Others, such as France and Germany, provide most of the money supply to keep the Euro afloat, receiving the benefit of enhanced trade via a currency which is artificially kept at lower international exchange rates. This is a recipe for abuse and resentment.

One abuse has been to finance Europe with alternative currencies. A whopping 37% of Polish home mortgages are financed not in Euros, but in the widely-respected Swiss Franc. Alternative financing in both the Swiss Franc and the British Pound has become widespread across Europe with both these nations assuming more and more debt load and financial risk as a result.

Meanwhile, the European economy continues to struggle. In the 31 days of 2015, we've seen the Greeks elect a government which all but promises to default on its national debt. In response, the European Central Bank has promised more quantitative easing and has driven interest rates deeper into negative territory. It's like pushing on linguini.

Thus, on January 15, 2015, the Swiss government abandoned the Franc's fixed rate versus the Euro. The Franc shot up 32% versus the Euro in thirty minutes. In that short time, the cost of a Swiss Franc-denominated mortgage held by anyone in Europe outside of Switzerland went up an equivalent amount.

The international bond market was badly rattled, and we saw a trivial downturn in our global portfolios. European stocks were down 8.6% in 2014. We're thinking that we might see further declines as the world wonders if the tiny Greek economy…about the size of the economy of Louisiana…might breach the dam of artificial Euro support.

This is why the Austrian Notgeld paper is so interesting and collectable: we've seen great sweeping changes in the European economy and currencies before, and Europe thrived anyway. The reality is that the Euro could lose participating marginal nations such as Greece, and the most likely result would be turbulence but not permanent losses. In fact, such temporary chaos is likely to create delicious bargains for us. If we're willing to think through the lens of history, we're likely to find value when others flee.