

Preface

This book is written for investors. It seeks to provoke thought about asset allocation between the United States and Europe. It would have looked much different several years ago. Then, the United States was viewed as the most transparent, most dependable, best-regulated, most liquid, and most trusted capital market in the world.

That has changed. The United States gave the world Madoff, Stanford, Nadel, and others of their ilk. That scarred and damaged the image of the supervisory prowess of U.S. agencies like the Securities and Exchange Commission. The United States shattered world confidence when the ratings agencies downgraded trillions in so-called AAA securities. Washington caused dislocations and distrust when the U.S. government bailed out its federal agencies such as Fannie Mae and Freddie Mac. The errors of their ways have subsequently been revealed to cost the U.S. taxpayers billions. Securities of those agencies, such as their preferred stocks, collapsed in value, even though they had been held by banks and institutions as the highest-quality instruments, according to governing regulations.

Perhaps the greatest devastation occurred as the world watched as Lehman Brothers failed, even though it was a primary dealer with the Federal Reserve. The last primary dealer to fail was Drexel Burnham, many years ago. Readers must not casually dismiss the absolute damage to the global image of the Federal Reserve when it effectively failed to police the risk-taking behavior of one of its primary dealers. The designation of primary-dealer status is rare in the United States and requires extensive effort on the part of the dealer to become qualified.

Lehman Brothers' demise was an unexpected and unmitigated disaster. Its fallout must not be underestimated. The world's stock

markets lost 25 percent of their collective value during the five weeks following the failure of Lehman. Bond market spreads widened to unprecedented levels, and many market sectors completely seized and froze up; others operated with huge, dysfunctional pricing levels.

Ethical lapses during this crisis period were and are a great embarrassment to the United States. The Federal Reserve Bank of New York had Lehman's CEO on its board of directors during the period following the Bear Stearns affair and as the Fed was altering its rules to provide Lehman and the other primary dealers with special new lending facilities. Subsequent revelations showed the present U.S. Treasury Secretary was a tax scofflaw while he was the sitting president of the New York Fed during the financial crisis. The New York Fed board chairman traded stock in Goldman Sachs while his Federal Reserve regional bank was involved in the financial bailout with that company and other firms who were indebted to it. The lack of ethical behavior at the New York Fed under then-president Timothy Geithner is appalling in the eyes of these authors.

This book will set forth the debate on a number of issues that lead to the conclusion that Europe is ascending to a preferred allocation choice over the United States. We will talk about the policy applications that have changed how the European Union and Eurozone have developed and how comparisons can be made against U.S. developments in the same historical period. We'll examine the nature of the Federal Reserve and the European Central Bank and their respective monetary-policy frameworks. We will compare fiscal policies and taxation. We will talk about the relationship between the dollar and the euro. And we will discuss the stocks and stock markets that may look appealing to a U.S. investor interested in Europe.

The genesis of this book came about a decade ago. Vincenzo Sciarretta and David Kotok were riding across Italy from Rome to a small town named Montorio al Vomano, in the province of Teramo in the Abruzzo region of southern Italy. Sciarretta was interviewing Kotok about the period after the tech-stock bubble burst. Readers will see the value of Sciarretta's interviews in the "guru" chapters of this book. Sciarretta's fiancée, Babbila, drove. Mutual friend and University of Pennsylvania professor Peter Steiner listened as Sciarretta argued that European stocks and European markets

had a positive outlook, in spite of the fact that the character and structure of the European Union were uncertain.

On the other hand, Kotok argued that the Eurozone was untried and, although he was hopeful about it, there was still time to shift asset weights from the United States to Europe. Kotok believed that the likelihood of an increasingly center-left form of government would impose higher costs and taxes on businesses in the newly developed and expanding European Economic Community. Kotok also believed that the price/earnings multiple on European stocks should be lower than that in the United States, because the United States had more of a free-market climate and was more entrepreneurial and risk-taking. Kotok argued that the United States would grow faster than Europe. Kotok's case suggested that U.S. stock markets deserved a higher premium than European stocks of companies in the same or similar businesses. This premium was measured in the traditional way, by price/earnings, price/sales, and price/book ratios.

After this journey, Kotok and Sciarretta remained close friends over the years. They visited each other regularly. Kotok watched as Sciarretta married Babbila, and their family grew. When Kotok and Sciarretta were able, they jointly attended Global Interdependence Center functions in Europe, which provided them the opportunity to remain personally in touch. Kotok is the program chair of the Global Interdependence Center, a Philadelphia-based monetary and trade think tank. The Europe versus United States debate between Kotok and Sciarretta continued throughout the decade.

Sciarretta never wavered. He took a longer-term view and still believes that European stocks remain cheap. His journalistic experience, writing about stock markets and businesses for many years, and his deep, local exposure to European markets give him comfort in his position.

It is Kotok who has changed his view of the world in light of the financial crisis and the policy actions that evolved in the Bush administration, with particular emphasis on the final two Bush years. Kotok's metamorphosis was completed with the lurching leftward of the Obama administration after it took office.

After a decade of debate between friends, for the first time, Kotok now agrees with Sciarretta and thinks that Europe has more potential in the future than the United States. That's not because the European normal growth rate will accelerate to some new,

higher level than it has experienced in the last decade. Rather, it is the policies of the United States, which are reducing the United States' outlook for growth and bringing it down to a new and slower growth level, in an era in which the United States, too, will function as a social-democratic form of government.

Kotok believes that the United States is developing a broad "industrial policy" and has already done that in sufficient depth to impact about half of the U.S. economy. Readers who are not familiar with the term industrial policy should recognize it from the political debates that have occurred over the course of a century in the United States and elsewhere in the world. Essentially, an industrial policy means some form of governmental direction and intervention into a mixed economy. Industrial policies are applied in lieu of, or in order to alter, traditional free-trading or free-market policies.

The United States recently has grown in the use of industrial policies. Americans have seen them for years in agriculture. In the United States, the agriculture industrial policy brought Americans things like the huge federal subsidies for ethanol or the tariffs and protectionism for sugar. In recent times, and more so since the financial crisis has evolved, the industrial-policy sectors targeted by the federal government have included housing and mortgage finance, banking, capital markets, health care, and automobiles and their related suppliers, just to name a few.

In other words, directives and influences from Washington now govern over half the U.S. economy in an interventionist way. This makes the United States more like the other countries in the world that engage in industrial policies. Government has removed, or is removing, the free-market-oriented structures of the past.

Kotok's view is that this eliminates the arguments for any risk premium attached to U.S. stocks. Essentially, we are growing more like Europe and will be practicing a form of mixed economy, and, Kotok asserts, so far we are doing this poorly.

Over time, the European Union (EU) has developed a fairly comprehensive although sometimes cumbersome structural framework by which the EU advances its economies and applies its industrial policies. (We are thinking specifically of the Treaty of Lisbon, signed in December 2007.) Europeans know how to be social democrats.

In the United States, this process is much newer and more fragmented. Americans are rank beginners when it comes to being social

democrats, and they are going to learn the hard way. That means any premium attributable to U.S. stocks needs to be reexamined. If Americans are going to be more like the EU, if our policies are going to be similar to the Europeans', if our social benefits are going to be ratcheted up to levels that rival theirs, and if the costs are going to be borne by the U.S. economy, as European costs are borne by their economies, then Americans must view the valuations of U.S. securities on an equal footing with Europe.

Under those assumptions, Sciarretta's argument that European stocks are cheap relative to U.S. stocks becomes valid. Kotok draws the same conclusion, albeit for a different reason than Sciarretta.

Sciarretta is very confident in his favorable view of Europe. He's a European. He lives within the EU. He uses the euro. He has examined these issues for many, many years and is comfortable with his position. Sciarretta will make his case for stocks in Europe in several chapters of this book. He will outline his valuation metrics and offer readers some backtesting of them. Readers may then judge the value of these metrics for themselves.

Kotok is less comfortable and less secure with his views. He doesn't know how to be a social democrat but is trying to learn. He developed his professional experience examining freer and more open markets and has only recently come to the conclusions articulated in this book.

Kotok isn't sure whether the political pendulum in the United States could reverse and swing back and away from an industrial policy that is very interventionist and very directed by the federal government. If, in fact, the post-Obama pendulum swings away from its present left-of-center position, then, Kotok argues, U.S. markets could again become a better bargain than European markets. That caution admitted, it is Kotok's view that reversal away from industrial policies is not likely to happen soon in the United States. Hence, at the moment, Kotok's view is not sanguine about the business and investment outlook for the United States relative to that for Europe. Readers will find this view articulated in the various chapters of this book.