Report from Paris

December 9, 2011, David Kotok, Chairman and Chief Investment Officer

“I simply do not know where the money is.” Former MF Global CEO Jon Corzine.

Current events again support the notion of a three-silo approach to money management. Cumberland has recommended and supported that concept from inception.

MF Global is the latest example of what can happen when you mix custody with advice and transactions. We witnessed this during the explosion involving Madoff. We have seen it occur in other, lesser-known firms. Now we see it writ large in this most recent sad tale.

The safety of investing in asset management is greatest when the parties are independent; when all fees and expenses are separately shown; and when the clients, consultants, and professionals can evaluate each party and process independently.

This three-silo approach simply means to separate custody: the safe-keeping and accounting of assets, from transactions; the brokerage, exchanges, and intermediary actions by which one transacts and accomplishes the purchase or sale; and the advisor, the consultant, the recommending party, or the analytical professional who offers help to the investor.

By separating all three, you diminish the risk of the types of events that we continue to read about in the media as this ongoing financial crisis unfolds. MF Global is the latest in a saga that has other names attached, such as Lehman Brothers, Madoff, Nadel, and so forth.

Since 1973, when my now-deceased founding partner, Shep Goldberg, and I created Cumberland Advisors, we sponsored the notion of a complete division of services. Cumberland does not take custody of client funds. Cumberland is not a broker dealer, and does not transact for commission. We are only a fee-for-service advisor. We only advise on separate accounts, not comingled funds.

It is this latest tragic event that requires a restatement of this basic principle. The world is such that we now confront a continuum of tragic events on a daily basis. We cannot depend on the regulators to protect us. Clearly, they can falter. We cannot depend on the rating agencies to accomplish valuations that give us comfort that there is soundness and creditworthiness. Clearly, they have failed. The nature of the world today is that one has to be self-sufficient and seek safety in the way things get structured.

In our view, separating every service, evaluating it independently, and avoiding comingled assets is one of the soundest principles. It matches diversification of risk as the type of approach that can protect investors in a world that seems to be rife with Lehmans, Madoffs, MF Globals, and others yet to be revealed.

In Paris, fear is growing among investors, bankers, and financial professionals. They recall the history of previous generations, when governments failed. They worry about an end to the grand "rapprochement" that led six decades of peace. Does the euro crisis portend that era may be drawing to a close? They watch from afar as another American firm blows up, as another Federal Reserve primary dealer joins the list of failures, alongside Countrywide and Lehman Brothers.

It is raining here. The holiday lights are dimmed by fog, just as the outlook is dimmed by uncertainty.

Report from Paris, Part 2

December 12, 2011, David Kotok, Chairman and Chief Investment Officer

During this trip to Paris, an ongoing e-mail chat has been underway with a number of North American colleagues. Some have asked to remain anonymous, and I will respect their wishes. The conversation centered on the current crisis and political negotiations in Europe, as seen from a North American perspective. Primary drivers of the chat were Americans who function as consultants, professionals, and activists in the financial markets.

One associate forwarded a quote by Terry Smith, chief executive of Tullett Prebon: *"[the UK] might be as isolated as somebody who refused to join the Titanic just before it sailed."* This was said in response to the decision of the United Kingdom with regard to the collective bargaining taking place among European Union leaders. Here is the link to an audio clip of Smith's discussion: http://news.bbc.co.uk/today/hi/today/newsid_9658000/9658489.stm.

Those who follow the news know well that the UK has opted out of an agreement, while the rest of the leadership of the European Union has either concurred (twenty-three countries) or left openings for further discussion (three countries). Twenty-six of twenty-seven countries have at least acknowledged the importance of the European Union and the eurozone.

Smith's quote implies that the 23 are the countries sailing on the Titanic, destined to sink, and that the UK has made the wiser decision and is still standing on the dock. Through my e-mail exchanges, I raised this issue. My respondents quickly explained to me why it is desirable to be standing on the dock and not on a sinking ship.

However, discussions with other consultants and those here in Europe who are witnessing the ongoing crisis proposed an interesting question. Simply stated, the question is: Who is really standing on the dock and who is sailing away on the Titanic?

The answer is yet to be determined. In fact, as was revealed during our discussion, the position taken by David Cameron, Prime Minister of the United Kingdom, and by the political leadership of the UK, is one that the financial district in London, affectionately known as "the City," was able to influence. In doing so, it has put Cameron in the position of sponsoring protectionism in its most extreme form. That may be a short-term response to the political pressures his government faces; but in the long run, has he hurt or helped the UK?

More information was revealed at our lunch, which included two expert observers of Europe and European markets who live in Europe and have watched these events unfold. They noted that if you take the income of London's financial district out of the equation and look at the rest of the UK, you find that it is at a very low level. One expert stated, "It's almost like Greece."

What has happened that prompted the UK to isolate itself from 26 other countries in the European Union? Was it a political force incorrectly applied by a leadership that faces political difficulties within its own coalition? Did the UK cast a lot that will eventually weaken the City? Is it possible that it is the UK that has sailed away on the Titanic and the coalition forming in Europe that is left standing on the dock?

European leadership is making every effort to respect history, with which they are very much in tune. The important thing is to look at what created the European Union and the eurozone in the beginning. The concept formed after World War II. It happened because the French and the Germans decided they needed to stop killing each other and that others in Europe needed to do the same. They replaced confrontation with *rapprochement*, with cooperation, with an attempt to unify points of view. The same leadership that evolved in the '50s and '60s also knew the profound distrust that citizens in all countries in Europe had for their currencies. The history of the Weimar Republic and the subsequent rise of Hitler were still fresh in their memories. So, they launched an attempt that led to the euro. They created by treaty a structure in which a central bank would be empowered with seigniorage and the maintenance of the value of the currency, and that it would have the same powers as the sovereign member states of the European Union.

Giving up a degree of sovereignty in return for a set of rules that were supposed to handle the governance of the central bank is the key aspect of the Maastricht Treaty that launched the euro.

There were flaws from inception. A monetary union is not a fiscal union. Fiscal authorities have to deal with taxes and spending, and this power was left in the hands of the sovereign member states. Each of them dealt with it in its own way. In the beginning, there were rules that were adhered to, and the system worked.

Then violations occurred; the leading and most profligate spender, the one that distorted the rules by the largest amounts, was Greece. It restated financial reports after the fact. It continued its behavior in violation of the rules, and did so repeatedly. The crisis started with Greece; but in fact it was the popularity of the concept of bending the rules, and the tacit permission granted by the leadership of the eurozone, that allowed the negative behavior to continue.

The eurozone's financial crisis is an example of moral hazard at work. Bend the rules once, and they will be bent again. The second time, they will be bent even further, and the eventual penalty may be even more severe. It is the classic case of the child with his hand in the cookie jar. Petulant children have difficulty with moral hazard – especially when the threatened penalty is finally imposed.

That is what has happened with some of the countries in peripheral Europe. The leading example is Greece, which has now become insolvent as a government. The next candidate is Italy, which is the third largest debtor in the world, and is now attempting to close the cookie jar by force.

Now, what lies ahead? We see a coalition of leadership that does not want the eurozone or the European Union to end in failure. Those leaders, including Angela Merkel and Nicolas Sarkosy, have agreed to continue the attempt at *rapprochement*, cooperation, and have agreed to reject confrontation. They understand that the risk in Europe is exceptionally high and that discussions about dismemberment of Europe and the outcomes from it are intense and reveal ongoing recognition of Europe's history. Many commentators believe full dismemberment could lead to some modern version of war. They also recognize that Mr. Putin and others of his ilk lurk farther east, watching this dismemberment debate and already fomenting difficulties where they are able to do so.

Lastly, they look at the behavior of the United States. While polite and attentive, since Europeans are very good at such diplomacy, they wonder privately about American arrogance. Think about this in light of the following situation: The Secretary of the Treasury of the United States comes to Europe to lecture Europeans on what to do about policy and financial-market disarray and about dealing with deficits, currencies, and economic issues. He brings nothing but words. He has no political power. His government, the Obama Administration, is stymied by a divided Congress. It cannot add funds to the IMF, even if it wanted to. Geithner traipses around Europe telling people whatever he chooses, making bland commentary about the need to correct imbalances; and then he returns home. He returns to a country that is running deficits as large as the worst deficits in Europe. He returns to a country politically divided and rancorous in its inability to solve a problem. He leaves an impression of American arrogance and failure. For an American in Paris, this is a troubling observation to make.

How will this all play out? I am reminded of the words of Philadelphia Federal Reserve President Charles Plosser on December 2nd. He opened the discussion at a special policy forum of the Philadelphia Fed. The conference title was "Budgets on the Brink: Perspectives on Debt and Monetary Policy." In his opening remarks, President Plosser raised questions that need to be discussed publically in the United States as well as in Europe. The problems are very similar: when you borrow more than you take in, you fuel the growth of a fiscal juggernaut that will eventually catch up with you and then, if you do not correct yourself, can crush you.

President Plosser offered the following: "Given the magnitude of the fiscal shortfalls in many countries, the way in which fiscal discipline is restored will have profound implications for some time to come. Will there be higher taxes on productive investments by the private sector and higher taxes on wage earners – which would discourage both investment and work effort? Or will there be cutbacks on government purchases of goods and services from certain industries, such as aerospace and defense, or cutbacks on entitlements that would affect health care and social insurance? Or will a viable fiscal plan combine various types of tax increases and spending cuts?" *Charles I. Plosser, President and CEO, Federal Reserve Bank of Philadelphia, The Philadelphia Fed Policy Forum: "Budgets on the Brink: Perspectives on Debt and Monetary Policy," December 2, 2011*

This is our second report from Paris. More meetings lie ahead. We will attempt to examine the details and intricacies involving 17 national central banks and the collective mechanics and transactional arrangements that take place in this entity called the European Central Bank. We want to question how the emergency lending assistance structure works with central banks. We have observed that over 40 billion euros in emergency lending has occurred between the Bank of Greece (the central bank of the government of Greece) and Greek commercial banks. The collateral used to secure that lending from the central bank was pledged by the commercial banks but did not qualify as collateral that could be used directly with the European Central Bank. In other words, commercial banks used lesser-quality collateral and borrowed from their own central bank, because they did not qualify with the ECB.

What happens if Greece defaults? What is the position of the central bank of Greece with those claims? How do they fit within the context of the 17 independent national central banks that collectively make up the European Central Bank? Remember, the ECB is just an umbrella of the 17 national central banks; on its own, it has a very minimal balance sheet. It is modeled after the US Federal Reserve System, in which the Federal Reserve has no balance sheet; rather, it is the collective balance sheet of the twelve regional Federal Reserve banks.

We have many questions to ask about TARGET2, the ECB clearing system; about the issuance of currencies; about the policing of collateral; and about reporting. It is going to be a fascinating trip. The rain has stopped in Paris. It's cold but clear, and one hopes the same visibility that allows the eyes to feast on the festivities in this glorious city can also reveal with some clarity and transparency the monetary and fiscal affairs of Europe.

At a lunch with my friend and fellow GIC board colleague Paul Horne, he recalled the Salomon Smith Barney/Citigroup economists' report on the UK, done in the late 1990s. At that time, they recognized the importance of the City in the UK economy and noted that without the City the UK would rank, on a per-capita GDP basis, among the poorer of EU countries.

After a quick search, Paul, whose Europe-based research credentials are impeccable, found an interesting report from 2008 on the importance of finance to the UK economy. See: http://postrecession.files.wordpress.com/2009/01/whitepaper6.pdf. The author is Rob Killick, CEO of cScape Strategic Internet Services Ltd. Most of his footnoted sources are reliable, i.e., they are the UK Treasury and BoE. See Section 3 for the importance of the financial sector in the UK. Chart 1.10 is particularly telling in showing the growing importance of finance and business services, relative to GDP.

In addition, check the 2010 rankings of countries by per-capita GDP, using nominal GDP and PPP which, if you take out the 10% of GDP represented by finance, leaves the UK around the level of Italy but well above Greece. See: http://en.wikipedia.org/wiki/Economy_of_the_United_Kingdom.

In my view, Cameron is playing with fire. Britain may be the Titanic, sailing away and leaving continental

Europe at the dock. In a world of globalism, he chose isolationism and protectionism. Horne asked, "Given the City's many advantages, relative to Frankfurt and Paris, would a Tobin tax or increased EU regulation really cause finance to desert London? Is protecting the City worth isolating the UK from EU decision making?"

We are going to find out. Cameron may have put the UK on an irreversible course. Continental Europe must coalesce fiscally to survive and for the euro to endure. Continental Europe has no other choice. It will happen without the Queen's picture on the currency.

Report from Paris, Part 3

December 13, 2011, David Kotok, Chairman and Chief Investment Officer

The rain, fog, and mist have returned to Paris. Along with them came our deeper probing into eurozone central banking and bank-related issues. Some of the interconnections among the seventeen national central banks (NCB) within the eurozone remain clouded in mystery. We summarize our observations with the following bullets:

· Europeans themselves are questioning the interrelationships of the seventeen national central banks (NCB) that compose the European Central Bank. In some respects they all function alike, such as in the interchange of payments via their TARGET2 payment-clearing mechanism. In other respects they operate under different rules, such as the Emergency Liquidity Assistance facilities (ELA) each NCB can have with the commercial banks within its particular country.

· The European Central Bank (ECB) presents aggregate data in a similar way to the Federal Reserve in the United States. The ECB has only a minimal balance sheet of its own, so the depiction of its assets and liabilities that we see and use in our macro-monetary and economic examination really consists of the assets and liabilities of the seventeen NCBs. That is similar to the construction in the United States, in which the Board of Governors of the Federal Reserve has no balance sheet of its own. The Federal Reserve System essentially has a balance sheet that consists of the allocation of assets and liabilities distributed among the twelve regional Federal Reserve Banks.

· Within the US and the Federal Reserve, no concern is given to solvency of the twelve regional Federal Reserve Banks. In the US, we clear payments, issue currency, and deal with central banking functionality daily. We never give central bank credit risk a second thought. In the eurozone, the construction was based upon that same concept. The presumption was that sovereigns would not default, that sovereign debt was absolutely creditworthy, and that the central banks of each country would fully and completely honor all obligations that occurred between and among the seventeen members of the eurozone.

· That underlying assumption of the eurozone is now flawed because of the lack of creditworthiness of the government of Greece. Everyone knows Greece is insolvent, and everyone recognizes that Greece must have a haircut on its sovereign debt and must restructure. Negotiations towards an eventual more sustainable and durable solution involving Greek debt are constant. The current operative framework is simply a small advance of funds to keep liquidity flowing through the Greek system while the next round of negotiations occurs. The Greeks have no choice but to participate, and the leadership of Greece understands that they must either comply to advance the restructuring agenda or they will run out of money and default.

· Greece is bleeding cash. Its banks are experiencing runs and withdrawals. Its commercial enterprises, economic activity, and employment characteristics are all deteriorating. Capital is leaving Greece.

· Similar activity is underway in other peripheral countries. One by one, an investor, depositor, commercial enterprise, or individual account – any agent within the economies of Portugal, Italy, or others that senses growing insecurity in the banking and financial system – one by one they move their euro balances to safer venues. We see withdrawals coming out of Italian banks and being deposited in German and other banks. There is a movement of finance from the periphery to the core of Europe, since the core is perceived as safer and more creditworthy.

· The flows of funds that flow from weaker eurozone members to stronger eurozone ones create an imbalance among the seventeen central banks. The NCBs of the weaker peripheral countries have growing liabilities to the euro system, and the stronger NCBs of countries such as Germany have growing assets. Those assets and liabilities are all balanced through the ECB, so Germany's claim on the ECB grows and Greece's liability to the ECB grows, and that process has not been arrested by the political negotiations to date.

· Two issues are essential: the TARGET2 payment system and the issuance of currency occur through the mechanics of adjustment that take place at the ECB. To understand them is to understand the flows of funds between the NCBs and how they clear through the ECB according to the "capital key." The capital key is the structure in which the financial characteristics of the ECB are apportioned among the seventeen member countries. Germany is the largest at 27%.

· The ELA activity is a separate function. It occurs between each NCB and its internal, national commercial banks. ELA is specific to each nation and not governed by the ECB unless the Governing Council of the ECB overrules an NCB by a two-thirds majority vote. In the case of Greece, ELA involves collateral that is not qualified for direct pledge to the ECB. The rules that apply to the ELA in Greece may differ from the rules that apply to the ELA in another country. The data reporting on ELA is somewhat obscure. It is difficult to find, it is simply listed by NCB, and the reporting time frame is not precise. From what we were able to observe in Europe, the NCB emergency ELA lending in Greece now exceeds 40 billion euros. It appears to be by Greek commercial bank-pledged collateral, which is of lesser credit quality than that acceptable by the ECB.

· ELA is taking place in other eurozone member venues as well. The total is estimated above 100 billion euros and steadily growing. ELA can indicate any number of characteristics. A key one is that the commercial banks within the country have exhausted the use of ECB-eligible collateral. Since they can no longer obtain additional funds from the ECB, they must use the NCB's ELA facility.

· The assets of each NCB are still merged into the ECB assets and liabilities, so that if the NCB of Greece lends to a commercial bank and takes collateral below the ECB standard in return, those assets and liabilities of the Greek NCB appear in the aggregate data of the ECB. One can find the aggregate lumped into categories, which do not reveal the specific characteristics of each of the NCBs. It takes considerable investigation to sort out these details.

· The process by which NCBs clear their payments is a simple either/or system. They either pay or fail. In the end, it comes down to the creditworthiness of each NCB. It is theoretically possible for the government of Greece to take a haircut on its outstanding sovereign debt and restructure it, while the Greek NCB continues to pay its obligations within the euro system without default. The central bank payment exchange mechanism is different from the sovereign debt pledge. The contingent liability of the ELA is not counted in the nation's debt aggregate.

· What the European restructuring is attempting to accomplish is to facilitate a haircut on the sovereign debt of a country like Greece, and create a mechanism by which debt can roll until it can be restructured and market access obtained. These political changes are expected to occur, while at the same time the eurozone members preserve the payment system within the seventeen eurozone countries. This is an intricate, difficult task, but it is possible to obtain such an outcome. European leaders are determined to work toward that end.

· We attempted to examine the structure of the NCBs and European Central Bank under the most extreme terms. Suppose a new Greek government were to take office, repudiate all debt, withdraw from the European Union and from the eurozone, launch a new drachma, and for all intents and purposes default on all of its euro-denominated liabilities. We know the holders of sovereign debt of Greece would suffer 100% loss. However, what about the internal payment structure of the European Central Bank? The NCB of Greece would not pay. Its liabilities to the ECB would remain unpaid; in addition, it has liabilities created through the ELA, directly between the NCB and the commercial banks of Greece. Those liabilities of the NCB also would not be paid. Where are the assets? The assets that are collateralized from the Greek commercial banks are in one category; they are internal to Greece. However, the liabilities of the NCB run though to the ECB, either directly or indirectly. They are part of the composition of the ECB balance sheet. If Greece has 100 billion euros of NCB liability to the euro system, and the Greek government defaults along with the NCB of Greece, those liabilities would be unpaid. Who would suffer this loss? As far as we can determine, the loss would end up distributed among the remaining sixteen members of the ECB. Germany, for example, with 27% of the ECB, would take 27% of the loss. It would have to make up that portion of the capital deficiency in the ECB. Could the ECB or its other member countries assert claims against the NCB of Greece or against its government? Of course; there is international law that deals with some of these issues, but they would take years to resolve. The uncertainties surrounding such claims and how they would be resolved are clearly unknown. We admit, too, that this is an extreme case and not likely to happen. We leave Europe with the puzzle that the answers to these claims and how they are asserted and what is their priority is indeterminate.

Our conversations involved nearly fifty people during our stay in Paris. They represented observers of Europe with many years of experience and great skill: central bankers, economists, market professionals, money managers. We found several characteristics that gave us a European view of how this process might unfold.

Europeans understand that the deleveraging taking place worldwide and especially in Europe has a deflationary characteristic. They recognize that they are going from a system in which debt was expanding faster than income and faster than growth, to a new system in which debt will have to contract or expand more slowly than growth. This is a transition that is difficult for Europe due to its many promised social obligations. It is not impossible to manage. Difficult but not impossible. European intent is to find a way to bridge from the old paradigm of debt-financed expansion to a new paradigm of debt control, growth, and rising income-financed expansion.
Can the Europeans accomplish this? That remains to be seen. I leave Europe with the view that it is possible; but the outcome is still unclear, hence the uncertainty premium is high. Do Europeans want to do this? The answer universally seems to be yes. Continental Europe understands that any option other than a durable European Union and sustainable eurozone will be much more painful than working through the difficulties they currently face. In the case of Greece, which is the extreme example, withdrawal from the eurozone could condemn Greece to a generation of poverty. About that there is universal agreement.

Another important take-away from this trip is the response of Europeans to what they see and read in the American media when the eurozone is discussed. Europeans universally feel they are not understood, that their problems are not correctly identified, and that there is much hyperbole coming from the American media. Having examined this issue from both sides of the Atlantic, I believe the Europeans are right. My own experience in gauging television and mass media in public debate over the issues is that Americans do not understand the payment mechanisms in Europe. They do not take the time to do the research. Instead they jump to conclusions and make dramatic assertions. In fact, they do not delve into the details, where the devil dwells – and where the answers may be revealed.

I believe the eurozone will continue to exist and that the European leaders will eventually restructure their debt-determined problems. They are in a struggle; it will be volatile with uncertain moments, but their determination to succeed is clear. Europe is on a path to strengthen itself as an outcome of this current test of its monetary experiment. Continental Europe is headed for a more robust fiscal union, which is what it needs to get to the restructuring of its debt.

We leave Paris to return to the US and face the rest of the difficulties that exist in financial markets worldwide. The best thing to do now is to leave you with recommendations and comments about some Parisian restaurants:

Aux Anysetiers du Roy, 61, rue Saint-Louis en L'Isle 01-56-24-84-58. This is a recurring favorite. Tell Lilliane I sent you. Try her *lapin* or *cassoulet*. Her *foie gras* is homemade. Yum.

Dorr, Place de Vosges, 33 bv Beaumarchais, 01-48-87-98-92. Take the metro to Bastille and walk three blocks. An exciting place for oysters, crab, and shellfish. They make a good *soupe de poisson*.

Chez Francis, 7 Place de l'Alma, take #9 metro to Alma, 01-47-20-86-83. Delicious food and lovely view of the Tower. Kidneys with a mustard sauce made a marvelous lunch.

Chez Flottes, 2 rue Cambon 01-42-60-80-89. Always a favorite. Close to Concorde. They have never missed and are a regular stop for me.

Vent et Marée, restaurant de poissons, 165 rue Saint-Honore, 01-42-86-06-96, v.msainthonore@hotmail.fr. This restaurant is a new addition to my list. Near the Louvre and with a somewhat nondescript exterior, it is a real gem for seafood. Their *soupe de poisson* was extraordinary. A superb masterpiece, as was the lobster salad and an excellent *dame blanche* for dessert.

Bon Nuit.