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Team A: Massachusetts Institute of Technology (M.I.T.)

Versus

Team B: University of Chicago

In 2011, financial news from Europe had a significant impact on daily changes in U.S. stocks and bonds. A study by Bloomberg News in December found that the European and American markets rose and fell to a very similar tempo and rhythm. The two markets had a correlation coefficient was 0.85. By comparison, 1.0 would describe what is called "perfect correlation," meaning the two markets move "in lockstep" with each other. This 0.85 reading shows that the two markets are close to moving in "lockstep" with each other and furthermore the 0.85 reading was the highest measurement since the Euro was established in 1999.[1]

The effect has been historic volatility in these two markets, averaging 1.7 percent on a daily basis during the July-December, 2011 period. Many feel stocks should move along a path based on its own fundamentals and performance. But that was not the case in 2011. Many stocks moved with high correlation to the direction of broad market averages.

[1] "DJIA 14,000 Depends of U.S. Saying We're in This With Europe," by Whitney Kisling, Nikolaj Gammeltoff and Inyoung Hwang, Dec. 7, 2011 at http://www.bloomberg.com/news/2011-12-07/djia-14-000-depends-on-u-s-saying-we-are-all-in-this-together-with-europe.html.

The fundamental cause of the European financial problem was Greece's inability to pay off its maturing debts. Greece has already received aid, but it needs more. In March, €14.4 billion of bonds come due. Greece is borrowing from Peter to pay off Paul. Its path is not sustainable. [2]

Many feel that Greece will leave the European Union and cause significant damage to European markets.

The advantage to leaving the European Union is that Greece would have its own currency (the drachma). It could be devalued, making imports more expensive and exports cheaper to buyers. The optimists think that Greece under these circumstances would have less need to borrow abroad.

The disadvantage to leaving the European Union is that there would most likely be a run on Greek banks. Depositors would want to move their Euros (€) abroad before the local currency is changed to drachma. The euro (€) debts would not evaporate, but would still be there. The exchange rate from drachma to Euros would make these euro (€) debts crushing. Bankruptcies would likely ensue.

Italy has the same leaking boat. It faces redemptions of debt, amounting to € 197 billion in 2012.These redemptions start in February with € 26 billion of ten-year bonds and € 11 billion of two-year bonds. The downgrade of Italy's credit rating by S & P makes a solution for Italy harder.

<u>What strategy then can investors adopt?</u>

If an investor believes there will be sovereign defaults, then buy or hold long-term U.S. Treasury bonds.

If an investor believes the European Central Bank (ECB) will "give into" external pressures "to do something," , then buy gold, silver and selected stocks.

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[2] For an interesting discussion about the current design of Greece's debt talks, see Iannis Mourmouras, "The Price of Austerity for Indebted Greece," Financial Times, January 16, 2012.

One clue in searching for insight about the future comes from understanding the curriculum at the Department of Economics at the Massachusetts Institute of Technology (M.I.T.). This school has a tradition of thinking of economics as a way to find a solution for the government "to fix problems."

M.I.T. Professor Paul Samuelson, a Nobel Laureate, advised President Kennedy to cut taxes. He wrote a multi-edition text book. He was instrumental in counseling five students to win the Nobel Prize.

Sir Mervyn King, Governor of the Bank of England and Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System had adjoining offices at M.I.T. in 1983 when King was a visiting professor and Bernanke was an Assistant Professor.[3] Bernanke earned his Ph.D. from M.I.T. Today, these two men are known to have collegial phone calls about what coordinated steps to take as central bankers.

Other central bankers today who are M.I.T. alumni are the heads of the Central Bank of Cyprus, Reserve Bank of India and the Bank of Israel, headed by Stanley Fisher who was the major professor for Ben Bernanke when he earned his Ph.D. at M.I.T.

Perhaps the most important M.I.T. alumnus for this discussion is Mario Draghi, President of the European Central Bank (ECB) and immediate past governor of the Bank of Italy. His major professors at M.I.T. were Nobel Laureates Franco Modigliani and Robert Solow, who was also a reader of Ben Bernanke's Ph.D. dissertation at M.I.T.

What is the link in this discussion about M.I.T. and investment strategy?

Many of today's most influential central bankers are M.I.T. alumni and with a Ph.D. in economics. This department had a <u>faith in government activity as a means to solve economic problems.</u> This is just the opposite of economic teachings at the University of Chicago where

[3] Rich Miller and Jennifer Ryan, "Europe Crisis Rescue Begins with MIT Men," www.bloomberg.com January 12, 2012

"free markets" should be left alone and allowed "to burn out" where there were imbalances.

It is reasonable to expect these M.I.T. graduates to work along the lines of using government's power to solve economic road blocks.

Where can we go with this reasoning?

Back to the debts of Greece.

Today's creditors to Greece are not known to have any secured collateral in the debt agreements with the Greek government. Hence, there would be no option of selling any collateral on the steps of the court house as banks do with repossessed collateral. As Greece adopts austerity policies, tax receipts will likely fall and transfer payments to the unemployed will likely rise, further extending a vicious cycle.

What recourse do creditors of government have in these circumstances?

They can seize foreign assets held abroad. They can reduce the defaulting country's access to capital markets. They can attack the defaulting country's reputation.

Will ECB President Mario Draghi let the Euro collapse via a Greek default? Or will he cave in to the demands of those who want government action "to do something"?

Relying on the M.I.T. discussion above, Draghi's most likely response would be to rely on government activity to overcome a financial meltdown and to work with his professional peers with whom he has historical ties and who have considerable public power. He is not likely to adopt a free-market solution. I am not saying in this report that his choice might be the best solution, but I am saying this is the most likely choice he will make.

What then can Mr. Draghi do? Will he adopt a Bernanke-like response with large asset purchases?

This path is most unlikely because he does not have the dual mandate (fight inflation and unemployment simultaneously) as does Bernanke. Mr. Draghi's mandate is to hold down inflation.

<u>However, Draghi can increase lending to European banks</u>!

Recall that M.I.T. graduate, Bernanke, has thrown a life line to Europe with dollar swap agreements on November 30th. These dollar swaps sustains Mr. Draghi while he offered his own European banks $638 billion in three year loans at 1 percent. These swaps hold down the euro printing press and help him with his mandate to hold down inflation.

Mr. Gerald P. O'Driscoll Jr., formerly vice president of the Federal Reserve Bank of Dallas, described these dollar swaps between Bernanke and foreign central banks as a "fig leaf."[4] O'Driscoll argues that the Federal Reserve suffered when forced to disclose the size of its assistance to foreign banks after the demise of Lehman Brothers in September, 2008. The swaps are to central banks, not private banks hence "fig leaf" because swaps are normal and customary among central banks. To which, the president of the Federal Reserve Bank of New York replied to O'Driscoll with the last word that these swaps are good for Europe and good for the U.S.[5] His reply is the last word because he is speaking for the M.I.T. fraternity which is in charge of international finance. As long as this group of men holds these powers, this is what the nature of international finance is. More dollar swaps could be offered because the U.S. capital market is colossal compared to Europe. For example, the market for U.S. Treasuries alone is estimated at $9.8 trillion, whereas German's sovereign market is $1.5 trillion and France's is $1.7 trillion. In other words, don't rule out a M.I.T. fraternity meeting asking for more U.S. swaps, designed to help Europe.

The S & P downgrades of sovereign debt do not impair the eligibility of sovereign debt as collateral, as far as the European Central Bank (ECB) is concerned when it lends money to private banks. The ECB

[4] Gerald P. O'Driscoll, Jr., "The Federal Reserve's Covert Bailout of Europe," Wall Street Journal, December 28, 2011.
[5] William C. Dudley, "Dollar-Swaps Protect U.S. Markets," Wall Street Journal, January 5, 2012.

has said that Portugal's paper would be eligible as collateral at the ECB *regardless of the rating.*[6]

If the M.I.T. line of reasoning becomes reality, *then stocks and precious metals should do well. Influential policy makers are adopting the M.I.T. model of getting the ox out of the ditch.*

Mr. Draghi's model is expected to be the path of *massive government intervention in the European capital markets.* [7]

When push comes to shove, if it hasn't already been pressed upon Mr. Draghi by gigantic external pressures, he is expected to say to himself:

> **"*The M.I.T. solution*" is a much cheaper solution than allowing the Greek government to fall.**

Critics and history may prove him wrong, but that is what is likely to happen in 2012 and beyond. Such a path should be good for stocks and precious metals.

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[6] This is from sources deemed reliable.

[7] As investors we have to make estimates of what is going to happen in the future.