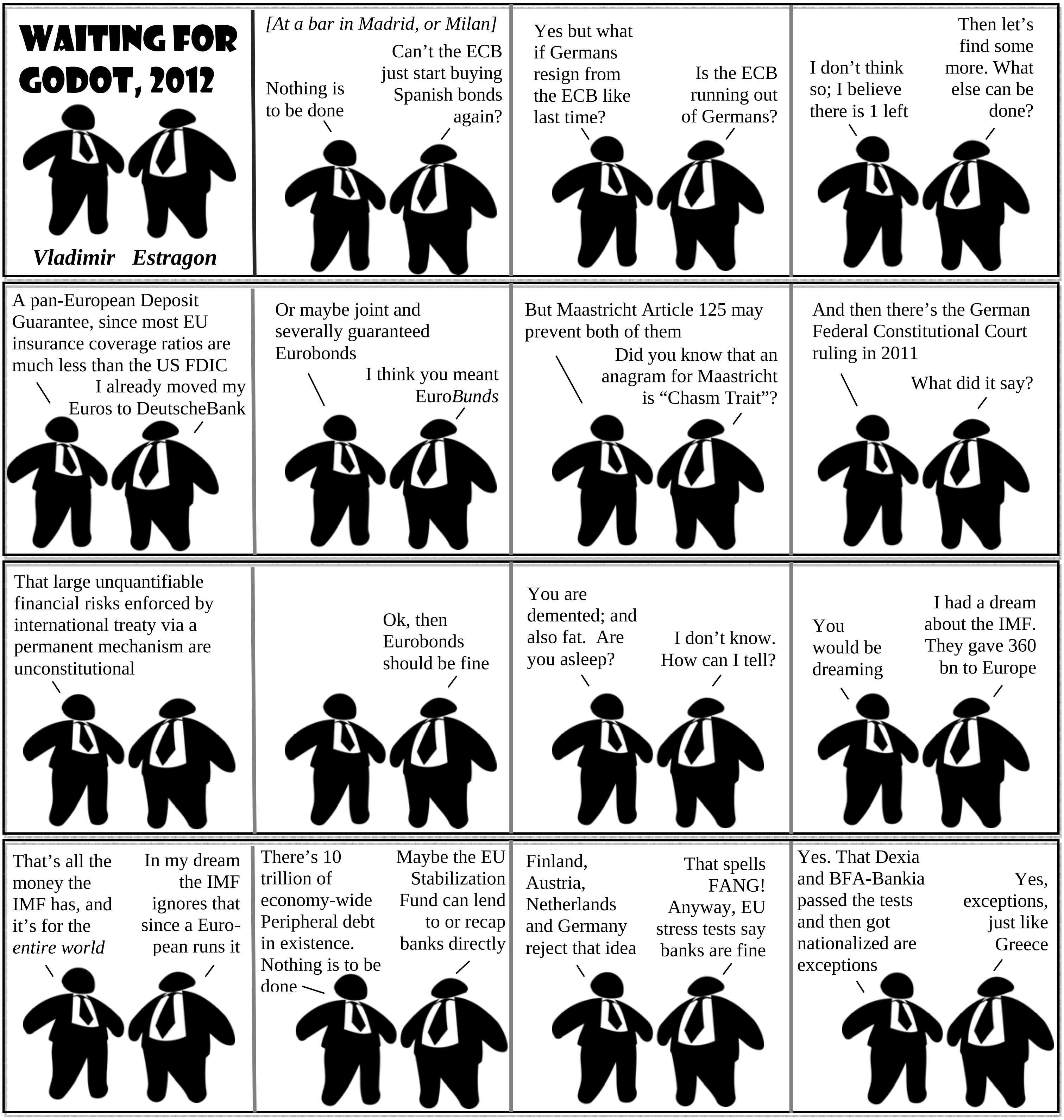
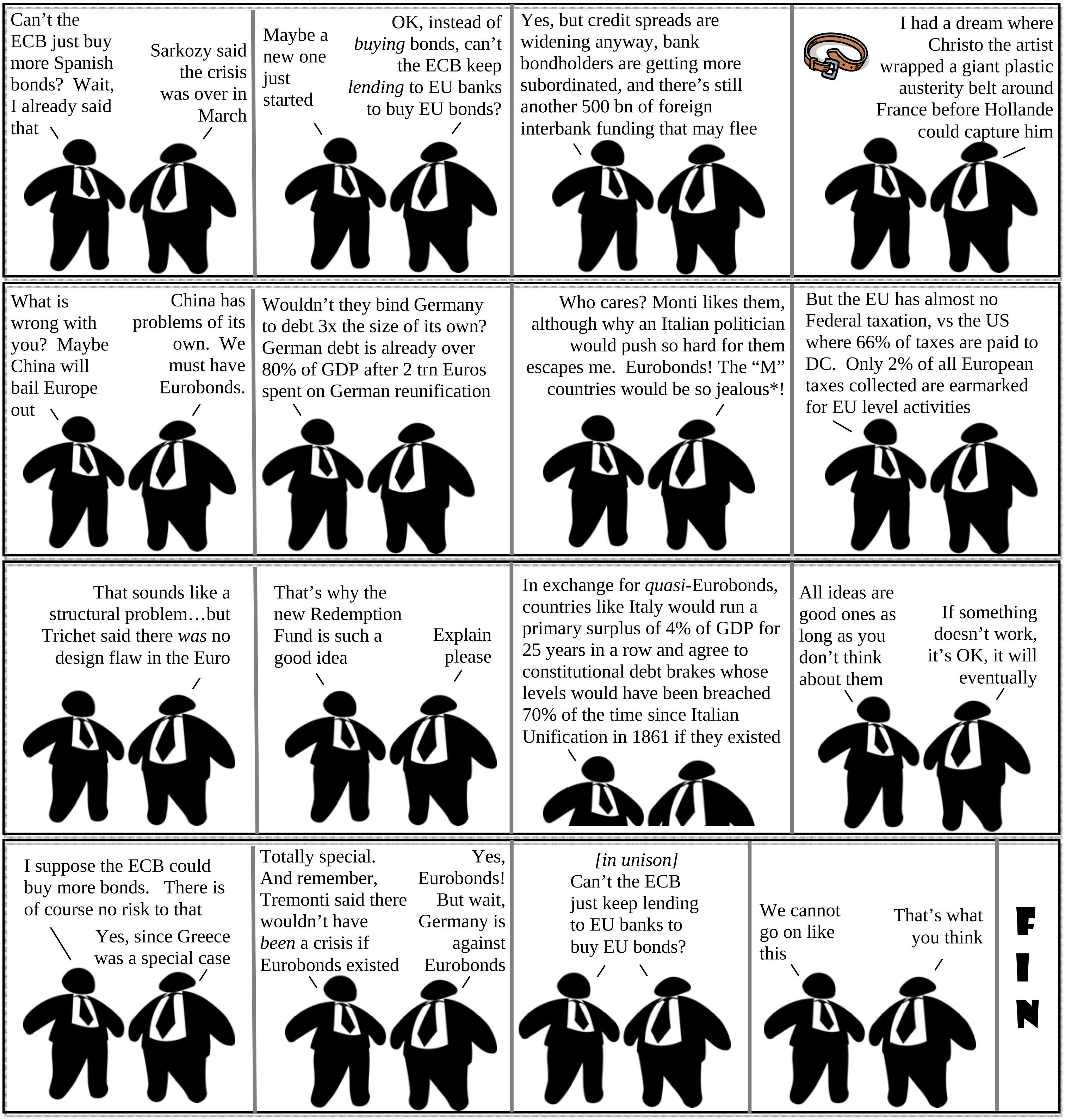
People often ask how I spend my time. Some is spent reviewing economic data (US: weaker than most recoveries but stable at ~2%; China: growth falling to 7%-8% with another stimulus drop coming; Europe ex-Germany: don't ask). Some is spent reviewing corporate profits (US: margins are high, but profits growth is slowing a bit), and valuations (on the low side). And some is spent reviewing investments we like, such as distressed US real estate (Jan 31st), oil and gas (Mar 22nd), high yield (Jan 11th), Asian private equity (Apr 17th), US tech stocks (Feb 8th) and European bank loan sales, mezzanine debt and macro hedge funds (Jan 1st); dates indicate when we wrote about them. The rest of the time, given the situation in Europe and its 38.6% equity underperformance vs the US since the EU crisis began in November 2009, I find myself in suspended animation, waiting.



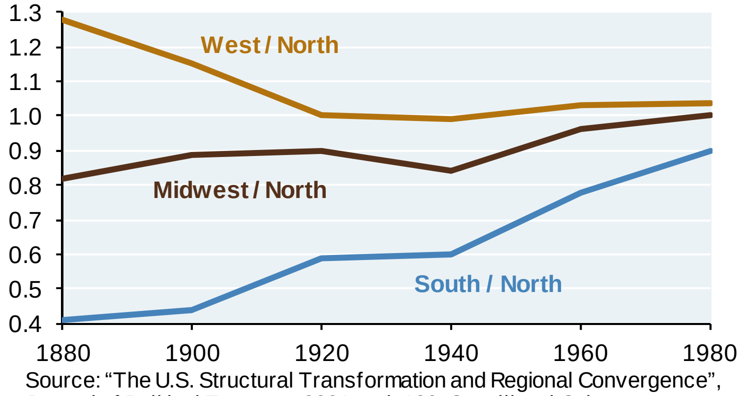


* *All countries in the world beginning with the letter "M". See chart on page 3.*

How long can this go on? It feels like a new policy option is needed (particularly in Spain, which looks terrible), but you would have to be a wide-eyed optimist to believe it will be a decisive one. Over the weekend, I reread an influential paper from the 1949 US Quarterly Journal of Economics which looked at how the US survived the Great Depression. A critical factor: US regional transfers undertaken by the US Treasury which were "***unilateral** in nature, akin to a capital movement, a gift or an indemnity in international trade*". These unilateral transfers enabled weaker US districts to maintain a level of growth and consumption which would otherwise have been impossible (see Sources). Other signs of the US monetary union becoming more durable are found in the gradual disappearance of regional wage differences (1st chart). If the hallmarks of a durable union include unilateral transfers to smooth out regional income differences, and signs of wage convergence, **Europe could sure use a lot more of both**. Just having a willing lender of last resort may not be enough.

Monetary unions should look like this...

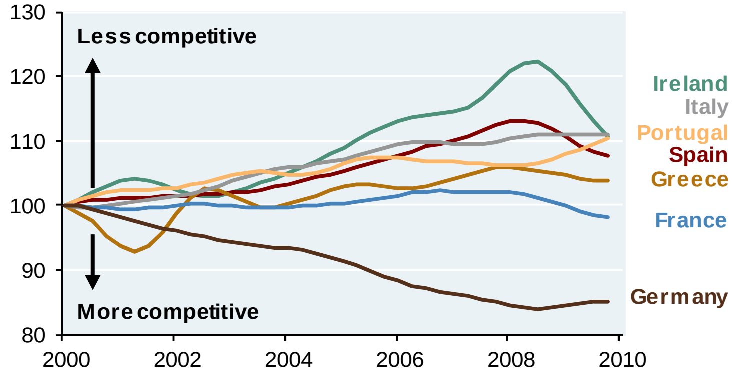
US regional wages relative to Northern states, ratio



Source: "The U.S. Structural Transformation and Regional Convergence", Journal of Political Economy, 2001, vol. 109, Caselli and Coleman.

...and not like this

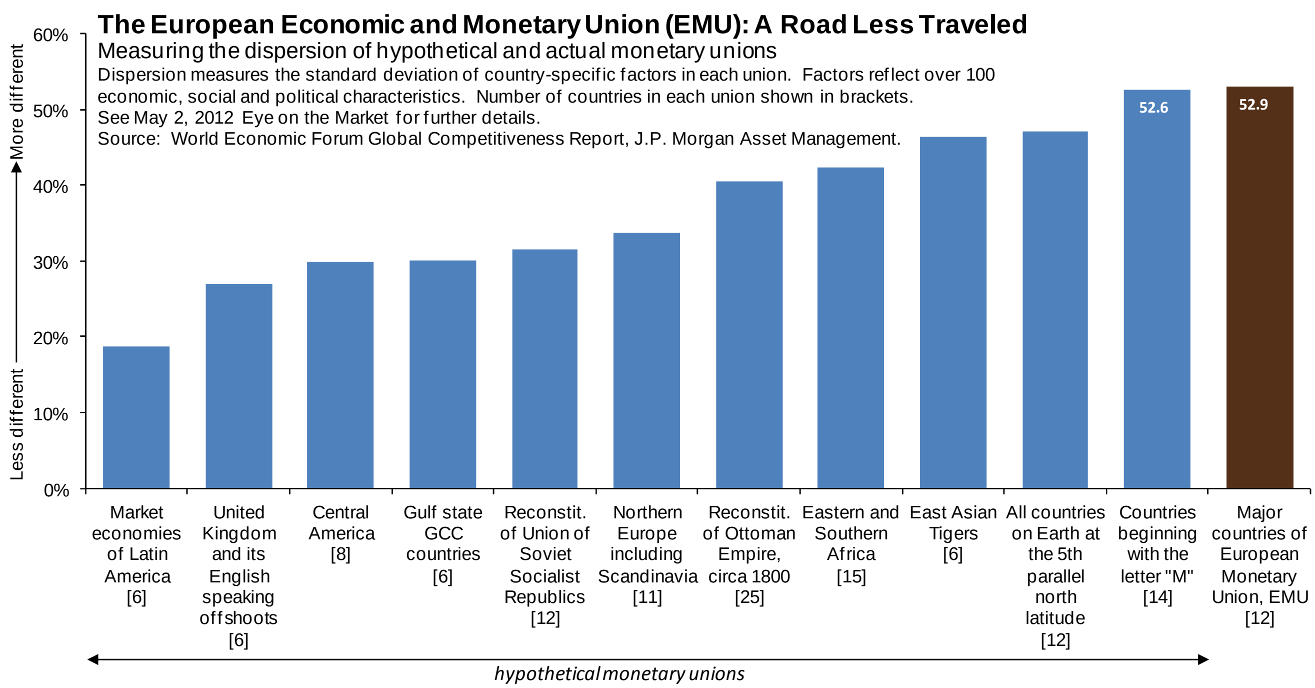
European unit labor costs, Jan 2000 = 100



Source: EU Commission.

From a political perspective, the European Monetary Union might deserve more time before final verdicts are rendered, as it's only 10 years old. But from an economic perspective, they may not get the chance: the resolution of a staggering **€10 trillion** in Peripheral sovereign, household and corporate debt may not wait. The pressure is resulting in the propagation of views like this: the Italian newspaper *Il Giornale* wrote that Germany, not Greece, is Europe's real problem, "*because it is bursting with health and, as a result, is also causing its neighbors to burst. Germany has to adjust to the rest of Europe, not the other way around*." Ah yes, German growth is the problem. I am rendered speechless by this logic, and can only guess that it is a manifestation of combining insufficiently similar countries in a monetary but-not-fiscal union (see chart below). Even if post-election Greece remains in the Euro, none of the fundamental questions will have been answered. The idea that Italy would run a budget surplus before interest of 4% of GDP for 25 years (as per the European Redemption Fund proposal) is frankly ridiculous.

No one has any idea what will happen next, as the Europeans are making it up as they go. From an investments perspective, it makes sense to continue to watch Europe mostly from the sidelines and focus on other things, such as those listed on page 1. **The shadow of European distress has made many of these assets cheaper**. Next week: prospects for a U.S. manufacturing renaissance and a look at the 2012 Presidential election.



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Sources

"*Interregional Payments Compared with International Payments"*, Penelope Hartland, Quarterly Journal of Economics, Vol. 63, No. 3 (Aug., 1949), pp. 392-407. Hartland found that during the Depression, unilateral US Treasury transfers from stronger industrial and financial regions into weaker agricultural regions almost completely offset the departure of private sector flows from the latter. We included charts on these transfers using Hartland's data in our April 20, 2010 *Eye on the Market*, as we had a premonition that Europe would not replicate them, and that they would play a role in understanding the structural problems of the European Monetary Union.

Il Giornale quote as reported in Der Spiegel Online, May 26, 2012