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By John Mauldin
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I have been doing a lot of reading this week, and today we look at some of the thoughts that keep coming to my mind. We'll think about the declining importance of economic theory (which is a tragedy) and then cast our eyes to Europe, where a truely tragicomic drama is being performed. Who needs the movies when you have the EU? There is a lot to talk about.

But first, some of my thinking has been deeply colored by some recent Conversations I have had with Neil Howe, Lacy Hunt, Dylan Grice, and George Friedman. Those audios and transcripts will soon be on the Conversations website, and others will join them shortly.

Conversations with John Mauldin is my subscription service, where I offer subscribers audio and transcripts of conversations I have with thought leaders about the topics of the day. It is just as if you were sitting at the table with us, listening in on our exchange. The service has been very popular, and the reviews are quite good. And the education you'll get, the ideas that are generated, will help you as you create your own investment strategy.

You can go to http://www.johnmauldin.com/conversations/ and type CONV in the coupon code to get a discount. And the Conversations I am lining up for later this summer will be just amazing, I assure you! Now, let's jump into the letter!

Economic versus Political Theory

Speaking of conversations, Dr. Woody Brock called me to say very nice things about my latest book, *Endgame* (www.amazon.com/Endgame). He used words like *tour de force.* Coming from Woody, who has one of the more powerful intellects I know, it made my day. Woody has so many degrees. He is a master (and the doctorates that come with them) of game theory, economic theory, and political theory. His multidisciplinary approach to markets is a thing of beauty to listen to; and since I had him on the phone, listen I did. It triggered the following thoughts.

I remember it was not so long ago when I was asked a question about how some government policy would affect the stock market. The question was in the context of which presidential candidate would be better. My answer was that presidents get way too much credit if the stock market goes up and way too much blame if it doesn't. Bill Clinton got elected at a very good time to be elected, as did Reagan. Carter didn't. If Gerald Ford had won, the economy would still have experienced turmoil and high inflation. It was Volker who made the difference, and then Greenspan's (and now Bernanke's) incessant easing. And Congress and their rule making, plus the (insert your favorite expletive) bureaucracies, have much more influence on the economy in the long run than presidents. It is the same in most democracies.

That is why, although we pay attention to politics, including Congress, we run models on our investments. We worry about long-term valuations, inflation/deflation, currencies, etc. Our primary tools for thinking about our investments are economic and financial tools, flawed though they may be. As business people and entrepreneurs, we are more focused on executing our business plans than worrying about politics, although one does pay attention to what they are doing, as regulations can change our plans. As a value investor, I want to know how the executives of a company are going to create cash flow and use that money to grow the business. When I invest in biotech, I want to think about the intellectual property and demand. And so on.

But all that is changing. I mentioned to Woody that it seems like we have to pay more and more attention to politicians and what they are doing and less and less to our economic theory. But that is the nature of the Endgame. And this is not just in the US, but all over the world. The choices that voters make, and then the things the politicians do, are becoming ever more important. Those choices can mean the difference between Muddle Through and a recession here and there, a full-on Depression 2.0, or even hyperinflation in some countries, with voters (and most assuredly politicians!) not thoroughly understanding the unintended consequences of their reactions.

Woody responded that it is now more about political and game theory than economic theory. How do politicians work through the trade-offs they will be forced to make? Can they even make them? Let's turn our eyes back to Europe to see what happened just this week.

Trichet Says "Non!" Again

I wrote sometime last year about a speech that Jean-Claude Trichet gave last May, and said:

"On Thursday of last week Jean-Claude Trichet, president of the European Central Bank, said three times "Non! Non! Non!" when asked in a press conference if the ECB would consider buying Greek bonds. His exclamation was accompanied by a forceful lecture on the need for eurozone countries to get their fiscal houses in order, some of which I quoted in last week's letter. Trichet was remonstrating about the need for the ECB to remain independent, and was rather definite about it.

"Then on Sunday he said, in effect, "Mais oui! Bring me your Greek bonds and we will buy them." What happened in just three days?

"Basically, the leaders of Europe marched to the edge of the abyss, looked over, decided it was a long way down, and did an about-face. It was no small move, as they shoved almost $1 trillion onto the table in an 'all-in' bet."

So this last week, *The Financial Times* reports that Trichet walked angrily out of a meeting chaired by Jean-Claude Juncker, in protest over Juncker's proposals to reprofile Greek debt. Reprofile is a nice word for default. Side note: I had to add reprofile to my MS Word dictionary. How many more synonyms/words will I need to add for *default* before this is over?)

From Eurointelligence:

"FT Deutschland reports this morning that Trichet told finance ministers on Monday night that the ECB would respond to a reprofiling by refusing to buy any new Greek debt instruments (meaning it will not be part of any voluntary arrangement in respect of its own Greek debt portfolio). Furthermore, the ECB would refuse to supply the Greek banking system with any further liquidity. (This is something we suspected would happen. A reprofiling would be considered by the rating agencies as a default, which would lead to an instant downgrading of all Greek securities, government and banks, to C, which would make them no longer acceptable to the ECB.) This means that the ECB will effectively boycott Juncker's silly plan. That, in turn, would force Greece to quit the eurozone within days.)

"Other ECB executive board members also went nuclear on this issue. Jürgen Stark said a restructuring would destroy the capital of the Greek banking system, and Greek bond would no longer count as acceptable collateral. Lorenzo Bini Smaghi called the term 'soft restructuring' an empty slogan."

Ouch. The European Central Bank is trying its best to channel its inner Bundesbank spirit. And if you listen to the new head of the German Bundesbank, his inaugural address made all the right statements about the need for central banks to control money supply and inflation. A brief quote from some emails going around the inner circle of GaveKal:

"Look at the May 2nd inauguration speech by Jens Weidmann, the new Buba [the German Bundesbank) president. In front of former Buba presidents Pohl, Schlesinger and Weber, Jens Weidmann made a pledge of "*no compromise on monetary stability"* and expressed a wish for a *"correction back to monetary policy normality"* and for "*full separation between monetary and fiscal policy."* Another interesting aspect of the speech was how Dr. Weidmann constantly referred to his predecessor, Axel Weber, in the familiar 'Du' form. Clearly, it seems that the new Buba president is cut from a very similar cloth to the departing one. And as inflation rates in Germany continue to creep higher, we can expect Dr. Weidmann's voice to become ever more audible. Looking ahead, this could prove disruptive for fragile European markets."

And the markets are continuing to hammer Greek debt. The Greek two-year bond yields 24.56%, up 39 basis points on the day, while the four-year bond yield rose by 76 basis points to 21.04%. The ten-year bond is now at 16.37%.

Greece will need another 30 billion euros early next year, on top of the current 330 billion euros they owe and on top of the 80 some odd billion already committed. To get access to that money, the Greeks will have to make asset sales of state-owned companies worth some 50 billion, plus even more cuts in government spending, coupled with more taxes.

The chair of the eurozone finance ministers committee, Jean-Claude Junker, acknowledges what everyone knows. Greece cannot pay its debt under the current debt burden, and the private market is not going to give Greece any more money (debt) at anything close to terms that make sense for Greece.

Last week I talked about how Europe would keep kicking the can down the road until they came to the end of the road, and then they would bring in road-building equipment. This week it appears they are seeing the end of the road in the not too distant future.

"Lorenzo Bini Smaghi, a member of the central bank's executive board, warned in a speech in Milan that restructuring by any nation would put all of Europe in jeopardy by potentially wrecking the banking sector.

"Time has been lost talking about how to come up with a way to reduce the debt, but if we accept this we'll jeopardize all of Europe," he said, according to Bloomberg. "A solution for reducing debt but not paying for it will not work."

"Juergen Stark, also a member of the executive board, insisted at a conference in a resort south of Athens that any attempt to restructure the nation's debt would be a 'catastrophe,'" Dow Jones Newswires reported.

"It is an illusion to think that a debt restructuring, a haircut, or whatever kind of rescheduling you have in mind would help to resolve the problems this country is facing," Stark said. "There is no other way than to continue with fiscal consolidation, and I would even say to double the effort in fiscal consolidation." (hat tip Mike Shedlock!)

Fiscal consolidation? That is a code word for loss of political independence. That is a code word for the Germans controlling Greek budgets and being in charge of collecting taxes. And if you go down that path with Greece? How fast do you come to Portugal, which just got a major financial commitment from the EU and IMF?

If the ECB did follow through with its threat, Greece's banking system would fail, said Jacques Cailloux, an economist at Royal Bank of Scotland. Greek banks have borrowed some €88bn from the ECB. "This is the last card in the hands of the ECB in warning about the implications of a restructuring," he said.

"The central bank is vehemently opposed to a restructuring of Greek debt, worried about a possible chain reaction through Europe's financial system and the losses it would face on the up to €50bn of bonds on its own books."

Fifty plus 80 is €130 billion (with possible double counting of some of this, as some Greek bank debt may be Greek government bonds. Note that the paid in capital to the ECB is only €10 billion. The market is pricing in a 50% haircut to Greek debt, which technically would make the ECB far more insolvent than Lehman! Member states (including Greece, Portugal, and Spain) will have to pony up tens of billions more to recapitalize the ECB, or the ECB will have to print money. Now do you understand why the Germans and the board of the ECB are so against restructuring?

The *London Telegraph* reported that "Most thought the ECB was unlikely to carry out its threat. 'It is a way by which the ECB expresses its disagreement,' said Luca Cazzulani, a strategist at UniCredit. Nonetheless, eurozone sources said governments were now considering asking holders of Greek debt to 'roll over' the bonds – buy new ones when older ones mature – rather than extend the length of the debt."

What Will the EU Do?

Seriously, will Trichet really say "non" when they once again peer down at the abyss? He blinked last time. But if the desire is to acknowledge in private what they cannot say in public - that Greece should leave the eurozone and go back to the drachma - there is no better way than to not take Greek debt onto the ECB's books. It is not a matter of whether Greece defaults, but when. It may be easier in the long run to clean up the mess they have now than continue to create even more debt that cannot be paid.

I am going to end this section with a long quote, which is essentially an email conversation between my good friends Louis and Charles Gave (son and father) and Anatole Keletsky (all founders of GaveKal) on this whole issue. It is just so powerful that it is better to quote in full rather than summarize.

Charles: Can the ECB continue to support the Euro through open refinancing operations—or are we not reaching a point where the whole system is stretched beyond credulity? Look at it this way: Greek issued debt is €330bn (forget the off balance sheet liabilities as the numbers get too scary) . This debt is now trading at 55c on the Euro on average. So there is a paper-loss of roughly €150bn on Greek debt alone floating out there. For the sake of argument, let us agree that there is probably another €150bn paper loss (conservative estimate) on Portuguese and Irish debt together. So European institutions face some €300bn of paper losses on Irish, Greek and Portuguese debt alone.

Now have these losses been taken? Or are the bonds still being marked at par in books? And how much of the unrecognized loss is on the ECB's balance sheet: €50bn? €100bn? Whatever the number is, it is bound to be much higher than the ECB's €10bn of paid-up equity capital. In fact, on a "mark-to-market" basis, the ECB is more bust than Lehman or RBS ever were; begging the question of whether there is a limit to how much paper the ECB can take on its balance sheet and pretend that it is worth par?

Wasn't this how everything got re-started anyway? Back in November, the ECB basically said they would no longer take Irish paper (remember Tietmeyer's promise back in the 1990s that, when the Irish needed help, they best not coming knocking on the ECB door?). Since then, the spreads on Greece, Ireland and Portugal have barely looked back!

Louis: At this stage, this much is obvious:

• Greece is bust and the maths on Ireland and Portugal are very challenging.
• There is a massive battle going on behind the scenes between those who want to avoid a restructuring at all costs (even if that means years of misery for Europe's weaker nations) and those who would rather bite the bullet, clean the slates and start again.

At the heart of the battle is the question of whether a right balance can be struck which a) puts enough pain/humiliation on Greece to satisfy the Germans, and b) is not so much pain that the

Greeks decide to take it rather than leave the Euro/ renegotiate their debt. It is a tough balance to strike and, a year into the process, we seem no closer to striking this balance. And so Greek bond yields continue to make new highs in spite of ECB purchases, IMF intervention, creation of the ESM and the EFSF, etc. With that in mind, it seems to me that the prospects of the above balance being reached and a deal being struck are getting more remote...

Anatole: What you are saying in effect (and I agree) is that as time goes on a durable solution, or even an orderly restructuring, becomes less likely, whereas EU politicians and most market commentators believe the opposite—that the longer they can keep this process going the more likely a solution becomes. I agree with you not because of Charles' belief that the Euro is inherently an incurable Frankenstein Monster, but for three other reasons:

1. Some powerful elements in the debtor countries will be *more* likely to stop their adjustment programs the longer the pain continues without sufficient evidence of economic recovery.

2. Some powerful elements in the creditor countries will be *more* likely to stop their lending programs the longer the lending continues without sufficient evidence that the financial problem has been solved.

3. The passage of time itself is evidence of how difficult it is to reach a political compromise between the debtor countries and the creditor countries. **Thus the longer this process continues, the clearer it will become to some powerful elements in either the debtor or the creditor countries that no political compromise can be achieved.**

This is why I became much more bearish after the failure of the March 24th European summit to agree on a credible funding and legal structure for the post- 2013 resolution mechanism (ESM). The official message from the EU was that the failure of the March summit was just due to lack of time and technical issues that would be resolved at the late June summit. In my view however these "technical" issues now seem much more daunting than they did before the March summit. As such, I would bet that the main outcome of the June summit will be to postpone a final decision until September, which will then decide to postpone to December and so on.

You will note that in each of the three paragraphs above I have deliberately used very similar phrases—"powerful elements in the debtor countries" and "powerful elements in the creditor countries". This I to emphasize two points that most people keep missing:

• The risks to the Euro come symmetrically from both debtor and creditor countries - this not just about Greece, Ireland and Spain or about Germany, Finland and Holland but about *both* - and a radical change in any of these countries' politics would be enough to blow up the entire process.

• "Powerful elements" in any of these countries would be sufficient to sabotage the system. To blow up the Euro will not require a majority vote in a referendum—merely a change of mind by just *one* powerful political group in just one of the creditor or debtor countries—e.g., the trade union movement in Ireland or the Bundesbank management in Germany or maybe even a single political party, as we are seeing in Finland.

So far there is not much evidence of the above happening but to rely on such an unstable equilibrium lasting for many more months, or even years, seems rather optimistic.

Charles: On your comment about my obsession on the "Euro being a Frankenstein," I do believe that the fact that Europe's polic makers do not seem to know what a currency is, or how it works, is indeed deeply problematic. Let me explain:

Our investing business is all about "value". Why do things have values and why on earth do these "values" move over time? To measure values we use currencies, though it is very hard to explain to me why currencies themselves have any value, since, in our world of fiat money the marginal cost of producing them is zero. So

I think that our business has two sides:

• The easier one is trying to understand how the values are going to move vs. one another (bonds vs equities, or oil vs coal etc…), making in the meantime the assumption that the value of money will not move.

• The more difficult one is trying to understand whether the value of currencies themselves are about to change.

Now currencies have two prices: a domestic price (interest rates), and an international price (the exchange rate). Finally, as we have discussed many times in the past, the only way for a fiat monetary system to work is if the different currencies, each one corresponding to a different economic and political system, can compete freely with one another.

The problem is that when Jacques Delors devised the common monetary zone, the two most important prices (interest rates and exchange rates) were locked together for countries with very different debt levels, demographics, culture, productivity, institutional set-up, etc. This is why we have argued in the past that the Euro was always going to lead to too many factories in Germany, too many houses in Spain, and too many civil servants in France.

Unfortunately, after more than a decade of blatant misallocation of capital, mostly financed by increases in government debt in almost all European nations, the consequences of the capital misallocation cannot be addressed democratically through the structures which have thus far been devised, especially in the countries that have financing problems today.

The only answer Europe's elites have so far come up with is to take away various countries' sovereignty and give it to an unelected foreign technocracy. This is very dangerous as local populations love their sovereignty (centuries of European wars illustrate that plainly enough).

This is why the Euro is a Frankenstein: what started as an earnest attempt to foster greater European integration is instead pitting age-old nations against one another and reviving dangerous nationalisms and populism (watch for Marine Le Pen to make a massive score in the French presidential election, or for the rebirth of the far-left and anarchists in Greece, Italy, Spain, Sinn Fein in Ireland etc.). It is the law of unintended consequences at work!

For the above reasons, it seems to me that it is increasingly irrelevant to be talking about "Europe" as an aggregate. **What we now have is a Europe of "winners of the Euro" and a Europe of "Losers of the Euro" and instead of convergence between those two Europes, the divergence is getting ever larger.**

All for One, One for All?

I have long said that the euro is not an economic currency but a political one. The question now before the voters and politicians in Europe is whether the EU evolves into something that looks more like the US, with limited state sovereignty and market-imposed limits on sovereign debt, where states and cities can fail and bond holders are at their own risk, and where the ECB takes over regulation of all national banks and becomes the backstop, as with the Fed, or devolves into something else.

Have the powers that be in the ECB quietly decided to let Greece go, as they should never have been allowed it into the eurozone to begin with, and because Greece clearly cheated on its statements about its debt and balance sheet in order to get in? You will never hear that in public from the leaders. It is simply not politically correct in "all for one, one for all" Europe. But that may be the outcome if Trichet really means "non!"

It really is the political class all over the world we have to watch. I will be glad when we get through the Endgame and can go back to worrying about balance sheets and consumer spending. What a quaint time that now seems. Think it is interesting now? Have you watched Spanish debt spreads? Wait until the market turns on Spain. Stay tuned.

(Woody assigned me some books on political theory to read on vacation. Hope I can get them on my iPad. Seems like a good time to start reading up on what the masters have to say.)

We're Off to Europe

I leave Monday for Philadelphia and Boston, and then its on to Tuscany (where the euro is way too strong!) for a few too-short weeks, where I hope I can catch up on some reading and get my next book outlined and started. I really have to get into Schumpeter and his thoughts on change. Most of my kids (5 out of 7) will already be there when I arrive; and then when they leave Tiffani (and Ryan and Lively and the nanny) and I will stay for a working holiday, with friends dropping in to see us. I am planning on not going more than a hundred meters from the villa, except for power walks. The little village of Trequanda (pop. 1,000) has a 4-star restaurant, Il Conte Matto (http://www.contematto.it/ita/index.php), an awesome pizza place, and a bar; and you can get local chefs to bring fresh food most nights and cook, so we can eat out on the patio watching the sun set over the Tuscan hills. It hardly gets any better. This is the first place I have gone back to for a vacation in my adult life.

I do travel a lot, and work on the road, but this is kind of an experiment for Tiffani and me to see if we can work and really get things done while not in Texas. I am usually not as productive on the road as in my office, so we will see if I can move my office to Tuscany. If you see us at a large table at Il Conte Matto, come by and say hello! I can recommend some great local chardonnays!

It is time to hit the send button. But I must confess that I am not pleased with the results of the Mavericks-Thunder series so far. Somebody forgot to tell Oklahoma City they are supposed to roll over. But I will say it has been great basketball. I will miss that while I am on the road.

Have a great week. If we have a week. Once again we have some guy getting a lot of press here in the US with his prediction that the world ends tomorrow (really, why is Fox News among others covering this nut case?). I can say with some certainty that all previous such predictions have been bad bets, and since I am writing this letter late at night, I guess we can say that I am doubtful of this one as well. Now, predicting the end of the euro as we know it? Or that Greece will default? That is an "end of the world" I can believe in.

Your assuming you did not get raptured if you are reading this analyst,

John Mauldin