

A Euro Perspective

The EMU is—ultimately—a monetary (not fiscal) union created through a political process. So, while we at First Quadrant do have a number of specific points regarding the economic and financial situation and the effect on the markets and economies (which we will discuss below), the “elephant in the room” is the politics of Europe (as well as the role the US and IMF play in interacting with those politics).

Where this leads us is to point out that political will in Europe has decreased in some ways. In particular note that the balance of power in Germany has swung a bit (the recent elections in North Rhine-Westphalia that resulted in the Christian Democrats—Merkel’s party—losing the majority in the German upper house – the Bundesrat), and the UK has brought in a Tory (i.e. Conservative) led coalition government whose first public act was to focus on austerity measures and the UK budget deficit. Those changes suggest that further stimulus measures that support foreign (including other EMU) countries will have a more difficult time passing in each country.

Note as well that the EMU has limited power in this arena (helping to “bail out” member states), as it is a monetary and not fiscal union (in other words, sovereign debt is still issued by the member countries—somewhat—as they see fit, subject to the terms of the Stability and Growth Pact). Hence the actual bail-out funds have come from the EU/EC, which is the more formal organizational structure to consider. And consider how difficult it was to get the EU constitution passed (in fact, it was rejected in 2005 by the Dutch and French voters, but it was reconstituted in 2007 as the Lisbon Treaty which failed to pass Irish voters the first time but was ultimately passed by them in 2009 leading to its adoption for the EU in Dec 2009).

There is even some evidence of such a coordination issue in the recent decision by BaFin (the German regulator) to ban naked short selling on 10 German finan-



Dori Levanoni
Partner,
Co-Director of
Global Macro



Jesse Davis
Director
Risk Office



Jeppe Ladekarl
Director
Research

cial institutions as well as Eurozone sovereign debt and CDSs on Eurozone debt, which appears to be a unilateral action rather than an EU-wide one (as evidenced by the later comment by the UK FSA that the ban only covers German participants or business taking place inside Germany but not any such business or participants outside of Germany (in particular the UK)). That stands in stark contrast to the coordinated approach taken for the EUR750b “bailout” package announced previously, which included both the EC/EU (and member states) as well as the IMF.

Now, when we begin to look at the economics that are creating the problem (which the political situation just discussed now has less ability to deal with should the EUR-750billion “bail-out” package not succeed in either keeping the Greece problem “Greek-only” or actually helping to resolve the Greece problem), we do have a bit more to say.

In this dimension, Greece does stand out. In particular, the size of its Public Debt and Deficit stands out. Yes, at the onset of the crisis, Spanish unemployment was worse (perhaps 10% in Greece vs. 20% in Spain), but the fiscal situation in Spain is far better (both in debt and deficit terms). Will Spain suffer in the near term? Most likely yes. Are there concerns about the banking sector in Spain? Yes, although the two largest banks (Santander and BBVA) are essentially “Global Banks” that are domiciled in Spain (i.e. a great deal of their business is outside of Spain), that is offset by worries regarding the “popping” of the Spanish housing bubble along with the rather larger exposure to that bubble that the cajas (i.e. the Spanish savings banks which are closest to US S&Ls) have. That does have shades of Japan in the 90’s (in terms of NPLs), but Spain does have their own form of FDIC with about EUR100b in it (this was approved as part of the smaller bank bailout in Spain in mid-2009, though it’s not quite that large yet), and they do have access to the EUR750b program as well. Portugal and Ireland may be worse than Spain, but they are smaller than Spain (they

are both comparable to Greece in terms of GDP and not nearly as bad on Public Debt/Deficits).

To that end, we don't see an obvious resolution for Greece, other than some form of sovereign default (either explicit—which would be difficult to manage—or implicit). We are less concerned about the remainder of the EMU in general, though we are still concerned about certain specific members (about Portugal in particular).

We would draw a parallel to the Greece debt issue with the sovereign crisis that Latvia underwent last year. The issue there was that a great deal of Latvian debt was held by Swedish banks (SEB and Swedbank in particular), and Latvia was very close to a sovereign debt and/or currency crisis. They avoided it via a mixture of domestic practices (i.e. austerity packages, deflation, etc.) as well as a backstop provided to Swedish banks by the EU/IMF (EUR7.5b). There are still deep concerns about Latvia (and some political instability hasn't helped in the last two months), but it has managed to weather that first crisis (though we'll see how it goes for them "if" another crisis forms).

Finally, when we look at our currency models, they've been pointing to a quite bearish view on EUR-USD for more than the last year, on the back of nearly every component of the model (Relative Valuation, Prospective Bond Flows, Prospective Cash Flows, Prospective Equity Flows, Unhedged Export Flows, FX Market Microstructure and Long/Short Carry). Relative Valuation, Prospective Cash Flows and Prospective Equity Flows have been bearish on the EUR-USD in each of the last twelve months. Unhedged export flows had been modestly bullish through November 2009, but has turned bearish since (looking at short-term trade dynamics suggested that the dynamics were shifting away from the EMU by the end of the third quarter of 2009). Prospective Bond Flows have been generally bearish, with two very slightly bullish months in the last twelve but the others either mod-

erately or significantly bearish. Note that the overall view has lightened up slightly in the last few weeks, but remains on the extreme end of the bearish spectrum still.

Each of these components (Political, Fiscal/Economic, and Models) point towards a lower EUR-USD, and in general a significantly lower EUR-USD. Looking only at the longest time horizon measures (Relative Valuation from our Models, and the Political/Fiscal/Economic issues) suggests that parity is well within the realm of possibilities. The history of EUR-USD since its inception on Jan 1, 1999 shows periods of weakness (Jan-1999 through Nov-2000 falling from 1.17 to 0.83, flat through Apr-2002, rising to 1.36 through Dec-2004, falling back to 1.17 through Dec-2005, rising to 1.60 through Aug-2008, etc.). While its average exchange rate over the Jan-1999 period to present is 1.18, it did spend nearly three years below 1.00 (Jan-2000 through Nov-2002). So parity is nothing "new" for EUR-USD.

A declining EUR-USD will act as a monetary stimulus, helping exports and driving domestic recovery in the medium term. That will help the countries outside of Greece, and may take sufficient pressure off them so that the EUR750b "bailout" may be sufficient to protect against significant contagion. But that conclusion is only weakly supported. Note that what this may do is shift the contagion to the US, as competition between European and US firms shifts more in favor of European firm's products (there are recent comments from China to that effect, for example).

To summarize, then, we're bearish on the EUR-USD both on a short-term and long term basis. The risk of an EMU breakdown is not zero, but also not something we can provide much insight into as the event is more of a political one than a financial/economic one.



FirstQuadrant

800 E. Colorado Boulevard, Suite 900, Pasadena, California 91101 • 626.683.4223

Marketing Services: info@firstquadrant.com • www.firstquadrant.com

Copyright © by First Quadrant, L.P. 2010, all rights reserved.