

## Second Chance for the Euro? Still not Clear

### Europe—Brinkmanship Continues

World financial markets breathed a sigh of relief earlier last week as it looked as though the

combination of a Merkel-Sarkozy deal along with potential support from Draghi at the ECB and Monti's new Italian budget would create the pre-conditions for the long awaited grand bargain needed to pull Europe back from the brink of disaster. Once again the politicians snatched defeat from the jaws of victory.

It has been obvious for some time that Europe can only obtain political movement on the ongoing financial saga by scaring politicians and the public with a close look into the abyss. This is high stakes brinkmanship and it has been stage-managed by Angela Merkel with consummate skill and sang-froid to get the Germans what they want: fiscal union, closer political integration, fiscal austerity and sustained and enforceable budget discipline. The Germans have the only balance sheet left to lever off of and that is why they call the shots. They have consistently been prepared to risk the confidence of financial markets by blocking big bailouts, so as to achieve an end to the moral hazard risk that accompanies such funding. The consequence is that the vicious downward spiral of euro banks and sovereign debt has not been ended.

When trading the deutschemark for the euro, the Germans made the naive mistake of thinking that everyone else would play by the rules they created. Now,

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*U.S. – Page 9*

smarter and more cynical, the Germans have been holding the feet of others to the fire to obtain the changes they want. Using the Scylla/Charybdis analogy, the Germans did not want to be too early nor too late in future bailouts, nor did they want the amounts too large. That is why the new agreed bailout funding is only €200 billion and will be done through the IMF in order to diminish the divisive politics that go with tough lending conditions.

Markets are not rules-based or logical at crucial times and the risk is that the package of measures agreed is too late, too vague, too small and too uncertain as to actual adoption. Markets swing from naive and complacent when profits are fat, to fear when confidence is snapped and losses start mounting. Confidence is not easily regained when the upside is dwarfed by the potential downside. That is why the short-lived confidence that appeared early last week snapped so quickly. Who really needs to own any European sovereign or bank debt or keep their deposits in a European bank? What Greek in his right mind would keep his money in Greece? That is why there has been a persistent and continuing run out of European paper, starting with the most egregious of the troubled debtors. It has rapidly moved to Germany, the financial heart of Europe.

The failed German bond auction two weeks ago and the spike in the 10-year rate is surely a warning shot as the German balance sheet suddenly doesn't look so solid.

A comprehensive and significant euro-deal is not beyond reach, but the agreements at the summit don't achieve it. The hoped for grand bargain would be a trade-off: meaningful Spanish and Italian fiscal austerity and growth-oriented reforms in

exchange for a broader fiscal union, i.e. centralized German control and enforcement of member budgets in the future. The quid pro quo for this fiscal compact is the hope that the ECB will become a central bank like others with potentially unlimited, lender of last resort powers. The agreement also includes a commitment not to force bondholders to take losses on future eurozone bailouts, to establish the new European Stability Mechanism in 2012 and an enlargement of funding for potential bailouts in the future.

The missing pieces are critical. First there is the failure to deliver a growth strategy for badly faltering economies and the EU as a whole.

Second, it is unclear whether the ECB received what it needs to become a more aggressive lender of last resort. The ECB has extended term lending to banks from one to three years at 1%. This provides arbitrage opportunities for banks to buy sovereign bonds of troubled debtors yielding 6% to 7% and finance them at 1% through the ECB. This is obviously a palliative of unknown size at a time when just France, Italy and Spain need €240 billion over the next three to four months. EU banks have some €500 billion exposure to the PIIGS and have been reducing their holdings. German and French banks have 160% to 200% of their capital in euro sovereign bonds.

Third, for obvious reasons, there is no confidence that the additional €200 billion bailout funding will actually get done. Even if it does, it is far too small. The so-called big bazooka did not happen and the eurozone is left with something more like a water gun to deal with the next crisis.

Fourth, there is still no adjustment mechanism between Germany—the big surplus country—and the deficit countries, which are most of the rest.

As Charts 1 and 2 show, the divergence between Germany and the troubled debtors, as evidenced by unemployment rates and current account deficits, is huge. With devaluation within the euro impossible, the competitiveness gap, estimated at around 30%, can only be achieved with internal wage deflation or faster productivity growth relative to Germany. Neither is likely. The former because of the European social compact—the acquired right that wages and benefits can never be touched. The latter is unlikely anytime soon because raising productivity requires high savings and investment, job layoffs and re-education—all long-term issues by definition. Migration is another potential adjustment mechanism, which happens in the U.S. In Europe, it is not an effective option because of language, customs, existing high unemployment and trade union power.

Chart 1

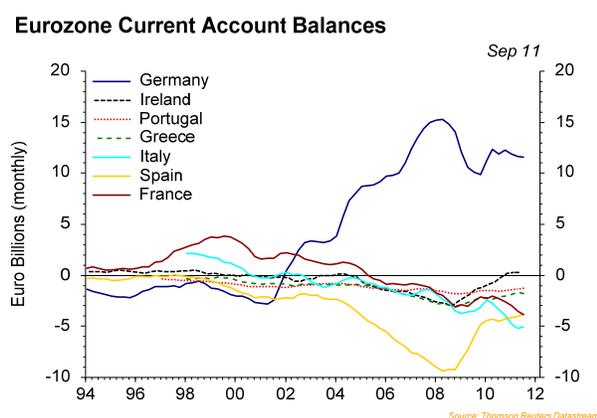
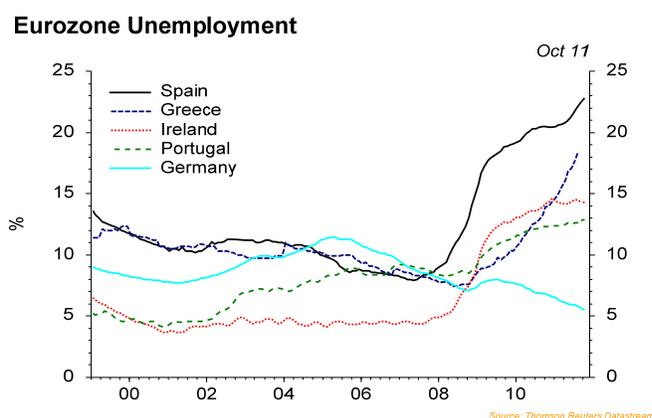


Chart 2



It remains obvious that the eurozone and the EU more broadly, are complicated, flawed political structures and the politicians have a poor track record of doing the right thing in a timely way. The exit of the UK from the new treaty is a catastrophe. The strain on the European social fabric caused by the need to dismantle key parts of the

welfare state when unemployment is so high, combined with a lack of social and political cohesion within Europe, creates the potential for unexpected political shocks to the system. There is no European-wide interest, only national self-interest. Most of the population in the troubled debtor countries do not believe they should be forced to bear the burden of government debt reduction when they are already struggling with reduced living standards. The risk is that the fragile social fabric will snap before falling debt trajectories sustainably improve investor confidence.

However, all is not black, and it is possible that the euro can be saved. Italy is the key to achieving stability. It obviously has a big debt problem but it is running a small primary budget surplus.<sup>1</sup> The arithmetic necessary to put debt:GDP ratios on a downward trend, requires a primary surplus larger than the gap between the country's growth rate and the real interest it pays on its debt. If we assume zero growth in Italy and 2% inflation, the primary surplus would have to be increased by about 4.5 percentage points. That is a hefty shift but, in a crisis, there is no choice. Combined with some asset sales and credibility on its austerity packages, Italy's real interest rate would likely fall faster than its growth rate, immediately reducing the length of time such austerity would be needed to restore confidence, so long as the Germans were standing over them.

Other countries such as Canada in 1994, Sweden and other Scandinavian countries in the 1990s and New Zealand in the 1980s have done this. It is ultimately a political decision requiring extraordinary public support, which enables a country to

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<sup>1</sup> Budget surplus excluding interest payments on public debt

escape from a fiscal crisis. This always requires fear of the alternatives to motivate action.

Italy, Spain and Ireland have the potential to avoid collapse. Greece does not; Portugal is a question mark. However, those two countries alone will not sink the euro or the euro banks, which are the other hugely important part of the equation. They need something in the area of €200 to €400 billion (far higher than what the authorities have admitted to) to properly recapitalize, depending on assumptions regarding the size of sovereign debt holdings and potential defaults on restructurings. The amounts are large but not impossible. However, the approach taken so far has been wrong. It focuses on tier one capital ratios. This encourages the banks to shed risky assets and to stop lending; i.e. working on the denominator to avoid raising capital at distressed prices. The banks should be forced to focus on the numerator—raising capital so as to minimize the negative impact on growth which comes from a bank-led credit crunch. The weaker the growth, the harder it is to deleverage.

However, one way or another, the banking system could be saved, along with the large government debtors. The summit did not provide any confidence that this will happen.

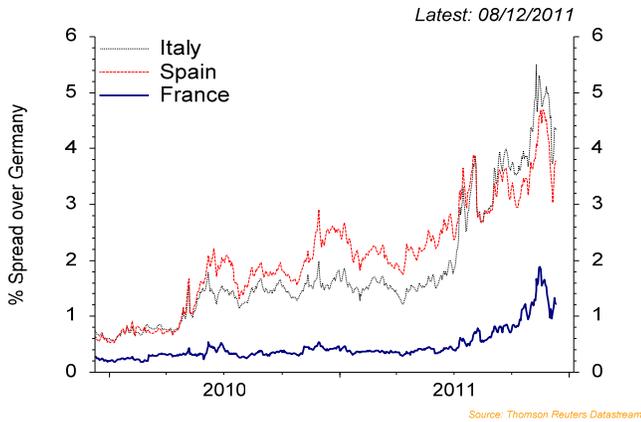
### ***What to Watch for:***

Charts 3 to 7 provide some key euro confidence indicators for investors to monitor. Spreads between French, Spanish and Italian 10-year yields against Germany's comparable bond are obviously key. Spreads had declined sharply, but unevenly since hitting peaks in early November. They are now spiking up again.

# Eurozone Financial Indicators

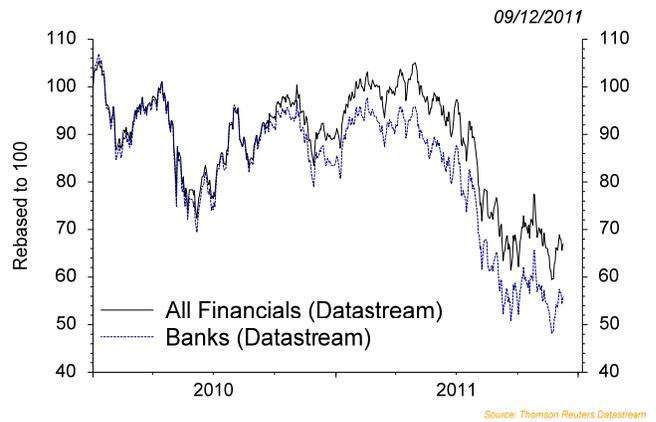
**Chart 3**

**Italy, Spain & France: Yield Spread (10 Yr)**



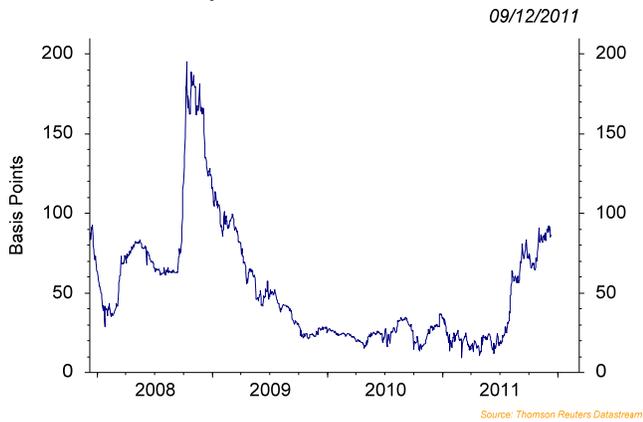
**Chart 4**

**Eurozone Financial Stocks**



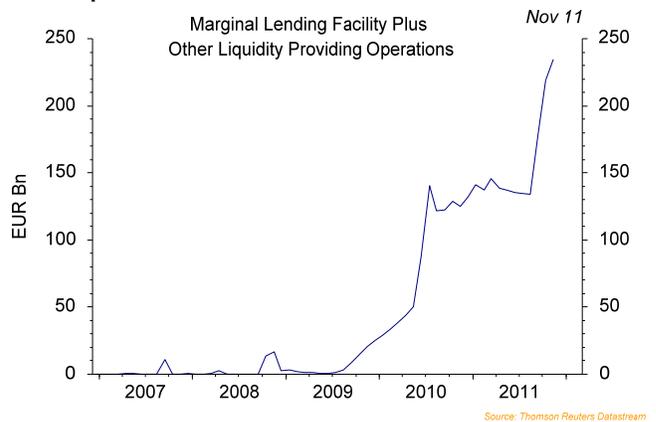
**Chart 5**

**Euro Libor - OIS spread**



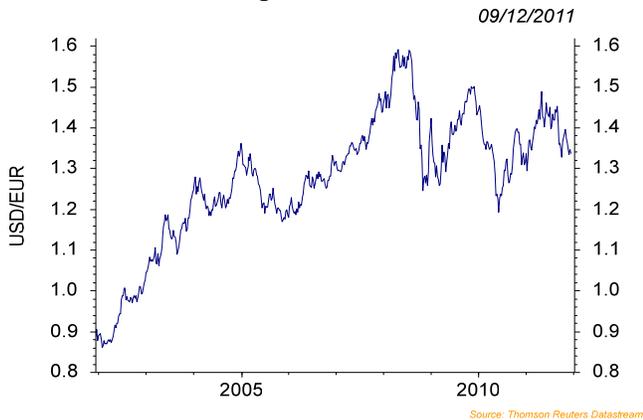
**Chart 6**

**ECB Operations**



**Chart 7**

**Euro - Dollar Exchange Rate**



Other key indicators have improved only a little or not at all. Stock prices of euro banks and other financial institutions are up only slightly and remain far below the previous peaks. The OIS-LIBOR spread is an important measure of euro banks' trust in each other due to counterparty risk. This measure has not yet fallen, indicating improved confidence in banks remains elusive. Another measure to watch is ECB lending and bond purchases. This tends to spike when confidence in banks falls. When banks experience increasing difficulty in attracting deposits, they are forced to the ECB for emergency loans. In addition, when sovereign bond yields in the secondary market spike, the ECB buys them to contain the rate increase. So far, there is no sign yet from this indicator that confidence is returning.

The euro/dollar rate also bears watching. When it rises, confidence in the euro is improving. In recent days, the euro behaviour is not healthy, supporting the notion that we are still a long way from being assured of stability.

It will be crucial to watch these indicators over the coming weeks to see if agreement at the European summit can restore some semblance of confidence and provide a second chance for the euro. Unfortunately, these are coincident, not leading indicators and investors will have to assess qualitative factors as well. Longer run, investors should be prepared for more crises. The measures agreed to at the summit are only a small step, necessary to avoid a collapse. The way back to stability and equilibrium will be long, hard and subject to repeated setbacks. Crises will continue to be a necessary factor in forcing governments to accept painful choices.

## **The U.S. Stock Market: Still Impacted by the Euro Crisis**

The continued uncertainty and risk surrounding the euro debt crisis continues to impact North American markets. Prospects for the U.S., while not as robust as past debt-driven cycles have been, are not as bad as the bears have led us to believe. Our view for some time has been that the growing bearishness since last spring was overdone in the short run, although not necessarily in the long run. There are four positive factors that support a more upbeat view of the U.S. when looked at in isolation: 1) a highly profitable and liquid corporate sector; 2) a very liquid financial system and strong money growth; 3) a sustained bottoming in the housing sector; and 4) good equity valuations.

Stock market performance in recent weeks suggests that there is a good chance that a significant market bottom occurred in September, assuming no catastrophic debt crisis in the EU. Prospects for a eurozone package of measures to pre-empt a full-fledged sovereign debt crisis may have improved, but the fundamental uncertainty has, by no means, been resolved.

### **The U.S. Banking System**

The U.S. banking system is extraordinarily liquid and credit is beginning to flow (Charts 8a - 8d). U.S. banks are not heavily exposed directly to euro sovereign debt but certainly counterparty risk is substantial and euro banks themselves have a strong

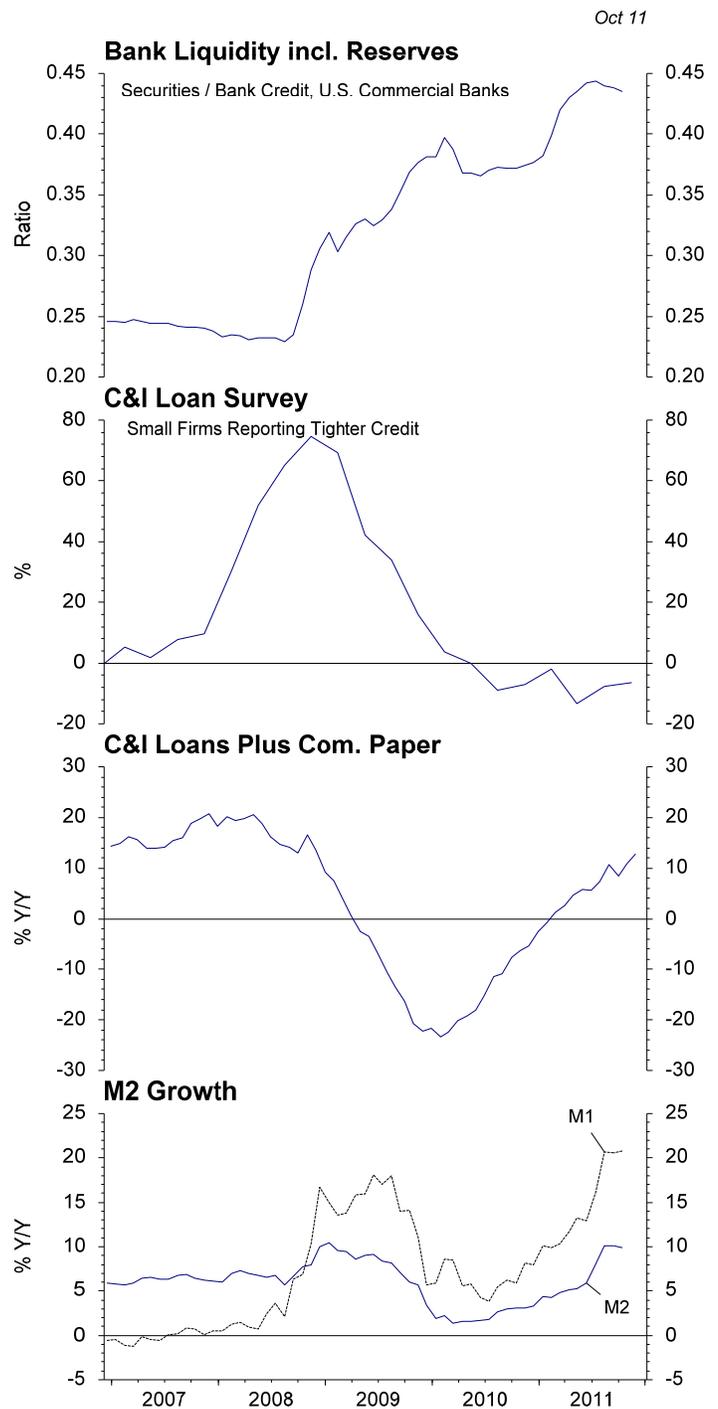
## Charts 8a- 8d

presence in the U.S. Bank capital, in general, has been greatly improved since the crash of 2008-2009. The banking system has healed very substantially since then as evidenced by the persistent easing of bank credit (Chart 8b) and the significant rise in credit extended to the non-financial corporate sector (Chart 8c).

Money growth on both the narrow (M1) and broad (M2) definitions continues to surge (Chart 8d). This clearly does not look like a prelude to depression as was the case in the early 1930s when money growth was actually falling and banks were tightening credit as they feared for their solvency.

## The Corporate Sector

Charts 9a to 9c show clearly that profitability as a percent of GDP is at a record high, private fixed investment is growing quite robustly and overall corporate liquidity is



exceptionally strong and these will all support further productivity gains, profit growth and stock prices.

Charts 9a - 9c

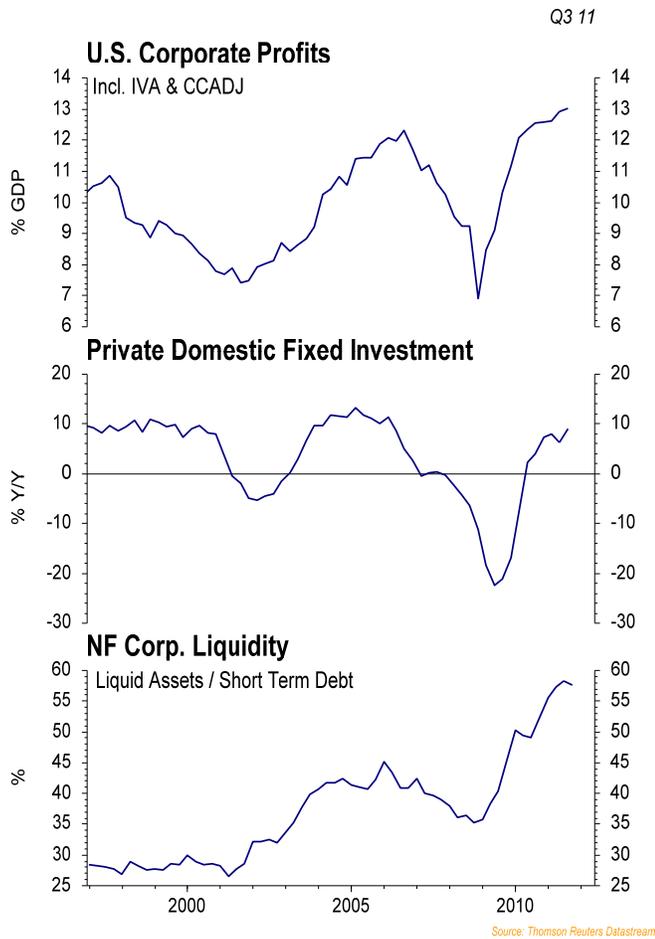


Chart 10

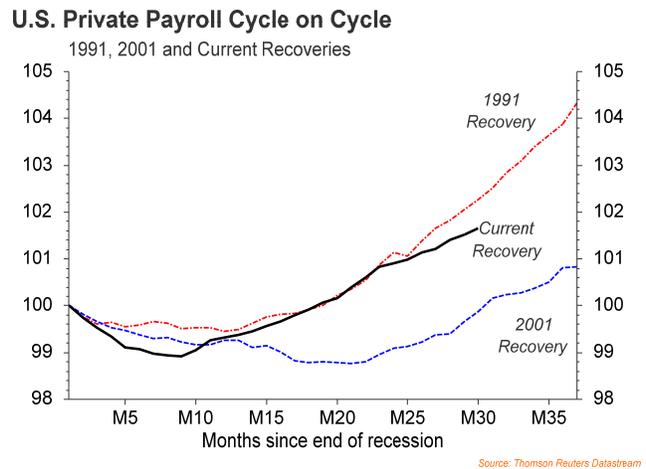
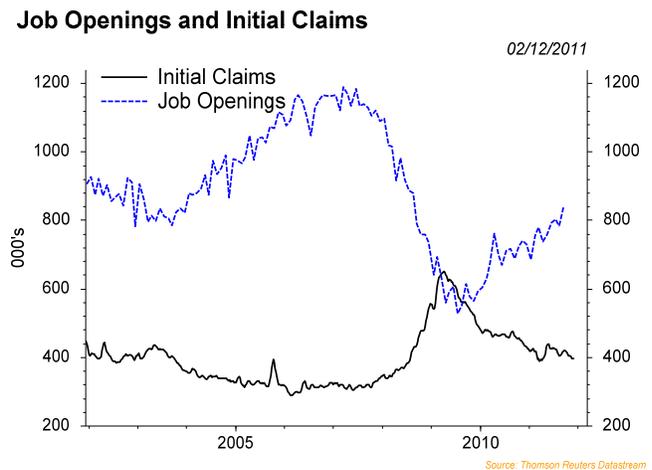


Chart 11



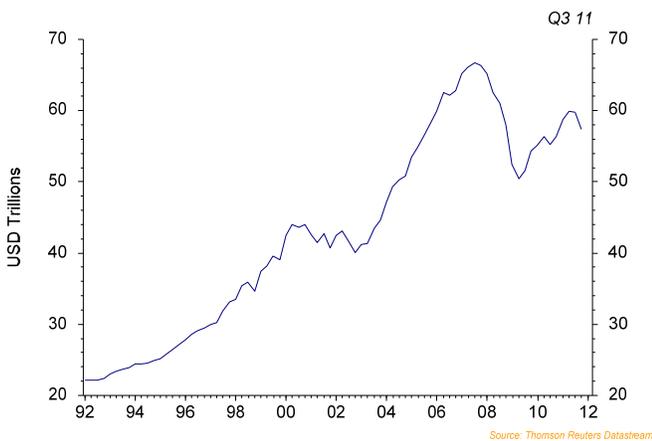
U.S. corporations prepared for the depression that never happened. As confidence returns, investment will continue to grow and that will support further productivity gains, profit growth and stock prices.

Rising investment will also continue to support private sector employment growth (Chart 10). This has been one of the unpublicized signs of persistent strength in the

recovery from the recession. At 1.4% per annum growth, it has outpaced the growth over the comparable period of the last recovery and almost matched the previous one. Other labour market indicators such as job openings versus layoffs (Chart 11), hiring plans and hours worked are also fairly strong. Structural unemployment remains very high but that reflects primarily a problem with inadequate skills, training and education relative to growth areas of the economy.

**Chart 12**

**U.S. Household Net Worth**



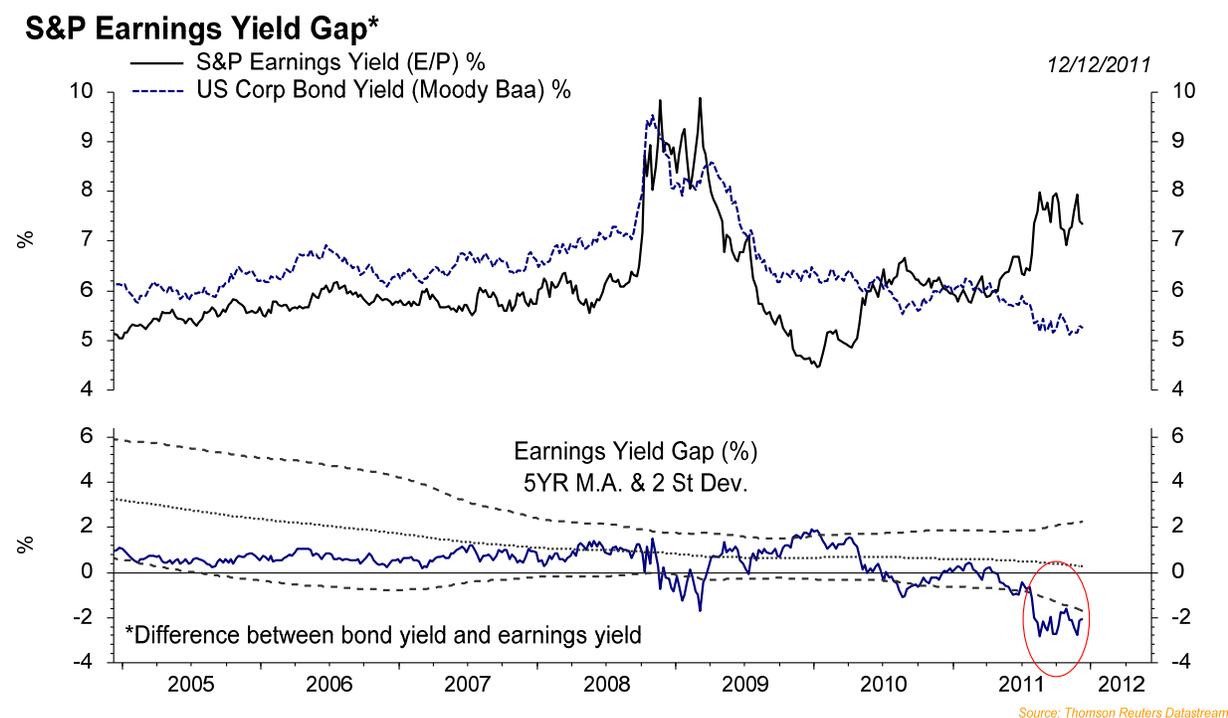
**Chart 13**

**U.S. House Prices**



U.S. personal income is growing enough to support decent retail sales as well as a higher level of savings. This has helped the household sector improve its balance sheet markedly (Chart 12). House prices have stabilized over the past 18 months (Chart 13) in spite of the still high level of foreclosed homes. No one expects a sudden resurgence in housing but the key point is that a huge negative factor has gradually been removed from the economy over the past 18 months. There is still a long workout ahead but the bottom in the housing sector is behind.

Chart 14



## Valuation and Psychology

There are many ways to look at valuation. One of our favourites is to look at the low-investment grade (Baa) bond yields relative to the earnings/price (E/P) ratio—the inverse of the P/E ratio. We smooth the earnings data by using the long-run trend to iron out cyclicalities. The series is shown in Chart 14, together with bands of one and two standard deviations. As can be seen, at the low point in September, valuation by this measure moved below the two standard deviation lower bound, indicating extremely good value. Currently, it is one standard deviation on the side of good value.

Chart 15

VIX: CBOE SPX Volatility

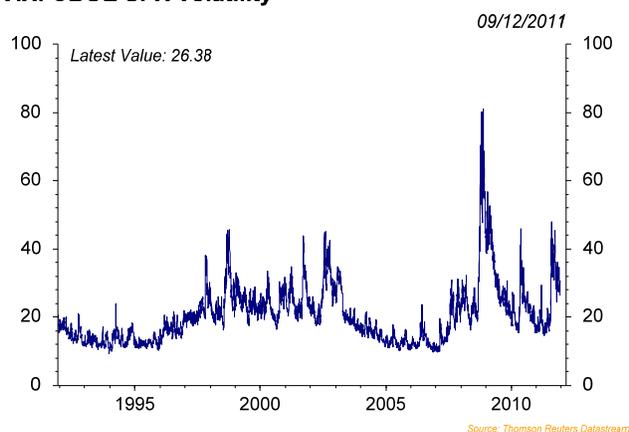


Chart 16

S&P 500 Comp



Bearish psychological extremes are almost always consistent with a solid stock market bottom. The VIX index, which roughly shows the expected movement of the S&P 500 over the next 30 days, annualized, based on the options market, can provide a good indication of major market turning points. Apart from the huge spike at the bottom in late 2008-early 2009, there have been five prior peaks in the area of 40. Each has been followed by a strong stock market rally. The big sell-off in September, which again pushed the VIX to over 40, qualifies as another emotional extreme, which is a good omen for a stronger market ahead.

Chart 16 shows the S&P 500 over the past ten years together with a 200-day moving average. The bottoming process in recent months is looking very much like the bottom in 2010. The recent sell-off may be a good test of the September low, but with eurozone uncertainty, that could change quickly. More time is needed to have solid confidence. An important development to watch for further confirmation of a more

durable uptrend is whether the market can move far enough above its long-term moving average and remain there so as to turn the moving average itself into another uptrend.

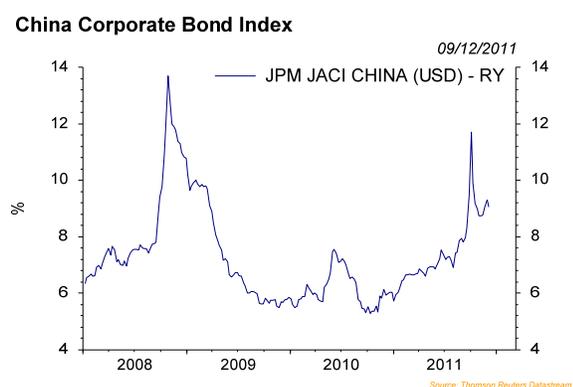
## Risks

While we are cautiously on the side of a more upbeat view of market prospects, there should be no illusion that it will be clear sailing ahead. There are plenty of big risks still in the picture, the global financial system and economy remain fragile and shocks have a bad habit of coming out of left field with little or no warning.

We have detailed these risks frequently and will only list them here as reminders:

- 1) The eurozone and EU as a whole have a consistent record of policy failure. There is no guarantee yet that a potential grand bargain will actually get put in place. Even if it does, Europe faces a long, tough road of deleveraging, austerity and recession at a time when the social fabric is also fragile. The eurozone banks are seriously undercapitalized and there is a narrow window to fix them before the next crisis emerges.
- 2) China is slowing down rapidly and the potential for large losses tied to property speculation and bad loans is material. This may come to have a significant impact on the financial system as well as government debt levels.<sup>2</sup> Yields on corporate bonds suggest considerable stress in the

Chart 17



<sup>2</sup> See BIL Special Report of November 29, 2011

financial system, although this appears to have subsided somewhat in recent weeks (Chart 17).

- 3) The U.S. commitment to reverse its spiralling debt to GDP trajectory remains highly questionable and, with a vulnerable economy and high unemployment, no one can rule out a shock to confidence in the long-term viability of the U.S. government bond market.

## Conclusions

The path of least resistance for the market is up, but we do not hold that view with much confidence at this point in time. Continued progress in the U.S. economy and financial system and good valuation are clear positives, but there remains too much uncertainty as to whether the euro crisis can be contained.

The problems of over-indebtedness, public disillusion with their politicians and the stress of declining living standards, high unemployment, sustained deleveraging and an unwinding of significant parts of the welfare state are not going away. Even though the ultimate outcome will be very bullish, there will be many painful bumps along the way.

That is why we continue to recommend that investors maintain a conservative stance. Rebalance on rallies; keep lots of cash so that positions can be held through turbulence and keep funds available for tactical allocation shifts when exceptional value appears. Positions in gold and related hard assets should be targeted at 10-15% for those focusing on very long-term wealth protection. Quality bonds are overvalued and

should be held only for liquidity and as a hedge against deflation. Duration should be short. Opportunities have opened up in the high yield market but experience and skill are necessary to control risk.

The U.S. dollar is likely to remain the best currency hedge while the euro crisis plays out. The yen is overvalued, reflecting the fact that money is too tight there. Commodity currencies are vulnerable to threats of increased deflation in the near term.

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