

A View from the Trenches Toronto, Wednesday, February 10th, 2010

Good morning,

We're back and still concerned about the situation the capital markets face and will continue to face. Essentially, (we differ with the mainstream view and) **we stand by our interpretation that Europe does not face a short-term liquidity crisis, but an institutional crisis.** Institutional economics is one of those underappreciated and misunderstood branches of Economics (in our view, if economists had properly read Von Mises' "Human Action", Institutional Economics or Behavioural Economics would have never taken off as disciplines. Perhaps the best known economist within the Institutional tradition is James Buchanan (1986 Nobel Memorial Prize), but we also enjoyed very much and recommend reading the works of Peruvian economist Hernando De Soto).

The institutional economist asks the following question: **"If the European Union is actually not a Union, but a Confederation, why should Euros be held as the world's alternative reserve currency, instead of Canadian Dollars or Australian Dollars or Swiss Francs?" We think this is a valid question and a question markets are asking as we write.** But first, let's briefly describe what a Confederation and a Union are:

Confederations are alliances of sovereign states. **"...In a Confederation**, the links among members are weaker. The legal instrument of the alliance is a "treaty". The purpose of a Confederation is economic integration and military assistance among members. Member states remain sovereign and as such, keep the powers of self-determination. Confederated states reserve the right to nullify, reject legislation and eventually, of secession. They may issue currency, keep customs and sustain armed forces. They lack a strong common government, although they may unify their foreign policy.

In a Union, the links among member states are more vigorous. In a Union, one finds a definitive purpose to integrate the states. There is a sovereign federal government, while the states are autonomous. The states can govern themselves, have their own legislation, but these acts are subordinated to the Union's constitution and federal laws. Secession is not allowed, although member states conserve those rights that they did not delegate to the federal government, when the Union was established...." (our translation from "Curso de Derecho Político", H. Sanguinetti, 4th Edition, 2000)

As investors, what should we interpret as a catalyst, as a defining moment? Here's our view: **If the IMF has to intervene, the European Union will definitely be a Confederation. This is unfortunately the path of least resistance. This is the easiest and less painful path. If the IMF is engaged, the Euro will no longer be considered an alternative global reserve currency and the bid that there was under such belief will no longer be there. We shall be sellers of Euros under this scenario. This is the worst-case scenario, for if the EU citizens lose purchasing power, the global recovery will become a long-term dream. Note that we don't care about Debt/GDP ratios or other metrics. The relevant issue here is that on the margin, the Euro would no longer offer more safety than other strong, healthy currencies. In fact, its complex institutional framework would be a burden, compared to other ones, simpler to understand.**

In the world of corporate credit, when lenders are not satisfied with the credit quality of borrowing subsidiaries, they may demand cross-guarantees, in addition to an irrevocable guarantee of the parent. Unfortunately, this cannot happen with sovereign debt. The more difficult and painful path for the European Union is to stand up to the challenge and lay the ground for a stronger integration, under a central government that can provide legally and operationally a guarantee for not just the debt of Greece, but of any other state under stress (i.e. Portugal, Spain, Ireland).



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Such integration demands political will and time. Unfortunately, the world lacks both. Therefore, we were very suspicious, when at 12:19pm yesterday, Bloomberg announced that Germany was considering assisting Greece. In fact, we smelled something wrong earlier, when after 10am, the Canadian dollar broke its correlation with oil (chart above, source: Bloomberg).

At 11am, it was clear that the source was the cross with the Euro. Somebody knew something that the rest of us ignored (chart below, Eur/USD, source: Bloomberg). And then, the rumor was officially out at 12:19pm, that a member of the German's Christian Democratic Union had said Germany was considering assisting Greece. The Euro had gained 1% and profits were immediately taken!



We are of the view that the market sold into this strength, for if it the rumor had had real merit, the bounce should have been way stronger. However, we are also concerned about the existing misinformation. As we write (11pm ET), the “Frankfurter Allgemeine” (at 11:02pm ET) reports Mr. Joaquín Almunia (ex-economy commissioner, since Feb 10th, according to Bloomberg) to have only expressed that the European Union should promise protection to Greece. However, Madrid’s “El País” reports that the European Union and Germany are preparing a package for Greece. Le Monde and Financial Times back the latter interpretation.

All we are certain of is that a European plan should put the IMF alternative farther rather than closer, and that’s a good thing. However, a plan for Greece is hardly going to solve the situation, for it is the European Union that is in crisis, not just Greece. And the upcoming strike of public employees in Greece is not going to make life simpler.

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