

Good morning,

This is a short week for the markets, as they are closed in the US. Today, we want to take the opportunity to disagree with two mainstream perspectives on some of the most “popular” market themes:

-The fall of the Euro is an escape valve that offsets the impact of fiscal tightening

This is by now a widespread myth, that will have to test reality, for it is still too early to tell. We disagree with this view mainly because it ignores the cause of the fall of the Euro. It is certainly not an oversupply of Euros, because the European Central Bank, so far seems to be sterilizing the sovereign debt purchases. But above all, because the fall began way before any sovereign debt purchases were made. **The fall of the Euro is simply a run against the currency**, a crisis of confidence.

What does a crisis of confidence in a currency mean? Currencies are the liabilities of central banks. **When people lose trust in the liabilities of an issuer, it's because they no longer believe in the quality of the assets backing such liabilities.** This is exactly what is driving the Euro lower, even before the ECB would announce its purchase and sterilization programs. The Euro is partly backed by gold, but mainly backed, ultimately, by sovereign risk.

Having said this, to believe that the fall of the Euro will serve as an escape valve implies two assumptions:

Assumption No.1: **The fiscal tightening will be successful.** We have our doubts on this issue, because the fiscal deficits are not the result of just a few tough years or a bad investment decision (i.e. sub-prime mortgages in the US). The deficits are structural. They are the natural result of a lifestyle. There are demographic drivers (i.e. aging population), taxation and fiscal spending asymmetries within Euro members, and a deeply-rooted market interventionism, causing them. A cut in public employees' wages or a spending freeze will do the trick? If you believe this, please call us. We have a bridge for sale!

Assumption No. 2: **There is an optimal value for the Euro, and this value is “stable”.**

This assumption is in total disconnect with the root of the devaluation. It assumes that exogenously, there was a previous value for the Euro, a degree of purchasing power that Europeans did not deserve, given their fiscal deficits. **This is a mercantilist view. This is 17th century economic thinking. It's absurd.** People were holding Euros as an alternative reserve asset regardless of the fiscal situation of EU members, because they trusted the Euro and until that confidence is restored the Euro will continue to drop. **The Euro will not be any more stable at 1.10USD than it was at 1.30USD, if the structural problem, the fiscal deficits of the Union, continue to be linked to the balance sheet of the ECB, affecting the quality of its assets.** Furthermore, this is not a linear development, but it will escalate exponentially, as it gets uglier.

There is a deeper problem here. Why did assumptions 1 and 2 first come to life? They are the result of an indiscriminate use the “comparative statics method”. As we wrote in our last letter, comparative statics macroeconomic models (http://en.wikipedia.org/wiki/Comparative_statics) ex-ante and by necessity, are based on the general equilibrium theory. This line of reasoning is a typical case of arguing in a circle, because the equations already involve the final equilibrium they try to prove.

-Deflation, or weaker inflation, has won the day

Those who believe in the effectiveness of fiscal tightening and the stability of a lower Euro, are right to believe in deflation. Why? Because they chose to ignore that the ECB is facing a run against its currency. In a typical run against a currency, things don't remain stable. Politicians fight back and try to kill “speculators”. The holders of the affected currency have realized they are subject to the inflation tax, that as long as they hold that currency, their savings will be taxed. Therefore, politicians strike back and first, they seek to close all the exit doors. We are currently seeing this coming from Germany. But this is not the only thing they do. They always go for more and they commit their one deadly sin: They raise the bets and escalate the debasement. We are months (at best) and perhaps years (at worst, though not many) from getting there.

As well, those on the deflation side always look at “asset bubbles” as a market anomaly, as much as they see the current volatility as the result of “animal spirits”, as if there was no rationale behind shorting a currency whose central bank has been taken hostage by Athens. We believe those bubbles are the natural features of an inflationary process, just as pregnancy is the

natural feature prior to birth. We cannot have a birth without pregnancy and vice versa, once we observe pregnancy, we know birth is on its way. Does it matter if it takes 9 months? Certainly not.

What are the latest bubbles? Here are a few:

a) USD funding costs (3-mo Libor –OIS spread):

We will surprise some readers here but we don't see the recent minor spike in funding costs as proof that the crisis is temporary nor as a result of "adaptive expectations" (on this latest point, refer: Bank of America's "Situation Room" report, May 27th, 2010).

With volatility levels approaching those of 2008, the fact that funding costs are no way near those of 2008 are a clear sign to us of a "bubble" in the funding market. This bubble is being bred by the currency swaps (at OIS+100bps) the Fed is providing the ECB with, at the US taxpayers expense. This is the point Congressman Ron Paul made before the Subcommittee on International Monetary Policy and Trade, on May 21st (please, watch at: <http://www.youtube.com/watch?v=hMo-V8HoNdc>). Mr. Paul (on minute 7:35 of the link) asks:

R. Paul: "...where do we get the USDs to give them (i.e. the ECB) for the Euros..."

Fed answers: "... it is created as a reserve and then unwound, when it comes back..."

Do we need to say more here to prove our case???? Can you imagine a risk manager of any bank replying to her employer's Risk Committee: "Don't worry about those lending facilities we provided to our customer. We know they are under priced, but we expect the customer will not use them"? She would be fired instantly! Yet, the Fed is not even audited on these issues!!!

b) Price of oil

How can it be that, having the European Union members lost 23% of their purchasing power (i.e. from 1.60USD/EUR to 1.23USD/EUR) oil does not fall below \$70/bbl? Do we need to show a chart here to make this more visual?

These are not bubbles. This is the proof of a monetary debasement that is looking us straight in the face. There is nothing deflationary here and we could go on and on with property prices that do not fall, food prices that increase, air fuel surcharges that keep being charged, etc.. There is only one way to protect ourselves from this: Civil disobedience. Sell your fiat currencies and buy gold. Having seen where the last debasement led us to (i.e. World War II), the Mahatma Gandhi would approve of this pacifist and preemptive method!