

Good morning,

Since February 8th, we have repeatedly stated (unlike mainstream economists) that the weakness in the Euro is not due to a solvency or liquidity crisis, but to an institutional crisis:

"...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...

...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..." ("An institutional perspective on the Euro", February 10th: www.sibileau.com/martin/2010/02/10)

We trust the later developments in Europe have proved our case, particularly after the IMF's involvement. On May 10th, the European Monetary Union announced the creation of an European Financial Stability mechanism with a special purpose vehicle (SPV), the European Financial Stability Fund (EFSF). The EFSF would provide up to EUR440BN, while the European Commission would extend an additional EUR60BN facility. The mechanism involved the IMF, which would contribute an additional 50%, our EUR250BN. Post the announcement, which included the launch of the European Central Bank's (ECB) Securities Market Programme, the markets sold off. At "A View from the Trenches" we had anticipated this reaction on May 10th and further elaborated on it on May 13th. More specifically, on May 13th we wrote:

"What could the ECB have done differently?"

A similar solution to that of the Fed in 2009 would have consisted in having the ECB buy German Bunds without sterilization, from a trust, administered by the Germans, to fund the trust's purchase of PIGS debt. In exchange, the PIGS sovereign would have had to ring-fence a cash flow stream to repay the trust. This is similar to what takes place in federal unions, where the federal government collects through federal taxes or alternatively, through specific royalties established with provinces or states. With this structure, the ECB would have been able to carry out an accommodative policy, with specific amounts and repayment sources..." ("ECB Plan = End of Paper Money?", May 13th, 2010: www.sibileau.com/martin/2010/05/13)

Since Monday, June 7th, more details on the configuration of the EFSF have emerged, which is the reason why we preferred to wait until today to publish our first letter of the week.

Why are these details so relevant to us? We want to know if there will be an institutional innovation in the European Monetary Union that can allow the Euro to find a bottom, although temporary. We think this is the only guarantee for the survival of the Euro as a currency. In our view, two necessary conditions have to be met:

- 1.- Germany and other sponsors stand unconditionally behind the SPV or Trust (and has accordingly significant control over it)
- 2.- There is a clear, ring-fenced source of repayment for the SPV

With these conditions met, the Euro would stabilize temporarily. The stabilization would depend on the ratio of the speed in fiscal improvements of Germany and France vs. the speed of fiscal deficits in the peripherals. As you can deduct, we are being realistic here. We don't ask for peripherals to reduce their deficits, but to at least keep them constant, while the situation improves for the SPV sponsors. We don't ask much, we think.

Lately, many economists are forecasting that the lower Euro will significantly help the export sector in Europe to offset the impact of the upcoming fiscal tightening. We don't want to get into the details but suffice it to say that on average, the two "forces" neutralize are expected to neutralize each other, albeit generating a lower than anticipated growth in GDP.

But as we have written before, this crisis has nothing to do with fundamentals, although it is comforting to hear that a lower Euro will help. We must add too that it can only help if it is low and stable. Otherwise, if the Euro spirals downwards, the benefit of the current low Bund yields will disappear. On this note, we must acknowledge we were very pessimistic: We had written (also on May 17th and 20th) that we failed to see how the ECB would lower the benchmark (i.e. Bund) yield. Benchmark rates are at record lows, but not as a result of the ECB's Securities Market Programme, but by the jurisdictional arbitrage investors are playing, which we discussed on May 17th.

Finally, returning to the main issue of today, i.e. the details on the EFSF, this is what we preliminary understand (A final decision will be reached on June 17th):

-The EFSF will be backed by national (from Euro-zone nations) guarantees on a pro-rata basis: Not joint or several. The guarantees will reflect the ECB capital subscriptions (not higher than 120%) of the nations.

-These guarantees are contingent. There is no previous funding involved nor any collateral identified in the EFSF. Guarantees will be priced at a rate equal to the difference between the market cost of the national debt and the cost of IMF money.

-If a contingency takes place, the EFSF will issue debt backed by the aforementioned guarantees (currently, analysts estimate that the weighted-average rating is Aa1, Aa+ equivalent, which implies the need for over collateralization, should a AAA rating need to be attained).

-National parliaments will not need to vote on activation or disbursements. Euro finance ministers still have to approve the activation of the SPV.

-The EFSF will be managed by the European Investment Bank, in Luxembourg

-The EFSF can issue debt to make loans to or buy sovereign bonds of Euro members. This will require unanimity. **Funds cannot be released without the IMF simultaneously funding its corresponding 50% contribution.**

-The EFSF is created for three years, although the loans it makes can have a higher tenor.

Conclusion

Briefly, although we admit this takes the Euro-zone closer to a much needed unified bond market in Europe, we think the structure of the EFSF, with a) guarantees not joint or several, and b) without an identified source of repayment, falls short of complying with the minimal conditions to stabilize the Euro. Back on February 10th, we suggested that:

"...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..."

So far, we think the European Union is not up to the challenge...yet, which leaves the bullish trend on gold and the bearish trend on the Euro intact.