

A View from the Trenches

Toronto, Tuesday, November 24th, 2010

Good morning,

We usually publish on Mondays, but this time, we wanted to see things play out before coming back. We stand therefore by our forecast published back in September, when most saw the European Financial Stability Facility as a source of strength for the Euro, while we publicly disagreed: We saw this facility as a key that would trigger chaos within the Union. The chart below (source: Bloomberg) redeems us: the Euro fell by four cents vs. the USD, since the Irish requested access to the facility.



In our last letter, we suggested that the best way to understand the ongoing action within the EU is to use a "game theory" approach, of a non-cooperative nature, we should add. We put forth three main players: Ireland, Rest of peripherals and Core Europe. Now that the bailout for Ireland is news, a new dynamics unfolded. Early yesterday, Bloomberg reported German Chancellor Angela Merkel declaring that the prospect of serial European bailouts was "exceptionally serious". However, we listened to the speech ourselves ([Click here to watch it](#)) and believe the press may have taken Ms. Merkel out of context, which implies that the markets may have overreacted but also, that there is more in hand here .

Now that Ireland seems to have gotten away with its corporate tax structure, other "participants" in line (i.e. Portugal) have learned something: Time is on their side. Why? Because marginally, once a country's sovereign yield shoots up and becomes the next in line, the marginal pain is bigger for Core Europe. When Greece's bubble went bust, Ireland felt the pain, Core Europe barely felt it. When Ireland's bubble goes bust, Portugal feels the pain and Core Europe begins to take notice. By the time Portugal's bubble goes bust, the pain for Spain will be felt and Core Europe will be very uncomfortable, since France or Italy will be the next in line and Germany simply can't afford this.

Therefore, the sooner Core Europe deals with Portugal, the cheaper it will be to cut the pain. How does Core Europe force Portugal to come to terms? By pushing their sovereign yields higher than the policy makers of the first-in-line countries expected. How? By going on record, like Ms. Merkel did yesterday, saying that the situation is exceptionally serious. That way, Portugal's credit risk jumps 35bps to 490bps threatening with a margin increase at LCH Clearnet. This move leaves the first-in-line country unable to raise capital and asking for help to the EU and European Central Bank (sooner, rather than later! This is the point!). To us, this makes sense...Otherwise, why would someone as serious as Ms. Merkel say what she said with such a brutal sincerity? When are politicians sincere?

Where does this all leave us? It leaves us with a change in our view: We think the EU is far more serious about the survival of the Euro than we had previously thought. The problem is nevertheless still institutional, the Euro will have to continue depreciating and fiscal austerity will remain in place. However, if they succeed, it may well have again a chance to become the world's reserve currency, if the US doesn't correct their monetary mistakes. Why? Because the only way to succeed is through a dramatic institutional change, a true federal pan-European structure. In the meantime, the opportunity to become a reserve asset grows for gold by the day, because the risks of failure are just too big to be ignored.

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