A View from the Trenches

Toronto, Monday, December 5th, 2011

Good morning,

Today we want to write a few comments on the news last week, of the IMF receiving loans from central banks from the Eurozone, to buy EU sovereign debt. We certainly don't know if this will work out or not and by the amounts that were speculated (EUR200BN or more). But there is merit to make a few observations at this point:

1.-We think the most interesting detail here, to which we believe little attention was paid, is that it will "apparently" be national central banks and not the ECB, that will lend the funds to the IMF, to purchase sovereign debt ("apparently" being the operative word here). Why do you think this would be relevant? It would not, if you were not considering an eventual break up of the Eurozone. But if that scenario plays out, the clearing of sovereign debt will be much easier. In other words: **this way of monetizing sovereign debt eventually allows an orderly dissolution of the Eurozone.**

2.-As usual, it will be interesting to see whether the funds are used to buy in the primary market (i.e. direct funding of governments) or in the secondary market (i.e. funding to bondholders). We suspect that given the limitations in size and the level of yields the Euro zone is facing, the funds will be exclusively used in the primary market. This has a negative impact on the pricing discovery process. We may see a funding stress on the existing bondholders, impacting the USD funding market and eventually leading to USD swaps at cero cost from the Fed. In summary, we would see more "inelasticity" from the markets (refer our last letter), with apparently sustainable high yields in sovereign debt. These situations very often lead to frustrated policymakers, who see no alternative but to increase the level of financial repression.

3.-If the IMF buys debt from governments, and the banks who hold past issues of government debt face funding problems, we assume the banks will still need liquidity lines from the ECB. Should we not see a transfer of these liquidity lines to national central banks? Which banks would benefit? Which ones would lose?

4.- What will occur with the sovereign debt that the ECB has already purchased since May 2010, through the Securities Markets Program? Will it also be transferred to national central banks?

5.- Will points 3 and 4 be contemplated in the next EU summits, when fiscal integration is discussed? How would the markets take the news, if they actually are?

Needless to say, lending printed money to the IMF to buy sovereign debt is to simply leverage the problem, without addressing its root. While every analyst dismissed the Greek problem at the beginning of 2010, saying that it was only a liquidity issue, we were the first and perhaps only ones to go on record saying that the Eurozone did not face a liquidity or solvency problem, but an institutional problem (See our letter from February 8th and 10th, 2010: www.sibileau.com/martin/2010/02/08 and www.sibileau.com/martin/2010/02/10)

On February 10th, we wrote: "…***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…"***

What could save the Euro? A real fiscal integration. By this we mean a structure where a EU wide federal tax is charged to all the Eurozone citizens, to allow transfers to countries in trouble. If this worked, this federal institution could issue its own bonds, Eurobonds, that would later be swapped to the IMF, in exchange for the national sovereign bonds that the IMF would purchase. This is the only way to save the Euro, and we think it is already too late to implement.

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