



CUMBERLAND

EUROPE, STILL LOOKING FOR THE DEEP POCKETS

There has obviously been some progress made on resolving the Sovereign debt crisis in Europe. However, it remains to be seen whether their actions go far enough to put this crisis behind them.

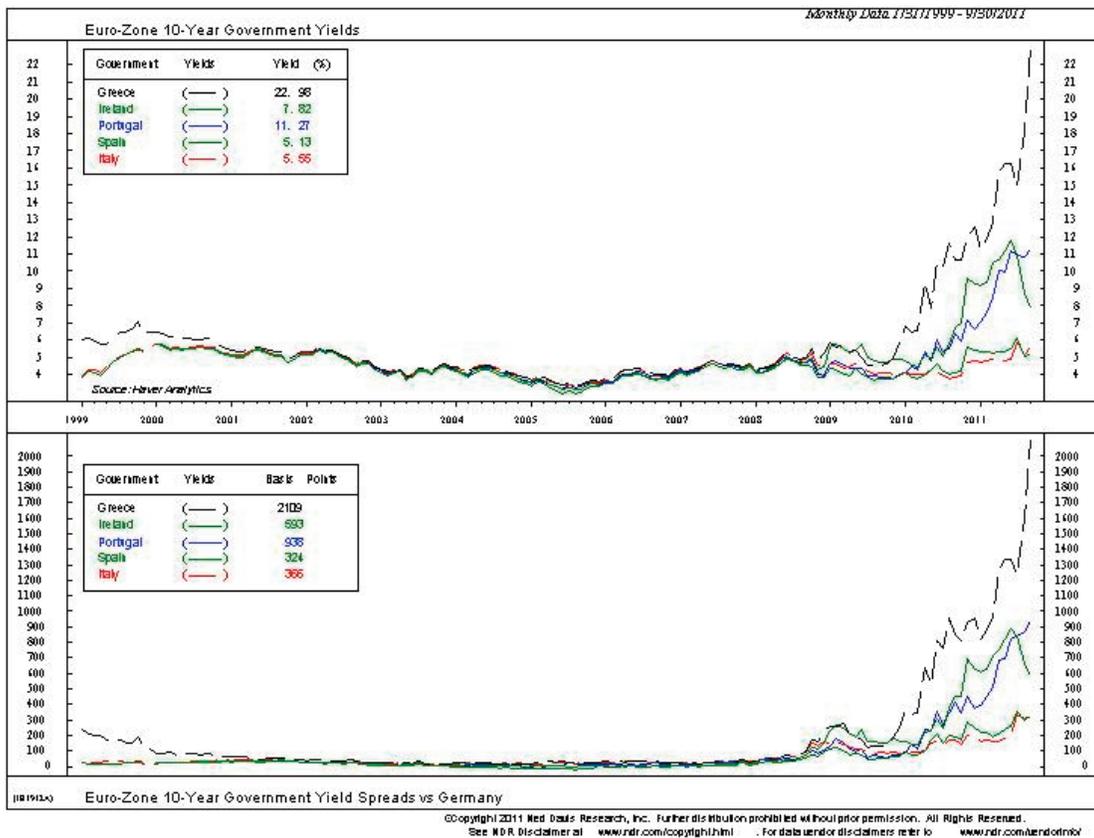
As I said in my Quarterly, unless there is recourse to some very “deep pockets”, this latest plan is likely to be considered just another attempt to “Kick the Can further down the Road.”

We'll probably have to wait until after the G20 conference on November 4th to hear more details. But, right now the Europeans seem to have rejected using the European Central Bank (ECB) as the backstop for funding and seem to be appealing to outside sources for help such as China, Brazil and the International Monetary Fund (IMF). That's an interesting contrast to what the United States did by creating the Temporary Liquidity Guarantee Program that allowed banks to issue bonds with the backing of Federal Deposit Insurance Corporation (FDIC). The Europeans also need a central agency that is unconditionally backed by the EU countries or the ECB.

Meanwhile, remember the ultimate goal here is to prevent another recession and to stimulate economic growth. No one is talking about reducing or paying off any debt outside of Greece through default. Therefore, the only way to reduce the debt to GDP ratios is through economic growth. But government austerity programs and shrinking bank balance sheets aren't a step in the right direction.

The best that can be said is that these measures are necessary evils that cannot be avoided, but they will probably have unwelcomed outcomes.

As I said, we don't have enough details to determine the likely success of the new initiatives, but the best barometer to judge their success is probably the yield on ten year Italian bonds. Above 6%, it is likely to signal more stormy weather. However, I'll offer a caveat to this opinion. In the short term, there is likely to be pressure on Italian bond yields until the EFSF plan is implemented. Why would anyone buy an Italian bond today, if he is likely to get some form of guarantee from the EFSF in the next little while? Until the new plan is implemented, investors in any of the troubled European countries are likely to defer their purchases to see if they can get a better deal. Once the plan is implemented bond yields will then be a better indicator.



Otherwise, let me lay out some random thoughts that I didn't include in my Quarterly. I'll start with the European Banks.

Part of the latest plan is to help the banks recapitalize their balance sheets after taking write-downs on Sovereign debt. The priority in doing this is first to let the banks raise their capital ratios on their own. This can be done by either going to the market to raise additional capital or by selling assets, i.e. potentially calling in loans to shrink their balance sheets; not good for the economy but certainly favoured by a number of frustrated bank CEO's who refuse to raise equity at such distressed valuations.

The second priority is for the country in which the bank is resident to inject equity into the bank. For countries such as Greece, the third option is to resort to the EFSF for capital. Ultimately, some banks will have to resort to this last option which will reduce the EFSF's available capital to support the Sovereign debt market. However, let's assume that the plan can deal with the banks' solvency in the face of 800 billion Euros of bond refinancing that they will have to do over the coming year.

How much will be required? Well that depends on who you listen to and how they define the size of the problem. The estimates generally range from 100 to 200 billion Euros. However, the European banks have been much slower to adjust to loan deterioration than their U.S. counterparts and have hardly reduced their balance sheets since the 2008 crisis. That means they're behind on dealing, not only with Sovereign debt issues, but also general loan portfolios which no one is really talking about.

However, Ned Davis Research did an interesting piece that examines three elements of recapitalizing the banks. This not only includes the cost of covering Sovereign debt write-downs but also new, higher capital requirements and further reserves against non performing loans.

Of course, these numbers can be reduced if the banks want to make themselves smaller by shrinking the balance sheets.

The capital required to cover Sovereign debt write-downs is about 70 billion Euros. This assumes a 50% haircut on Greek debt and a 20% write-down for Irish and Portuguese bonds. It will be more if Italy and Spain get into trouble.

Bank capital ratios are also being raised from 5% to 9%. It is estimated that this will require another 185 billion Euros, so we're already at 255 billion Euros.

The third element isn't required but should be considered when judging the health of the European Banking system. Currently, the Europeans have reserves to cover only 40% of their noncurrent loans, which is low by historic standards. In the U.S. they have been writing off loans and have improved this coverage ratio to 67%. Therefore, if the Europeans were to come into line with the Americans, they would require a further 287 billion Euros, bringing the total to 444 billion Euros after some offset for the higher capital ratios.

If the banks decide to deleverage, which seems to be the route they are taking, it will not be good for the economy, especially when you consider that the European banks are regularly used to achieve national goals as opposed to strictly economic purposes. For example, during the initial stages of the credit crises the Euro Zone governments pressured their banks to purchase significant amounts of Greek debt in hopes that it would avoid a problem. In Spain, the government pushed Spanish banks to treat about one million, recently naturalized citizens as having prime credit, despite the total lack of credit history, in order to support the real estate and construction markets.

When you consider that European banks provide about 70% of the funding needs for consumers and corporations compared to about 40% in the U.S., their contraction will have a meaningful impact on the economy.

Yet, there is hope that some of the troubled European countries can pull out of their financial straight-jackets.

Essentially the currently troubled countries can be grouped into three categories.

1. Unsalvageable – Greece
2. Those with banking sector crises but not over indebted governments- Ireland and Spain.
3. Low growth and high government debt, Italy and Portugal.

Ireland and Spain could consider resolving their issues by imposing losses on the bank bondholders as they don't have significant sovereign debt risk. The bondholders were the beneficiaries of the government bailouts.

Italy and Portugal need greater GDP growth to “grow” out of their problems, which is going to be a tall order.

However, Ireland is setting a positive example. Their government bonds now yield less than when they received their 85 billion Euro bailout. Ten year bonds currently yield 7.7% down from 14.5% in July. GDP growth in the 2nd Quarter was 1.6% and the current account is in surplus for the first time since 1999.

As I said in my Quarterly, Greece is really a sideshow, the real issue is preventing them from becoming a catalyst for a pan-European recession.

One of the solutions that regularly crops up for dealing with Greece or other insolvent countries is to kick them out of the EMU. It isn't out of the question, but it isn't as straightforward as it might seem.

Why doesn't Greece get out of the Euro?

Woody Brock, a long standing consultant to Cumberland, recently provided an interesting perspective on how the European Monetary Union actually helped cause some of the current problems.

Historically, Sovereign Countries could control their economic growth and inflation with a combination of tools such as monetary growth, interest rates, exchange rates and fiscal policy. For example, when a country needed a bit more growth they could lower their interest rates and devalue their currency a little. But, not with the European Monetary Union (EMU). With this, they gave up three out of four controls with only fiscal policy remaining. So is there any wonder how Greece got into trouble? With only one option, they elected to spend and borrow to create growth in an otherwise uncompetitive economy.

Consequently, what seems to make the most sense is for them, or anyone else in their position, to get out of the EMU to recover control of monetary tools that could salvage their economy.

However, the results of a return to the Drachma, are far from certain. Consider some of the consequences.

First, any suggestion of leaving the EMU would result in a run on the Greek Bank which would require foreign exchange controls.

Second, devaluing the currency would result in more inflation. It's true that it would make their workforce more competitive, but unions would likely demand adjustments to offset the inflation, thus cancelling out any competitive advantage from the devaluation.

There are also financial consequences. What do you do about debts and contracts that are denominated in Euros?

One benefit however, is that they could monetize their own debt by forcing the Greek banks to buy their bonds, if there are any deposits left.

Consequently, the costs are pretty easy to determine, but the longer term benefits are fairly uncertain as the country would be financially abandoned with severe consequences to asset values.

Obviously, the other option facing the EMU is to gain control over fiscal policy. This would require a central treasury that could issue bonds on behalf of all members rather than letting each country issue its own bonds. This also means that you need a unified tax policy that is collected by a single ministry that could redirect revenues to assist troubled regions. Something that France and Italy might support, but you're not likely to get the Germans on side any time too soon.

Bottom line, for any debtor nation to gain a competitive advantage they need to experience deflation and a reduction in their standard of living. Do you think that will get the rioters off the street?

As a postscript, Greece made a surprise announcement on November 1st that Prime Minister George Papandreou has called for a confidence vote in Parliament on November 4th and a national referendum on the European bailout plan after details of the plan are known.

This creates a number of unknowns. How does Greece get funded if it turns down the plan? What are the consequences to the banks, etc? Reality is, these are the wrong questions. In fact, maybe a Greek vote against the proposal would save money. At least the EFSF could stop funding them.

The real consequences of a rejection would be to create a true default. Under the current European plan the Greek debt reorganization is "voluntary" and does not trigger any consequences.

With a default, the debt problem takes on an entirely different complication because of the Credit Default Swaps (CDS's) held by many U.S. banks that guarantee the Greek debt. Should these be triggered, there is a very complex web of interrelationships that would be activated with unknown consequences.

Let me give you an example. Guarantees sold by U.S. banks on European government, bank and corporate debt rose by \$80.7 billion to \$518 billion, in the last quarter according to the Bank for International Settlements, mostly in the form of credit default swaps.

The biggest U.S. underwriters are J.P. Morgan, Goldman Sachs and Morgan Stanley. They say they have hedged their books so that their net exposure is reduced by purchasing offsetting swaps. The problem with that, is that they retain "Counterparty" risk. What if the guy they are buying protection from goes broke?

Currently, CDS's held by U.S. banks are about 3 times as much as their \$181 billion in direct lending to the five troubled countries of Greece, Portugal, Ireland, Spain and Italy.

The five largest underwriters of CDS's, besides the above, also include Citigroup and Bank of America. Collectively they wrote 97% of all credit default swaps in the U.S. and claim they have about \$45 billion in net exposure to those five countries.

If Greece defaults, it could cause some of these CDS's to pay off, but the consequences could be even worse. This could result in a run on some of the other peripheral countries that could result in margin calls to support their collateral for those banks that sold the guarantees.

Banks also buy CDS's on their Counterparties to hedge the risk of their trading partners defaulting. However, it isn't clear if this is being done in every case or if the U.S. banks are simply betting that the European Union will rescue their major lenders.

The U.S. Federal Reserve says that it isn't worried about these U.S. banks' exposure because the banks have sufficient collateral from their counterparts. But do they?

Last month, Morgan Stanley reported that its exposure to Spain amounted to a net \$499 million. However, the Federal Financial Institutions Examinations Council disallowed some of the netting and said the firm's exposure to Spain was actually \$25 billion. They also reported their exposure to Italy as \$1.8 billion while the agency suggested that it was closer to \$11.0 billion. Morgan Stanley says the numbers don't take into account collateral, short positions or offsetting trades.

That may be so, but there is room to doubt what we are being told.

Is this confusing? For sure! It's a tangled web that no one can sort out and most want to avoid at all costs.

The best case is that things are as they are represented. But, we can only wonder if anyone really knows what the overall exposures are or the consequences of their unraveling.

The only thing you can be sure of is that the Federal Reserve will be there with a cheque book if things do get out of hand. And that's more than we know about Europe.

GRC/amh

Thursday, November 3, 2011

Credits: Ned Davis Research
 Woody Brock
 J.P. Morgan
 Bloomberg