February 2009

The euro ten years on – growing pains, not the final nail

Investment Letter IV

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The euro – "change we can believe in"?

The euro has just passed its tenth anniversary. The occasion was not as celebrated as might have been expected. At the time of the single currency's launch many respected economists were critical of its prospects and doubted it would last a decade. Given this background, and the fact that the currency has strengthened by around 20% against the dollar since launch, one could have expected this occasion to have been the source of much backslapping in Brussels and Frankfurt. However it looks increasingly as if the euro's teenage years will be troubled, indeed many of these original detractors are now, once again, predicting the imminent demise of the great experiment. Although we rule nothing out, particularly in fast changing times such as these, we do not foresee the imminent disintegration of the currency. Perhaps the most elegant solution would be a break-up of the euro of a North/South basis, however there are thorny issues here, involving the denomination of debt. In our view it will ultimately be the German taxpayer that foots the bill for a required bailout, but the largesse will come with strings attached which will be the surrendering of fiscal independence of participating countries to the EU.

Background

Most currencies start as much for political as for economic reasons, the euro was no exception. Sterling, in its current form, was created by the Act of Union in 1707 as a single currency for England and Scotland. The US Dollar was created at the bequest of Treasury Secretary Andrew Hamilton in 1792 to provide common coinage for the original thirteen States.

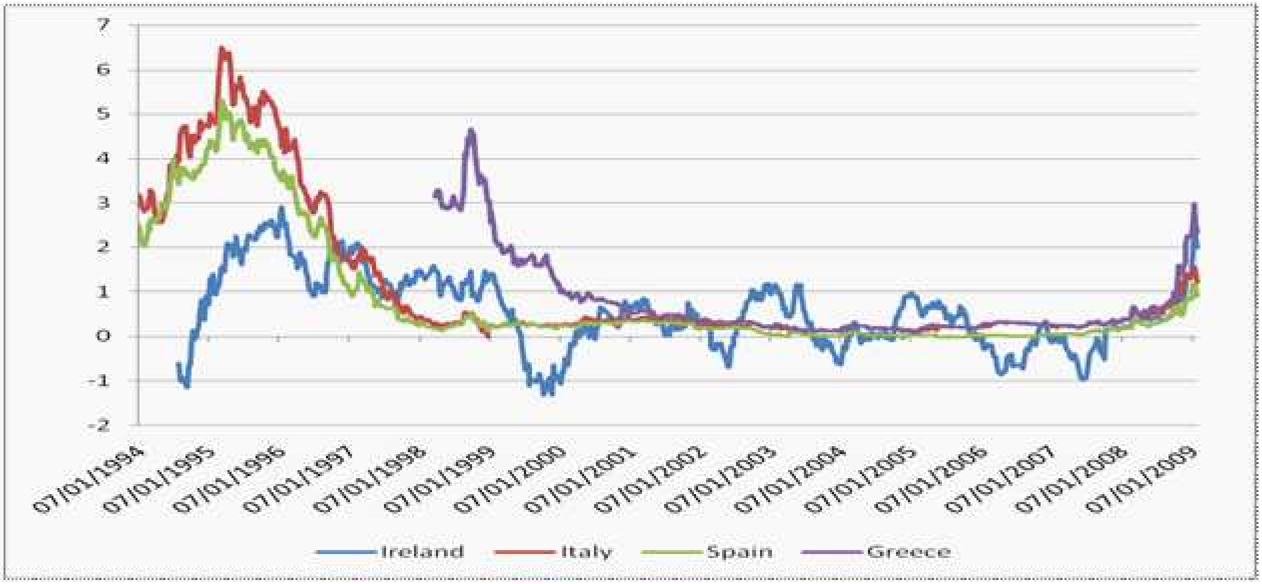
The euro was formally approved at the Maastricht Treaty in 1992, which also transformed the then European Economic Community (EEC) into the European Union we have today. Jacques Delors, the President of the Commission at the time, emphasised the political nature of the currency right from the start: "Obsession about budgetary constraints means that the people forget too often about the political objectives of European construction. The argument in favour of the single currency should be based on the desire to live together in peace." In 1999 the currency formally launched, driven more by politics than by economics.

Aside from the fact that at the time of the currency's launch the economies were not synchronised, the main concern that we have always had is that because of the fixation on the politics of it, the currency area was an artificial and disjointed construct. We discuss the concept of Robert Mundell's Optimal Currency Area (OCA) a little later, but for the moment suffice it to say that in order for the euro to work in the long term more economic integration is required between the participating countries. The most glaring omission from the project at the moment is that, unlike the U.S., there is no fiscal transfer mechanism (i.e. tax and benefit system) to redistribute money from booming to struggling areas across the cycle.

Where are we now?

Ten years on the system is facing its most serious crisis so far. The rapidly diverging trajectory of Northern Europe's economy from that of the South is the nub of the euro's current malaise. A picture tells a thousand words. CHART I shows the spread over German bond yields of Ireland, Italy, Spain and Greece. The markets fear that one or all of these countries default, leading to the euro-area's disintegration.

CHART I: Spreads over German 10 year bunds – Source: Bloomberg



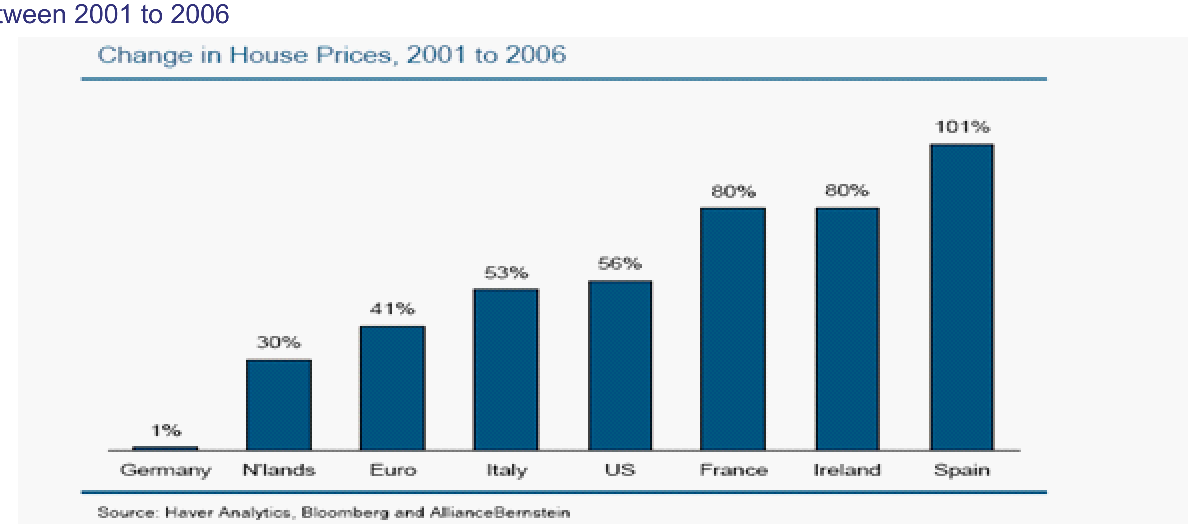
The economics of the problem

The euro area is very diverse, the 11 initial members (Austria, Belgium, Finland, France, Germany, Holland, Ireland, Italy, Luxembourg, Portugal and Spain) have been joined by 5 more since launch (Greece, Slovenia, Cyprus, Malta and most recently Slovakia). In addition Denmark, Estonia, Lithuania and Latvia are members of the European Exchange Rate Mechanism II (ERM II), de facto pegged to the euro. These 16 member economies are in many ways structurally different, but they can be broadly divided into three groups.

'Northern Europe' – we've already had our recession

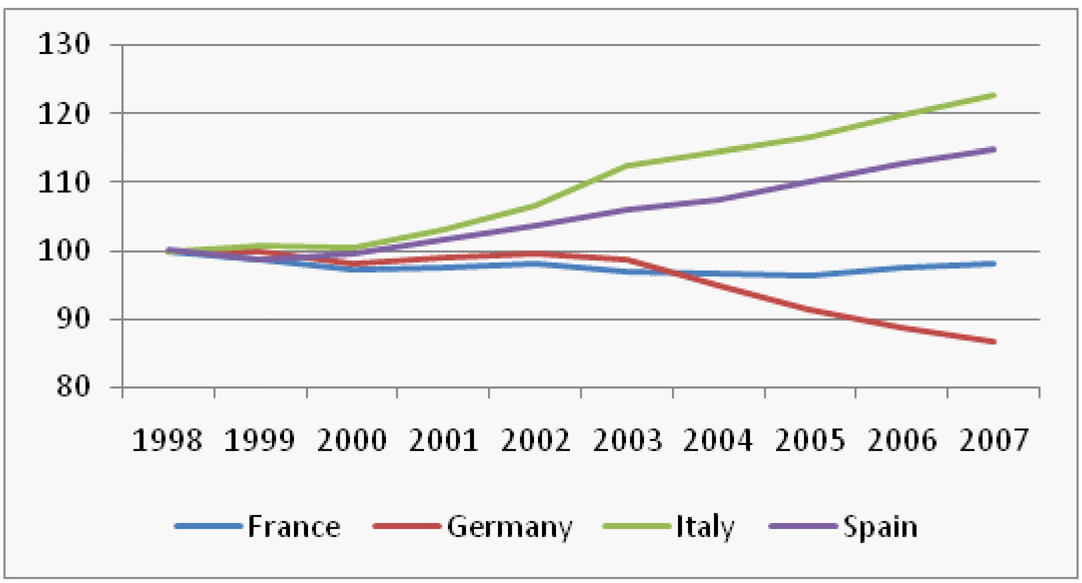
Germany is the key Northern European economy but Holland, Belgium and Luxembourg are in many ways similar. The German economic model is based on its exporters (traditionally involved in engineering and heavy industry) relying less on domestic demand. As a result of the heavy hand of Germany's further and recent past, the Bundesbank is structurally 'hawkish' (i.e. wary) of inflation and is brutal in squeezing price rises out of the system, often at a heavy cost. After Germany's reunification in 1991 tax breaks designed to encourage (re)-construction of Eastern Germany led to a property boom, shortly followed by a bust. This was followed by a protracted period of disinflation as inflation cooled from 6% to 0.2%. Although the German Consumer Price Index (CPI) did still remain positive between 1991 and 2006 it masked broadly deflating asset prices –property prices sank 22% from 2003 until 2009, just as the most of the world was "enjoying" a property boom that morphed into an alarming bubble. Even more recently, Germany missed out on the property boom:

CHART II – European House Price moves between 2001 to 2006



From the late 1990's, Germany was regarded as the 'sick man of Europe' with a stodgy labour market and interest rates that were too high for an economy experiencing sluggish growth. Various government led reform plans, notably Chancellor Schroder's 'Agenda 2010', succeeded only in splitting the Social Democratic Party. With no lead coming from the government, no domestic demand and high real interest rates German corporations had to get more efficient or die. Even old giants such as Siemens, cut costs dramatically and strengthened their balance sheets. CHART III illustrates what happened to German unit labout costs up until 2008. This was a very profitable time to be investing in German equities.

CHART III: Source: Unit labour costs rebased: Source: OECD



'PIIGS' – Celtic Tigers & Spanish Economic Miracle = negative real interest rates

Meanwhile, the so-called 'PIIGS' (Portugal, Ireland, Italy, Greece and Spain) enjoyed a party fuelled by low real interest rates, the result of joining the euro with structurally higher inflation than the North. Indeed for much of the past decade these real rates have actually been negative leading the massive expansion of consumer and corporate borrowing, encouraged by the fact that the real value of the debt fell year upon year. Predictably, the easy money found its way into property assets. Between 2001 and 2006 Spanish house prices doubled; Irish prices soared 80%. Much noise was made about the 'Celtic Tiger' and the 'Spanish Economic Miracle' as Dublin boomed and Spanish corporations acquired a host of international assets (in Britain alone – O2 mobile phones, the BAA airport group and Abbey National Bank). As the PIIGS economies had become even more dependent on access to wholesale credit markets than even the Anglo-Saxon world, they are suffering more than the Northern Europeans. In Spain, unemployment is up 40% over the last few months and applications to join the military have soared, with three out of four applicants being turned away. Meanwhile in Ireland civil servants have had their pay cut. What is more worrying is that over the past decade these countries have allowed their competiveness to fall. As is highlighted in CHART III whilst German labour costs have fallen by about 12% since 1998, Spanish labour costs have actually risen by 15% and Italian by over 20%.

In the past Italy would have responded to a downturn of such magnitude by allowing the lira to depreciate, hence making its exporters miraculously and painlessly more competitive. With the introduction of the euro the only option now available to the PIIGS is to embark upon a programme of corporate restructuring similar to that of Germany, but unlike Germany with a very unfavourable economic backdrop.

Companies, consumers and policy makers across the PIIGS are like rabbits in the headlights, unable to make tough decisions. The elevated levels of debt (even more so than the Anglo-Saxons) in a deflationary environment raises the serious risk of full blown debt deflation, with the real value of the debt acquired in boom times increasing every year as the economy slows further. These countries are facing depression.

France – not as restructured as the North; and not as indebted as the South

France is perhaps the odd man out of the major euro-zone economies. The country's corporate sector has not restructured to the extent of Germany's, nor has it taken on as much debt as its Southern cousins. France has not experienced the asset and wage deflation of Germany nor the boom of the PIIGS. Indeed it has muddled along, much as it always does. In many ways it will be the attitude of France, as Europe's 'swing voter', that determines how this crisis and any reform to the euro plays out. This is reinforced by the political power which France has always enjoyed in the EU.

Optimal Currency Area Theory

With the economic and political backdrop covered, it is worth introducing Robert Mundell 's 1960's idea of an 'Optimal Currency Area' (OCA). He ascertained that for a currency area to be optimal it must meet the following four criteria.

- Labour mobility across the region in question

.i.e. workers must be prepared to relocate from areas of high unemployment to areas of shortage.

- Product diversification.

The argument runs that a more diverse region will overall be more balanced than one dependent upon, say, a single commodity.

- Capital mobility, price and wage flexibility.

Capital must be able to invest freely across the region, relocating as needed. Prices and wages must respond to changes smoothly.

- Automatic fiscal transfer mechanism.

This is in many ways the most crucial. For a currency to work there must be an automatic way of redistributing money from areas that are booming to areas that are suffering. The most common method of achieving this would be a common tax and benefit system.

To put this in perspective it is instructive to look at how the United States fares according to the Mundell checklist:

- Labour mobility across the region in question.

This is certainly the case. Americans routinely travel across State lines for both education and work.

- Product diversification.

America is a very diverse economy, from the oil fields of Texas, to New York's financial centre to the high tech nature of California's silicon valley.

- Capital mobility, price and wage flexibility.

Once again, this undoubtedly is the case. Someone from, say Iowa, looking to open a factory could build it in any state.

- Automatic fiscal transfer mechanism.

The Federal government provides this mechanism through taxes and benefits. If California is booming and Ohio is in recession, an automatic transfer will take place. Companies and individuals in California will pay more tax (as profits and wages will be higher), whilst Ohio will received more Federal money – as larger numbers of unemployed people mean it will receive higher welfare payments. In other words, money is automatically transferred by the fiscal authority from the boom area to the bust areas.

In the Eurozone however, only one of these conditions is met:

- Labour mobility across the region in question.

The problems of language and different national cultures are an impediment to full blown labour mobility.

- Product diversification.

On this criterion the Eurozone economy is broad enough (German engineering companies, Irish service industries, Slovakian agriculture) to meet it.

- Capital mobility, price and wage flexibility.

Capital mobility was indeed very fluid until recently. However, it is clear that the current bailout packages have put a brake on capital mobility. Examples include the Greek Central Bank stipulating, after it had bailed its banking sector out to the tune of €28bn, that the banks were not allowed to use that money to support their Balkan subsidiaries. The emergence of capital protectionism is not confined to periphery countries; France too is injecting €21bn into its largest banks to ensure that they are not at a disadvantage to other EU banks.

- Automatic fiscal transfer mechanism.

This is where the euro-zone really falls down. There is no automatic transfer mechanism in place. Between 1998 and 2006 money was not transferred from booming Spain to struggling Germany and right now, money is not being transferred from, comparatively better off Germany to struggling Spain. The introduction of a federal fiscal transfer system was a political step too far as it would mean that a United States of Europe had officially been created.

What will happen?

CHANGE NOTHING – leave the PIIGS to take their medicine

Without serious action the PIIGS face prolonged depression. They will have to regain their competitiveness by embarking on a restructuring far more severe than anything Germany faced and coupled with the pernicious effects of debt deflation. To many in the German, and indeed French, governments 'doing nothing' seems to be the preferred option. Their attitude is that the PIIGS boomed for a decade and now it is their turn to feel some pain.

With a more clement economic backdrop the option of painful restructuring would be, if not attractive, at least feasible for the PIIGS. With export markets having collapsed and domestic consumers and companies over indebted, it may not be possible without mass unemployment, wage cuts and a collapse in house prices.

The political imperative on the PIIGS' governments to 'do something' is rising. Italian politicians and its Press have not been shy at 'saying and thinking the unthinkable' i.e. readopting the Lira. The Greeks have already started to riot. Leaving the euro would permit these countries to sharply devalue their currency which would stoke domestic inflation (as imports became more expensive) and hence lower the real value of their massive debt piles, whilst at the same time regaining international competitiveness for their exporters.

If only things were so simple.

If the PIIGS government (s) did switch to a new currency they would immediately face problems on account of the fact most, if not all, of government, consumer and corporate debt is denominated in euros. This is in stark contrast to the UK's exit of the ERM in the early 1990's where all debt was denominated in Sterling. Withdrawal from the single currency would leave two options either (i) leave the debt dominated in euros or (ii) pass a law automatically converting debt into the re-born domestic currency.

Option (i) would mean the value of the debt would explode crippling the economy. If, say, Italy were to do this it and devalue the New Lira by 25% (probably what is required to regain competitiveness) then the debt burden on government, consumers and corporate would rise by 25%. Any gains in competitiveness would swiftly be offset by higher interest payments, negating any advantage.

Option (ii) would be akin to a Sovereign default. The non-Italian holders of debt would lose 25% of their capital overnight. Whilst Italy could 'enjoy' the enhanced competitiveness, it would surely be severely punished by the market. Any attempts to raise debt from abroad would be viewed with great suspicion and only provided at (even more)penal interest rates. The route of Sovereign default is not one that has ended well for other countries. Argentina has never been able to re-emerge as anything other than a 'basket case' since its first modern default in the 1940's

The economics of a country's departure aside, the political implications would be vast and would in many ways spell the end of the European project towards ever closer union, the defining movement of post-war European politics. The importance of the political angle to the Europeans, but most especially to the Germans and French, continues to be underestimated by us as free-market island dwellers and we have been careful not to let any prejudices that we have creep into our analysis of the situation.

What we believe will happen is that there will be a game of geo-economic chicken. The Germans will insist (right up until the point that they don't) that the PIIGS should swallow their painful restructuring pill, and not to expect any help from them. The reasoning behind this being that no PIIGS country would be economically suicidal enough to leave, given that it would mean even crushing debt or national default.

Meanwhile expect the squeals from the PIIGS to increase as their economies continue to deteriorate and the domestic political pressure to do something reaches fever pitch, to the point at which it becomes inevitable one has to leave. At this point the Germans, encouraged by the French, will swerve and offer the squealer (s) a lifeline as much to save the euro as to prevent a major European economy becoming a major competitor for exports in its backyard.

What lifeline is most likely?

Bail out – lite

One solution, currently being mused by policymakers, is the idea of issuing euro-zone bonds through the ECB. i.e. rather than the individual member states issuing their own debt, bonds would be issued jointly with all member states being liable, and with the Bundesbank's credibility attached to them.

The attractiveness of this to the PIIGS is obvious, in that it would alleviate some of the worst effects of the downturn by reducing interest rates, and without having to pursue an economic policy option that would spell domestic political disaster. The poor German corporate and taxpayer on the other hand will react badly to their increased borrowing costs, but will be ultimately placated with promises of the PIIGS narrowing their budget deficits and reforming their economies.

Total bail-out

Should the abovementioned 'bailout-lite' not succeed, there is a more radical option. The aforementioned implementation of a federal tax and benefits system for the eurozone, through which the bail-out would be conducted. Economists would dub this 'creating an automatic fiscal transfer mechanism'; it would in fact spell the official creation of 'a European super-state'.

The logic of the idea is that by creating a common tax and benefit policy (harmonized welfare payments and corporate and personal tax rates), then euro-zone would become more of an 'optimal' currency area. If this were to be the case, taxes levied upon German corporate profits could be used to pay the dole to the Spanish unemployed. Of course this works both ways and from 1998-2006, the transfers would have gone the other way.

As we hope is now clear, if the euro is to work there must be a common fiscal authority. Although this might raise eyebrows amongst the British press, it would be the natural conclusion of the 1958 Treaty of Rome's call for 'ever closer integration'. The truth is, there simply might be no other choices.

The most radical option – two separate currency blocks

Perhaps the most elegant (and therefore unlikely) solution to the problem would be a straight forward split of the euro-area into two currency blocs along North/South lines. This would allow the PIIGS a monetary policy more appropriate to their stage in the cycle, and boost their exporters. The problem would again be the euro denominated debt pile; however this would be less severe than in the case of single country leaving .

Such a split would be along the existing fault lines within the EU. The political will to allow such a breakup may be lacking – any split of the euro-area would be seen as split in the EU. Faced with such a prospect, Germany would probably rather bailout the PIIGS than allow them to leave. Leaving aside politics, Germany would probably not relish the prospect of a large, exporting bloc competing against it with a devalued currency. To do this would be to hand back 16 years of hard won competitiveness against its Southern European neighbours.

Road map

Over the coming weeks and months the squealing from the PIIGS and the grumpiness of the Germans will intensify. As a first step, Germany, nudged by France will agree to some form of euro-bond as a first step. Should this be unsuccessful (and for us it is a question of waiting to see the facts), expect to see the beginnings of the establishment of a common European fiscal policy. The first step might simply be Germany providing direct support by purchasing PIIGS government bonds.

Investment Implications

The investment implications of the above, of course depend upon exactly how this crisis plays on.

Currently

Currently, whilst we are in the 'change nothing'/'game of chicken' phase, the implications are straightforward.

The global economy is experiencing debt deflation, and capacity among many industries remains structurally too high; unemployment is leading to wage deflation and the structural output gap will continue to put downward pressure on prices, which is deflationary and therefore positive for government bonds.

Surprisingly, history shows that the issuance of government bonds on a large scale does not necessarily lead to lower bond yields and inflation; the example of Japan is a case in point. Investors and commentators pointed to a bubble in Japanese Government Bonds (JGBs) years before the yields bottomed out at 43bps. Offsetting fears over higher levels of supply is the shift in natural demand into bonds. Although higher prices mean that yields have come down, bunds remain appealing, as locking in a safe yield of 3% is attractive against an economic background that threatens deflation.

The Senhouse Europe Focus Fund has made 14% on its exposure to short-dated German bunds (in euro terms, 37% outperformance against the Stoxx 50 Index since purchased in September). As we have been arguing for quite some months, those who fret about inflation do so due to their memories of the 1970's recession which was caused by a supply shock (rise in oil price) rather than a fall in demand (as is the case today). The first mentioned recession is inherently inflationary whilst recessions such as today's are marked by falling prices (e.g Japan in the 1990's). Please see the investment letter that we wrote in July 2008 entitled: Inflation: Fighting the Last War.

An improvement in investor sentiment would likely lead to higher government bond yields, as the flight to safe haven investments is partially reversed; this should be seen as positive if it represents a partial move back into risk assets.

In the equity markets we will also continue to invest in companies where big-spending governments are the customers and the company is a market leader (such as Alstom), but beware companies that rely on vendor financing to generate their sales. In a recent investment letter entitled: Vendor Financing: The other shadow banking system we highlighted BMW and Tesco as being two examples of this phenomenon. It has come to our attention that Siemens is also an offender, but the market appears not to have picked it up. Although 1Q09 earnings results were good, operating cashflow swung deeply negative from €487m in 1Q08 to -€942m in 1Q09, the swing factor being the blowout in working capital, a result of the fact that receivables are increasing. This strongly suggests to us that the company is now engaged in vendor financing and essentially "buying" earnings.

Other attributes that we look for in companies are those with monopolies (such as the high-yielding shares of Greece's monopoly betting operator, OPAP) and companies that capture a shift in tastes such as Piaggio (which recorded an 85% sales in the US in November, year-on-year).

We will await a suitable time to invest selectively in PIIGS companies once there is evidence they have embark on restructuring and the pace of decline of the economies slows; there will be plenty of restructuring stories, similar to the restructuring of corporate Germany. Indeed spotting the restructuring corporate early will be the source of very good returns for stock pickers such as ourselves.

If a country were to leave

Whilst we regard this as unlikely, it is possible. The key risk here would be currency risk. Until the details became clear, it could be difficult to hedge the nascent currencies until the market finds a level. The logical investment action would be to buy exporters from the southern bloc once the currency had found a new, lower level. In the meanwhile, the fund would remain positioned as outlined above.

Euro-bonds are issued

There will be another convergence play opportunity – similar to the one when the Euro was first launched; the logical approach would be to sell the higher quality, liquid government bonds, particularly the German bunds, and buy the government bonds of the periphery countries, as the relatively higher yield would be expected to reduce as the risk premium reduces.

It is highly possible that the equity risk premium of the periphery countries would ease, as the risk of these countries breaking away also reduces. This would make PIIGS equities better value.

A new Federal Fiscal Solution

If this step were to be taken, it would likely be bullish for PIIGS bonds and equities (who would be receiving a fiscal bailout), whilst bearish for German assets (who would be bankrolling it). Whilst this may be the ultimate ‘end game’ it is still some time off and we will have time to react.

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February 2009

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P.S. As an aside, the events unfolding in Eastern Europe and their impact on sentiment towards the euro, should be seen as a separate issue. The affected Eastern European countries are not members of the euro-zone and hence the impact is indirect. However there is a chance that the deepening crisis in Eastern Europe could act as a catalyst for the EU to implement some form of federal fiscal infrastructure. We have the ability to invest in Eastern Europe but we have studiously avoided the region. The growing macroeconomic stresses (particularly the alarming current account deficits and growing debt mismatch) remind us of our time in South East Asia during the crisis, one decade ago.