

MARKET INSIGHT REPORT

To Save the Euro, Throw Germany Out

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By John R. Taylor, Jr.

Chief Investment Officer



Athens, Greece might look like the focus of the first euro crisis, but the real center is 1800 kilometers north-northwest in Berlin, Germany. Although this is the first time that one of the countries within the EMU structure has been threatened with the economic, political, and social disruption that will accompany an attempt, successful or not, to remain in the euro, it is not the first time that we have seen a European monetary crisis. There have been many. The most infamous resulted in the collapse of Sterling on September 16, 1992 when George Soros, supported by a host of good economic reasons, drove the pound from the ERM. Although the pound lost almost 30% of its value in a few months, the British people did not suffer the enormous economic pain associated with a lengthy currency defense. In fact, the UK began the longest uninterrupted economic boom in the country's history. In 2002, at the ten-year anniversary of that Black Wednesday, London was the financial center of the world. A more recent example of a euro-centered currency crisis is the one being experienced in Latvia where an effort to hold the lat within its narrow ERM bands has resulted in extreme economic distress that has caused the economy to contract by roughly 20% in the past year. Although Latvia has its own currency which is tightly tethered to the euro, the events there could be very similar to those that will unfold in Greece. Unfortunately, the Greeks are in a worse spot than the Lats, for two reasons. The first is that the Latvian economy is very open and the Greek economy is relatively closed and its exports equal only 28% of its imports. Latvia can become a mini-exporting powerhouse, saving themselves, but the Greeks cannot. Secondly, the Lats have a rather terrifying next door neighbor who occupied their country for 70 years and still looks threatening. For them the euro is a security blanket that will protect them from being re-absorbed by Russia, but the Greeks have no reason to starve themselves and lose their savings, just to be part of a super-state run by far-away overlords in Brussels and Frankfurt.

Although the Greeks are faced with the Hobson choice of penury and diminished prospects for the future, the instigators of the Greek financial crisis, and the crises to come in Portugal, Spain and Italy, are the Germans. It is the dramatic increase in German productivity that has driven the current account balances of these countries into deep deficit. To balance its books against the rest of the EU, Greek domestic demand would probably have to drop by about half, an obvious impossibility in a modern democracy. Jurgen Stark, both German and a member of the ECB board, commented this week that Greece had overspent and their budget deficit was at fault; "Greece needs to catch up on its homework." Maybe the Germans have been studying too much, as their productivity growth far outshines that of France, Italy, Spain, and Portugal as well as Greece. All of these countries have seen their current accounts decline against the Germans, and all will end up in similar spots as Greece at some point in the future. The single currency structure means that any adjustment in relative competitiveness must come out of productivity growth, which is very difficult to manage. As higher productivity implies more work for the same wages, it is a deflationary concept and needs to be offset by the money illusion. This persistent inflation makes labor feel it is gaining at the same time 'capital' is gaining through productivity growth. The balance between productivity and inflation is a very tricky one, but when inflation is eliminated, productivity growth becomes drudgery at best and the seed-bed of social discontent at worst. With nothing but deflation ahead in its effort to dramatically increase productivity, the Greeks will see political and social unrest. This problem will soon occur in many larger euro-countries. The odd-man out here is not Greece, which is joined by many other countries, but Germany. If the euro is going to survive, it is Germany that must leave.

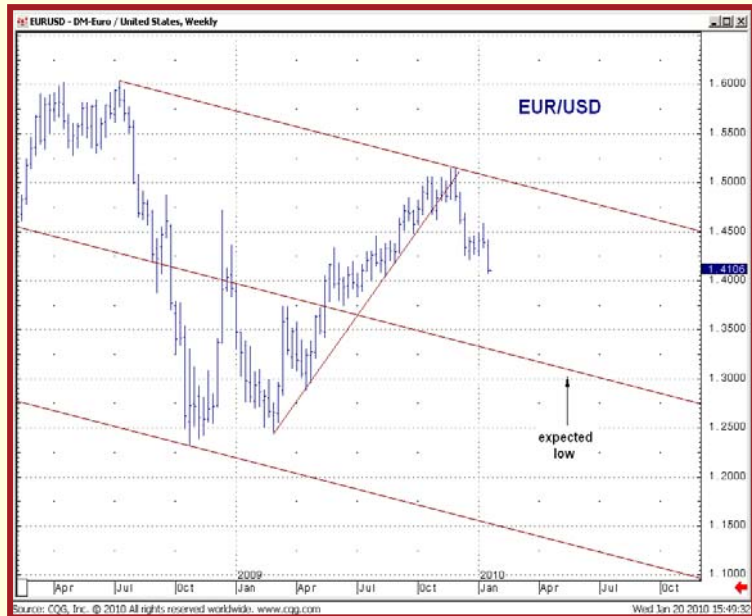
CURRENCY – Europe Long-Term View

The Euro has Seen its High for the Year

By Jonathan Clark

The euro fell to its lowest level in five months as the financial markets are punishing the Eurozone for allowing in weak members that have undermined the credibility of the single currency. Greece is dominating the headlines, but significant fiscal problems exist in a number of other countries as well. **A few have enacted unpopular measures to reduce their budget deficits, but the major part of most European countries' plans to reduce the deficits relies on economic growth increasing fiscal revenues and herein lies the problem.** The rebound in exports allowed countries like

Germany to return to growth, but unemployment remains high and domestic demand has failed to increase, and Germany's exports are other EU countries imports so there is no net gain. The ECB has a relatively tight monetary policy compared to other major countries and this ensures that it will have slower economic growth than the US and Asia. The EU will be far slower to tighten monetary policy, as was the case following the 2001 recession, and interest rates will fall in the Eurozone versus the US, undermining the euro. However, trading could be choppy for a month or two before a sustained downtrend begins. This downmove could also be triggered by a Eurozone 'accident' and Greece is the most likely candidate.



It is clear the EUR/USD has seen a significant peak and will decline into the middle of the second quarter of the year at a minimum. The euro should form an initial low on Thursday and a second low late next week. If the support at 1.4030 breaks on a closing basis the euro will fall to the 1.3750 area during the final trading days of January, but we suspect the downmove will prove less aggressive. Following this low the euro should turn higher and strengthen into the week of February 8 and there is a chance there will be a further high seen around the middle of March, but it will have a difficult time surpassing the resistance around the 1.4500 area. It should then turn lower and resume its downtrend into May and the longer-term cycles argue this weakness could persist into September.