

Euro Zone comedy/tragedy continues

Last Friday, the EU approved the disbursement of €7.5bn and €11.5bn of financial assistance to Ireland and PORTUGAL (not Greece) respectively". Comments from the Troika (EU, ECB and IMF) state that both countries are meeting their fiscal targets - indeed, an IMF report, just released, suggests that Ireland is ahead of its fiscal targets, though could suffer if there is a global slowdown in trade - very important for the Irish economy, as domestic consumption is declining and unemployment (14.4% in August, from 14.3% in July) rising. Portugal is to implement additional measures to ensure that they comply.

In stark contrast, representatives of the Troika exited Athens abruptly on Friday, having suspended talks with the Government on fiscal issues - apparently to reconvene in 10 days to allow Greece to "allow the (Greek) authorities to complete technical work... related to the 2012 budget and growth enhancing structural reforms". Troika representatives have done this before, but caved in subsequently. Informed sources state that the issues include a serious disagreement as to how to bridge an €1.2bn shortfall in this year's budget and Greece's reluctance to implement structural reforms, privatisation plans and improve tax collection.

You will recall that Greece lied to get into the Euro and, to date, has not ever met any of its targets and/or commitments. The proposed privatisation programme (to raise €50bn) is complete nonsense. Not only will they raise far, far less (some estimates suggest €10bn at best), the Greeks now want to postpone the privatisation of the football pool operator (Opap) and the award of a concession to operate the Athens airport. The reasons cited are that they will not raise enough proceeds at this time, given the country's economic woes. In addition, there are serious problems relating to title to property (no effective Land Registry) which make most Greek privatisations virtually impossible. The PM is to make (yet another) speech this weekend - and Greeks are set to strike next. There have not been any serious strikes/civil disorder recently - the reason is that it's too hot in Summer - the strike/civil disorder (Greeks are revolting) stuff will start soon, believe you me - temperatures in autumn start cooling down, though the usual chucking of Molotov cocktails during Greek protests should heat things up.

The current target/commitment for the Greek budget deficit this year is 7.6% (the Greeks acknowledge it will now be between 8.1% - 8.2%) - the actual number is likely to be around 9.0% (the IMF believes it will be 8.6%). The Greeks argue that the reason for the revenue shortfall is due to the severity of the recession - the Government states that the economy is to contract by 5.0% this year (the Minister of Finance forecast 4.5% just 2 weeks ago, which has now been revised higher to 5.0% by his Ministry - my own view is that it will be closer to 6.0%). However, the Troika reports that only 25% of the shortfall is due to the recession - the balance is due to the Greeks failing to comply with the measures they have agreed to. The new Greek Finance Minister Mr Evangelos Venizelos stated that the Government has no plans to introduce additional austerity measures. Just the other day, Ms Stella-Savva Balfousia was forced to resign, after her independent Parliamentary Budget Committee reported that Greek public debt was out of control and criticised Government actions or should I say, inaction.

It is clear that the Greeks are blackmailing the EU. Essentially, they say, give us the money, or we will default and the contagion effect will create an enormous financial and political crisis for the Euro Zone. Well, at present, they are right - it will. In addition, Greece does not have any bond redemptions until March next year. The Euro Zone has not cordoned off Greece and contagion will spread to the other PIIGS and then to other (even core) Euro Zone countries. However, the IMF does not have to play ball - they remain the most sceptical. What happens, if the IMF refuses to provide more financing - what does the EU do? Unlikely, I accept, but.....

Core Euro AAA rated Zone countries, particularly Germany, Holland, Austria and Finland are facing increased criticism from their population (read voters) - and it will get worse, as their economies decline further, which will happen. Politicians will find it difficult to ignore these sentiments, in the only way they understand, the polls.

Mrs Merkel is facing another regional election this Sunday - this time in her own home State of Mecklenburg-Western Pomerania - she has lost all 5 regional elections and, in addition, has lost control of the Upper House in the German Parliament this year. If she survives, she faces a General election in 2013. The peripheral Euro Zone financial crisis is the main election theme in tomorrow's regional election - basically the Germans are getting totally fed up of bailing out their Southern neighbours and Mrs Merkel is talking tough - no Euro Bonds, no bail outs without austerity etc, etc. Should be a vote winner, as the SPD and the Greens are more Euro Zone supportive.

Given this scenario (she also faces another regional election later this month), I really can't see how she can continue to provide financial assistance to Greece, especially when they fail to meet their targets and, indeed, will continue to miss all their targets, as they surely will. In addition, the Finns demand for collateral (they have not backed off) suggests to me that the Greek comedy/tragedy is coming to an end - to date a lot of money has just vanished down the plughole. The Finnish finance Minister is visiting Berlin on Tuesday, along with the Dutch Finance Minister. The Greeks may (just) get away with it this time around (as there is no plan in place to avoid contagion), but the game has a definite "sell by" date written all over it - in my opinion, no later than the year end.

There is increasing chatter of a coup against Mrs Merkel's leadership, which is why she has become more hawkish on the peripheral Euro Zone debt crisis, recently. Whilst unlikely, there have been too many recent reports to dismiss the idea of her demise as Chancellor. This threat is forcing Mrs Merkel to take a tougher stand. However, what does she do. To date, the German plan has been to dismiss the various serious financial issues as hysteria dreamt up by the markets, which they will ignore - a very dangerous attitude. Indeed, just the other day, a senior German Politician repeated exactly that to me, here in London.

The changes to the Euro Zone temporary bail out fund, the EFSF are to be ratified by the Parliament's of the 17 Euro Zone countries this month. The key will be the Germans (on the 29th Sept) and the Finns (as they are still demanding collateral). Whilst its passage is still (marginally) likely at present (though the odds are worsening day by day), it is, by no means, a foregone conclusion.

The IMF have always proposed that Greece be allowed to default - its the crazy guys at the EU/ECB who have resisted. A Greek default will be painful, but not terminal, as long as the other PIIGS countries are ring fenced. However, Italy is back tracking from recent tax increases/spending cuts that they promised in return for the ECB buying Italian bonds in the markets to bring down the yield. Essentially, Italy promised to implement a plan which would reduce its budget deficit to zero by 2013. There are strikes being called by the Italian public sector unions. If Italy does not comply with its commitment, how can the ECB continue to buy Italian bonds, particularly given the serious criticism to such purchases by the Germans - the Euro Zone paymasters.

Spain talks a good talk (it is to include a balanced budget provision in its constitution), but in reality it is sticking to its targets by not paying its bills and by the Government bringing forward some E2.5bn of revenue from next year to this. Basically, smoke and mirrors stuff. Virtually all the regional Governments in Spain have missed their targets. Furthermore with 21% unemployment (and rising - currently 4.13mn Spaniards are unemployed), including over 40% for under 25's, Spain is toast - plain and simple. Recent reports suggest that retail spending (an important factor in the Spanish economy) is declining, as is the savings rate - Spaniards are running out of money. Not good news at all.

Personally, I believe that the EU will have no choice but to pull the plug on Greece, quite possibly this year - Greek 2 year bonds are yielding near 50%. The next question is how do they deal with Italy and Spain - even though Portugal and Ireland are making progress, they will also be sucked into the crisis. Then you have question marks over Belgium and France and.....The Euro Zone will have to address these countries before taking action on Greece. Then there are those (grossly under capitalised) European banks, sitting on mountain loads of PIIGS Sovereign debt - whoops. The IMF/Lagarde stated that European banks need some E200bn+ of additional capital - they are right, though as we all know, the situation is always worse - just look at Ireland and the mess they are in, which was as a result of the banks. Unfortunately, it is impossible to assess the capital requirements of European banks - all I do know, it will be much larger than E200bn - reports I have read suggest that German banks require in excess of E100bn.

Last week, the Euro began to weaken - it weakened further, even after the announcement of the dreadful US NFP's data. This is in spite of Asian (mainly Chinese, though the SNB is also rumoured to be buying German/French debt to reduce the value of the Swissy) buying and is the 1st time recently that I've seen this - totally agree with the move but, previously, the Euro has been strong in spite of all the negative news. I believe that the Euro will weaken further. Whilst Trichet is unlikely to reduce interest rates next week (he is unlikely to want to admit he made a mistake, which to him is far more important than minor issues such as the Euro Zone), the ECB will have no choice but to reverse the 2 ludicrous 25bps hike this year - quite likely starting this year. In any event, rate hikes are definitely off the table. Remember Mr Mario Draghi will be presiding over the ECB from late October onwards - suggests to me an ECB rate cut by December, at the latest - quite possibly earlier, if a crisis develops. Reduced interest rates will dampen investor interest in the Euro, in spite of US QE3/Operation Twist etc.

By the way - what does a weaker Euro do for commodities, including gold/silver and oil, though gold and silver rose materially on Friday, in spite of a weaker Euro, suggesting that increased uncertainty overcame the impact of a weaker Euro - yesterday.

As you know, in spite of repeated denials, I believe that the Euro Zone (if it wishes to exist even without Greece - and I believe there remains a strong political desire for it to do so) will have to issue Euro Bonds - I really cannot see any other solution. The German fear (and I accept strong opposition to Euro Bonds) of having to pay higher interest rates for their borrowings and that fiscal discipline in the Euro Zone will be discarded, can be dealt with in a manner that actually forces precisely such (much needed) actions to occur. Indeed, I am working on a proposal at this moment, which, I believe, addresses the relevant issues.

If Euro Bonds come into play, the Euro will pick up, as the Euro Zone will have a near equivalent US capital market and a number of investors will want to diversify away from just US assets - ie in theory, the Euro could become a 2nd global reserve currency. This creates problems for the US, but more on that later. There is also the possibility of the ECB issuing Euro Bonds, particularly if it has to sterilise even larger amounts of funds resulting from its programme of buying Italian and Spanish bonds - last weeks purchases will be announced on Monday. I would not be surprised if, last week, the ECB bought more Italian and Spanish bonds than the previous week - in any event, the market will target Italian and Spanish bonds even more in coming days/weeks - I suspect quite strongly. I suppose the ECB can embark on their own QE programme, but that's unlikely at present, given that Trichet is still around at the helm and he will not want to tarnish his "alleged" reputation.

Pie in the sky stuff - well quite possibly and I accept, certainly no market and/or political consensus. However, I really DO NOT SEE ANY ALTERNATIVE to the issue of Euro Bonds, sooner rather than later, if a break up of the Euro Zone is to be avoided. Indeed, not only will it solve the current crisis, I would argue that various measures could be incorporated to (finally) get the Euro Zone's finances in better shape and to force financial discipline. In any event, as we all know, there can be no monetary union without fiscal union. A break up of the Euro Zone will be far more expensive, which is why I believe that the issue of Euro Bonds is the only alternative, in spite of all the well publicised (recent) denials by German politicians, officials and German Central Bankers, in particular.

Volatility will continue to be the name of the game across all asset classes.

US markets closed very near their lows on Friday. However, unlike other sell off days, volume was not that high. I accept that the vast majority of the volume was on the downside, but the 3 day weekend probably caused a buyers strike, rather than the mass selling we have all seen recently. In addition, there was a calm around - not like the panic sell off/high volume days recently. After an initial sell off, I would not be surprised if European markets recover from their lows on Monday - ex any news/events. Expectations (very likely to be announced on 21st September) of QE3/Operation Twist (basically extending the maturity profile of the bonds held by the FED, by buying longer dated - presumably including 10 year US treasuries, given that 10 year yields are used to price mortgages, for example) continues to do the rounds, which is equity positive, for the moment. However, as I understand it, an Operation Twist was tried before and it did not work.

My friends at Unicredit advise that seasonal factors in the compilation of US jobs data expect employment to pick up in September, October and November. With the current uncertainty, global slowdown and companies unwilling to hire (very likely), further disappointment re US jobs data is very likely in the coming months. Not good news - sorry.

It's going to get pretty "interesting" out there - soon.