

January 20, 2012

“The problem with socialism is that eventually you run out of other people’s money.”
- MARGARET THATCHER

Special Message:

In support of our ongoing effort to grow EVA readership, ECM is initiating a contest among our readers to see who can refer the most new EVA subscribers. Every month the reader with the most referrals will win a \$100 gift card to the restaurant of their choice. In addition, the reader with the most referrals by year end will win an iPad 3! In order for a referral to be counted the EVA prospect just needs to enter their e-mail on the front page of www.evergreengavekal.com, click subscribe, and then enter the referring reader’s name into the required reference section.

Thank you! Good Luck!

Author’s privilege. As mentioned in last week’s EVA, my intention was to devote this issue to Evergreen’s upcoming predictions of major trends for 2012. Perhaps it’s due to our usual beginning of the quarter frenzy, but it belatedly dawned on me that if I did so I’d be scooping our own annual forecast event to be held next Thursday. (By the way, if you haven’t signed up and still would like to attend, please advise Tiffany Southworth as soon as possible at 425-467-4604 or tsouthworth@evergreengavekal.com).

Thus, I’m invoking writers’ prerogative in deciding to wait until next week to put our 10 calls for 2012 in writing, even though I realize Evergreen clients will have already received a hard copy version of them via our quarterly Strategist. However, that was a very condensed version of next week’s EVA and the overview we will present at our event.

If you do attend the presentation, you’ll be among the first to hear an extremely significant announcement concerning our firm. It is something we’ve been working on for a year and we believe it will substantially benefit our clients and their future returns. To say we are extremely excited about this development is a considerable understatement.

It also occurred to me that delaying our forecast issue for a week would allow me to run our monthly guest EVA. No regular EVA reader will be surprised by the source I’ve chosen—Hong Kong-based GaveKal Research. GaveKal is not quite at the Cecil B. DeMille level of a “cast of thousands,” but it does have a cast of a few hundred analysts, portfolio managers, and, most relevant to this EVA, gifted big-picture (aka macro) strategists.

The essay below was written by one of the company’s deepest thinkers, Charles Gave, on a subject that had largely died down—at least until S&P’s sweeping downgrades of European sovereign debt last week. In case you missed it, this included stripping France of its coveted AAA rating (welcome to our club, mon ami!).

Over the last two years, I’ve lost track of the number of times that the investment community has decided to relegate Europe’s travails to the back burner. But, as with housing four years ago, the acute distress and the far-reaching reverberations just keep bringing it back to the front of the stove where the pot of problems once again threatens to explosively boil over.

It further occurs to me that I’ve previously endorsed one of Charles’ essays as among the best

synopses I've seen of Europe's debilitating dilemma. Well, that was true then and it's true now. The time he spent reflecting and reading while on holiday up at Whistler (as discussed in the December EVA, [click here to view](#)) was obviously very well spent. His cogent analysis reinforces in my mind that Europe's road to redemption remains long, winding and very hazardous.

One final note is that we've been working on a way to offer Evergreen clients materially more exposure to GaveKal's exceptional research—which is another reason we encourage those readers who are not Evergreen clients to consider joining the fold!

As I often do...

“repo” is an action banks take to borrow against assets they hold with a promise to repurchase (repo) them in the future.

“M1” represents money supply (in this case, the difference between Italy's and Germany's)

The “ECB” is Europe's equivalent of the Fed (and its new boss is Mario Draghi)

The “EMU” is the European Monetary Union, and

“USD swaps” refer to the dollar lending the Fed is extending to the ECB and other European central banks to provide them with the US currency they so desperately need right now.

Now, try to get mind your mind in the alpha state, the best condition for learning, so you can fully appreciate what Charles has to say.

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Draghi in Control - But For How Long?

In his first week on the job, Mario Draghi brought the key policy rate back to where it was before Jean-Claude Trichet's untimely hikes in early 2011. Before the end of his first month, the new ECB head had announced an aggressive plan to help European banks repo various assets for the next three years. These actions have triggered a flurry of year-end commentaries on the beginning of the end of the European crisis. But are Europe's problems genuinely salvageable by the central bank? In the following ad hoc comment, we aim to review 1) the situation before the ECB's recent actions, 2) what the ECB is doing now and 3) the logical consequences of the central bank's activities. Our readers should note that this piece will draw on a number of concepts developed in other papers over recent years, most specifically Communist France vs Capitalist France, How the World Works, numerous Euro Debates and last summer's pieces on The Unfolding Liquidity Crisis.

1—The Situation Before the ECB's Recent Actions

Following last summer's private sector “voluntary” restructuring of Greek debt, the European credit markets became completely dysfunctional. Commercial banks with excess deposits started to place them at the ECB instead of lending them to other financial institutions, similar to the interbank lending crisis in 2008. European banks without large deposit bases became

starved of liquidity and had to turn to the ECB—which has been lending out liquidity against increasingly relaxed collateral requirements. We thus witnessed a simultaneous massive inflow of deposits at the ECB and a massive outflow from the ECB to the “not-so-safe” banks. For all intents and purposes, the ECB endeavored to replace the free markets (which used to link banks) by using its balance sheet to perform a function that the market no longer wanted to perform.

Indeed, assuming that the “bad banks” mostly own “bad assets” (otherwise, the free market would be happy to lend to them) and that the “bad assets” were mostly issued mostly by the worst-managed states, **then one could say that the ECB discounting is helping the “bad issuers” to keep financing themselves at the wrong price, thereby allowing them to delay necessary reforms.** In turn, this finances the continuing survival of the “communist sectors” everywhere in Europe, leading to ever falling growth rates.

So, in short, after the credit markets broke down, the ECB took it upon itself to replace the decentralized and free credit markets with a totally centralized redistribution of credit; one where the risks are no longer analyzed individually with a profit motive in mind, but by a system in which the totality of the risk is assumed by a public body, with political clout replacing market discipline. This amounted to the boldest attempt ever to get the credit markets out of the private sector and under the control of a transnational public body, managed by unelected technocrats.

Importantly, however, even this very bold move proved insufficient to stabilize the system as the “bad banks” apparently started running out of (bad) collateral to discount. This is when Mr. Draghi comes in.

2– Draghi’s New and Improved ECB Plan

Stepping back a moment, let us remember that European banks and insurance companies have, for years, been encouraged or compelled to buy the bonds of countries running outsized budget deficits. When the bond markets seized up over the summer, the private-sector financial sector ran the risk of collapsing under the weight of these investments. The ECB is now trying to kill two birds with one stone with its new three-year unlimited repo loan program—it is bailing out the governments and the banks.

Here is how it works. A bank in Italy (for example) has always been able to place collateral with the ECB in exchange for short-term money, then invest in longer- dated government bonds in Italy, executing a “carry trade” in a perfectly legitimate banking operation. However in the past, when indulging in this kind of carry trade, the bank carried the risk of rising short-term interest rates. The ECB has now reduced the risk by extending the repo loans to up to three years, with the cost of the money an average of the main policy rate over the period of the loan. Right now that rate is 1% and nobody in his right mind expects this going higher soon. The ECB is saying yes, short rates could go up so this is not a subsidy, but the probability that they will is close to zero so gorge yourself. Moreover, the loans on tap are unlimited, so our bank can take the proceeds and do this discounting operation again and again, practically without limits.

This will ultimately renationalize the debt markets. Because the one remaining risk is a European breakup leads to a mismatch between a banks’ liabilities (deposits) and assets (loans). To mitigate this risk, an Italian bank (for example) will prefer to buy Italian assets and to borrow from Bank of Italy (whose loan book would be redenominated in Lira in a breakup). As such, the potential exchange rate risk is transferred from the Italian commercial bank to the

Bank of Italy (which directly borrows from the ECB to lend to its local banks). And if Italy ever does leave the Euro, then the Bol will just have to negotiate with the ECB anyway... In such a system, with the Italian banks preferring Italian bonds, the French banks French bonds, etc, the higher the local interbank rates, the bigger the subsidy! In other words, the banks in the badly managed countries will receive a higher subsidy than the banks in the well managed countries.

So in short, as the cost of funding goes up for bankrupt governments, banks that hold the existing debt face collapse. The ECB then steps in to provide liquidity for bankrupt banks to buy the bonds of the bankrupt governments, helping the banks to make a profitable carry trade and rebuild their depleted equity cushions. So have we found the solution to Europe's double problem of financing the survival of the "communist sectors," while allowing the commercial banks to remain profitable?

3- A Return to Some Economic Laws

When governments and central banks manipulate the market to such severe degrees, it is no easy task to understand the potential ramifications. The only thing we can do is to return to some time-tested economic laws and relationships.

Let us start with Gresham's law that "**Bad money drives out good if the exchange rate is set by law**". By bad money Gresham is effectively referring to artificially inflated exchange rates. This law is relevant since, as few people realize, in Euroland we really have not one, but many currencies. Indeed, take an Italian saver as an example. Our Italian can deposit his Euros in an Italian bank—or in Luxembourg, Germany or even Zurich (as long as he declares it). In the case of the Italian bank deposit, our saver runs the risk that, one weekend, his savings are transformed overnight into New Liras. Thus many are shifting deposits offshore. As we write, M1 is collapsing in Italy and swelling in Germany.

Moreover, short-term treasury yields in Germany have hit negative territory! This is because funds flowing into Germany prefer treasuries, which are perceived to have lower currency-conversion risk in the event of a Euro breakup. So instead of going into bank deposits—which could be lent back to the private sector—the safe-haven flows end up financing government spending in Germany, while the collapse of liquidity in Italy leads to a recession or even a depression on the peninsula... By the end of the process, Italian deposits will be too scarce to buy the government bonds. This makes the financing of the Italian budget deficit more difficult, except on more and more leverage by the banks. Needless to say this "Greshamian" movement which is nothing but a slow moving "bank run" is already well under way as evidenced by the following graph:

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From 2003 to 2008, Italian M1 was centered at around 85% of German M1. Since the beginning of the Euro crisis, M1 in Italy has fallen by at least 20% against the M1 in Germany. The tragedy of all of this is that Gresham wrote about this perfectly natural phenomenon in...1558. So one would have expected the geniuses who created the Euro to have been aware of Gresham's Law.

Let's move next to a second law, expressed this time by Milton Friedman. With the fact that **"there is no such thing as a free lunch"** in mind, let us try to summarize what European politicians and Eurocrats in the ECB are trying to achieve. The German politicians do not want to pay for the rest of Europe while the French politicians and the Eurocrats want to save the standard of living of the guys working in the communist parts of the economy and who, being a majority, have to be accommodated by the politicians who otherwise would not be reelected. The solution chosen is to subsidize the banks (which the Germans do are also bankrupt), the subsidy being distributed by the ECB through a blatant manipulation of the interest rate "time structure" to for banks while also financing the communist sectors.

So the subsidy is going to be paid to the bankrupt banks with the proviso that in order to get the subsidy, they will have to buy the bonds issued by the bankrupt governments to maintain the standard of living of those working in the communist sectors. **The winners are obviously the banks' shareholders and the civil servants all over Europe, but according to Milton Friedman, someone in the system has to pay for the subsidy.**

To unearth who the payers of the subsidy are, we will have to enlist our third rule, namely Frederic Bastiat's observation that **"in economics, there is always what you see and what you don't see"**. What we can see is that the beneficiaries of the ECB's policy are the banks and the communist sectors. Now we have to move on to the things that we do not see.

What bank is going to lend at a reasonable cost of money to an Italian company—supporting a reserve requirement on this new loan while taking a risk—when they can lend to the Italian government at a higher rate and with no reserve requirement? The answer is none. **The entrepreneurs are thus going to be the first victims of the free lunch.** The average entrepreneur will see that his bank is no longer there for him and will thus no longer feel compelled to maintain his deposits in national institutions to "preserve the relationship". Instead, the deposits will flow to Credit Suisse, HSBC, JP Morgan, etc... Deposits in local commercial banks will continue to go down, and since over the long term Savings=Investments, capital spending will collapse and with it any chance to make Italy, Spain, France and other troubled nations more competitive. Which brings us to the second major consequence of the "free lunch".

As Francois (*my note: a fellow GaveKal strategist*) argued in many of our debates, Europe's communist sectors would only reform if the market stopped lending to them. Following Draghi's repo-loan program, it would seem that this hope is now over. The government's weight in the economy will not decrease, thus the structural growth rate of the economy will continue to fall and the budget deficits will explode—as we are seeing in Greece or Portugal already. The lack of reforms will allow the lack of competitiveness of Southern Europe to get worse and worse, which eventually will lead to a balance of payments crisis.

4—An Inevitable BOP (Balance of Payments) Crisis

The ECB's solution has been to address the difficulties in funding the budget and the external deficits which were labeled in Euro (what you see). **Part of the external deficits are, however, in US dollars, and the new ECB plan does not address this problem at all.** Italy, France,

Greece, Portugal and others are all going to continue becoming less and less competitive. Their external deficits in US\$ have increased non-stop since 2000. Since the ECB cannot print Dollars, and since the Dollars needed can no longer be borrowed by the private sector, the borrowing of Dollars is increasingly dependent on public entities (swaps between the Fed and the ECB).

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However, sometime in the not too distant future the **solvency risk** for the Fed will become so great that the US central bank will have to stop funding the communist parts of the European economies, and Euroland will enter into an **unavoidable balance of payment crisis** a la Argentina in 2001, Russia and South Korea 1998 or Thailand 1997. At this point, the main victim will be the European consumer whose standard of living will collapse.

The logical result of what the ECB has done so far is thus to delay the resolution of the budget crisis, thus allowing it to morph into a balance of payments crisis. In addition, this transfers over time the political power to manage their affairs from the citizens to unelected technocrats at the IMF and at the Fed. For make no mistake about it: the survival of the Euro will, in the coming quarters, depend on decisions taken at the Fed (and thus indirectly the US Congress) and at the IMF... Hardly a policy victory for the Eurocrats who have promised European voters that the Euro would mark the dawn of a new era of European power!

Unfortunately, this sequence of events could have already started and could accelerate out of control at any time. Of course, the reality is that while it is quite easy to see when the conditions for a balance-of-payments crisis are met, no-one knows precisely when a BOP crisis will start. In Southern Europe, the conditions have been met for quite a while already.

Accentuating the risk of a balance-of-payments crisis is the fact that the international liquidity crisis continues to march on.

Central bank reserves deposited at the Fed keep falling and the US current account ex-China and ex-oil continues to improve (meaning that the US is exporting fewer and fewer US\$ to the global private sector) and will probably continue to do so for the next two years (given the current level of the trade-weighted US\$). This means that excluding China and the oil-producing nations, many of the fellows who need Dollars to pay for their oil and their other global trade are not earning these Dollars and thus either have to use their FX reserves (which are now going down as a result) or borrow US\$.

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However, the fact that the Fed has been forced to step in and offer foreign central banks US\$ through its swap-lines triggers a new risk: namely that to earn US\$, European countries currently short US\$ will likely have to devalue in the future. But if the Euro devalues, the losses on the swap-lines could end up seriously impairing the ECB balance sheet! This is rather ominous: could a much weaker Euro push the Fed into presenting the ECB with margin calls?

In any event, whenever central bank reserves shrink, somebody big somewhere goes bust and the victims typically are the countries running twin (budget + current account) deficits of over 10% of GDP. Throughout 2011, we kept a tally of the fellows in the red zone and suffice to say that most (Hungary, India, GIPS, Turkey...) are looking shaky right now. So who will be the whale of 2012? For our money, we would have to say Italy.

Now we realize full well that Italy supposedly runs a primary surplus. But at this stage, it seems highly unlikely that Italy will be able to maintain its forecast primary surplus of 0.5% of GDP. Indeed, if we assume that Italy's economy grows at a nominal rate of +2% (a heroic assumption as Italy has not achieved this growth on average in the past decade and the upcoming year does not look like an "average" year), the government would need to run a primary surplus of 4.8% of GDP (calculated as 6% interest incurred on its debt minus 2% nominal growth multiplied by 120% debt to GDP) just to stabilize its debt-to-GDP levels. Meanwhile, any effort to increase the primary surplus through austerity and tax increases runs the risk of creating a downward economic spiral. In fact, Italy looks more and more like Greece did two years ago...

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5- Conclusion

Schumpeter liked to say that he wanted to be remembered as “the greatest economist ever, the best lover ever and the best horseman ever.” After a pause he would then add “I am not doing so well with the horses.” We cannot vouch for the second proposition but for our money, Schumpeter deserves the first title. And Schumpeter explained that, for an economic system to prosper and grow, one needed three things and only three:

- A sound currency
- Property rights guaranteed by an independent judicial system
- A functioning, privately owned, but well-regulated credit system

One does not need to be a rocket scientist to realize that the **ECB’s plan strikes a mortal blow to at least two of these three principles**. To thus assume that the European crisis is coming to an end is fanciful. Instead, the next steps in our never-ending descent into the technocratic nightmare created by the Euro will have to be more attacks on the soundness of the currency, and more nationalization of the credit system—possibly including foreign exchange controls and seizure of assets belonging to the private sector by governments.

So while the ECB’s actions may allow for a relief rally in European risk assets—with the riskiest

banks enjoying the biggest subsidy and thus likely seeing the biggest short-term upside—this too will fizzle. As we have been saying for the best part of the last few years, the only thing to own in the EMU, if one has to own something, are shares of companies which are quoted there but have very little of their business in Europe and have nothing to do with the European governments or consumers.

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