



Revisiting Europe and the Euro: *Will Atlas Shrug?*

If you saw Atlas, the giant who holds the world on his shoulders, if you saw that he stood, blood running down his chest, his knees buckling, his arms trembling but still trying to hold the world aloft with the last of his strength, and the greater his effort the heavier the world bore down on his shoulders — what would you tell him to do?

I... don't know. What... could he do? What would you tell him?

To shrug.

DIALOGUE BETWEEN FRANCISCO D'ANCONIA AND HANK REARDEN, FROM ATLAS SHRUGGED

By no means will we reach the dimensions of other central banks (with bond buys) ...The eurosystem (of central banks) goes into market when there are dysfunctions. We have always stressed that the programme is limited in time, it will not become a permanent instrument.'

JÜRGEN STARK, MEMBER OF THE EXECUTIVE BOARD OF THE EUROPEAN CENTRAL BANK, DECEMBER 21 2010 ¹

Ayn Rand's magnum opus, *Atlas Shrugged*, is loved and hated with equal fervour. The novel, first published in 1957, explores a dystopian society where successful citizens progressively disappear in defiance of growing government control over private industry. For some, the book is a celebration of the individual and free markets. Others view Rand's brand of libertarian philosophy as both impractical and immoral. Of course, Rand's title is a reference to Atlas, a Titan from Greek mythology, who is used as a symbol for the most productive people in society — "holding the world aloft" in a metaphorical sense. What happens if they "shrug" off their responsibility?

In the Eurozone, Germany may be feeling like Atlas, bearing the burden of the peripheral nations. While many countries outside "core" Europe continue to struggle with weak economies and exploding sovereign debt, conditions in Germany could not be more different.

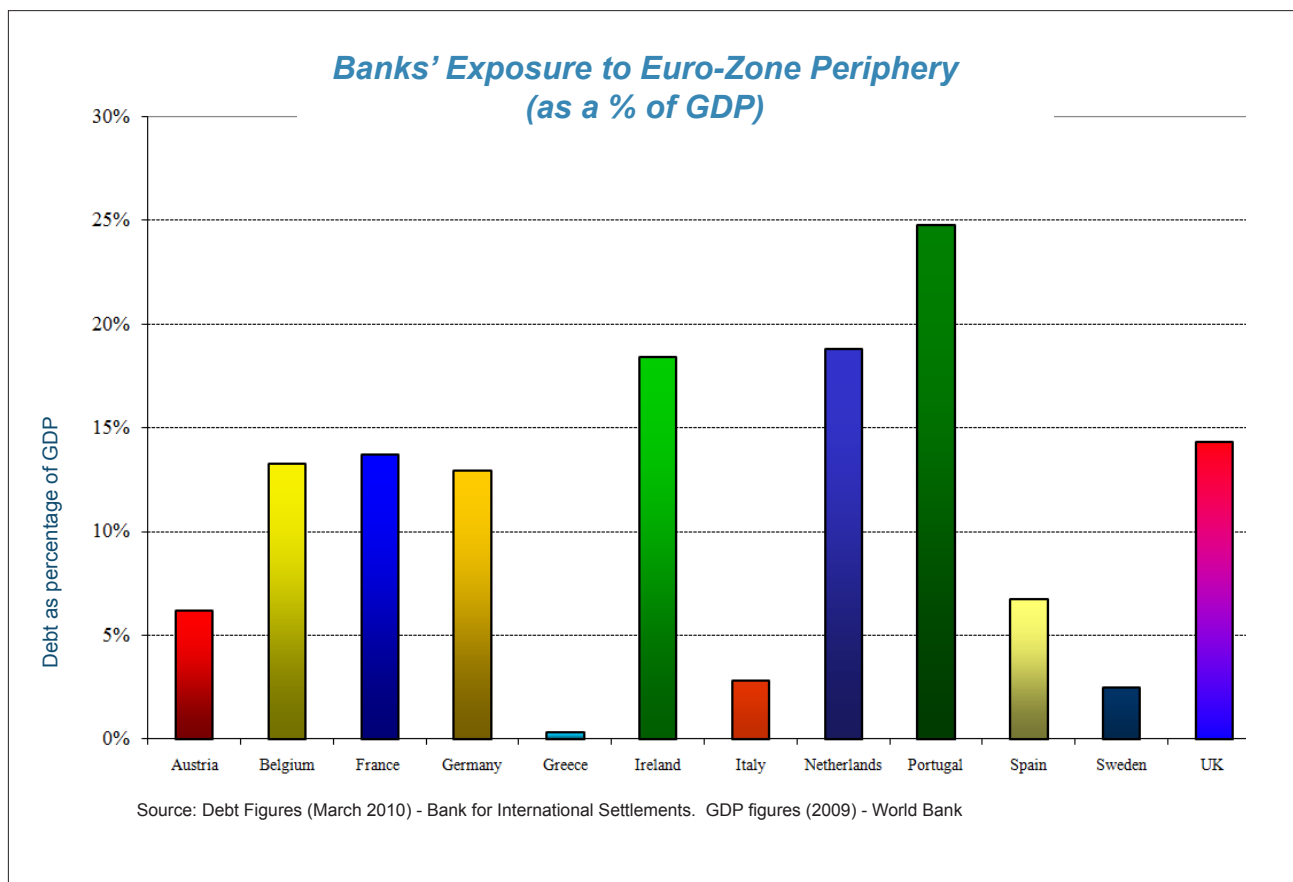
Take unemployment rates as an example, where wide divergences can be seen among individual countries. November's numbers for Ireland and Spain stand at an alarming 13.9% and 20.6% (*respectively*), while Germany's figures hit a post-reunification low of 6.7%. Exports are

also booming in Germany's industrial sector (*EUR 11.8 billion trade surplus in November*), while they languish in neighbouring countries.

The euro wasn't supposed to function like this. Rather, the monetary union and common currency was expected to promote balanced and mutually beneficial growth. Yet a deep economic and fiscal division developed between stronger and weaker countries in the region. That has not gone unnoticed. The view that Europe is one monolithic economic zone has unravelled rapidly over the last year.

Euro Trashing and Other Myths. Can these internal divergences persist? And, if so, where to for the euro? After all, since the crisis began, sovereign bonds in the periphery have been hammered while the euro's value has continued to erode. In fact, it seems the entire world has turned against the currency.

Trends in euro currency ETFs confirm negative sentiment. While the Proshares Ultra Short ETF (*NYSE:EUO*) has gathered assets of USD 330 million in 2010, Rydex's long euro currency ETF (*NYSE:FXE*) saw net outflows of 185 million for the year.



It wasn't always this way. Not long ago, the euro reached near cult currency status. Many even hailed it as the heir to displace the U.S. dollar as the world's reserve currency. For a while, that seemed likely. The currency appreciated from a low of 0.825 to the U.S. dollar in 2000, before recording its high of 1.599 in 2008 (as we write the rate stands at 1.32 USD/EUR).

Where to from here? Are fears of a Eurozone and euro implosion misplaced?

To be sure, this is a complex topic. Yet it pays to separate facts from opinion. A number of misconceptions exist. First, Germany is not quite Atlas. True, it may hold the title of economic stalwart within the region. But unlike the burdened Atlas, Germany has benefited since the advent of the euro. Most specifically, exports have boomed in recent years, resulting in a chronic trade surplus. Consider that if Germany's Deutschmark still existed, its foreign exchange value would be much higher versus other currencies in the Eurozone. Were the Deutschmark to return, that persistent trade balance would undoubtedly turn negative.

More broadly, not all is grim in the wider Eurozone. While the durability of a full economic recovery is tentative, recent economic figures have been encouraging. Euro-

zone industrial production rose a healthy 1.2% in November, with an annual growth rate of 7.4%. Perhaps the key area where it surpasses other Western countries (like the United States) is seen in its lower household debt and higher aggregate savings levels. This is a key headwind for many Western countries that is much less severe in many Eurozone countries.

Eurozone Fault Lines. While there are some hopeful factors, not all is well. Indeed, a constellation of risks remain. Below, we outline the key areas:

1. Sovereign Debt and other Credit Bubbles. Up until 2008, one of the biggest benefits of joining the EMU for peripheral countries had been a radical narrowing of interest rate differentials. Countries like Italy, Spain and Ireland could borrow at virtually the same rate as Germany. (Astute money managers benefited from this "convergence" trend by purchasing government debt of countries anticipated to adopt the euro).

However, there was a dark side. With lower rates and easier access to credit, sovereign debt levels exploded. Some new recruits ran large budget and trade deficits (like Greece), while low rates in other countries contributed to real estate bubbles (like Spain and Ireland). Of course, these trends in debt levels violated the Maastricht Treaty

which prescribed fiscal guidelines for member countries (i.e. government debt/GDP and budget deficits should not exceed 60% and 3%, respectively).

Now, saddled with heavy debt loads and sovereign bonds under attack (10-year Greek rates are at 11.3% — more than 8 percentage points above German bund equivalents), there are no easy answers. To date, the ECB and EU (with assistance from the IMF) have attempted to protect peripheral country bondholders — including programs ranging from the gigantic USD 750 billion European Financial Stability Facility (EFSF) to the Securities Markets Programme (SMP). Yet these approaches are simply short-term patches targeting liquidity ... and not the longer-term solvency of troubled nations. Eventually, this piecemeal approach risks collapsing under its own weight. Even though it may not be an immediate risk, it is likely that some form of debt restructuring will need to take place (really a euphemism for default or some form of haircut for bondholders).

2. European Banking Sector — Running With Scissors?

In hindsight, Greek yields had no business hanging around German or French yields. Clearly, sovereign credit ratings were different and commanded different risk premiums. Yet prior to 2008, risk considerations took a temporary hiatus ... with many bondholders believing that member country debt was immune to losses or even default. Clearly, that was not the case. (Reminds one of Frank Borman's quote, "Capitalism without bankruptcy is like Catholicism without hell").

For a marginally better yield, European banks loaded up their balance sheets with peripheral government debt. For example, Germany holds more than half a trillion USD of so-called PIIGS debt. Last year, the Bank for International Settlements estimated that 78% of Greek, Irish or Portuguese debt sat with banks in the Eurozone or Britain (see chart 1). Indeed, a tangled web of cross-border lending was woven, creating a systemic link between Eurozone's sovereign debt crisis and the solvency of its banking system. Should the crisis flare up again, a European banking crisis should not be ruled out.

3. Austerity Now. How best to solve this crisis? To date, the EU has opted for imposing strict austerity measures on struggling nations. While that may be a prudent longer term strategy, it significantly heightens short term risks as lower economic growth also leads to lower tax revenues. That impedes the ability to stabilize debt levels.

What else can be done? The case of Iceland is instructive here. While their government implemented draconian austerity measures following its debt crisis, it has also had the economic tailwind of a large currency devaluation. Nominal GDP actually continued to rise since the crisis began (while the Icelandic Krona was devalued by more than 60%).

Greece and Ireland, on the other hand, do not have the option of cheapening their home currencies. Yet they are forced to contract fiscally. Without the ability to resort to devaluation, their economic adjustment paths will be much more difficult ... with deflationary spirals and frequent recessionary lapses much more likely.

4. Back to Devalued Drachmas and Pesetas? Can a single currency system among such varied countries work? The original architects and visionaries certainly thought so. Today, even in Germany, there continues to be strong political will to make the euro work.

But some question the euro's longer running viability. Others argue that the crisis can be contained by raising the EFSF's size and increasing liquidity injections, allowing time for countries in the periphery to undertake fiscal and structural adjustments.

However, obvious flaws with the structure itself remain. Economic and fiscal divergences have already grown (when the opposite was supposed to occur). Why? A number of reasons, but consider that while members of the Eurozone may share a central bank, each country has its own unique economic and financial factors. They do not share a common treasury (although they have the Maastricht guidelines ... which many countries have violated). As long as its members are bound by the constraints imposed by a single currency, total economic convergence and a singular monetary policy for all members is not realistic. The current crisis is evidence of that fact.

Looking Ahead. Given the above risks, where to next? Admittedly, a wide range of scenarios are likely. And our forecasts are multi-stage, relying on "if-then" significant events. For example, should a few peripheral countries exit the euro, the remaining "higher quality" countries would lead to a stronger currency.

But that will not happen quite yet. For now, the peripheral economies realize the Eurozone's backstops and support packages are necessary to finance their deficits. And, core countries still have a strong political commitment to the euro, not to mention their bank's exposure to peripheral debt.

Under this view, a long and painful adjustment will be necessary. Debt levels and competitiveness need to be restored to healthy levels. No doubt, some heavy lifting lies directly ahead. And, the next catalyst to renewed market turbulence is unknown. Could Spain — with an economy nearly five times larger than Greece and a banking system hugely overexposed to property — be the next shoe to drop? Or, will the new Irish government renege on bank guarantees set up by their predecessor?

Actionable. What does all this mean for investors? Here are some recommendations:

Hedge Euro Currency Exposure Versus Other Western currencies. Currencies are like stocks — they can become overvalued or undervalued. While long euro positions were rewarded over the last decade, the currency has become very expensive and the crisis is not yet over. While the final crescendo may lie in the future, any rally will be brief and followed by lower lows. Remain hedged versus the major developed currencies: USD, GBP, JPY.

Avoid “Deadbeat” Cap-Weighted Western Broad-Based Bond ETFs. Consider that most international bond indices track “broad-based Western bond ETFs” benchmarks. This means that countries with the largest issuance of debt have the largest weights in the index. (Laurence B. Siegel of the Ford Foundation calls this the “bums” or “deadbeats” problem). To the extent that more debt is a sign of future distress, these traditional global bond indexes have a structural bias — overweighting nations that have mismanaged public finances and likely to face future debt dislocations or credit downgrades. To avoid the “deadbeats” problem, investors need to be selective with their international bond exposures. Broad-based, developed market bond ETFs are unlikely to be successful investments.

Avoid European Financial Sector Exposure. If a country defaults or abandons the euro, a banking crisis would be virtually guaranteed. Financial sector exposures in many “Club Med” country ETFs are too high (NYSE: EWI, EWP). For aggressive investors, stay long Eurozone’s industrial sector while shorting the banks.

Embrace “Reverse Convergence” Trade. Within European fixed income, stay long German government bonds. Continue to avoid peripheral country debt, especially countries vulnerable to debt downgrades and renewed crisis. At this time, limited upside remains while downside risks are uncapped.

Prefer Emerging over European Sovereign Bonds. Over the long-term, the “quality” of sovereign fiscal positions drives returns (e.g. attractive growth prospects, solid balance sheets, and appropriate monetary policies). Today, the irony is that sovereign debt crises are playing out in the developed world. Euroland is hardly alone in its worsening fiscal situation — the U.S., Japan and other select Western governments also face alarming debt

burdens and persistent budget deficits. Indeed, the “quality” status is moving to countries in the emerging world where fiscal conditions are rapidly improving. Within global bond portfolios, stay overweight emerging market bonds (NYSE: ELD, EMLC). Volatility notwithstanding, a secular currency tailwind is also likely, particularly in developing Asia.

Conclusion. From the onset of the global financial crisis, Rand’s “Atlas Shrugged” has enjoyed resurgent popularity — selling over 200,000 copies in 2008. It’s no surprise. Since being published 54 years ago, sales have always spiked during periods of financial stress and heightened government intervention.

The fact that Rand’s work still sells speaks to its controversial subject. How should societies respond to divergences in productivity, debt levels and so forth? *ETFfocus* is not a socio-political publication. Global investing is our beat. But in many ways, Europe faces a similar dilemma. Can Germany and other core countries really be expected to underwrite peripheral debt forever? Of course not. Nor should the ECB be expected to continue to pursue unconventional measures. As ECB’s President recently said, “monetary-policy responsibility cannot substitute for government irresponsibility.”

To *ETFfocus*, the most practical solution has always been a euro restructuring, with at least a partial restoration of national currencies in the troubled nations. But all this lies in the probable future. For now, rolling sovereign turmoil is likely to persist in Europe ... lurching from one country to the next.

At this stage, policymakers do not have a silver bullet for years of unrestrained credit expansion. Layering new debt over old may buy time, but does not address fundamental credit overhangs and growth deficits. History shows that high levels of public debt are associated with poor economic growth and related investment losses. While Atlas may not shrug just yet, market dislocations and attendant portfolio opportunities surely lie ahead.

Endnotes:

¹ <http://www.reuters.com/article/idUSECBQUOTES20101229>

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