FX CONCEPTS

MARKET INSIGHT REPORT

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"EUROPE" IS HEADED FOR TROUBLE

The market was stunned earlier this week when it heard Axel Weber and Christian Noyer, two powerful figures at the ECB, say that they would not rule out a rate hike as their next move. With the forward curve predicting a rate cut in the second half of the year and most economies in Europe perched on the cusp of a slowdown, the market reacted violently. Our first thought was: What planet are these two on? Some reflection leads us to argue that the Europeans are, in fact, on two different planets, one in the north of the continent and one in the south and on the periphery. Considering the future course of the global economy and Europe's place within that economy, it is clear that the political reasoning behind these rate-tightening statements means that "Europe" as a concept and the euro as a currency are in for a rough ride in the next two years.

The last nine years have seen the German economy go through a very rigorous test within the euro-girdle, as German wages relative to productivity levels were set too high when the mark was transferred to the euro in 1999. This left Germany with no alternative other than a forced reduction in wages and increase in productivity that would allow it to compete with its fellow "Europeans," i.e. the others who were bound by the single currency. After seven years, Angela Merkel was the lucky recipient of a slimmed down and highly productive Germany, which now is the most efficient competitor within "Europe," and becoming more so every month. The PIIGS (Portugal, Italy, Ireland, Greece, and Spain) had a different experience when they joined the euro. They were undervalued relative to Germany, so at first were successful exporting there and protecting the home market from northern European manufactures. At the same time, the dramatic drop in interest rates associated with joining the euro caused a monetary explosion, a building boom, and inflation. Now the PIIGS labor is overvalued and the only way out is the seven bad years Germany went through, with high unemployment and declining real wages, but not all the PIIGS have the economic strength and political will to do that. As the global economic landscape is much bleaker now, severe recessions are ahead for these countries. It is almost certain that some kind of political upheaval will occur within these countries or within "Europe."

It might be important to know that Weber is German, Noyer is French. Other "hawks" include Jean Claude Juncker and Yves Mersch (Luxembourgeois) and Juergen Stark (German), not a PIIGS citizen among them. The ECB is not elected, and most politicians outside of Germany and Luxembourg are much softer on inflation and keener on easing the coming economic pain than the ECB. The leading indicators of European economic well being all point down (see this week's Cyclical Perspective) and the spread between the 2-year Schatz and 10-year Bunds inverted on Tuesday, reversing any sign of lower rates ahead. The forecast is grim, a recession next year is a certainty, and it is clear that the PIIGS will get the worst of it. With the election of Silvio Berlusconi in Italy, Nicholas Sarkozy has a rabble-rousing ally to bring down the ECB if it does not drop rates and weaken the euro as soon as possible. With the recent public speaking offensive by the "hawks" it is obvious that "Europe" is dividing itself into strongly opposing camps. The outcome of this battle could easily result in the destruction of the "Europe" we know today.

CYCLICAL PERSPECTIVE

Belgian Business Confidence, an accurate indicator of European economic trends, just dropped sharply, establishing a new downtrend, a sure leading indicator of a recession in the euro zone. Over the past few months, the yield on the German Bund has been falling, as one would expect with a recession on the horizon, but in the past few weeks these yields have turned sharply higher (and two year yields have even moved more aggressively higher). This toxic cocktail of a coming recession and climbing interest rates assures a more tenacious slowdown in economic growth in the years ahead. At the same time, the euro is climbing against most other currencies in the world, approaching its all-time high against our 50/50 basket of USD and JPY while the economy is tailing off.

It is clear that the value of the euro is most out of sync with today's economic outlook. Examining the past two periods of a strong euro, we can see that sharp declines in business confidence followed and that recessions did as well. But in both cases we can also find particular reasons for the strength that do not exist today. In 1990, Germany had just re-united, enthusiasm was high – in Germany, not Belgium – and the merger of the Ost-mark had forced interest rates to extremely high levels, as you can see on the Bund chart. The recession in 1992-3 was fierce, nevertheless, and the euro and Bund levels came down sharply, and let us not forget that we also saw the October 1992 currency crisis at this time. In September 1998 when the euro was at its next high, the yen was very weak and Bund interest rates were dropping sharply. The euro was born at year-end, and as a new-born, it also dropped like a rock. The following recession was almost minor and confidence quickly turned up. The past argues that a drop in yields and especially in the euro will come soon.