

A monthly commentary by Gabriel V. Safdié
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FROM MONETARY UNITY TO POLITICAL DISUNITY

Generalities (1-7)

1. In our view, the main event in July was the new and sharp fall of commodities of 10.8 % according to the Thompson Reuters Core Commodity Index, obviously led by oil : -21.5 %. But this drop occurred in all sectors, with, for example, -19.3 % for wheat, -10.8 % for copper and -7.5 % for gold.

2. This decline, coupled with a continuation of the bear market in China (-29 % from the top of June 12th, but still up 66 % over the last twelve months), put an end to the developed countries' stock market rally which followed the fact that Greece did not leave the euro at the beginning of the month.

3. Thus, in the end, Europe rose during the month 3.3 % for the DAX and 5.2 % for the Euro-Stoxx 50, followed by both the US and Japan : +2 % for the S&P500, +2.8 % for the Nasdaq and +1.7 % for the Nikkei 225.

4. On the opposite, the decline was significant for the MSCI Emerging Markets index in dollars, which lost 6.3 % in July.

5. Regarding bonds, the yield of the 10-year US sovereign bond fell from 2.35 % to 2.18 %, while the German equivalent moved up and down between 0.64 % and 0.90 % during the month, before closing close to the low at 0.65 % from 0.76 % in the previous month.

6. But - and this is much more interesting - the yield on junk bonds continued to rise and is now at 7.2 % for the Bloomberg USD High Yield Index. In two months, it has moved up 1 % and is now above its level of the beginning of the year (7 %).

7. Finally, in the currency sector, the major currencies remained relatively stable and consequently, against the dollar, the euro closed at 1.10 and the yen at 124.

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Currencies (8-19)

8. One of our regular readers sent us a text that the economist Milton Friedman wrote in 1997 regarding the euro.

9. First, let us mention that Friedman is as much a hero for those who vote for the right as John Maynard Keynes is for those who are left wing.

10. In a very summarized way, it is Keynes who introduced the idea, during the depression of the 1930's that the free market by itself could not stabilize the situation, since the economy had fallen into a vicious circle where aggregate demand was continuously contracting. He therefore advocated the use of fiscal, monetary and budgetary policies in order to increase government spending so that overall demand would start rising again, thus leading to a revival of the economy. US President Franklin Roosevelt was the first to implement his ideas.

11. After World War II, all Western countries followed Keynesian stimulus policies after each recession, thus steadily increasing the size of government spending in the economy.

12. Friedman's hour of glory came with President Ronald Reagan. The US economist was against Keynesian stimulus policies, a source in his eyes of inflation and financial imbalances. His analysis of the 1930 crisis considers that the problem was not a lack of demand, but an overly restrictive monetary policy.

13. His view was that the government should play the lowest possible role if citizens were to keep their political and economic freedom. It is through monetary policy - by injecting or withdrawing liquidity - that the optimization of economic conditions should be done.

14. Having been the author of two major works : "Capitalism and Freedom" and

"Free to Choose" - where it is not a coincidence that the word "freedom" appears in both titles - Milton Friedman could only be hostile to a government sponsored project of a single currency, which he saw as a straitjacket.

15. But his opposition also had serious economic reasons, to the point that his article, written 18 years ago, is totally up-to-date.

16. Its title was : "The Euro : monetary unity to political disunity ?" So, we have removed the question mark in our own title as presently we have, unfortunately, a positive answer to this question.

17. In his text, Milton Friedman first of all observes that : "Flexible exchange rates are a powerful adjustment mechanism for shocks that affect the entities differently. It is worth dispensing with this mechanism to gain the advantage of lower transaction costs and external discipline only if there are adequate alternative adjustment mechanisms."

18. Then, he explains that this is the case for the United States, with one single language spoken, the easiness for citizens to move within the country with no problems whatsoever and the fact that the federal government collects and spends twice as much tax than states and local governments.

19. On the opposite, in the European Union, none of these factors exist and loyalty to a citizen's national country is much stronger than to a common market or towards the concept of Europe. Furthermore, not only the circulation of goods and capital is much worse within the union than in America, but also the level of regulation is much higher, resulting in a labor market that is less flexible and mobile than on the other side of the Atlantic.

Currencies (20-29)

20. Then the continuation of his reasoning foretold exactly what is happening in Mediterranean countries since the beginning of the Greek crisis : "If one country is affected by negative shocks that call for, say, lower wages relative to other countries, that can be achieved by a change in one price, the exchange rate, rather than by requiring changes in thousands on thousands of separate wage rates, or the emigration of labor."

21. And already he illustrated this assertion by mentioning the austerity that came with the strong franc policy then practiced in France, as part of the European Monetary System which preceded the introduction of the euro. For him, the contrast was striking with the United Kingdom, where once the British pound was ejected from the European mechanism, it did indeed lead to a sharp fall of the pound but this also opened the door for a sustained period of economic growth.

22. And the more things change, the more they stay the same. After the 2008 crisis, the pound was devalued by 30 % against the euro and the British government allowed its public deficit to rise above 8 % of GDP. On the opposite austerity measures were taken in the Eurozone, leading to the currency moving sharply higher. Also massive tax increases were introduced.

23. In France, for example, in the three years under Mr. Hollande's reign, taxes increased by EUR 74 billion and this without taking into consideration the strong rise that Mr. Sarkozy had already imposed in 2012.

24. Without surprise, this weighs on the French economy, with a serious increase in unemployment which continues to this day and an important emigration, both from wealthy individuals as well as from well-educated youths. But, despite these sacrifices, France's public deficit is still closer to 5 % than to the mythical Maastrichtian level of 3 %.

25. And quite ironically the French deficit is currently the same as the British one. But with one big difference : in the UK, citizens work from the beginning of the year until May 9th to pay their tax bill, while in France it is only from July 29th onwards that workers can finally begin to enjoy the fruits of their labor. Only Belgium is worse in Europe.

26. One doesn't need to be clever to notice that without the euro this policy would have never been followed in France; the necessary adjustments would have been made via the decline in the value of the national currency.

27. In the remainder of his text, Mr. Friedman explains why the period of the gold standard was not the paradise imagined by those requesting that currency rates be once again set in relation to gold. And then he finds that only Germany, Benelux and Austria were close to the conditions necessary for a monetary union.

28. And he concludes : "The drive for the Euro has been motivated by politics not economics. The aim has been to link Germany and France so closely as to make a future European war impossible, and to set the stage for a federal United States of Europe. I believe that adoption of the Euro would have the opposite effect. It would exacerbate political tensions by converting divergent shocks that could have been readily accommodated by exchange rate changes into divisive political issues. Political unity can pave the way for monetary unity. Monetary unity imposed under unfavorable conditions will prove a barrier to the achievement of political unity".

29. The above mentioned text perfectly summarizes what happened during the meeting of the Euro-group in early July. Yes, Greece remained in the Eurozone, but with a "plan" that both creditors and the debtor consider unworkable.

Currencies (30-38)

30. For example, one assumption is that Greece will privatize public assets for an amount of EUR 50 billion and this in the midst of an economic crisis. It is absurd. In comparison, Italy will start at the end of the summer a long-term privatization program in order to collect only EUR 12 billion. Furthermore, if one thinks of the railroad company for example, is it rather the Greek state which should pay a private investor to take over this financial abyss.

31. The truth is that during this meeting, Greece was not ready for a Grexit, despite a last attempt to get Mr. Putin's Russia to finance it, and it was politically impossible for Germany to expel Greece.

32. Anyway in reality, the famous "plan" is no such thing as the true discussions will start now. And it is quite facetious that the IMF has become the main ally of Greece as it is the only one among the creditors to state the obvious : the debt level of the country is too high. This was already true in 2010 and it is still the case today.

33. It should be noted that a simple solution exists to this problem and without the need for a debt write-down. As we have already mentioned in a previous comment, Greece is paying today as a percentage of its GDP an amount of interest lower than Italy. The debt service is thus quite bearable. It would be therefore sufficient to transform all or part of the loans into perpetual bonds, with Greece having the option to reimburse them when it decides. The matter would thus be settled in a mutually satisfactory way : Europe would not have to recognize a loss on its loans and Greece would no longer have to deal with loan maturities which cannot be paid without a new rescue plan.

34. What one must be aware of is that, after the Euro-group meeting earlier this month in which Mr. Tsipras yielded, we are only at the intermission of this episode of

the Greek crisis; the soap opera will soon resume and with it the discussions on a "real plan", which will use the one presented in July as a basis for negotiations. Five years after the beginning of the crisis, it is time to find a solution that would allow the country to return to normality. Yet, as Milton Friedman had predicted, the euro has exacerbated political tensions. So it is not sure that common sense will prevail on both sides and an exit of Greece still in 2015 remains a possibility.

35. Let us mention that the only interesting element that came from the Greek referendum was the fact that younger voters rejected the plan by close to 80 %. As Milton Friedman noted, the euro was the political consequence of the German reunification. By sacrificing its precious deutsche mark, Germany symbolically wanted to show how much, after being the "bad guy" during the twentieth century, the country now desired becoming the "good guy".

36. But, as with a boomerang, the euro has now come back to its face and, once again, Germany finds itself in the role of the "bad guy".

37. In Greece as elsewhere, young people see that the euro did not bring prosperity and unlike old people, they no longer have the trauma of the wars that torn apart the continent. If the Eurozone is unable to find the mechanisms which will allow for adjustments to be done in a less painful way, the probability of 20 % given by the market today for the disappearance of the euro will inexorably rise in coming years.

38. Anyway on the short-term, the Greek uncertainty makes it even more difficult than usual to have a clear idea of the evolution of exchange rates in coming weeks, as to economic factors this political element is now added.

Currencies (39-40)

39. Let us simply recall that from an economic point of view the EUR/USD exchange rate is caught between two fires. On the one side, there is the surplus of the balance of payments of the Eurozone which favors an increase of the single currency and, on the other, the expectation of higher US interest rates provides a boost to the greenback.

40. In view of so much uncertainty, we advise investors not to take for the moment aggressive currency positions outside their base currency.

Commodities (41-45)

41. By the way, it should be mentioned that the latest events in the commodities sector are not favorable to a large phase of rising interest rates in the US.

42. First of all because, obviously, any decline in this sector is beneficial to developed countries since it reduces their production costs, thus pushing prices lower.

43. But also because the new sharp falls in this sector indicate that the slowdown of Chinese growth will amplify. This is confirmed by the bursting of the Chinese stock market bubble, which the authorities had strangely encouraged.

By itself this is not serious but it is a further sign that the country's growth target of 7 % per year will have to be revised downwards.

44. This is a situation which must worry the Chinese authorities and it is likely that they will eventually react vigorously by implementing a monetary policy aimed at weakening the Yuan, thus exporting deflation towards the world economy.

45. We also consider that the price of gold is adjusting downwards to reflect this new coming deflationary push.

Equities (46-49)

46. If current events are a source of short-term uncertainty for equities, they reinforce the structural bull market, since, as it was already the case in 2013 and 2014, the prospect of interest rate increases is moving away once again.

47. Indeed, in the US only a symbolic increase of 0.25 % is expected to occur this year in September, and the next increases will probably be delayed, since the international situation will reinforce the FED's cautiousness at a time where it is already dissatisfied with the current level of US growth.

48. These low interest rates will therefore continue to support equities and in particular because the world continues

to grow. Morgan Stanley recently estimated that even if growth slows in China and Greece exits the euro, global growth in the second half of the year should reach 4 %, thanks to the expansionary monetary policies of a majority of central banks.

49. In the short-term the situation is more fragile as concerns linked to Greece and/or China could weigh on prices. And all the more so as professionals are cautious because of the current level of equity valuations. Indeed, 60 % of fund managers and British analysts polled in a survey done by CFA UK - which represents 11'000 professionals - believe that equities are overvalued.

Equities (50-53)

50. For us, we consider that equities are currently at their fair value, given growth prospects and the current level of interest rates.

51. But the key to the evolution of equities in coming weeks is in the US. For now, in America, the stock market has behaved remarkably well in view of the current uncertainties, simply marking time. But, the risk of a correction - i.e. a decline of more than 10 % from the high - remains and even more so as investors are nervous

since the stock market has not had such a correction since 2011, the second longest such period in the history of the market.

52. However, the main factor that could have justified it - i.e. the need to adjust stock prices to higher interest rates - has declined this month.

53. Therefore, we continue to consider that the main risk should be taken through equities.

Bonds (54-63)

54. And all the more so as equities have a significant source of potential buyers : those who currently are holding bonds.

55. Two years ago, when analysts were beginning to expect the, what has now become the much talked of, first rise in US interest rates, the market was predicting that investors would do a great rotation from bonds into equities.

56. However, as this interest rate rise has been continuously delayed, the great rotation did not occur.

57. In fact it was quite the opposite. In 2014, bond funds collected USD 286 billion of new funds, against USD 220 billion for equities. One should note the strong positive level of these two figures, testimony of the quantitative easing policies pursued by central banks.

58. And in the first four months of 2015 the difference even increased with USD 153 billion for bond funds against USD 43 billion for equity funds.

59. We do not have yet the final figures, but in the last three months it seems that redemption requests from bond funds have increased to the point where net

withdrawals of cash are now happening. This can be illustrated by the increase in the yield of the Bloomberg High Yield Index.

60. This is probably due to increased concerns regarding the creditworthiness of debtors of the energy sector and well as of those domiciled in developing countries in which economies are suffering.

61. But the unease is also evident in developed markets. If the CFA UK survey mentioned above indicated that a majority of professionals considers equities as overvalued, 70 % of them also believe that there is a bubble in bonds.

62. Faced with the ultra-low current yields, one should still expect that a portion of the bond holdings will eventually be transferred towards equities. But for this to happen it is necessary that not only the US interest rate normalization phase be felt to be imminent, but also that economic growth be strong enough to allow stocks to jump the barrier of higher yields.

63. In any event, one must be aware that inevitably the bond market will become more volatile given the increase in public and private debt.

Bonds (64-65)

64. For example, the total amount of bonds issued by the US government increased from USD 4.5 trillion in 2007 to USD 12.6 trillion in 2014, i.e. an increase of 275 %. When this sea of debt, today frozen by the low level of interest rates, will begin to

move because of the heat generated by the rate increases, the bond vessel will find itself in quite turbulent waters.

65. This is why we only like in this sector a few rare special situations.

Conclusion (66-73)

66. What a surprise ! Even after five years of a severe economic crisis, Greeks did not become Germans.

67. And Germans, despite a commitment of more than EUR 70 billion towards Greece, find themselves once again as the “bad guys”.

68. In fact, what would be needed today is that both Greeks and Germans become Anglo-Saxons : rather than fighting and arguing about who is responsible for what, it is time to become pragmatic and to put in place a plan that solves the problem permanently.

69. But it is not certain that this will happen, as both parties feel trapped in what has become an unhappy marriage and where bitterness has accumulated on both sides.

70. Anyway, the crisis has highlighted the dysfunctions foreseen by Mr. Friedman. To solve them, a deeper political integration than the existing one is needed at a time when each country is under a strong nationalist pressure fueled by the mediocre economic situation of the area.

71. At the macro-economic level it should be mentioned that countries are presently following at the same time both the Keynesian policy of large public deficits and the one advocated by Friedman of a loose monetary policy. Normally, each one separately should have been able to turbo-charge growth and the fact that the two together have been unable to do so is disturbing.

72. Thus, the world is in need of a new brilliant economist capable of suggesting a new policy suited to our times.