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Greek Farce

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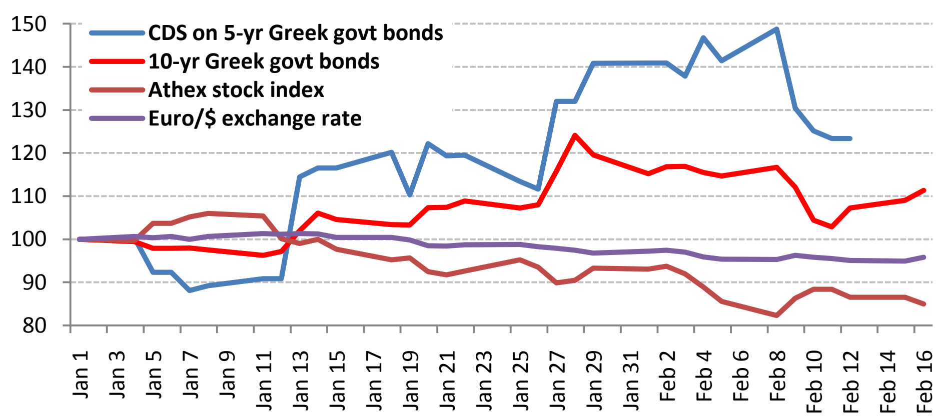
The EU's credit crisis has abated, at a deep cost to currency credibility worldwide.

The crisis in Greek sovereign debt seems to have subsided, with assurances of unspecific support from European leaders. Following the Dubai World crisis last Thanksgiving, this marks the second time in three months that world markets have been thrown into sudden sharp corrections by uncertainty about whether deep-pocket sovereigns would come to the rescue of distressed lesser credits (see "On the Dubai Debt Crisis" November 27, 2009). These are important tests, because their essence is to probe the ongoing viability of the paradigm of the government bail-out that saved the world from complete credit collapse last year. The test is especially critical, because it is two-fold -- not only of the *willingness* of governments to keep bailing, but also of their *ability* to do so. So far so good, for Dubai and for Greece, and for their patrons but there's a race against time involved here. If enough crises keep showing up, we can extrapolate a state of the world in which governments would like to keep bailing, but no longer have the necessary resources -- other than inflation.

There's a whiff of that in the case of Europe's yet-unspecified bail-out of

Key market-based stress indicators during Greek credit crisis
Indexed to 100 on January 1, 2010



Source: Reuters

Update to strategic view

GOLD, US RESOURCE STOCKS, COMMODITIES, OIL: The likely passing of the Greek credit crisis, and the blow to Europe's credibility that it leaves in its aftermath, set up the perfect storm for a recovery in hard assets and inflation plays.

US DOLLAR: Our long-term forecast remains bearish on the dollar, based ultimately on ongoing inflationary risks. But as the recent Greek episode demonstrates, at least the appearance of dollar strength can be created versus other currencies facing their own special problems.

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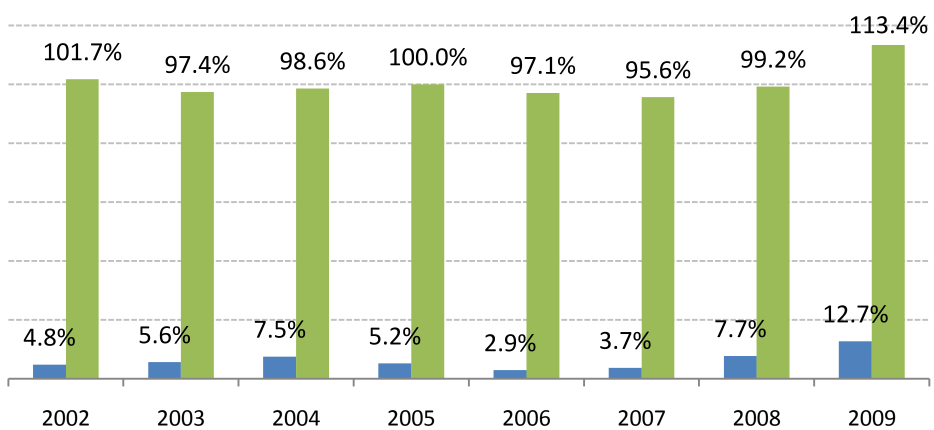
Greece. While yields and credit default spreads on Greek government debt have come in substantially from their panic levels of early last week, Greek stocks have barely recovered at all, as the Greek economy faces the likelihood of years of growth-killing fiscal austerity (please see the chart on the previous page). And until this morning's uptick, the euro has continued to weaken versus the US dollar on the same trajectory along which it was weakening when the panic was still at its height. That indicates to us that, whatever Europe ends up doing for Greece, it will likely be costly -- in credibility and confidence, if not in actual treasure.

Even if we discount the widespread scare stories about how this will result in the destruction of Europe's monetary union, there's no way that Europe and the euro don't come out of this substantially tarnished. First, the vagueness of Europe's assurances to world markets about its support for Greece is corrosive to the confidence a currency requires in order to hold its purchasing power. What's worse, Europe isn't fooling anybody -- markets know exactly why the bail-out terms must be so vague. A specific bail-out is all but prohibited under section 104b(1) the [Treaty on European Union (the "Maastricht Treaty")](), which says that neither the community nor a member state shall "assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law or public undertakings of another Member State…" In other words, an EU bail-out of Greece would be as lawless as the Fed's bail-out of AIG -- perhaps necessary and desirable, but nevertheless lawless, with all the long-term consequences for institutional credibility that implies. Indeed, Greece's accession to the euro was lawless from the beginning. Since joining the monetary union in 2002, Greece has far exceeded the permitted debt level of 60% of GDP every single year. It has exceeded the permitted deficit level of 3% of GDP every year but 2006 (please see the chart below). Italy is nearly as bad, nearly as consistently.

The resulting loss of confidence in the euro has gone a long way toward explaining the apparent strength of the US dollar this year. But as we've

Greek — government debt and — deficit
Percent of GDP



Source: 2002-2008 Eurostat, 2009 Reuters

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Key documents

Treaty on European Union

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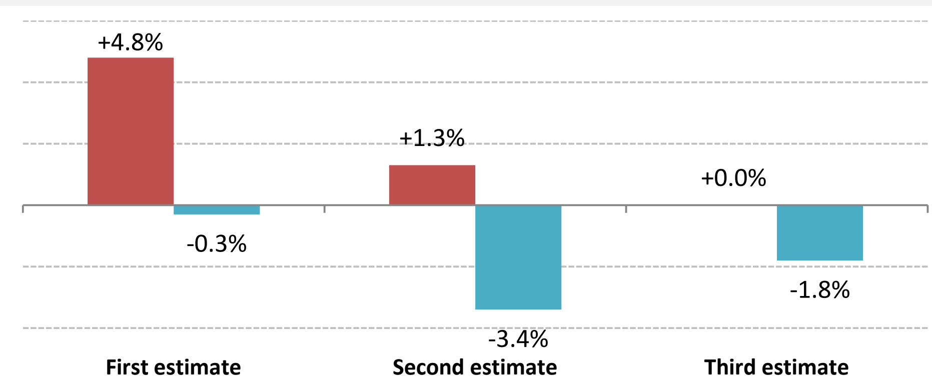
cautioned many times before, don't mistake euro weakness for actual dollar strength -- the faults of one currency don't imply any virtues in another one for which it happens to exchange (see, among many, "Geithner and the Dollar: That's Not My Job" October 15, 2009). Rather than strength or weakness in any particular currency, we see the Greece affair as strengthening the case for hard assets such as gold by eroding confidence in all currencies together. As we have detailed, the immediate effect of the Greek debt crisis was to reinvigorate residual deflation fears still latent from the global panic of 2008-9, sending inflation-sensitive gold lower (see "PIIGS, Panic and Jobs" February 5, 2010). We said that gold would recover first among risk-assets, as the EU eventually quelled the panic, and indeed it is. As of this writing gold is breaking out vigorously from its short-term downtrend from its December 2009 all-time highs.

This is not only because the EU's vague promises have allayed deflation fears, but more because the whole affair has served to more deeply instill skepticism in the euro, and currencies in general. Deepening the credibility gap in the case of the euro is the embarrassment of Greece's repeated errors and deceptions in reporting debt and deficit statistics, and the failure of Eurostat, the EU's central data collector, to police it. It's a macroeconomic version of the existential crisis triggered in 2002 by the serial accounting scandals of Enron, Worldcom and others, or in 2007 and 2008 by the market's inability to assess the value of bank assets embodied in opaque mortgage-related securities.

Japan has a macroeconomic credibility gap, too. Yesterday the Cabinet Office reported Q4 2009 real GDP growth of 4.6% at a seasonally adjusted annual rate. Bad enough that this apparent growth is due almost entirely to deflation, without which it would have been reported at only 0.9%. What's worse, Q3 2009 real growth was revised down to zero. This is its second downward revision. In early December it was reported as 1.3%, having been reported originally in November at 4.8%. Even the original 4.8% was more than entirely due to deflation, without which it would have been reported at negative 0.3% (please see the chart below). Which version is reality -- any of them?

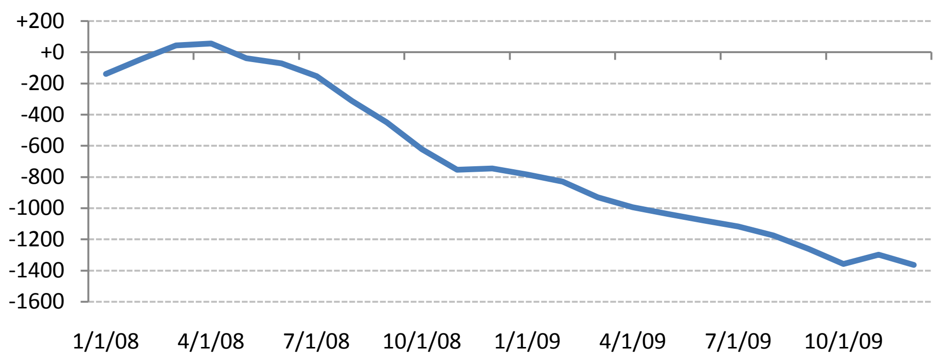
Japan GDP Q3 2009 — real and — nominal
Sequential quarter change, seasonally adjusted annual rate



Source: Cabinet Office

The US is not without such issues. With the January jobs report released earlier this month, revisions to the methodology for calculating payroll employment increased the number of jobs lost since the onset of recession by 1.36 million (see the chart below, and again, see "PIIGS, Panic and Jobs"). Again, what is real? Is it real that the White House Office of Management and Budget concedes that the US could not qualify for accession to the euro, given its forecasts that the federal budget deficit will exceed 3%, and the debt will exceed 60%, for the entirety of its planning horizon to 2015? Or is it worse than that?

Non-farm payroll jobs, revisions announced February 5, 2010
Thousands, seasonally adjusted, cumulative from December 2007



Source: Bureau of Labor Statistics

This all plays into our forecast that the US economy, while out of recession to be sure, will only gradually recover. And while the abatement of the latest iteration of the credit crisis may end the worst of the US stock market's correction from the January recovery highs, the steam has gone out of the bull market from the March 2009 bottom, and we still expect at least consolidation if not further correction. But it's the perfect storm for gold and other inflation plays. We've got it all -- slow growth and recurring credit jitters keeping the Fed on hold at a zero interest rate as far as the eye can see, while subterranean inflation pressures inevitably build, while at the same time confidence in currencies and the fiscal condition of the sovereigns that issue them continues to degrade.

Bottom line

The likely passing of the Greek credit crisis, and the blow to Europe's credibility that it leaves in its aftermath, set up the perfect storm for a recovery in hard assets and inflation plays. Our long-term forecast remains bearish on the dollar, based ultimately on ongoing inflationary risks. But as the recent Greek episode demonstrates, at least the appearance of dollar strength can be created versus other currencies facing their own special problems.