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If Portugal Fell…

Thursday, March 24, 2011

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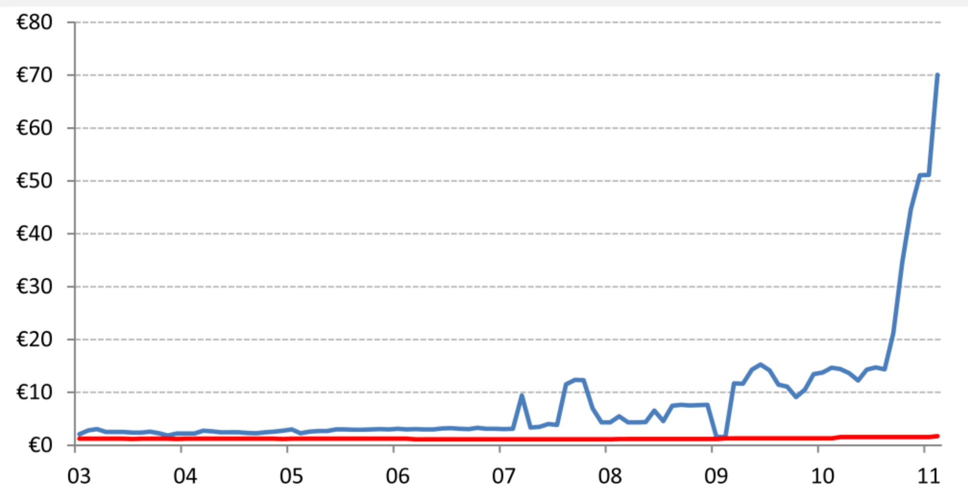
…in the forest and no one was there to hear it, would it still make a noise?

The debt crisis in the Euro Area just gets stranger and stranger. Yesterday Portugal's parliament voted to reject an austerity budget, which will likely necessitate a bail-out which, in turn, will likely necessitate an austerity budget. Prime Minister José Sócrates resigned after the vote, days ahead of a European Union summit, which he will now attend only as a powerless representative of a caretaker government, at which will be ironed out the terms of future bail-outs, such as the one the Portugal will have to accept, which will require the austerity it rejected yesterday. But unless an unlikely coalition can be cobbled together, Portugal will have no government to do the accepting (and at the same time Finland will have no government to ratify it). Are you getting all this?

Meanwhile, extraordinary lending agreements (ELA) by the Central Bank of Ireland with insolvent Irish banks have swollen to €70.1 billion from an already astronomical €51 billion a month ago (please see the chart below, and "The Libyan Connection" February 22, 2011). This risk of the Irish sovereign, much of it secured only by promissory notes, is 44% of Ireland's



Source: Central Bank of Ireland

Update to strategic view

US DOLLAR: The strong euro is focusing myopically on the ECB's coming rate hike. But hike or no hike, the future is euro-negative. If the hike doesn't come, expectations will be unwound and the euro will weaken. If it does come, then that will make the ongoing European debt crisis even more intractable, ultimately requiring even more liquidity from the ECB and the sovereign central banks, ultimately weakening the euro.

GOLD: Gold has moved to new highs in USD terms, but not euro terms. This gives us confidence that even with a likely tightening error from the ECB in April, monetary conditions world-wide are continuing to be eased. We reaffirm our $1500 price target.

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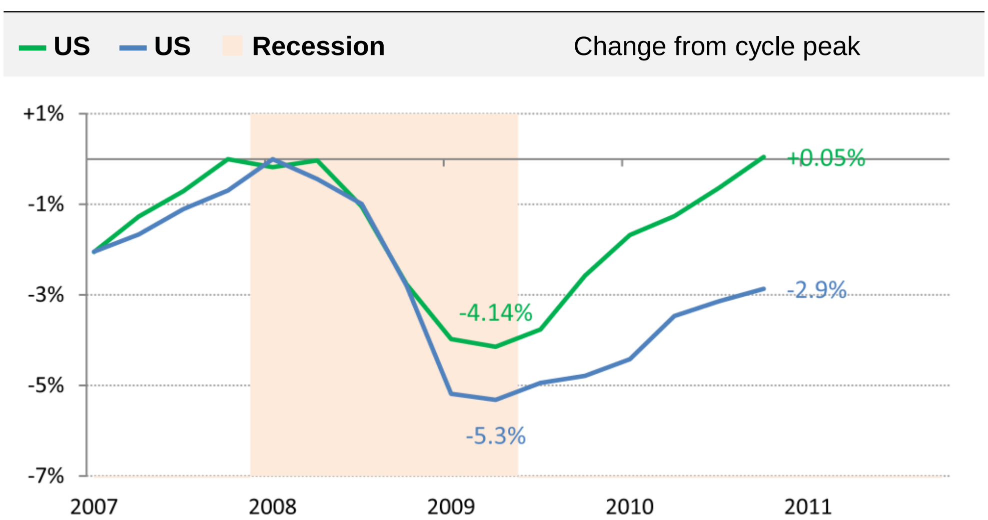
annual GDP, and 41 times the CBI's capital and reserves.

None of this appears to matter. Until Japan and Libya crowded Europe's debt crisis out of the headlines, this was seen as the most virulent potential source of systemic event-risk. Now another PIIGS domino is about to fall, and as it teeters, it's been "risk on" for markets. In one sense this is all exactly as we've predicted -- that smaller peripheral nations would continue to require bail-outs, but that by hook or by crook the Eurocratic elite would manage to prevent a systemic shock no matter what it took (see "Europe Gropes toward Stress-Tests" July 12, 2010). The non-reaction in markets as the Portugal affair has unfolded this week seems to indicate that markets have come around to our view.

But in another sense this is a complete bafflement to us when it comes to the euro currency. The euro's recent strength is probably explained by the ECB's apparently unshakable intention to raise rates next month. This week ECB president Jean-Claude Trichet reaffirmed the rate hike threat he first floated several weeks ago at his monthly press conference, and several other members of the European central banking community have chimed in along the same lines. But it stuns us that the ECB would do this, when it so clearly would make an already very difficult matter of debt resolution much worse (see "The Fed is from Venus, The ECB is from Mars" March 9, 2011). *And whether it really follows through and does it or not*, we don't see how it can end up being euro-positive.

- By the textbooks, a currency associated with higher expected rates ought to strengthen. So if the ECB fails to raise rates in April as expected -- perhaps citing uncertainty arising from the Japan earthquake or Middle East turmoil -- then the euro will weaken.
- But if the ECB follows through and raises rates in April, it will make it harder for Europe to grow its way out of its debt problems. Europe is still basically in recession, having lost more output than the US and having recovered far less (please see the chart below). This will drive more bail-outs and more re-negotiations of existing



Source: BEA, Eurostat, TrendMacro calculations

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Recommended Reading

Activism
Alan Greenspan
Council on Foreign Relations
International Finance 2011
March 15, 2011

Understanding policy in the great recession: Some unpleasant fiscal arithmetic
John H. Cochrane
European Economic Review 55 (2011) 2-30

Catastrophic Natural Disasters and Economic Growth
Eduardo A. Cavallo, Sebastian Galiani, Ilan Noy and Juan Pantano
Interamerican Development Bank
Working Paper Series
June, 2010

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bail-outs. Fiscal authorities are getting bail-out fatigue, as evidenced by Angela Merkel's party's poor prospects in the upcoming elections in Baden-Württemberg -- so the only possible solution is more liquidity support from central banks (such as the Central Bank of Ireland's ELA's). The euro can't help but get corrupted in the process -- again, the euro will weaken.

- We've been wrong on the euro so far. But we don't see any way out for it.

Bottom line

The strong euro is focusing myopically on the ECB's coming rate hike. But hike or no hike, the future is euro-negative. If the hike doesn't come, expectations will be unwound and the euro will weaken. If it does come, then that will make the ongoing European debt crisis even more intractable, ultimately requiring even more liquidity from the ECB and the sovereign central banks, ultimately weakening the euro. Gold has moved to new highs in USD terms, but not euro terms. This gives us confidence that even with a likely tightening error from the ECB in April, monetary conditions world-wide are continuing to be eased. We reaffirm our $1500 price target.