

The last act begins for the EUR peg

Why the EUR-peg is likely to break

Why new QE is deflationary and counterproductive, so it may soon be up for review

We have long been negative on the prospects for the EUR peg to survive the test of global structural deflation and local ineffective policymaking. [Back in 2013](#), we wrote of the **instability and unsustainability of a currency construct set for failure**. At the time, we highlighted three big problems with it:

- **Structural Deflation / Secular Stagnation**: debt overhangs and chronic over-supply (misallocation of capital), bad demographics (aging population, falling working population), technological disruption ('Amazon effect', 4th Industrial Revolution), falling productivity of credit (diminishing marginal impact of new lending, while also credit growth decelerates) all conspire to the deficient aggregate demand, the structural deflation and the liquidity trap, across the globe: a process which began well before the Global Financial Crisis and the Lehman-moment.
Why does deflation matter that much? Because durable deflation in a period of economic stagnation is like a death penalty for debt-laden countries burdened with high unemployment: no matter how much virtuous they get fiscally their debt-GDP ratio is set to rise over time, i.e. their debt go up in real terms and make a recovery progressively less likely. So they remain trapped in a long period of debt deflation / balance sheet recession. Take the case of Italy, for example, at 132.5% gross public debt-GDP, where at zero inflation even a primary surplus of ~8% would just about manage to prevent debt ratios from rising further. And such surplus would be heavily contractionary, thus a self-defeating strategy. Such is the evil of deflation. No wonders the ECB embarked on unprecedented expansion of the monetary base. But it failed at stopping deflation. [Here](#) are our thoughts in 2014 on that.
- **EU mistaken diagnosis**: instead of seeing Secular Stagnation for what it is, EU policymakers saw a problem of low productivity caused by a lack of structural reforms and fiscal discipline. The ensuing quest for austerity drove by 'internal devaluation' and aggravated the crisis, helping the inner workings of secular stagnation.
- **Dysfunctional politics**: the inability to reach an agreement and put to work sound crisis resolution policies at the EU level has become proverbial. It is still fresh in memory the epic struggle to tackle the restructuring of Greece, which accounts for a ~1% of the bloc's GDP, while it took over 90 meetings – between EU summits, EU ministers etc - to reach a

temporary solution. Gridlock reigns and stands in the way of efficient policymaking. Not so long ago, lack of coordination and a flawed currency construct led to the 'Black Wednesday' ERM's fiasco, with Sterling breaking away disorderly.

EUR BREAK-UP IS A REAL POSSIBILITY



EU MONETARY UNION MAY COME UNDER PRESSURE IN THE NEXT YEARS

- › In the long term, we think the EUR currency experiment may likely implode
- › At current rates, the structure of Europe is both instable and unsustainable
- › We see three main problems with Europe at the moment:



Source: Fasanara 2015 Investment Outlook

The implosion of the EUR may not be such an outlier in financial history: after all, each and every fixed exchange-rate regime in history was let go, sooner or later. However, there was reason for hope this last June. The Brexit referendum sent an unequivocal message in rejection of the current state of affairs of EU policymaking. In addition to issues with migrations flows and income inequality, the anti-elite stance taken against Brussels was hard to miss. The more so as it added to several other indicators of anti-elite discontent all over the world, from the rise of Trump in the US to support for extremists in Austria and Hungary, etc. Brexit was part of a trend, not an isolated data point.

Sure thing, secular stagnation, technological disruption and globalization all conspire to feed on income inequality and stagnant real wages to a point where they can easily serve as scapegoats. But the **EU crisis policymaking fell short (unable to avert deflation), if not backfired (new QE is disinflationary), while the EU red tape super-state exacerbated the crisis (further impediment to growth), leading to the political defeat of Brexit.** First and foremost, it was a defeat for the EU.

On grounds of logical thinking, it should have worked as the **proverbial canary in the coal mine, the last minute wake-up call averting disaster**. It did not.

In the aftermath of the Brexit referendum, we thought Europe had the unmissable chance to seize the opportunity for building consensus for deep structural reforms of the EU, acknowledging defeat and learning from past mistakes. Yet, **despite the second biggest GDP in the EU opting to drop out, the EU is very much business as usual, much as Brexit never happened. To this day, no grand action plan is in sight, no sense of urgency, except the idea of bullying the UK upon negotiations in an attempt to deter further uprising across Europe.**

The list of past mistakes is long and getting longer:

- Pushing for fiscal austerity at a time of secular stagnation, mistaking a problem of deficient global aggregate demand for one of lack of structural reforms.
- Wasting a most precious monetary expansion through QE without accompanying it with redistributive fiscal expansion. QE was then able to purely buy time and kick the can down the road some more
- Failing to complete the Banking Union, providing the safety net of deposit insurance and other structural reforms of the banking system. To the contrary, bail-in rules were introduced, which only led to financial instability and a crisis of confidence in the banking system, further undermining their profitability, thus curtailing bank lending to the real economy and wasting the efforts at the monetary level
- Preserving the supremacy of EU bureaucracy over pragmatic crisis policymaking, thus dampening already-scarce animal spirit, and ultimately leading to disaffection for the EU project

On the other hand, we believe only a dramatic shift in narrative at the EU level could derail the train before it hits the wall, with measures including:

- Temporary Suspension of the Fiscal Compact
- Banking Union completion via a deposit guarantee, in exchange for fiscal controls post-normalisation of growth rates/inflation
- Allowing for State aid of troubled banking sector (e.g. Italy), before State intervention has to occur anyway but at zero-periodic equity valuations
- Programming substantial Fiscal Expansion, possibly Helicopter Money down the road (discussed below), as ways of forcing income redistribution policies (Brexit vote had inequality, not just immigration, as key tipping factor). Deflation is the elephant in the room, that needs to be taken care of, or else all bets are off.
- Democratic elections for Brussels' bureaucracy-enabling functions
- Diversion of Brussel policymaking away from red tape overdrive, clear endorsement of member states for most matters

The biggest threat to EU survival is then not so much Brexit but the lack of response that followed. The dramatic warning signal shot by Brexit fell on the deaf ears of inadequate EU policymaking.

We doubt the UK will ever prove weak enough to help the case of the EU current policymaking. If anything, so far it seems like the UK is performing remarkably well, if one is to look at the business and consumer confidence surveys of late. The GBP is weaker than any QE by Mervyn King/Mark Carney could ever achieve/dream of. But is surely too early a time to draw conclusions, Article 50 has not even been triggered yet. Chances are, though, that the UK will do ok even after that, relative to the rest of Europe. We expect a mild recession, if any, and a rebound afterwards. And that is just more problem for Europe (see also Fasanara Interview at CNBC: [Brexit: don't think UK is 'standing on the cliff of a disaster'](#)). **The UK doing well will send another unequivocal message to struggling EU countries: there is life after the EU.**

Professor **Joseph Stiglitz** has recently reaffirmed his view that the EUR will break, as 'the cost of keeping the Eurozone together probably exceeds the cost of breaking it up'. Earlier this year, former BoE's Governor **Mervyn King** predicted the collapse of the Eurozone. Russia's President **Vladimir Putin** recently said that Russia holds 40% of its FX reserves in EUR, while he thinks the Union may comprise fewer stronger countries in the future ([see BBG interview](#)), thus leading to an appreciating EUR. **The time for treating the EUR-peg as a taboo may soon be past us, and an open discussion become the dominant narrative, in pursuit of a long-term durable solution to economic stagnation, in an attempt to save the European Union, so to orderly drive the process as opposed to end up being overwhelmed by the trending course of events.**

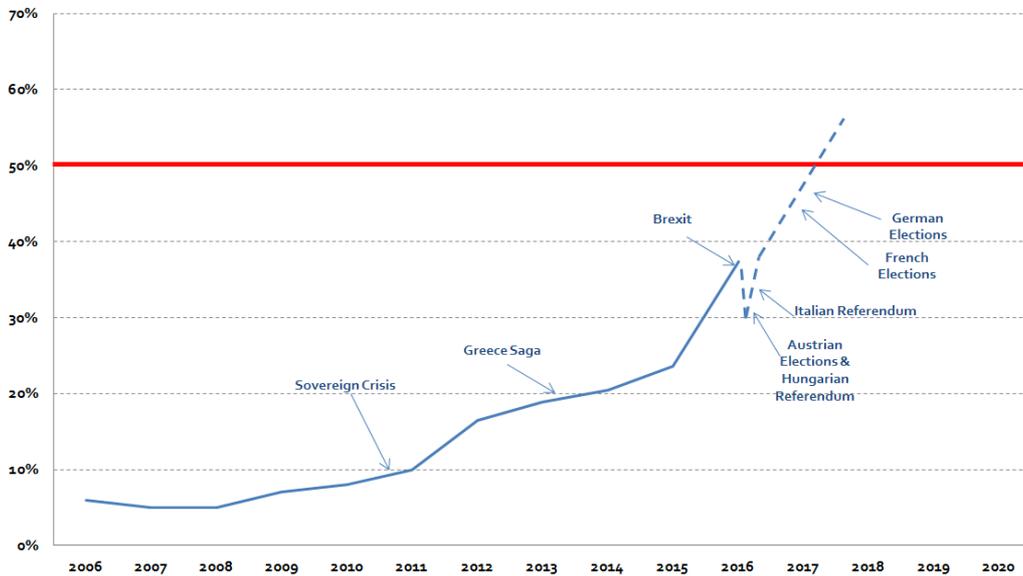
Timeline for a EUR de-peg

In terms of timing the de-peg, other than saying that whatever is unstable and unsustainable will necessarily have to come to an end, that no fixed currency regime ever survived the test of time, the next obviousness is to say that it is impossible to know what precise trigger will precipitate events. However, **one can look at the steady growth of EUR-sceptics across Europe, and interpolate from there to get some rough idea.**

At present, when looking through populist parties and EUR-sceptics, **an estimated 30%-40% of the European electorate would stand to vote against staying in the Monetary Union** (which does not necessarily mean leaving the EU). **That number shrunk somehow after the Brexit vote, in fear of disaster hitting the shores of the UK. One year from now, it may be evident that the UK is doing just fine, while some parts of Europe further crumbled. At that point, the 30%-40% will have become 50%-60%, offering the political capital for a regime change.** That may trigger the change in course for crisis policymaking that might have happened today if only the strong message of Brexit was not wasted. At that point then, the EUR-peg may be going, in one of two ways: orderly sacrificed in an attempt to preserve the EU, or disorderly as momentum/chaos takes the upper hand.

TREND PROJECTION OF EUR-SCEPTICISM

RISING MALCONTENT REACHING A TIPPING POINT



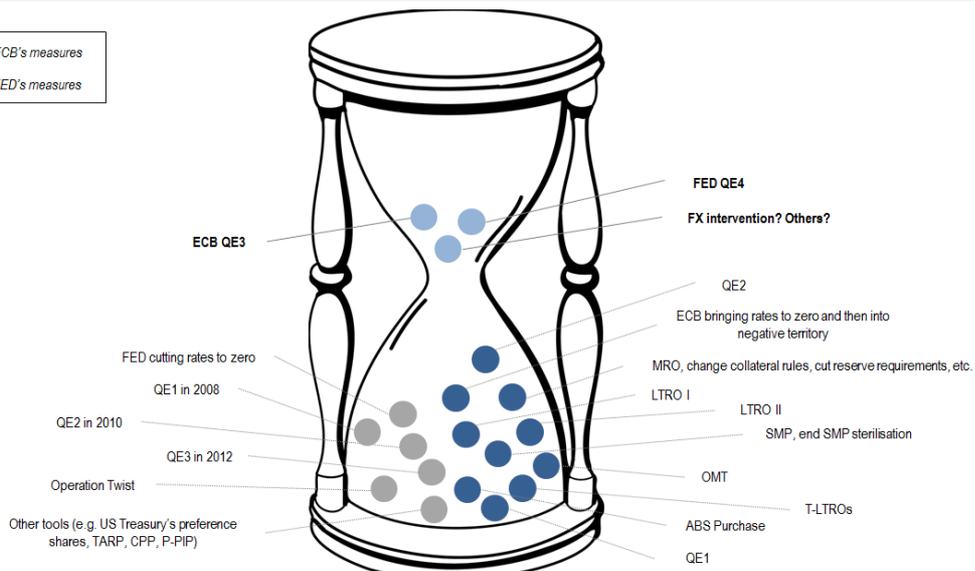
Source: Fasanara estimates based on polls, surveys and political support for EUR-Skeptics & populist parties in Eu. Dotted lines is a projection based on recent trend line

So far QE provided the glues and tapes to stick the broken pieces together in Europe. Now though, it seems that QE may be running out of steam. This timeline assumes just that. Next is then for us to analyse why QE may soon be up for revision, possibly phased out.

CBs' AMMUNITION ARSENAL DRYING UP

WE THINK WE ARE PAST 85% OF TOTAL AMMUNITION AVAILABLE

- ECB's measures
- FED's measures



EXIT: CENTRAL BANKS ABILITY TO BUY TIME

Source: Fasanara Capital 2015 Investment Outlook

Sea change ahead: QE running into a dead end

In terms of EU crisis policymaking, the only game in town was Central Bank's QE for the last few years. Now though, the QE trick may be coming to an end, as the limits of monetary printing are getting more evident by the day, while its unintended consequences compound. This is not a European problem but rather a global phenomenon. However, its implications are the most dangerous in Europe, given the inability / unwillingness to use fiscal capacity / alternative roots.

QE has been ineffective

QE was instrumental in avoiding a short circuit in Europe (although one may argue that the 'whatever it takes' cheap talk had already achieved that). **Still, it failed at resurrecting GDP and inflation. It may be due to one of two reasons:**

- (i) **It was too late.** Even after July 2012 'whatever it takes', the ECB balance sheet was allowed to shrink by over Eur1trn (down to EUR 2trn in mid-2014), while the EUR appreciated to almost 1.40 to the US Dollar. Draghi was masterful in building consensus for QE, despite strong Weidmann-led opposition. However, inevitably, the delay had consequences in terms of jobs, GDP, industrial production, inflation.
- (ii) **Not accompanied by fiscal policy.** Quite the opposite, German orthodoxy called for fiscal austerity, all the while as it was admitted that fiscal multipliers were underestimated (i.e. the contractionary effect of fiscal tightening on the economy). It brought up 'internal devaluation' in southern European countries, in itself a form of deflation.

In a 2014 research ([Deflation in Europe is Just Beginning](#)), we gave our take on the root causes of structural deflation and the flaws in the EU response.

Whatever the reason, though, QE was ineffective at its main task: averting deflation, resurrecting real or nominal GDP. Not just in Europe, but around the world.

QE hitting capacity issues, while market dislocations compound

At approx \$200bn per month, global QE is running out of safe assets to buy. In Europe, 60%+ of government bonds are currently trading at negative yields. In Japan, ~75% of JGBs is trading negative. True, you can change rules, but then the marginal effectiveness runs asymptotically close to zero (while still having some use for currency debasement purposes). Central banks around the world discuss how to keep going forever, enlarging the spectrum of securities they can buy (last was FED's Yellen, most unexpectedly), to possibly include equities (the BoJ already owns half of the ETF

industry in Japan). However, one must wonder how we would still be able to call it a market economy in a capitalistic society then.

Also, **removing bonds from the market negatively impacts the liquidity of the market itself, counterproductively**. Look at Europe, where liquidity on corporate bonds is now dreadful.

Already now, **some asset classes became unusable**:

- **Government bonds** trading at negative yields are unusable, unless as safe haven (like Gold, or to cover against counterparty risk if you feel your custodian German bank may default) or for regulatory requirements. Tellingly, GS estimates that 89% of Eurozone government bond funds have costs above typical yields.
- **Corporate bonds** trading close to zero yield, in low liquidity. GS estimates that 24% of Eurozone corporate bond funds have costs above typical yields.

The list of **market dislocations** is also growing:

- Historical relationships between asset pricing and valuation metrics have broken down: HY vs. default rates, HY vs. recovery rates, median leverage vs. HY, covenant-lite issuance vs. credit spreads, economic surprises vs. credit spreads, global equity markets vs. world GDP expectations etc.
- Bond market “illiquidity” is one of the main problems that market participants are experiencing these days. Liquidity is overstated in one of many ways: (i) liquidity terms on numerous fund investment vehicles does not reflect the liquidity of the underlying assets, (ii) do not be fooled by tight bid-offers, liquidity is best gauged by looking at light volumes, (iii) dealer inventories of corporate bonds, both IG and HY, have been declining markedly in the last years.

QE alone for long is a threat to capitalism

The structure of the market is deteriorating, cracking down. **The existence itself of certain industries is at risk. Think of non-public non-central Banks. At negative rates, banks’ business model becomes unsustainable. If rates are negative for long enough, the business faces a life threat.**

Banks’ main commodity is interest rates, so much as oil is the main commodity for oil companies: the lower the level of interest rates the least profitable its core and non-core businesses (fees, carry, bid-offers, trading, liquidity providing are all affected).

The **shape of the yield curve** is a major driver of profitability for commercial banks: the flatter the curve the least profitable its traditional core business of borrowing short-term/lending long-term. The low **level of interest rates** is a major driver of profitability for all banks, not just commercial.

Other factors (Fintech, over-regulation, etc..) are second order drivers, though all headwinds at present times. In truth, the business models of **pension plans, insurance companies, money managers** are all affected by what happens to the yield curve, in different ways. But nobody like a Bank is so inescapably impacted by its shape (see also Fasanara Interview at CNBC: ["Italy NPLs are undeniably a problem..but look beyond it to overwhelming macro factor"](#)).

So much for banks being the transmission channel of monetary policy to the real economy: faced with shallow profitability, they have less - not more - incentive to lend.

Critically, if fiscal expansion were introduced, **fiscal and monetary policies would be mutually beneficial to one another**. Public spending financed by a permanent increase in the money stock would help redistribute wealth in the private sector, while also increasing the pool of safe assets, allowing for a continuation of QE without as many side effects in terms of market dislocations. QE would then be needed as fiscal expansion takes hold, so as to prevent rates from rising too much and kill any recovery to come in its infancy.

New QE is disinflationary

At \$12trn plus bonds trading negative around the world, we are well past the point of efficiency in terms of Bernanke's 'balance channel theory'. **The 'trickle down' wealth effect of QE runs dry**, as bonds cannot rally as much after yields went negative and P/Es on equity are so stretched that further multiple expansion is arduous. So far so good for savers, after all, as they did in capital gains what is no longer available in 'carry' (coupon clipping on new issues and dividend yields on stocks). Indeed, for example, US equities total returned 12%+ annualized in last 6 years, while bonds total returned 6%+ per annum over the period, both above historical averages. **From here on, however, capital gains and carry will both likely be zero-ish, when not negative, on augmented volatility (read uncertainty), not allowing much for financial planning, making wealth effect a thing of the past.**

From now on, QE maintains income inequality at intolerable levels, while contributing to the real economy even little less than the little bit it did before. Notwithstanding the well-known fact that the typical ultimate beneficiary of QE flows is not the most inclined to spend and therefore help the real economy. The higher propensity to spend is with small uprising businesses and lower income households, whereas QE typically benefits other economic agents for most part.

Without adequate fiscal policy expansion / helicopter money, **QE becomes disinflationary, as it affects return expectations on all asset classes, killing savers, making them feel poor, increasing saving propensity over consumption/investment.**

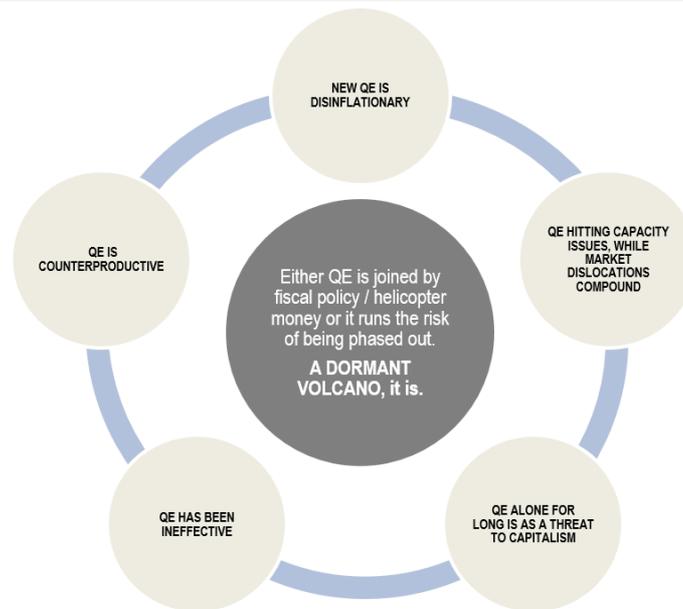
QE is counterproductive

A narrative may soon emerge and affect the political debate around QE: QE proved counterproductive (see also Fasanara Interview at CNBC: ["QE has proved counter-productive, and might be up for review"](#)). A case can be made for it to be blamed for diverting the focus of businesses away from the real economy into the realm of pure financial engineering: M&A, buybacks instead of Capex/hiring. Cheap funding was utilized not for financing new projects in people, plants and machinery but rather to help activities which have little effect on the real economy, when not an adverse effect. After an M&A, efficiencies of scale call for layoffs, not new hires. M&A is an attempt to buy somebody's else stream of cash flows, as opposed to try and produce a new one on your own, thus also implying a lack of trust in the future.

QE RUNNING INTO A DEAD END


FASANARA CAPITAL

LIMITS OF QE ARE GETTING MORE EVIDENT BY THE DAY, WHILE ITS UNINTENDED CONSEQUENCES COMPOUND



Source: Fasanara Research

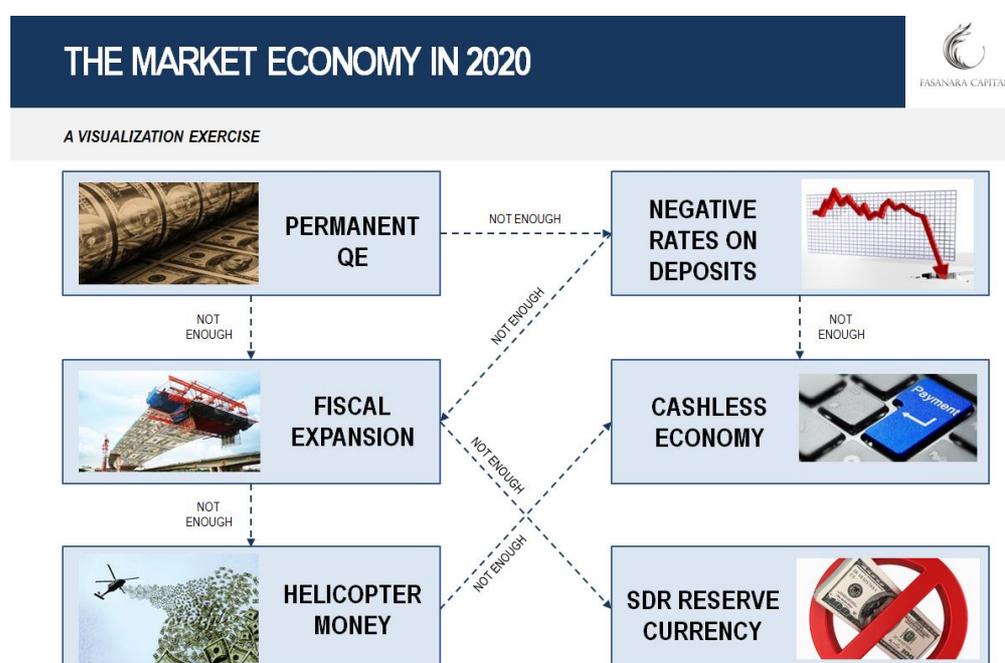
To recap, QE to be joined by fiscal, or no QE at all: tertium non datur

Therefore, either QE is joined by fiscal policy / helicopter money or runs the risk of being phased out. Large risks for European financial assets loom ahead in next 12 months, as QE runs into muddy waters, the UK does fine, and election rounds take place in Italy (referendum), France, Germany. A dormant volcano, it is.

Transformational times: the Market Economy in 2020

Professor Nouriel Roubini remind us of Economist Arthur Pigou warning against projecting current trends to predict the future: 'prosperity ends in a crisis, the error of optimism dies in a crisis, but in dying it gives birth to an error of pessimism. The new error is born not an infant but a giant'. Still, for the sake of a visualisation exercise, we tried to imagine the market economy as it may look like in 2020, a few years down the road, as a plausible scenario if we are to progress from here at current rates. We assume that previous attempts at kicking-off GDP growth have continued to fail, and inflation did not spontaneously ascend, in none of the next few quarters, or at least not so in any meaningful fashion.

On current trends, we could see the 2020 market economy to be characterised by an unprecedented combination of (i) permanent QE, (ii) fiscal expansions, (iii) helicopter money, (iv) negative rates on deposits, (v) a cashless economy. [Our full analysis is available here.](#)



Source: Fasanara Capital Scenarios, June 2016.

However, it is a bumpy road ahead and policy mistakes and market accidents along the way are all too likely and legitimate. Japan will first adopt helicopter money-type policies, but it may take time and hefty volatility meanwhile is inevitable. **For Europe, we believe that such transition will not materialise without a crisis.** German-led mistaken orthodoxy brought the continent to a halt (a monumentally lousy achievement), trapped in global deflationary trends, local inconclusive policymaking, a flawed currency construct. **'Creative destruction' lies ahead for Europe,** if one wants to be positive about it. **Regime changes, EUR break-up, full recap of the banking sector once they reach zero-ish valuations (de facto nationalisation) are all but far-fetched scenarios:** they rather stand tall as natural consequences in the years ahead, linearly interpolating from here on current trends.

Implications for Investment Strategy

As we fast approach the end game for global policymaking, markets are getting interesting and great investment opportunities are likely to present themselves over the next months, mostly on the short side. To us, **patient capital** (while it may be frustrating most of the times) and an **un-orthodox, opportunistic, multi-dimensional approach** (our 3-bucket portfolio model) is the way to go. **Unconventional markets call for unconventional portfolio management. A strategy designed for a negative rates and extreme policymaking environment.**

We will discuss investment implications in further details in a different write-up.

Francesco Filia

CEO & CIO of Fasanara Capital Ltd

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