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THE POSITIVE SCENARIO OF A FRIENDLY RESTRUCTURING OF THE EUR PEG IS IN REACH

We argued long ago that the Europe's EUR peg break-up was right alongside a well-defined trend-line. Dots of such a trend-line can be identified as follows: 1) European sovereign crisis, 2) rise of populism, 3) Brexit, 4) Trump, 5) failed Italian referendum. Policy missteps along the way that prevented the trend-line from bending away from collision course are also easy to identify: 1) austerity overdrive in the face of a global deficient aggregate demand (secular stagnation), 2) underwhelming handling of immigration flows, 3) bail-in rules in the presence of systematic risks, 4) failure to make material progress on deposit guarantee/banking union/EU institutions, rebalancing of competitive gaps across countries/fragmentation of credit markets. The instability and unsustainability of the current set-up is before the eyes of anybody who cares to see: 1) youth unemployment in peripheral member states, 2) shallow GDP growth after years of contraction, 3) extreme debt-GDP levels despite record-lows interest rates, 4) rising imbalances within the Target II Eurosystem, 5) ECB running out of ammunition. We discussed some of this here.

The positive news is that we may have got to a time when the national interest of the largest stakeholders of the EU project might be aligned to actively seek workable solutions, as opposed to elect for sticking the head in the sand and muddle-through policies. We think we reached a stage where a consensus may build for functional pragmatism and a friendly restructuring of the EMU, so as to return to growth and preserve the EU itself from slow-motion implosion.

We believe that this should be seen as a positive development, one from which the European economy can benefit in the long run. It also protects the prospects of a functional European Union, while deterring the odds of more extremist populism to come. It would act as a 'safety valve' against a dangerous second wave of more extreme populism in the making.

The current situation does not work for anyone, now not even for Germany. Surely it does not work for a country like Italy, for example, where youth unemployment resumed ascending, above 40%, Industrial Production free-fell ~25% since Lehman, GDP contracted ~10%. What is a 0.9% rise in GDP when you have 132% debt-GDP and come from a loss in output of 10%: where is the slack? Where is the pent-up demand? How is that sustainable? How can one be surprised by ballooning and un-abating Non Performing Loans weighting on the balance sheet of banks and restraining new lending.

However, more notably, from now on the monetary-peg does not work for Germany either. Germany today risks losing EUR 2trn on a disorderly break-up of the EUR. That equates to the total sum of current account surplus of EUR 2.09trn from 1999 to Q2 2016, which epitomizes in simplest terms the benefit to Germany of a weaker than Deutschmark currency (15% to 30% undervalued, depending on valuation metrics). Call it a stop-loss.

The EUR 2trn ballpark figure is arrived at by considering the Bundesbank exposure to the ECB for almost EUR **800bn** (50bn higher than at the peak of the European sovereign crisis in 2012), which would be at risk in a disorderly break-out as the ECB would default and Germany's claim is collateralized by the likes of BTP/Bonos, in addition to the private sector's ownership of sovereign debt, corporate debt/equity, financial sector debt/equity of peripheral European countries.

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THE POSITIVE SCENARIO OF A FRIENDLY RESTRUCTURING OF THE EUR PEG IS IN REACH

Conversely, take the case of Italy, where the Target 2 euro system exposure at EUR **364bn** (almost EUR 80bn higher than in 2012) is to be added to BTP owned by foreigners (EUR **710bn** at the end of 2016), funding (non-financial deposits and interbank funding) for Italian banks (in excess of EUR **350bn**), financing to Italian companies made by foreigners (EUR **700bn**+). It comes to mind the old adage about debt: 'if you owe the bank $100 that's your problem, if you owe the bank $100 millions that's the bank's problem'.

In addition to spot losses for Germany, never before German savers were hit as hard by **negative real rates**. With **inflation at 1.9%** and **short term rates at almost -1%,** German electorate is paying for the EMU party more than ever before. Accelerating the scope for Germany to stop Brexit-like posturing, come forward and pragmatically discuss viable alternatives.

The complacency in equity markets should not fool us. Inter-governmental spreads started widening visibly, Target 2 exposure is on a rampage (pointing to real capital outflows from peripheral countries at accelerating speed), rates and inflation are picking up since mid-2016 (well before Trump), all the while as Quantitative Easing is out of fashion and being tapered out.

The alternative to an unfriendly and disorderly rupture of the peg - as we fast approach a tipping point - is available and may be grabbed: restructuring the EUR into EUR-A and EUR-B currencies, with a flexible exchange rate between the two. If handled cooperatively, friendly and wisely it could result in a 20-25% devaluation for peripheral European assets, and a contained rise in interest rates of 1.5%-2.5%. As opposed to a negative disorderly break-out, market-driven or forced by regime changes, which could determine a 40-60% messy devaluation, capital controls and loss of access to capital markets for long, rates and inflation spiraling out of control in peripheral Europe, potential for sequential defaults.

Execution risks are evidently there, but the status quo is hardly an option: the road to a break-up of the EUR is a well-defined trend-line which stretches back years. Now though, interests are aligned to sit at the negotiation table and agree a workable creditors to debtors restructuring solution. One might look at it with optimism, as time is right and it might prevent trouble for the EU political project as a whole, preventing radical populism to steal the agenda and force regime change.

The EUR peg is a policy instrument, not a policy goal. If it fails, it should be changed/modified. The young rat Remy, in Ratatouille, was told by his dad that he couldn't change nature, and he should accept for things to be the way they are, they way they have always been. He responded with optimism: 'Change is nature. The part we can influence. And it starts when we decide.'

The implications for risk assets are touched upon here and will be the subject of upcoming notes.

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APPENDIX

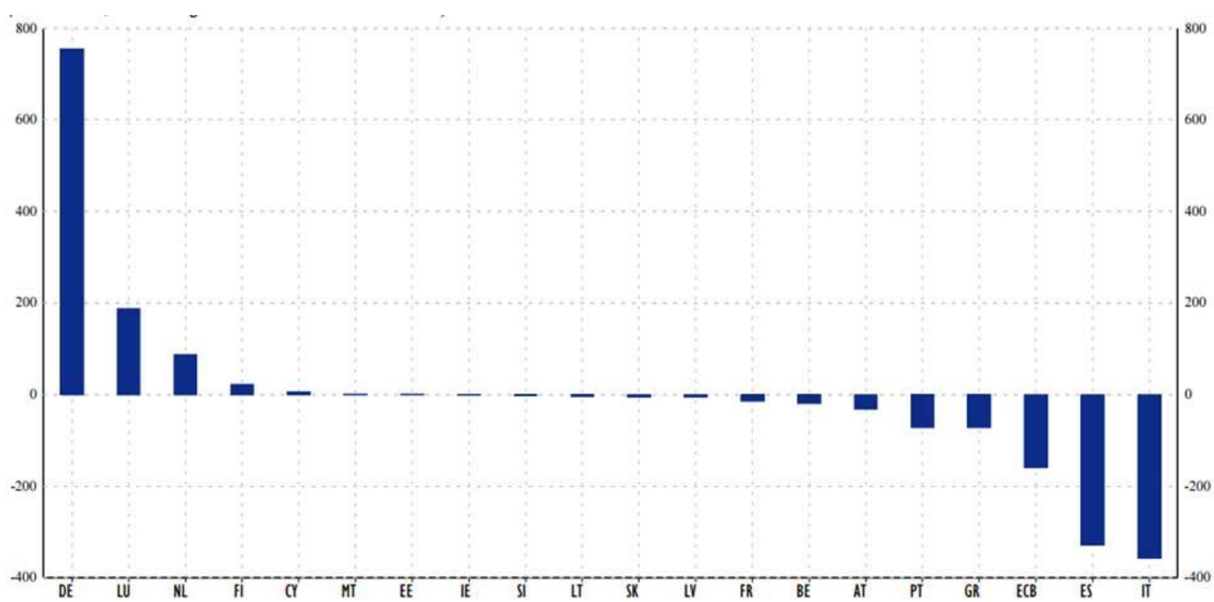
TARGET 2 BALANCES OF NATIONAL CENTRAL BANKS – EURO AREA

HISTORICAL SERIES. EUR – Billions. Source: ECB, ECB Calculations

	ECB	BE	DE	EE	IE	GR	ES	FR	IT	CY	LV	LT	LU	MT	NL	AT	PT	SI	SK	FI	U4 [1]
2009	4.0	-42.5	177.7	-	-53.5	-49.0	-41.1	-62.0	54.8	-7.1	-	-	52.5	-0.8	15.4	-19.6	-23.4	-3.3	-14.5	9.5	3.2
2010	-22.4	-13.9	325.6	-	-145.2	-87.1	-50.9	-28.3	3.4	-6.4	-	-	67.9	-1.2	40.5	-27.5	-59.9	-2.1	-13.3	19.7	1.1
2011	42.2	-52.9	463.1	0.6	-120.4	-104.8	-175.0	-77.4	-191.4	-7.9	-	-	109.4	-0.4	152.8	-34.6	-60.9	-2.7	-13.6	66.0	7.9
2012	-2.2	-38.2	655.7	1.7	-79.3	-98.4	-337.3	-54.8	-255.1	-7.5	-	-	106.2	-0.2	120.8	-39.9	-66.0	-4.4	0.9	70.6	27.4
2013	-6.7	-15.5	510.2	1.8	-55.1	-51.1	-213.7	-16.2	-229.1	-6.8	-	-	103.7	-0.7	46.1	-39.2	-59.6	-1.0	2.7	22.2	8.0
2014	-23.6	-12.4	460.8	3.2	-22.7	-49.3	-189.9	-17.0	-208.9	-2.5	-0.8	-	105.1	-1.9	19.4	-30.1	-54.6	2.4	2.2	19.7	0.9
2015	-83.8	-7.7	584.2	2.8	-3.0	-94.4	-254.1	-29.2	-248.9	2.4	-1.3	0.2	147.6	-0.9	54.7	-29.2	-61.7	0.2	0.5	20.1	1.5
2015 Q3	-65.5	-4.4	555.2	1.6	-3.0	-104.9	-228.3	-35.2	-235.7	1.8	-2.5	-1.2	129.8	-0.9	53.1	-34.5	-56.4	0.5	-0.5	29.3	1.9
Q4	-83.8	-7.7	584.2	2.8	-3.0	-94.4	-254.1	-29.2	-248.9	2.4	-1.3	0.2	147.6	-0.9	54.7	-29.2	-61.7	0.2	0.5	20.1	1.5
2016 Q1	-100.1	-15.9	609.2	1.6	-1.1	-95.4	-266.5	-24.6	-263.3	2.5	-3.8	-1.6	156.1	-0.6	57.1	-34.8	-64.8	-0.7	-0.6	45.8	1.8
Q2	-125.2	-24.3	681.1	1.1	-3.6	-79.8	-307.1	-16.9	-288.9	4.2	-5.1	-2.1	149.9	0.1	71.6	-35.3	-65.2	-0.4	-2.6	46.1	2.3
2016 July	-133.5	-27.1	660.3	1.1	-4.0	-81.3	-293.1	-33.5	-292.1	5.0	-4.5	-1.2	156.4	-0.2	82.1	-31.6	-65.7	-0.5	-2.7	64.0	2.1
Aug.	-137.9	-17.0	677.5	0.9	-0.6	-78.3	-313.6	-10.6	-326.9	5.3	-4.8	-1.3	151.8	0.2	88.4	-31.9	-66.3	-0.2	-3.8	67.1	2.1
Sep.	-141.5	-10.4	715.7	1.3	2.2	-77.3	-319.7	-37.0	-353.9	5.1	-4.9	-1.9	164.9	0.4	103.6	-37.1	-65.6	0.7	-4.6	57.1	3.0
Oct.	-153.4	1.5	708.0	0.9	-2.5	-72.7	-313.8	-36.1	-355.5	5.5	-4.9	-1.5	169.0	0.6	99.6	-30.8	-69.4	-0.6	-4.1	57.8	2.3
Nov.	-161.5	-6.4	754.1	1.0	-1.9	-71.8	-330.4	-38.7	-358.6	5.6	-5.2	-1.9	166.8	0.9	99.6	-30.5	-72.3	-0.7	-4.5	53.7	2.8
Dec.	-159.7	-18.6	754.3	0.9	-1.0	-72.3	-328.1	-13.8	-356.6	5.9	-5.3	-3.6	187.4	1.0	87.0	-31.2	-71.6	-1.2	-5.1	22.0	9.5

TARGET 2 BALANCES OF NATIONAL CENTRAL BANKS – EURO AREA

OUTSTANDING AMOUNTS as of end of December 2016. EUR – Billions. Source: ECB, ECB Calculations



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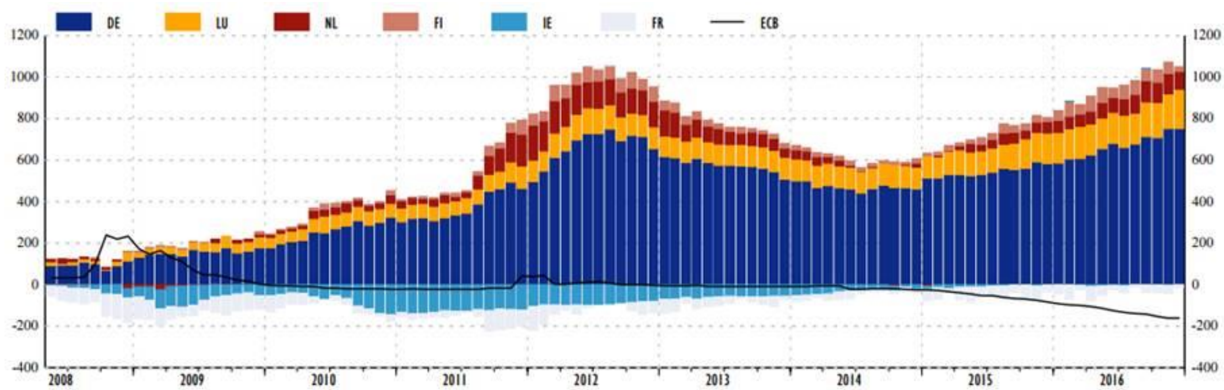
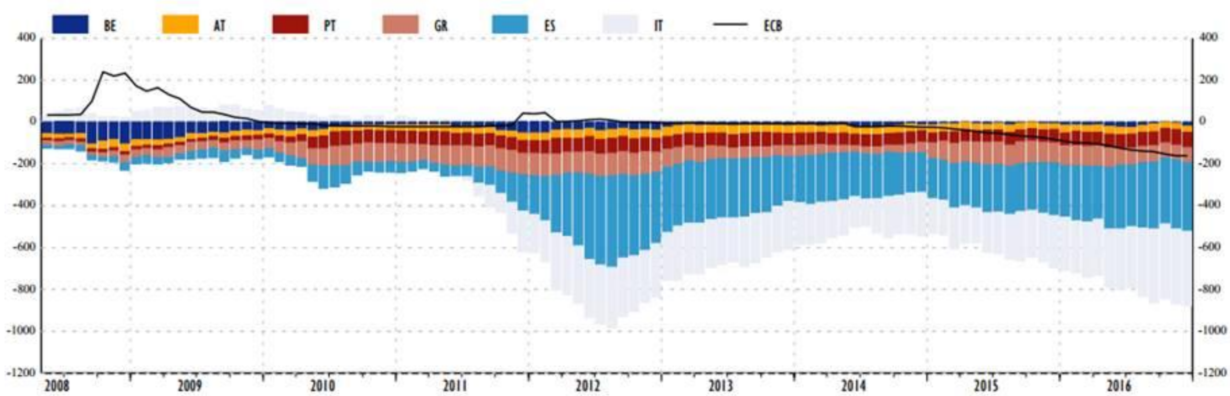
APPENDIX

TARGET 2 BALANCES OF THE SIX NATIONAL CENTRAL BANKS WITH HIGHEST BALANCE WITH THE ECB
OUTSTANDING AMOUNTS as of end of December 2016. EUR – Billions. Source: ECB, ECB Calculations



TARGET 2 BALANCES OF THE SIX NATIONAL CENTRAL BANKS WITH LOWEST BALANCE WITH THE ECB
OUTSTANDING AMOUNTS as of end of December 2016. EUR – Billions. Source: ECB, ECB Calculations



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GERMANY TARGET 2 CLAIMS WITHIN THE EMU vs ITALY TARGET 2 LIABILITIES

HISTORICAL SERIES, 2006-2016. EUR – Trillions. Source: Bloomberg, Fasanara Research

ITALY vs GERMANY: BEFORE AND AFTER THE EUR – RATIO OF GDP, INDUSTRIAL PRODUCTION & EQUITY INDEXES

HISTORICAL SERIES, 1998-2016. Source: Bloomberg, Fasanara Research

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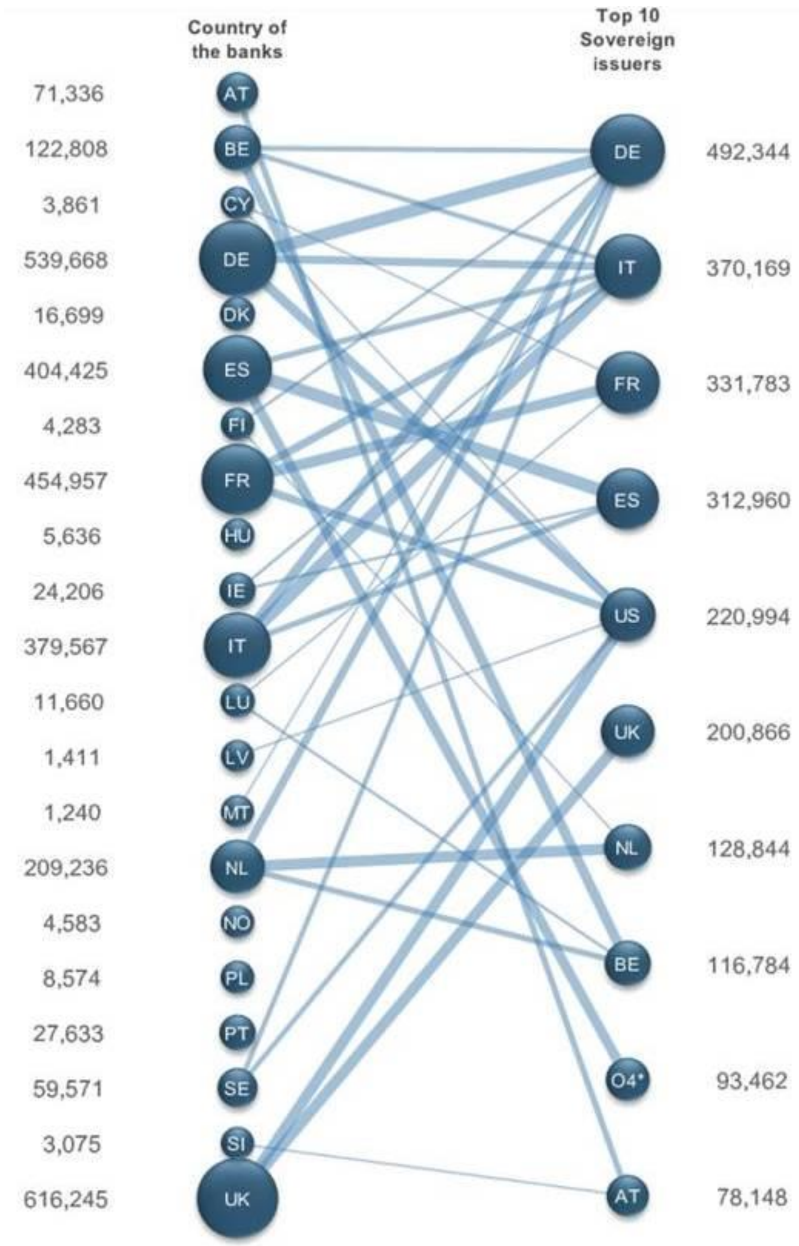
CROSS-COUNTRY HOLDINGS OF EUROPEAN SOVEREIGN DEBT
Data as of June 2015. Source: European Banking Authority



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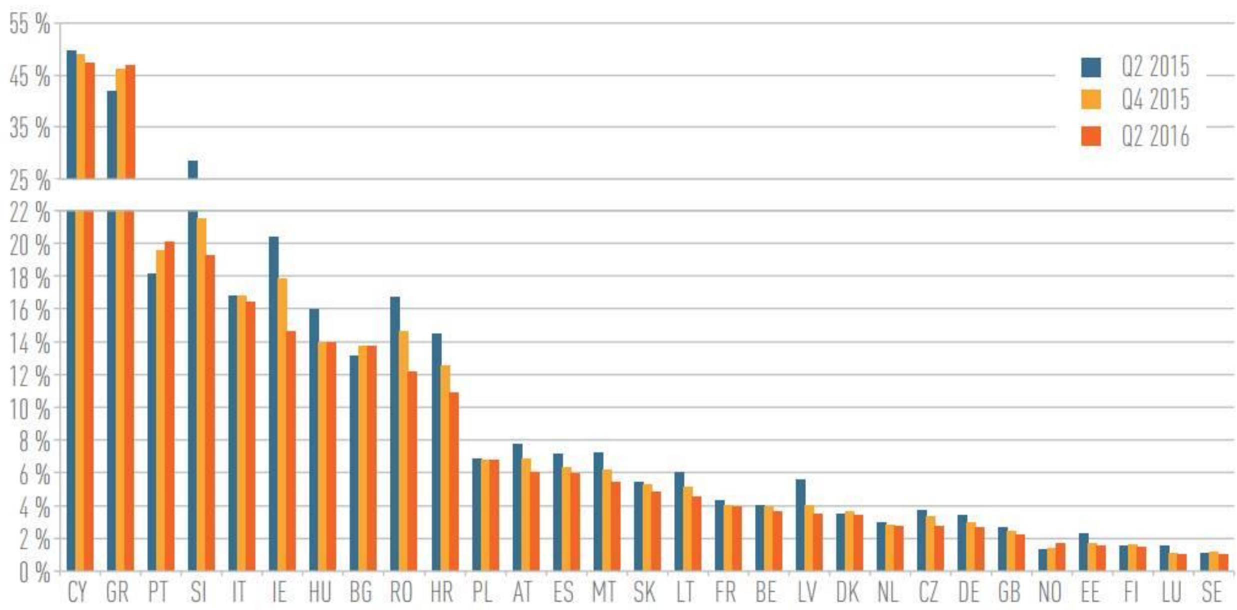
NON-PERFORMING LOANS RATIO – WEIGHTED AVERAGE BY EU COUNTRY
Data as of Q2 2016. Source: European Banking Authority



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