

JVB Financial Group, LLC

CRONIN'S CORNER MONTHLY

A Perspective on the International Economy

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by Keith Cronin, JVB Senior Vice President of US Credits and International Sovereign Trading

It was a time when Margaret Thatcher and Francois Mitterrand were in accordance because the English and the French had a common concern. They became allies again across the twenty one mile English Channel, against the perceived threat of a Teutonic marriage of West and East. Demands were made to the Russians, fatalistic predictions made to each other, but in the end both countries accepted the inevitable and ratified the treaty that unified Germany in 1990. There were the usual demonstrations across Europe's major countries but these protests were led mainly by war veterans and the older generations and they ultimately amounted to nothing more than a pedantic dance. Europe decided that a larger Germany would not ultimately undermine the union and the denizens welcomed the marriage and what it represented. A united Germany within a united Europe. A larger Europe bulked up through further integration, a policy that Germany fully supported in order to assuage any European fears of a mammoth Federal Republic. Strength within strength to spawn a united states of Europe to finally challenge America the 'bully'. Twenty years after the German unification, many Germans must surely be questioning its worth, especially given the economic stresses it has placed upon the former western state. Eighteen years have passed since the signing of the Maastricht treaty and again many Germans must be questioning. Debating. Yearning. Yearning for the days of the Deutsche Mark and when German industriousness dictated a German future. A time when Germany led Europe instead of carrying her.

The current crisis that is smothering Europe can of course be found in the Maastricht treaty or at least in its philosophical and functional DNA. Its purpose of course was to grant its members the benefits of free trade amongst each other. It would enable one country to move goods, services, capital, and even people to another country without inhibition. This would naturally bolster the ties between the member states from an economic, cultural and, significantly, a political standpoint. It gave birth to the European Union, which today is comprised of twenty republics and seven monarchies and for which the waiting list for entry can be terse. Turkey has been waiting for entry since the mid-nineteen eighties and even Iceland has applied for membership. The logic seemed tight for a larger Europe and the arguments for further integration dripped with economic plausibility. However, the problems we are seeing today, we feel, arose from the creation of the Euro-zone. Comprised of sixteen members that share the same currency, it seemed, upon its creation, that everyone would benefit from adopting the Euro as their unit of commerce. Of course everyone did and therein lays the problem. From an economic standpoint, the Euro has brought immense benefits. The costs of undertaking currency exchanges have been removed as have the currency risks of doing business within the Euro-zone. Intra zone trade has increased and investments in companies whose countries had previously weak currencies have also

increased based upon the relative stability of the Euro. However, the introduction of the Euro also decreased the interest rates of many of the countries that adopted it as their new unit currency. These countries achieved access to, essentially, Germany's stellar credit rating and lower borrowing rates. The perception in the market was that countries like Greece, Portugal, and Spain had the protection of the Bundesbank and would be saved from a financial or economic abyss by the Teutonic mammoth. This notion wasn't, it must be said, that far-fetched as Germany had often intervened in currency markets before the advent of the Euro to help its beleaguered neighbors. With a single currency now in place, founded on the strength of the Deutsche Mark, the market's participants felt secure. The result was that the cost of borrowing for the PIIGS kept dropping and a catastrophic credit binge ensued. Thus was the market's level of confidence in the Euro zone and the German backbone for Europe's peripheral denizens that spreads between the PIIG debt and German bunds was almost negligible. In early 2005, spreads between 10 year Greek and German debt was less than ten basis points. Portuguese spreads for the first eight years of the last decade never really went wider than twenty basis points whilst Irish yields were essentially on top of their German counterparts. Of course the same can be said for the Spanish and Italian Sovereigns where investors were not being compensated for the risks that, at the time, they did not know they were taking. However, as far back as late 2004, there may have been a warning that was ignored when the Greeks admitted to falsifying their budget figures to gain entry into the Euro zone in 2001. The criterion was that their budget deficit was below three percent of GDP. It never had been. When Greek debt was downgraded late last year the debacle was ignited which this year, as is ubiquitously known, resulted in a joint EU and IMF bailout.

Germany's contribution of nearly thirty billion Dollars to the Greek bailout was obviously a very difficult decision to make but it was also a very easy one. Whilst opposition to the package on the German frontier was fervent if a bailout plan had not been crafted and Germany had not been part of it the whole future of the European Union and the Euro would surely have been tenuous. The reluctance of the Germans has to be appreciated given their own strict methodology of fiscal prudence and the sparkling code of their unique industrial shibboleth. The eventual ratification of the loan package by the German Bundestag was in the ultimate interests of Germany and her economy, but has the damage already been done? The initial reluctance of the Germans to bail out the profligate no doubt resonated across the European states, evoking gasps of supercilious incredulosity. The country's popularity has hardly hit new acmes since the crisis began and internally the commitment to a broader more integrated Europe must now surely be

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floundering amongst many Germans. Angela Merkel et al. have to now walk between the rain drops whilst walking on egg shells, so to speak. It will be imperative for the German administration to ensure that fiscally recalcitrant nations undertake severe and effective austerity measures whilst still making a solid argument to the German people that it is worth Germany's while being part of a union that seems on the brink of economic insanity. The European Union has been integral to Germany's export-led growth and, given the fragility of the global economic recovery, the country will need as many economic transactions as it can — thus it cannot afford to play down the trade benefits that the union have yielded it. As the global recovery crawls to maturity so does Germany's. The unemployment rate is now at seven and a half percent as a result of twelve consecutive months of falling joblessness but the labor market could hardly be categorized as stellar. Additionally, it would probably be misguided to think that a fully fledged recovery will be led by the consumer. Not only will a still uncomfortable unemployment rate deter shoppers but, as we have noted, the German people's fiscal self control will keep consumption skinny. It is likely (and ironic perhaps) that the motor that will turn Germany's recovery will be exports, aided significantly by a weaker Euro, in its traditional mainstay sectors of heavy machinery, automobiles and chemicals. German manufacturers have become more confident regarding the prospect of an upswing in export activity and despite pressure from the Obama administration for Germany to promote stronger domestic demand growth, it will be exports that will lead Europe's largest economy higher. However not only does Germany face economic unease but the political sphere of Chancellor Merkel has recently become very unbalanced. As the Euro zone fiscal crisis was unraveling, Merkel's

popularity was not only falling abroad but also at home. With the ratification of the loan to bail out Greece, she became left wing fodder. In June her government announced austerity measures to save nearly one hundred billion Euros by 2014 which include cutting about ten thousand federal administration jobs, scaling back the armed forces and reducing some special parental allowances. The program is intended to cut the structural deficit to less than 0.5% of GDP by 2016. Not only is this required by a new constitutional amendment but it also sets an example for Germany's profligate euro zone companions. These measures will likely crimp the consumption component of growth, which makes it even more important for German exports to carry the torch. Thus we feel that a Euro trading between 1.25 and 1.30 to the USD would not be a negative for Germany. It is highly plausible at this stage that German officials would be more concerned about the volatility of the unit and the speed of any depreciation rather than a lower level that the Euro might eventually embrace versus the Greenback and other majors this year.

The US administration will be keeping a very keen eye on developments in Europe and specifically within Germany. As we have noted earlier, the Germans, along with most of the rest of Europe, have roundly refused to take Obama's 'advice' and spend their way into a sustainable recovery. The voices in Berlin, London, Paris and Rome are all on the tones of austerity and will lean more towards getting their citizens to save rather than to spend. Of course this could have repercussions for the US economy as exports to Europe could be impacted. However we feel that that Germany will not facilitate the US administration's economic agenda by pandering to Keynesian desperation but what they might provide instead is a lesson in fiscal discipline. •

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Yields on German Bunds and those of the PIIG nations did not really start to diverge until the recent financial crisis and ensuing recession.
SOURCE: Bloomberg, July 6, 2010

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