

**The Contagion Risk of Europe
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**By John Mauldin
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I am back from Europe. The last three weeks I spent quite a bit of time talking with money managers and investors from a lot of countries, as well as numerous locals about the European situation. This week's letter is a collection of my thoughts, as I recover from jet lag. I expect the letter will thus be shorter than usual, but hopefully a few pithy comments will emerge. But first...

As you know, I am a firm believer that the state of the global economy is such that we as investors have to be especially agile and focused today. Consequently I spend a great deal of time and effort looking into alternative investment strategies and managers. **I'm very pleased to announce that I am relaunching my special newsletter for accredited investors, to share the latest opportunities and pitfalls in alternative assets.**

The good news is that this Accredited Investor Letter is completely free. The only restriction is that, because of securities regulations, you have to register and be vetted by one of my trusted partners before you can be added to the subscriber roster. They include Altegris Investments in the US, Absolute Return Partners in Europe, Nicola Wealth Management in Canada, and Fynn Capital in Latin America. This is a painless process (I promise!), and just to sweeten the pot, after you register my partner will provide you access to the video of Gary Shilling's speech from my Strategic Investor Conference in La Jolla, as well as those of Martin Barnes and David Rosenberg; and we have just added Louis-Vincent Gave, who focused on China. These guys are all great speakers with absolutely compelling presentations.

[[[Click here now to register](#)]] and you'll be part of the summer relaunch of my letter exclusively for accredited investors. In the meantime, enjoy the video presentations and benefit from their wisdom as you plot your investment course. Over time, we will make all the conference videos available to the subscribers of the free Accredited Investor E-letter. Those who attended the conference, or have spoken with an Altegris professional, already have access to all the speeches and panels.



I do not like limiting the letter to accredited investors, but those are the rules under which I work. This is not of my choosing, and I have worked in front of and behind the scenes to try to change what I think is a very unfair rule. (See important risk disclosures below. In this regard, I am president and a registered representative of Millennium Wave Securities, LLC, member FINRA.) And now to the letter.

The Contagion Risk of Europe

Bernanke gave another press conference after the FOMC meeting this week. Taking his time to address the situation in Europe, and the increased urgency of the crisis in Greece, Bernanke said US bank exposure to Greece was minimal and only indirect, via positions in large, core-nation banks in Germany and France. Raising a red flag, the bearded academic said that money-market mutual funds had substantial exposure to those same banks and could take a big hit if push came to shove in Europe. “A disorderly Greek default would have significant effects on the US” economy, he added.

About the only thing there was seeming consensus on in Europe was that Greece will eventually default. The question is when. European leaders, along with the IMF, have caved and will give Greece €12 billion to tide them over while they debate on finding €70-100 sometime late next month. By some accounts that amount will have to be a lot more. Meanwhile, the ECB is adamant that Greece cannot be allowed to default.

The whole process is somewhat akin to trying to help someone who is drunk by giving them another bottle of whiskey. Trying to cure a problem of too much debt with even more debt is simply irrational, and everyone but Europe’s leaders can see that. So why are they doing it?

Because if Greece is allowed to go, there is real reason to believe that the problems will spread rather quickly to the rest of peripheral Europe. By the way, it is not just French and German banks that US money markets have exposure to; there are a lot of Spanish banks that have issued commercial paper as well. And my sources told me that many of the state-owned German Landesbanks are essentially insolvent, with massive amounts of sovereign debt. By the way, another source notes that US money-market funds are not rolling over the commercial

paper to some of the banks (like Spanish ones), so there is a liquidity squeeze coming to European banks in peripheral countries.

The ECB has taken on some €100 billion of Greek, Irish, and Portuguese debt, if I remember the number right. They have capital of only about €10 billion. They want to take on even more debt from the banks, as the banks are using sovereign debt as collateral. The whole process is a way to paper over the fact that many European banks are essentially insolvent if they have to mark to market their Greek debt.

I think it is a given that in the near future Ireland is going to tell the ECB that the line item on their balance sheet for €60 billion that says “Loans to Ireland to bail out their banks” should be moved from the line that says loans to the line that says capital. They will simply walk away from the debt. “Here are the keys to your banks. What are you going to do with your banks?”

Let’s assume (generously) that there is only a 50% haircut on Greek debt. Add in the Irish debt, assume a smaller haircut on Portugal, at least initially, and you can easily get to €100 billion in losses for the ECB. That makes Lehman look like small potatoes.

The ECB would either be forced to print money to cover the losses or have a massive capital call to ECB members. Germany is 27% (again, from jet-lagged memory), so their portion would be a mere €27 billion. How do you think that will play with the voters in Bavaria? The ECB was not supposed to take on bad debt, according to its original charter. More than one person speculated to me that Germany might simply use that as an excuse to leave the euro. Not by the current set of politicians running the place but the new set that will be elected when things go bad.

And printing? Not all that good for the value of the euro.

Will the Euro Survive?

We had dinner on Monday night at the home of Hervig von Hove of Notz-Stucki Bank, where I was speaking the next morning. There were 16 of us at the table, and these people represented a great deal of money as managers and investors. All very well-informed. We sat outside in perfect weather in the Swiss countryside. Charles Gave sat across from me at the middle of the table, and we talked and debated as the rest asked questions and offered opinions for 3-4 hours. The wine was flowing, and it was a most interesting evening. Now, with that set-up...

I was asked if I still thought the euro was going to parity with the dollar, and I said I did, although I was not sure what the euro would look like in three years, or who would be in it. There was some pushback from people who thought the dollar would be the weaker currency. So I asked for a show of hands as to how many people thought the euro would be higher in one year’s time. There were 6 hands raised, but one gentleman said he was actually abstaining. So I asked how many thought the euro would fall, and we got 12 hands. Yes, that is 19 votes for 16 people. Clearly there were at least three economists in the group who voted both ways!

Then someone asked Charles about the issue. Now, for those who have never had the extreme pleasure of time with Charles, he is a powerful, white-haired French patrician, and one of the better economists I know. Quite a brilliant thinker and not afraid to express his mind forcefully with a voice that sounds like God talking, with about the same assurance (note to self: never again follow Charles on a speaking stage).

“The question is entirely irrelevant” – punctuating the air for added emphasis. “The euro will not exist in a year. The whole thing was dysfunctional from the beginning.”

I suggested that was a tad bearish.

“Not at all. I think it is extremely bullish. The demise of the euro and the return of national currencies will allow for proper allocation of investments and resources. It is the best thing that could happen for the markets.”

I could not get him to commit to exactly how that process of dissolution would look.

“I didn’t create the euro so it is not my responsibility to solve the problem for them.”

But I cannot help but think that any exit by anyone from the euro will be disorderly, giving rise to Bernanke’s “significant effects.” Many European banks are simply not solvent if there are major sovereign defaults. The US banks have sold some \$90 billion in credit default swaps on Greek, Irish, and Portuguese debt to European banks. That is supposedly balanced with other purchases of CDS, but my sources say that much of that insurance is from German Landesbanks. Yes, the same ones I mentioned above that are basically insolvent. We are joined at the hip to Europe. A European recession would certainly be felt here. And a credit event could cause the same problem as in 2008, as banks start to refuse to lend to each other again. Ugh.

The potential for a real crisis is far too high for comfort. It would mean another recession for sure, with the US already close to stall speed and global growth slowing. I hate to sound alarmist, but I am worried. Absent a problem in Europe, the US should be fine, if slow. And maybe European leaders can stall the crisis off longer, buying time for banks to move their debt to the ECB and raise capital. We have to really keep our eyes on this.

At some point, Europe needs to realize that the problem with Greece, Portugal, et al. is not illiquidity, but that they are insolvent and have few prospects for economic growth anywhere close to what is needed to solve their problems.

Europe would be better off just taking the money they are giving to Greece and using it to recapitalize their banks. Let Greece go. Give it up. Let them enter a 12-step program or whatever it is that insolvent nations do. That is harsh, but it is also the truth.

But there are very sad things going on. It is not just banks that are losers here. Pharmaceutical companies are starting to refuse to deliver to Greek hospitals, as they are up to two years behind on their payments. It turns out that Greece owes some €6 billion to private

businesses like hospitals and simply cannot pay. Those costs are rising, and much of it is to hospitals for medical care supported by the government. They are issuing bonds (shades of California) for the debt in some cases, which sell for a discount of 50%, if they can be sold. And we thought finding €12 billion was a hard thing.

This is not just a Greek problem, it is a concern in many countries that are having financial difficulties.

A Greek Coup?

Now, time for some speculation on my part. For Greece to leave the euro, the politicians would have to make a rather serious decision. That will not happen overnight. The minute there was any speculation or a “secret” meeting of Greek leaders to discuss leaving the euro, the run on the banks would be massive and fast. It would all come down quickly.

To go back to the drachma would require a bank holiday for a week, and it would have to be a surprise move. About the only way for that to happen would be a military coup coupled with a bank holiday and promises to return to elections after the currency issue was solved. The current government does not have the votes or the power to declare a holiday and move to the drachma, or at least they don’t as I read it. Just a thought.

No Good Deed Goes Unpunished

Switzerland was irrationally expensive. Small Diet Cokes at the Mandarin Hotel were \$12. That is not a typo. I get a full 12-ounce can on sale here for about \$.25. A casual meal, not particularly outstanding, was easily \$100. Taxis are outrageous, with a one-mile trip costing up to \$70.

In the category of no good deed goes unpunished, the Swiss are suffering such high prices due to managing their country responsibly. Everyone wants the Swiss franc. It was about \$1.20 for one franc. I remember when it was \$.25. Then again, so was the German mark.

In the Biggest Loser category, the award for the central bank that made the worst trade in history goes to Switzerland, with losses of 21 billion francs in 2010, trying to keep the value of the franc down against the euro. That’s about \$25 billion at today’s valuation.

Home Again, Home Again

I have been gone for 31 days, and it is good to be back home. And I am home for much of the next three months, at least the way it looks now. I have a speech at the Agora conference in Vancouver late July, and my annual trip to Maine to fish with my son at David Kotok’s event (with so many friends) in early August (which I will likely combine with a few days in New York). And not all that much travel in September, though that could change. That really sounds good right now, as I have almost 100,000 miles on American Airlines alone this year. I hope I can cut that down to about a third for the last half of the year.

Kiev was amazing. I don't know what I was expecting, but what a vibrant place with lots of things going on and building everywhere. Our host, Andy Bain, came to Kiev in 1992, fresh from Yale with an MBA. He started going east in Europe and kept finding too many MBAs to compete with, until he got to Kiev. He now has some 20 companies and is quite successful.

He invited us to his annual company picnic on Saturday, at a lake park outside the city. There were about 200 people there. The unusual thing was how young the group was. I remarked on that to his CFO, who is only 38 himself. Who are all these young girls and guys?

He pointed them out: "This girl manages that company and that one has this account..." One woman started out as a receptionist two years ago and is now managing three national advertising accounts. I looked around. The only "gray hair" was the ex-patriots. It turns out that when Andy started, he had to hire young people who were trained under Soviet management styles and who would work. They were right out of college, and as the business grew they simply got promoted fast. Andy was essentially training a new generation. This was also an alumni picnic, so many people came who had been trained at his companies but now run other operations. Quite the eye-opener.

My son Trey had a great time, with so many young ladies in bikinis. Kiev may have the most beautiful girls of any city I have ever been to. I think Trey is thinking of learning Russian, which many of them spoke. He is certainly begging to go back. It was fun to have him on this trip. But for Dad, the best moment was when he said, "I have to learn another language. I don't want to be stuck in the US all the time." Italian? French? He now gets it. It made the whole trip worth it. I wish I had figured that out at 17. I truly regret not being multilingual. C'est dommage.

It is time to hit the send button. I have to start in tomorrow on the 400 emails that are still in my inbox. I owe a lot of people responses and will work hard to catch up, plus I have some writing to do, etc. While I love the internet and it has been very, very good to me, it has also got me busier than at any time in my life. But who's complaining? It is a fun life! Have a great week.

Your happy to be home analyst,

John Mauldin